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CR&B Alert

Commercial Restructuring & Bankruptcy News

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In This Issue:

ANNOUNCING OUR NEW CROSS-BORDER INSOLVENCY AND RESTRUCTURING PRACTICE, AND NEW SINGAPORE OFFICE

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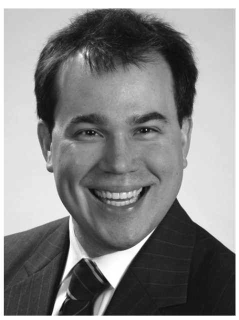
This week, we announced the opening of our Singapore office, which is our fourth office in Asia and which will have a practice emphasis on energy and natural resources, shipping, trading and commodities, international arbitration and India. As the Firm continues to build out its international platform during a time of economic turmoil in many countries, the CRAB Group has experienced a significant increase in cross-border engagements. For example, a team of lawyers in numerous offices represented the trustee to several hundred Lehman-sponsored structured finance deals that originated in Europe and Asia and which were governed by English law. Our CRAB lawyers assisted this effort by litigating a series of novel issues in both New York and London, while advising our teams of structured finance specialists in London on the impact of the U.S. bankruptcy laws on certain instruments that Lehman used. As a result of this increased need by our clients for cross-border insolvency advice, we have formed the Cross-Border Insolvency and Restructuring Practice. You can read a summary of the Practice here, and please click here to read a recent article written by Ed Estrada on the increased use of Chapter 11 by foreign ship owners, an area in which we have been actively involved over the better part of this year. Please let us know if we can be of assistance, and I hope you enjoy this edition of the CRAB Alert.

'UNFINISHED BUSINESS' DOCTRINE IN LAW FIRM DISSOLUTIONS IS THE SUBJECT OF RECENT OPPOSING DECISIONS WITHIN THE SAME DISTRICT



Jared S. Roach
Associate, Pittsburgh

1) *Dev. Specialists, Inc. v. Akin Gump Strauss Hauer & Feld LLP,* Case No. 1:11-cv-05995 (S.D.N.Y. May 24, 2012)

CASE SNAPSHOT

The estate administrator of the bankruptcy estate of a dissolved law firm brought suit against 10 law firms for recovery of profits earned by former partners while working for their respective new firms. The estate administrator argued that fees earned from "unfinished business" (fees earned on pending cases by the former partners after the dissolution date of their former firm) constituted estate property. The law firms argued that the "unfinished business" doctrine did not apply to matters billed on an hourly basis. The court disagreed, finding that the doctrine applied regardless of the nature of the legal fees (contingent or hourly), absent a contrary provision in the partnership agreement.

FACTUAL BACKGROUND

Coudert Brothers LLP was a law firm that operated pursuant to a partnership agreement. Following the dissolution of the partnership, many of Coudert's partners were hired by other law firms. In numerous instances, the partners brought clients and pending matters that Coudert had been handling with them to their new firms.

Some time after dissolution, the firm filed for bankruptcy, and Development Specialists, Inc., an administrator, was appointed. DSI brought suit against the firms that hired the former Coudert partners who had brought pending business with them. In the lawsuit, DSI alleged that the open matters, and the fees collected therefrom, that the partners took to their new firms constituted "unfinished business," and were partnership assets. DSI sought the return of the fees that the new firms had earned as a result of the Coudert partners' completion of this unfinished business. The new firms made two arguments: first, the firms argued that Coudert did not have a property interest in the matters following the dissolution date because the clients were billed by the hour; and second, if Coudert has an interest in the matters, it is limited to work performed pre-dissolution, and any benefit generated post-dissolution is the property of the new firm.

COURT ANALYSIS

The "unfinished business" rule holds that, absent a contrary provision in a partnership agreement, any business that is unfinished as of the dissolution date constitutes an asset of the partnership – not an asset of the partners. Accordingly, each partner owes a duty to account to the partnership for any profits derived from the post-dissolution completion of unfinished business. Prior case law held that law firm *contingency* matters completed by departed partners following dissolution did constitute "unfinished business," and required that the profits derived from those matters be accounted for and returned to the partnership.

The defendant law firms here argued that a meaningful difference existed between cases billed on an hourly versus contingent fee basis. The district court, looking at other states' case law, discerned no meaningful difference between legal matters billed on a contingency basis or an hourly basis. The method of calculating fees was irrelevant to the question of whether outstanding matters constituted "unfinished business" and were therefore considered partnership assets, unless the partnership agreement specified otherwise.

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THIRD CIRCUIT COURT OF APPEALS AGAIN MODIFIES THE DEFINITION OF 'CLAIM' BY INCLUDING 'POST-PETITION, PRE-CONFIRMATION' EXPOSURE

Amy Tonti
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Wright v. Owens Corning, 450 B.R. 541 (W.D. Pa. 2011), aff'd in part, rev'd in part, 2012 WL 1759992 (3rd Cir. Pa.) (May 18, 2012).

In *In re Grossman's Inc.,* 607 F.3d 114 (3d Cir. 2010), the Court of Appeals established a new test to determine when a "claim" exists for bankruptcy purposes. Utilizing that new test in *Wright v. Owens Corning,* a consumer who purchased shingles prepetition, but suffered property damage post-confirmation, had a "prepetition claim," while a second consumer who ***purchased the shingles post-petition but suffered property damage post-confirmation had a "pre-confirmation claim.***" In *Wright*, the district court also found that because the plaintiffs' claims had arisen by the time of confirmation, the published notices of the claims' bar date afforded the plaintiffs due process, and hence the plaintiffs' claims were discharged under the confirmed chapter 11 plan of the debtor.

On appeal, the Third Circuit reiterated the "two competing concerns with future claims: the Bankruptcy Code's goal of providing a debtor with a fresh start by resolving all claims arising from the debtor's conduct prior to its emergence from bankruptcy; and, the rights of the individuals who may be damaged by that conduct but are unaware of the potential harm at the time of the debtor's bankruptcy." *Wright v. Owens Corning*, 2012 WL 1759992 at *4. In *Grossman*, the Court of Appeals adopted the rule that a "' claim' arises when an individual is exposed pre-petition to a product or other conduct giving rise to an injury, which underlies a 'right to payment' under the Bankruptcy Code." *In re Grossman's Inc.,* 607 F.3d at 125. In affirming part of the district court's opinion in *Wright v. Owens Corning,* the Court of Appeals extended its ruling in *Grossman* "to include post-petition, pre-confirmation exposure to a debtor's conduct or product." *Wright v. Owens Corning,* 2012 WL 1759992 at *6.

However, the Court of Appeals reversed the discharge of the post-petition, pre-confirmation claims, finding due process was not afforded to the plaintiff in this case because the Owens Corning plan confirmation preceded the *Grossman* decision. Not until *Grossman* "did the Plaintiffs unexpectedly hold 'claims' that arguably could be discharged in the proceedings addressed in the Owens Corning bar date notices." *Id.* In refusing retroactive application of *Grossman*, the Court of Appeals held "due process affords a re-do in these special situations to be sure all claimants have equal rights." *Id.* Accordingly, the court reversed the finding of the district court that the confirmation of the Owens Corning chapter 11 plan resulted in the discharge of the plaintiffs' claims.

PRACTICAL EFFECT

For "exposure type claims": (i) pre-petition exposure claims that occurred prior to the *Grossman* ruling (June 10, 2010) would not be claims subject to discharge under a confirmed chapter 11 plan; and (ii) post-petition, but pre-confirmation exposure claims that occurred prior to the *Owens Corning* ruling (May 18, 2012), would not be claims subject to discharge under a confirmed chapter 11 plan.

LOW-INCOME HOUSING TAX CREDITS MUST BE INCLUDED IN VALUING SECTION 506(A) COLLATERAL

Ann Pille
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In re Creekside Senior Apartments, LP, 2012 Fed App. 0008P (6th Cir. B.A.P. June 29, 2012)

CASE SNAPSHOT

In a case of first impression, the Sixth Circuit BAP held that, for purposes of valuing collateral under section 506(a) of the Bankruptcy Code, the availability of Low-Income Housing Tax Credits must be considered in valuing a creditor's secured claim.

FACTUAL BACKGROUND

Five affiliated limited partnerships each purchased a low-income housing development, borrowing money from the bank, and securing the loans with the housing development as collateral. Each project was developed pursuant to the federal Low-Income Housing Tax Credit (LIHTC) Program, and was subject to rent and land use restrictions in connection therewith. Each borrower syndicated the LIHTCs to its respective investor limited partners. Each borrower filed chapter 11 bankruptcy petitions. In each case, the bank filed a proof of claim, asserting fully secured claims. The bank's valuation of the collateral took into consideration the valuation of the LIHTCs.

The debtors objected to the bank's valuations, arguing that the LIHTCs should not be included because (i) the credits were not property in which a security interest could be taken, (ii) the credits were not part of the debtors' estates because they had been transferred to the limited partners, and (iii) the specific language of the bank's security interest did not cover the tax credits, so the credits could not be considered collateral for purposes of valuation.

In contrast, the bank argued that the tax credits must be considered in the fair market value of the properties because, under the relevant provisions of the Internal Revenue Code, ownership of the credits was tied to ownership of the properties, and the tax credits would factor into any willing buyer's calculation of a fair purchase price.

The bankruptcy court agreed with the bank, and the debtors appealed.

COURT ANALYSIS

The court reviewed the Internal Revenue Code requirements regarding LIHTCs, and found that ownership of the credits and the subject property must reside in the same hands. In this case, the investor limited partners had no ownership in the LIHTCs. Instead, they were merely entitled to the tax benefits of the credits under the terms of their partnership agreements.

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PENNSYLVANIA SUPREME COURT TO DETERMINE IF GUARANTY SIGNED UNDER SEAL IS AN 'INSTRUMENT'

Osprey Portfolio, LLC v. Izett, No. 942 MAL 2011 Supreme Court of Pennsylvania, August 13, 2012

Christopher D. Milla
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CASE SNAPSHOT

The Pennsylvania Supreme Court has agreed to hear a case to consider how to define the time bar on loan guarantees. The high court will determine whether a guaranty signed under seal constitutes an "instrument" (which is governed by a 20-year statute of limitations pursuant to 42 Pa.C.S. 5529), or a "contract" (which is governed by a four-year statute of limitations pursuant to 42 Pa.C.S. 5525).

FACTUAL BACKGROUND

In September 1999, Izett Manufacturing, Inc. and First Union National Bank entered into a loan transaction for $50,000. In connection with this loan, George Izett executed a guaranty under seal, whereby Izett agreed to unconditionally guarantee timely payment of all sums due under the loan. Subsequently, the bank sold the loan to Osprey Portfolio, LLC, and assigned Osprey the Note and Guaranty. In December 2005, the borrower failed to make timely payments under the loan, and received a notice of default and demand for immediate payment from Osprey. Five years later, Osprey filed a complaint of confession of judgment against Izett, seeking repayment of the loan pursuant to the Guaranty. Judgment was entered June 15, 2010 against Izett. Izett then filed a petition to strike/open the judgment, arguing that Osprey had failed to file its complaint within the four-year statute of limitations codified at 42 Pa.C.S. 5525, which Izett claimed was the applicable statute. After a hearing, the trial court found that the applicable statute of limitations was the 20-year statute governing instruments under seal, set forth at 42 Pa.C.S. 5529.

COURT ANALYSIS

In his appeal to the Pennsylvania Superior Court, Izett argued, in part, that since the statute did not provide a definition for "instrument," then the UCC definition of "instrument" (which defines an instrument as a negotiable instrument) should apply. The Superior Court rejected this argument and held instead that the ordinary meaning of "instrument" must apply. The court stated, in part, that "Black's Law Dictionary defines 'instrument' as a 'written legal document that defines rights, duties, entitlements, or liabilities, such as a contract, will, promissory note' or 'in fact, any written or printed document that may have to be interpreted by the courts.'" Applying this definition, the Superior Court determined that the Guaranty was, in fact, an "instrument" because it defined rights, duties, entitlements, and liabilities of the parties involved and, therefore, the applicable statute of limitations was the 20-year statute. The Pennsylvania Supreme Court will decide whether the Superior Court erred in determining that the Guaranty was an "instrument" under seal rather than a "contract" under seal.

PRACTICAL CONSIDERATIONS

Clearly, there is a huge span of time in which to bring an action at stake here. We will keep you updated. In the meantime, parties must check with legal counsel to determine the potential effects of signing any contracts "under seal."

PURCHASED CLAIMS ARE SUBJECT TO PREFERENCE DISALLOWANCE UNDER SECTION 502(D)

In re KB Toys, Inc., 470 B.R. 331 (Bankr. D. Del. 2012)

Elizabeth A. McGovern
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CASE SNAPSHOT

The trustee sought to disallow claims held by a claims purchaser under section 502(d) of the Bankruptcy Code because the original holders of the claims were liable to the debtor for preferences. The trustee argued that the claims purchaser purchased the claims subject to all rights and disabilities of the original claim holders, including section 502(d), which disallows claims held by creditors subject to preference liability if the creditor has not paid the amount or turned over the property subject to the preference. The claims purchaser asserted that the sold claims were not subject to 502(d), because this section only applied to the original holder of the claim and did not apply to a purchaser of a claim. The bankruptcy court, analyzing legislative history and case law, held that purchased claims are subject to section 502(d) and disallowed the claims purchased.

FACTUAL BACKGROUND

KB Toys and certain of its affiliates filed for bankruptcy early in 2004, and shortly thereafter filed the Statement of Financial Affairs. In the SOFA, the debtor listed creditors who received disbursements within the 90-day preference period preceding the chapter 11 filing. After the SOFA was filed, ASM Capital purchased nine claims from creditors who were among those listed as having received possible preference payments. The trustee filed preference actions against the original claim holders, and eventually obtained default judgments or summary judgments against each of them. The trustee then filed claim objections, seeking disallowance of the claims sold to ASM under section 502(d).

COURT ANALYSIS

The bankruptcy court considered the issue of whether the purchaser of a claim holds the purchased claim subject to the same rights and disabilities as the original claim holder, and is thus subject to section 502(d). Section 502(d) provides that the court shall disallow *"any claim of any entity"* that is a transferee of a transfer avoidable under section 547. ASM argued that the wording of the section meant it applied to the "claimant" only, while the trustee argued that it applied to "any claim," regardless of whether or not it was still held by the original claimant or transferred to a third party. The bankruptcy court reviewed the

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ANOTHER COURT CHIMES IN ON VALIDITY OF INTERCREDITOR ASSIGNMENT OF VOTING RIGHTS

In re Coastal Broadcasting Systems, Inc., Case No. 11-10596 (Bankr. D. N.J. July 6, 2012)

Elizabeth A. McGovern
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CASE SNAPSHOT

At confirmation, the bankruptcy court considered whether the assignment of voting rights in an intercreditor agreement was enforceable. The bankruptcy court noted that various courts had reached differing conclusions, but ultimately found that the voting assignment in the intercreditor agreement before it was enforceable.

FACTUAL BACKGROUND

In 2008, Coastal Broadcasting, a radio station operator, entered into various agreements to restructure and refinance its business. As part of the restructure, Coastal redeemed the stock of five shareholders in exchange for a secured note. At the same time, Coastal also refinanced its debt with its secured lender, Sturdy Savings Bank. The bank and the redeeming shareholders entered into a subordination and intercreditor agreement, which allowed Coastal to make ongoing payments to the shareholders provided that no event of default had occurred. The intercreditor agreement also provided that in the case of a bankruptcy filing by Coastal, the bank would be entitled to exercise any voting rights the shareholders might have, and the shareholders would not receive any payments from Coastal until the bank was paid in full.

Coastal filed for chapter 11 bankruptcy, and sought confirmation of its reorganization plan. The plan, which was supported by the bank, classified the claims of two of the shareholders who objected to the proposed plan separately from other claimants, and designated their claims as unimpaired. The dissenting shareholders objected, contending that their claims were impaired.

COURT ANALYSIS

The bankruptcy court agreed with the dissenting shareholders that their claims were impaired because the proposed plan sought to totally extinguish all rights the dissenting shareholders would otherwise have under the subordination agreement, including the right to any recovery after the bank was paid in full. The court then turned to the question of the enforceability of the voting rights assignment provision in the intercreditor agreement.

The bankruptcy court noted that intercreditor agreements are clearly enforceable under section 510 of the Bankruptcy Code insofar as such agreements address payment and the priority of payment. What is less clear, however, is whether clauses waiving or transferring various rights of junior creditors (such as filing a proof of claim or voting on a plan of reorganization) are similarly enforceable. Enforceability of voting rights assignments have been addressed by several bankruptcy courts with varying results, and no circuit court has yet addressed the issue.

In performing its analysis, the bankruptcy court noted that terms of a subordination agreement are enforceable in bankruptcy under section 510(a) to the same extent they are enforceable outside of bankruptcy. The subordination agreement at issue was governed by New Jersey law, which applies the same principles of contract interpretation to intercreditor agreements as it does to other contracts. Under New Jersey law, a clear and unambiguous contract should be enforced in accordance with its terms. Based upon the clear wording of the agreement, the bankruptcy court found that the voting assignment was enforceable and the bank could vote in favor of the plan despite the objections of the dissenting shareholders.

PRACTICAL CONSIDERATIONS

Bankruptcy court decisions are not unanimous in cases that involve the assignment of voting rights. Some courts have held that voting is a fundamental right under the Bankruptcy Code that cannot be assigned, and parties to subordination agreements must be aware that there is a divergence of opinion, yet to be addressed by a Circuit Court.

Low-Income Housing Tax Credits Must be Included in Valuing Section 506(a) Collateral—continued from page 3

The court also assessed that a willing buyer would take into account the benefit of the tax credits, as well as the drawback of the restricted income arising from the rent restrictions, in arriving at a fair price for the properties. In rejecting the valuation of the properties proposed by the debtors, the court found that it would be "incongruous" to consider the income restrictions, but not the tax credit benefits. Because there could be no benefit (of the tax credits) without the burden (of the rent restrictions), the LIHTCs could not be separated from the debtors' properties, and therefore, the bank's claims appropriately valued the real estate in light of the LIHTCs.

PRACTICAL CONSIDERATIONS

This decision confirms that low-income housing tax credits are not separable from the property to which they are attached. Furthermore, for purposes of section 506 valuation, it confirms that a secured creditor is entitled to value the property on an income approach, with appropriate consideration of those factors that might affect the fair market value of the property.

LETTER OF CREDIT PAYMENT MADE INDEPENDENT OF BOND INDENTURE IS NOT A 'SETTLEMENT PAYMENT' PROTECTED BY SECTION 546(E)

In re Qimonda Richmond, LLC, 467 B.R. 318 (Bankr. D. Del. 2012)

Christopher Rivas
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CASE SNAPSHOT

The liquidating trustee filed an avoidance action against a letter of credit (LC) issuer to recover a $33 million transfer by the debtor to repay the LC issuer for an LC draw made by the debtor's bondholders under an indenture agreement. The LC issuer filed a motion to dismiss the trustee's suit, arguing that the transfers were settlement payments made in connection with a securities contract and thus protected by section 546(e) of the Bankruptcy Code. The court disagreed with the bank, and denied its motion to dismiss on the grounds, among other things, that the LC repayment was independent from the bondholder repayment.

FACTUAL BACKGROUND

In 2000, debtor Qimonda's predecessor borrowed $33.7 million through the issuance of bonds pursuant to an indenture agreement. Citibank issued an LC in the amount of $34.1 million in favor of the Indenture Trustee to secure Qimonda's payment obligations to bondholders. Qimonda agreed to reimburse Citibank if the LC was drawn, and gave the bank certain liens on assets as security for that obligation.

Upon being notified of the imminent expiration of the LC securing its bonds, the Indenture Trustee sent a redemption notice to bondholders. Shortly thereafter, and in rapid succession: (i) Qimonda deposited funds into its empty Citibank account to satisfy its obligations under the LC issued by Citibank to secure the bonds; (ii) Citibank debited the account; and (iii) Citibank paid $33 million to the Indenture Trustee, which had made a draw request under the LC. Less than a month later, Qimonda filed for relief under chapter 11. The Liquidating Trustee filed a complaint against Citibank seeking to avoid the $33 million transfer to Citibank as a preferential and fraudulent transfer. Citibank filed a motion to dismiss on the grounds that the transfer to Citibank was part and parcel with the debtor's repayment of its bonds and was, therefore, a "settlement payment" pursuant to section 546(e) and protected from avoidance.

COURT ANALYSIS

Citibank asserted that the Trustee's complaint should be dismissed because, among other theories, the transfer to Citibank was within the section 546(e) safe harbor as a settlement payment made in connection with a securities contract.

Citibank relied on a New York bankruptcy decision in which the court held that a series of transactions, including the debtor's transfer of money into a bank account, the disbursement of those funds to the indenture trustee of the debtor's notes, and the retirement of those notes when the holders received payment, constituted a "settlement payment" within the 546(e) safe harbor.

Here though, the bankruptcy court distinguished the New York decision, noting that all of the transfers in that matter were made solely to complete a securities transaction, and there was no independent obligation between the debtor and the bank. In the instant case, however, the debtor's obligation to Citibank under the LC was technically separate from the debtor's obligation to repay its bondholders, even though the independent transactions went hand-in-hand and the debtor was repaying its bondholders "through" the LC issuer. In any case, the court was not persuaded that the bonds themselves were "securities contracts," and, thus, it was not persuaded that the LC repayment was a credit enhancement in connection with a securities contract sufficient to bring the payment within the 546(e) safe harbor.

PRACTICAL CONSIDERATIONS

In the past several years, courts in several jurisdictions have determined what payments are, and are not, within the section 546(e) safe harbor. This is a dynamic and somewhat unsettled area of the law – in particular where multi-step transactions are at issue. Whether a court will consider a transfer within a series of transfers to be a "settlement payment" depends on the jurisdiction and obligations underlying the transfers.

Purchased Claims Are Subject to Preference Disallowance Under Section 502(d)—continued from page 4

legislative history of this section, as well as cases construing its application, and was ultimately persuaded that the section applies to any "claim."

The bankruptcy court noted that ASM had constructive, if not actual, notice of the possibility that the sold claims could be subject to preference actions, since the original claim holders were listed in the SOFA as potential preference defendants. Additionally, the court noted that ASM had negotiated indemnity provisions in four of the purchase agreements, indicating that ASM was aware that the sold claims may very well be recovered in the bankruptcy case.

The bankruptcy court sustained the trustee's objection and held that a claim purchaser holds that claim subject to the same rights and disabilities as the original holder, including section 502(d).

PRACTICAL CONSIDERATIONS

Claims purchasers should be aware that they take claims subject to section 502(d), and should structure their agreements and pricing accordingly.

The court then analyzed the Coudert partnership agreement to determine if any provisions indicated that unfinished business did not constitute a partnership asset. There were no such indications in the agreement, and in fact, certain provisions expressly incorporated the dissolution provisions of the New York Partnership Law (NYPL).

The district court examined the defendant firms' argument that the application of the unfinished business doctrine contravened an important public policy – supporting unfettered client choice of counsel. Despite calling this the firms' strongest argument, the court concluded that the unfinished business rule did not contravene this policy. The court stated two reasons for its conclusion: (i) partnership dissolution is governed by statute, and thus the statute is unlikely to violate public policy; and (ii) neither the Second Circuit nor any New York state court that applied this doctrine to contingency fee matters had expressed a public policy concern. Accordingly, the district court held that applying the unfinished business rule to open, hourly matters did not violate New York's public policy supporting a client's choice of counsel.

The defendant firms argued that, if hourly matters were subject to the unfinished business rule, the "efforts, skills and diligence" of the former Coudert partners nullified the value of the fees owed to the partnership. Essentially, the defendant firms argued that they should be allowed to deduct expenses associated with the partners' "efforts, skills and diligence" before transferring fees to the partnership, and this calculation would equal the amount the partners had generated for the new firms. The Second Circuit has recognized this exception, despite provisions in the NYPL and the Uniform Partnership Act (UPA) that prohibit compensation to a partner for his or her post-dissolution work in completing open matters. The district court ruled that this issue raised factual questions that would require the presentation of evidence, before the court could make a ruling. The court granted DSI's motion for declaration that the open client matters were partnership assets on the dissolution date, and denied the defendant firms' motions to dismiss.

PRACTICAL CONSIDERATIONS

The district court's ruling is germane to current and future law firm dissolutions. Not only does the ruling impact the dissolving law firm, but it also greatly impacts any firm that hires former partners and performs work on matters that originated with the dissolved law firm. This case provides a cautionary tale that firms hiring former partners of a dissolved firm may not reap the rewards of immediate case work and fees that the former partners bring with them. Practically speaking, the dissolved law firm could seek the return of any fees generated by the new firm that are associated with the transferred matter.

Complicating matters, a different judge in the District Court for the Southern District of New York reached the opposite conclusion while reviewing almost identical facts. Both cases have been certified for appeal. The issue must be resolved by the highest New York state court.

2) *Geron v. Seyfarth Shaw, LLP,* Case No. 1:11-cv-08967 (S.D.N.Y. Sept. 4, 2012)

CASE SNAPSHOT

This is the second of two recent cases involving the application of the "unfinished business" doctrine to fees earned by former partners of the dissolved law firms from matters that had been pending prior to the dissolution. This decision reached the opposite conclusion of the earlier decision, setting up an interesting state of affairs in New York.

Here, the chapter 7 trustee of the bankruptcy estate of a former law firm brought fraudulent transfer claims against two law firms that hired partners from the former law firm. Similar to *DSI v. Akin Gump,* the trustee sought to recover profits, generated by the partners for their new firms, that were associated with clients and pending matters of the now bankrupt firm. The trustee asserted his claims under the "unfinished business" doctrine and argued that profits derived from hourly fee matters should (like profits associated with contingency fee matters) be deemed property of the estate. Both defendant firms argued that hourly matters were dissimilar to contingency fee matters and did not constitute unfinished business.

In contrast to the *DSI v. Akin* Gump decision, the district court held that hourly matters are not partnership property under New York law, and not subject to the unfinished business doctrine. The court did, however, find that hourly matters may constitute "unfinished business" under California law, but only to the extent that the former partners received remuneration beyond "reasonable compensation" as set forth in the Revised Uniform Partnership Act.

FACTUAL BACKGROUND

Thelen LLP, a multi-national law firm, was a registered limited liability partnership governed by California law. In 2008, Thelen's partners voted to dissolve the firm. A year later, the firm filed a chapter 7 bankruptcy petition in the Bankruptcy Court for the Southern District of New York. In connection with the plan of dissolution, the Thelen partners incorporated a so-called *Jewel* waiver into their partnership agreement, which, in contravention of the *Jewel* decision that pending matters are partnership assets, affirmatively removed any unfinished business from partnership assets. The chapter 7 trustee brought fraudulent transfer, accounting and turnover claims against Seyfarth Shaw LLP and Robinson & Cole LLP, arguing that the adoption of the *Jewel* waiver constituted a fraudulent transfer because the defendant firms received a property interest that rightfully belonged to Thelen. Seyfarth moved for judgment on the pleadings, and Robinson moved to dismiss. The district court granted Seyfarth's motion and denied Robinson's motion.

COURT ANALYSIS

Seyfarth's Argument

The court applied New York law to the trustee's claims against Seyfarth because the majority of significant contacts occurred in New York. The trustee argued that under New York judicial interpretation of the "unfinished business doctrine," the partners could not disclaim an interest in unfinished business that would be completed by other law firms. Conversely, Seyfarth argued that New York law did not recognize a law firm's property interest in pending hourly fee matters. The highest state court in New York has yet to rule on whether pending hourly fee matters constitute partnership property of the dissolved partnership, so the district court had to predict how the state court would rule.

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THIRD CIRCUIT CLARIFIES BURDEN OF PROOF ANALYSIS UNDER SECTION 506(A) VALUATION, AND ALLOWS LIEN STRIPPING IN CHAPTER 11

In re Heritage Highgate, 679 F.3d 132 (3d Cir. 2012)

Christopher Rivas
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CASE SNAPSHOT

The junior secured creditor objected to the motion of the unsecured creditors committee to reduce the value of the junior secured creditor's claim to zero in this chapter 11 reorganization case, arguing that to do so improperly valued the collateral, and constituted impermissible lien stripping. The committee offered appraisal evidence proving that the fair market value of the property was less than the amount of the first priority lien holder's claims. The junior creditor argued that the valuation of the collateral should not be fixed at the current value as of the confirmation date, because the debtor's estate would continue to generate revenues. The Third Circuit clarified the burdens of proof and persuasion for section 506(a) valuations and held that a junior creditor's liens may be stripped in a chapter 11 reorganization.

FACTUAL BACKGROUND

Heritage Highgate borrowed money from several lenders in order to develop a residential subdivision. A bank lender was the senior secured lender, and Cornerstone Investors was the junior secured lender. In 2009, Heritage filed for chapter 11, proposing to pay senior and junior secured creditors in full. The debtor's appraisal of the property during early cash collateral hearings, to which no party objected, was $15 million, which was enough to cover all of the secured debt.

Subsequently, at the time of the plan confirmation, the senior lender was owed $12 million, and Cornerstone was owed $1.4 million. However, the value of the property had dropped to $9.5 million since the time of the earlier appraisal, as a result of certain sales that had occurred in the interim. Cornerstone stipulated that the $9.5 million fair market value was correct, but argued a "wait and see" approach to valuation based on the debtor's plan projections that the property would be worth more than enough to pay all secured claims in full within the next four years.

The unsecured creditors committee moved to reduce the value of Cornerstone's secured claims to zero, because the collateral securing the liens now was worth less than the amount owed the secured creditors. Cornerstone objected. The bankruptcy court agreed with the unsecured creditors committee and stripped Cornerstone's liens. On appeal, the district court affirmed, after which Cornerstone appealed to the Third Circuit Court of Appeals.

COURT ANALYSIS

Cornerstone argued that the lower courts erred in two respects: (i) section 506(a) of the Bankruptcy Code required that property be valued "in light of … [its] proposed disposition or use," i.e., in light of anticipated post-confirmation projected values; and (ii) by fixing the value at the time of confirmation, resulting in impermissible lien stripping.

First, the Third Circuit clarified the valuation standards of 506(a). It rejected Cornerstone's "wait and see" approach, holding that plan projections were not "valuations." The appraisals, not the plan's projections, were the proper measurement of current fair market value, and the appraisals appropriately considered projected uses of property in their valuations, and thus satisfied section 506(a)'s requirements.

The Third Circuit also established a burden-shifting evidentiary framework for section 506(a) valuations: the objecting party had the initial burden of proof to overcome the validity of the secured party's liens, but the secured party had the ultimate burden of persuasion to prove, by a preponderance of the evidence, both the extent and the value of its lien.

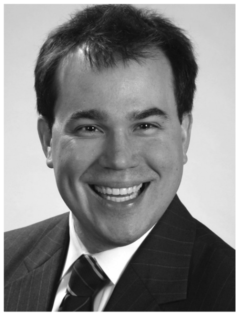
Second, having found that the value of the property was insufficient to secure the junior creditor's liens, the Third Circuit rejected Cornerstone's arguments that its liens could not be stripped. The court held that, although lien stripping was not permissible in chapter 7 liquidation cases (where secured creditors should receive the full value of later foreclosure sales), there was no similar prohibition of lien stripping in chapter 11 cases. The Third Circuit identified the framework of 1129(b) and the 1111(b) election process as examples of the Bankruptcy Code's acceptance of lien stripping in chapter 11 cases.

PRACTICAL CONSIDERATIONS

A junior creditor in chapter 11 cases must be prepared for the possibility of its liens being stripped. Junior creditors should not rely on plan projections or statements by the debtor to "establish" the value of properties or hope that the court will wait for improved economic circumstances to value the properties. Instead, the junior creditor should obtain independent appraisals to counter any appraisals that estimate the value of property as insufficient to cover the junior creditor's liens. Ultimately, the burden to establish the validity and extent of a junior creditor's liens will fall on the junior creditor, and it should obtain as much evidence as it can to establish its liens.

'CONTINGENT CLAIM' NOT SUFFICIENT TO ESTABLISH RIGHT OF SETOFF FOR LIFT-STAY MOTION

In re WL Homes LLC, Case No. 09-10571 (Bankr. D. Del. May 16, 2012)



Jared S. Roach
Associate, Pittsburgh

CASE SNAPSHOT

The debtor's insurer sought to lift the automatic stay in order to setoff $2.2 million in return premiums against potential defense costs that the insurer expected to incur related to certain insurance claims made against the debtor. The court denied the motion, finding that the insurer had not established a right to setoff under either state law or the Bankruptcy Code.

FACTUAL BACKGROUND

WL Homes, a national homebuilder, purchased insurance policies from Zurich American Insurance Company, to provide protection against claims relating to construction defects. The policies required WL Homes to pay a certain amount of such claims, defined as "self insured retention." Zurich's obligation to pay claims only kicked in after WL Homes paid the self insured retention; Zurich could elect to pay any portion of the self insured retention, but if any final judgment or settlement was less than the retention amount, Zurich would have no obligation to pay damages.

At the time WL Homes filed for bankruptcy in 2009, Zurich held $2.2 million in premium overpayments (called a return premium). Under the policy, WL Homes was entitled to the return premium, but Zurich had not relinquished it as of the time it sought relief from the automatic stay. Zurich's motion for relief from the automatic stay sought the court's permission to apply the return premium toward any amount it may elect to pay in defending claims against the debtor. The chapter 7 trustee objected to the motion.

COURT ANALYSIS

Section 553 provides that the Bankruptcy Code does not affect any right of setoff that a creditor had before the bankruptcy. Creditors seeking to exercise their setoff rights, however, must seek relief from the automatic stay and show that the setoff could be exercised under nonbankruptcy (state) law. The most common form of proof is that a mutual claim and debt arose prior to the debtor's bankruptcy.

Zurich argued that it had a "contingent claim" against the debtor's bankruptcy estate because it had not yet advanced, nor had it decided if it would advance, defense costs within the self insured retention. Zurich claimed California state law permitted a party to setoff a contingent claim. The court did not agree with Zurich's argument and found contrary authority stating that a party's setoff rights were only available with fixed claims.

The court also found that Zurich's claim did not fit within the parameters of section 553(a), which requires that a mutual debt and claim "both must have arisen pre-petition." Case law has consistently held that, for setoff purposes, a claim arises when all transactions necessary for liability occur.

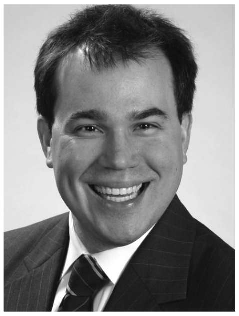
Zurich did not present any evidence that as of the petition date it had paid, or elected to pay, any amounts within the self insured retention. "If there is still an election *yet to be made* and money *yet to be paid* - both of which are decisions entirely within Zurich's control post-petition - then not 'all transactions necessary' for a definite liability to accrue occurred as of the petition date." (Emphasis in original.) Thus, the court held that Zurich had not established a right to setoff, and denied Zurich's motion to lift the automatic stay.

PRACTICAL CONSIDERATIONS

The court clearly held that, when showing "cause" pursuant to a motion for relief from the automatic stay in order to exercise one's setoff rights, the movant must: (i) demonstrate its right to setoff under state law, and (ii) show that it meets the requirements set forth in section 553 of the Bankruptcy Code.

SECURED BLANKET LIEN ON INVENTORY TRUMPS RECLAMATION RIGHTS

In re Furrs Supermarkets, Inc., No. 11-01-10779 SA (Bankr. D.N.M. Aug. 15, 2012)



Jared S. Roach
Associate, Pittsburgh

CASE SNAPSHOT

An unsecured trade creditor of the debtor filed a reclamation claim to recover certain goods sold to the debtor. The Trustee filed a Motion of Summary Judgment and argued that the debtor's secured creditors had a blanket lien on all of the debtor's inventory; therefore, the unsecured creditor's reclamation claim was valueless because the debtor's inventory was worth less than the claims held by the secured creditors. The court agreed with the Trustee's analysis and held that the unsecured creditor was not entitled to an administrative or secured claim.

FACTUAL BACKGROUND

On the chapter 11 petition date, the debtor, Furrs Supermarkets, owed its secured creditors more than $127 million. The secured creditors held a floating security interest in the debtor's inventory. The value of the inventory on the petition date was $66 million. Certain unsecured trade creditors filed motions for reclamation. The Trustee initially objected to each reclamation claim, and one unsecured creditor filed a response. The Trustee then filed a motion for summary judgment pursuant to Federal Rule of Bankruptcy Procedure 7056. The creditor failed to file any response. The court granted the Trustee's motion for summary judgment.

COURT ANALYSIS

The court first looked to section 546(c) of the Bankruptcy Code and outlined an unsecured creditor's right to reclaim goods from an insolvent debtor. The court did not dispute the unsecured creditor's right to make a reclamation demand; rather, the court focused its analysis on whether a creditor with a prior perfected security interest defeats a reclamation demand. Also important in the court's analysis was the language of the floating lien that provided an after-acquired property clause, which gave the secured creditor a blanket lien on all of the debtor's after-acquired inventory. The court agreed with a Delaware Bankruptcy Court decision providing: "where a secured creditor has a floating lien on all of a debtor's inventory and its claim exceeds the value of the inventory, a creditor's reclamation right is valueless and the reclamation creditor is not entitled to receive an administrative or secured claim under section 546(c)(2)." The court applied this reasoning to the case before it, and granted the Trustee's motion.

PRACTICAL CONSIDERATIONS

While the Bankruptcy Code and state law provide creditors with reclamation rights, the creditor should thoroughly analyze whether any creditors – quite often banks – have blanket security interests in the debtor's inventory. A secured party with a blanket lien is considered a good faith purchaser under the Uniform Commercial Code, and the secured creditor's lien will trump the unsecured creditor's reclamation demand.

'INTENT' INFERRED, SUMMARY JUDGMENT GRANTED IN DEBT RECHARACTERIZATION CASE

In re Shubh Hotels Pittsburgh, Inc., Bankr. No. 10-26337JAD (Bankr. W.D. Pa. July 24, 2012)

Joseph D. Filloy
Associate, Pittsburgh

CASE SNAPSHOT

The Creditor Trust and Plan Proponents of the debtor's chapter 11 plan filed motions for summary judgment with respect to claim objection, asserting that the claimant affiliated with the debtor had made equity contributions, rather than loans, to the debtor and, therefore, such claim should be denied. Based upon the lack of documents evidencing loan terms, interest rates, maturity dates, balance sheet entries, or any other support that the cash infusions were loans, as well as contradictory testimony of the claimant, the court granted summary judgment, holding that the "debt" should be recharacterized as an equity contribution and, therefore, did not support the claim.

FACTUAL BACKGROUND

Shubh Hotels, LLC (SH), at the direction of its sole managing member (Bisaria), transferred funds between various hotel entities in which Bisaria maintained an interest. One such hotel was Shubh Hotels Pittsburgh, LLC, which filed a chapter 11 petition. SH filed a proof of claim in the amount of $15.2 million, asserting that it had a general unsecured claim for "loans to the corporation." No loan agreements or any other type of documentation supporting the claim that SH had loaned money to the debtor was filed or ever presented to the court. Additionally, many of the "loans" were made through Bisaria's personal bank accounts and were booked on the debtor's records as equity. Bisaria admitted the transactions were structured this way to avoid triggering covenants in pre-existing loan agreements with other lenders that capped the amount of outstanding debt. Moreover, Bisaria, as the debtor's manager, had executed the debtor's schedules that did not list the "loans" as outstanding loans. The court evaluated the well-established set of factors used by courts to determine that the cash infusions were properly characterized as equity, and not debt, and granted the motions for summary judgment.

COURT ANALYSIS

The moving parties, the Creditor Trust and Plan Proponents, pointed to testimony of the Chief Operating Officer of SH that the cash transfers were entered on the debtor's books as equity, and that the debtor's balance sheet (prepared seven days before the petition date) did not show that any money was due to SH. Further, the debtor's bankruptcy schedules (signed by Bisaria) did not show any money owed to SH. SH was unable to present any evidence that the

CONTINUED ON PAGE 11

REASONABLENESS OF PRE-PETITION DEFAULT RATE UNDER SECTION 506(A) NOT SUBJECT TO EQUITABLE ANALYSIS

In re 400 Walnut Associates, L.P., 2012 BL 140988 (E.D. Pa. June 7, 2012)

Joseph D. Filloy
Associate, Pittsburgh

CASE SNAPSHOT

The creditor appealed the denial of its claim for pre-petition interest at the contractual default rate. The district court reversed and remanded the case, holding that the bankruptcy court had incorrectly applied an "equitable analysis" in making its decision.

FACTUAL BACKGROUND

The debtor's real property was subject to a loan and mortgage. Prior to filing for bankruptcy, 400 Walnut Associates, L.P. had stopped making payments on the loan, and its lender sent the debtor a formal notice of default. The loan agreement provided for a default rate of interest of 16 percent (the non-default rate was 5 percent). The lender subsequently sold the loan to 4th Walnut Associates. Upon purchasing the loan, 4th Walnut issued a new notice of default to the debtor. Months later, the debtor filed a petition for relief under chapter 11 of the Bankruptcy Code. 4th Walnut filed a proof of claim for $15.3 million, which included pre-petition interest calculated at the default rate. The debtor objected. The bankruptcy court, applying an equitable analysis, held that the creditor was not entitled to interest at the default rate, which decision was appealed by 4th Walnut. The bankruptcy court, relying on case law founded on section 506(b) of the Code, found that default interest was inappropriate because it was unreasonable, as the loan was purchased at a discount; the default rate was more than three times the non-default rate; and the rate hindered the debtor's ability to confirm a chapter 11 plan.

COURT ANALYSIS

The debtor argued that the district court lacked jurisdiction to review the lower court decision, arguing that the decision was not final and that the district court should not exercise its discretion to hear an interlocutory appeal. The district court agreed that the lower court's decision lacked finality because it did not dispose of all of the claims, but nevertheless exercised its discretion to hear the appeal as interlocutory. The court concluded that the appeal of the bankruptcy court's decision satisfied all of the elements necessary to exercise its discretion because: (i) it involved a "controlling question of law;" (ii) it offered "substantial ground for difference of opinion" as to its correctness; and (iii) if appealed immediately, it "materially advance[d] the ultimate termination of the litigation."

Turning to the merits of the case, the court concluded that the bankruptcy court applied the wrong legal standard in deciding the claim for pre-petition interest at the default rate. Rather than analyzing whether the default rate was appropriate and permissible under state law, the bankruptcy court stated that the claim for default interest was subject to an "equitable analysis" focusing on the risk of default, the reasonableness of the default rate, and the "effect of the higher rate on the debtor's ability to reorganize."

The district court found that the lower court "incorrectly applied an equitable analysis to Creditor's entire claim for default interest, failing to distinguish between interest that accrued before and after Debtor filed its bankruptcy petition." The district court adopted the majority approach that section 506(b) of the Bankruptcy Code is applicable only in the context of post-petition claims. "The Bankruptcy Court's reliance on section 506(b) with respect to claims for pre-petition interest is misplaced. There is no 'reasonableness' test for interest that accrues prior to the filing of the bankruptcy petition." The district court, in reversing the bankruptcy court decision, held that a creditor "may recover pre-petition default interest so long as the parties contracted for it and it is permitted under state law."

PRACTICAL CONSIDERATIONS

The court made clear that a claim for default interest is evaluated in light of the contractual terms, and state law, and that a determination of reasonableness consistent with section 506(b) is inapplicable to claims for pre-petition interest.

'Intent' Inferred, Summary Judgment Granted in Debt Recharacterization Case—continued from page 10

transfers constituted loans. The court reviewed the actions in light of a list of factors, including: the presence or absence of a fixed maturity date and schedule of payments; the presence or absence of a fixed rate of interest and interest payments; the adequacy or inadequacy of capitalization; and the identity of interest between the creditor and the stockholder. The court found particularly persuasive Bisaria's testimony that the "loans" would be repaid "whenever it had the cash flow available" as indicative of an equity position rather than a debt. The court readily found that the factors weighed heavily in favor of equity infusions, rather than loans.

SH argued that summary judgment was not appropriate because the intent of SH regarding the transfers was at issue. "Though summary judgment is generally inappropriate when intent is an issue, it may be granted when all reasonable inferences defeat the claims of a party, or that party has rested merely on unsupported speculation." Here, the court found the moving party had met its burden establishing that the advances should be characterized equity, and that the intent of the parties was reflected by the evidence supporting the recharacterization, thereby shifting the burden to SH. Because SH could not produce a scintilla of evidence to prove that its intent was that the advances would be treated as loans (beyond self-serving testimony), the court held that summary judgment was appropriate. As the court noted, "this stage of the case is 'put up or shut up' time," and SH failed to put up any evidence to support its claim.

PRACTICAL CONSIDERATIONS

This case highlights the factors used by courts to characterize a claim as debt or equity. It also demonstrates that the stated intent of parties post-transaction may be insufficient to overcome overwhelming evidence in support of contrary assertions. Moreover, questions of intent, although typically factual, may be resolved at the summary judgment stage when a position is without any factual support, aside from self-serving testimony.

COUNSEL'S CORNER: NEWS FROM REED SMITH

Presentations

Kurt Gwynne spoke September 12 in Pittsburgh for the 17th PBI Annual Bankruptcy Institute on "Bankruptcy Litigation: Demonstrating Effective Direct and Cross Exam for Consumer and Commercial Cases."

Kurt Gwynne will also speak for the Pennsylvania Bar Institute on "Director and Officer Liability" November 15 in Philadelphia.

Charlotte Moller will participate on a panel at the Insolvency Today Annual Conference 2012 October 10 in London, addressing "What's Special about the Special Administration Regime."

Andy Rahl will participate in a panel discussion about "Multi-National Firms in U.S. Bankruptcy Proceedings" at the 20th Annual Distressed Investing Conference to be held November 26 at the Helmsley Park Lane Hotel in New York City.

Bob Simons spoke September 12 in Pittsburgh at the 17th PBI Annual Bankruptcy Institute, on, "*Stern v. Marshal:* Have We Figured Out What It Means?"

Bob Simons will also be a speaker at the National Business Institute Continuing Legal Education seminar, "Bankruptcy Litigation 101," November 9 in Pittsburgh.

Greg Taddonio spoke September 12 in Pittsburgh for the 17th PBI Annual Bankruptcy Institute, on "Top Commercial Bankruptcy Cases in 2012."

'Unfinished Business' Doctrine in Law Firm Dissolutions is the Subject of Recent Opposing Decisions Within the Same District —continued from page 7

New York courts have applied the unfinished business doctrine to contingency fee cases, but have not extended the doctrine to hourly billed cases. This court refused to extend the unfinished business doctrine to hourly billed cases and cited three reasons for its holding.

First, the court recognized a real distinction between contingent fee and hourly cases. "Unlike in the contingency fee context, applying the unfinished business doctrine to pending hourly fee matters would result in an unjust windfall for the Thelen estate, as 'compensating a former partner out of that fee would reduce the compensation of the attorneys performing the work.' Such an expansion of the doctrine would violate New York's public policy against restrictions on the practice of law." Accordingly, such an extension would violate public policy.

Second, the court found that recognizing a property interest in hourly matters would conflict directly with New York's Rules of Professional Conduct, which prohibit a lawyer from dividing a fee with another lawyer not associated with the same firm (except under circumstances not relevant here).

Third, the court, citing New York case law, also stated that, unlike a contingency fee case, all post-dissolution fees earned in an hourly case "are due to that lawyer's post-dissolution efforts, skill and diligence." This holding recognizes that the lawyers and the new firm, and not the former firm, create and add value to a matter after it is transferred.

The court granted Seyfarth's motion to dismiss pursuant to the court's interpretation of New York law and subsequent determination that "a dissolved law firm's pending hourly fee matters are not partnership assets."

Robinson's Argument

Unlike Seyfarth's claims, which the court determined were governed by New York law, the court applied California law to the trustee's claims against Robinson. Robinson asserted that California's enactment of the Revised Uniform Partnership Act nullified the holdings of *Jewel* and its progeny, arguing that under RUPA, a partner is entitled to "reasonable compensation for services rendered in winding up the business of the partnership." This argument is inapposite to the *Jewel* holding because under *Jewel*, absent a contrary agreement, the partnership would be entitled to the profits associated with the completion of any unfinished business. The court agreed with Robinson's argument, but held the question of what constituted "reasonable compensation" to be fact-intensive and not suitable for dismissal. Robinson's liability, if any, depended on the quantification of "reasonable compensation" as applied to the former Thelen partners – the court could only make the required determination with a more developed record.

PRACTICAL CONSIDERATIONS

This is the second decision from the Southern District of New York within three months that has dealt with the significant question of whether pending hourly client matters constitute partnership assets under New York law. Recognizing the import of this issue, the *Geron* court certified the decision for interlocutory appeal. This decision comes on the heels of the *DSI v. Akin Gump* decision, where a different judge sitting in the Southern District of New York held that unfinished business was a partnership asset (this decision was also certified for appeal). These two cases certainly impact current and future law firm dissolutions, and the likelihood that partners of the dissolved law firm will be forced to return profits earned at their new law firms. We will keep you updated as these appeals progress.

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