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CR&B Alert

Commercial Restructuring & Bankruptcy News

OCTOBER 2014, ISSUE 3

In This Issue:

JUDGE SAYS THAT STOCKTON, CALIFORNIA CAN CUT PENSION OBLIGATIONS

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On October 1, 2014, the bankruptcy judge overseeing the chapter 9 proceeding of Stockton, California observed from the bench that the city can cut pension obligations. In a statement made during plan confirmation proceedings, the judge said he believed that Stockton could exit the state's retirement system by rejecting its contract and restructure about $1.6 billion in unfunded pension liabilities as part of a plan of adjustment. In addition, he said that any lien that the retirement system would have resulting from such rejection could be avoided. The judge believes that the federal bankruptcy laws control over state law which prohibits California cities from repudiating pension fund payments. In response to the ruling, CalPERS, the state public employee retirement system, says it disagrees with the judge's comments and that the comments do not have an immediate effect in the Stockton chapter 9 case since the judge will not rule on whether Stockton's plan is confirmable until later this month. The City's current proposed plan does not seek to impair its obligations to CalPERS or to its retired employees. Stay tuned!

On a different note, I am pleased to announce the launch of Global Restructuring Watch, our blog dedicated to bringing readers the latest worldwide trends and developments in bankruptcy, insolvency and restructuring. Please click here to subscribe and to read our blog posts. http://www.globalrestructuringwatch.com/

THIRD-PARTY RELEASES – BETTER MAKE SURE THEY ARE ADEQUATELY DISCLOSED

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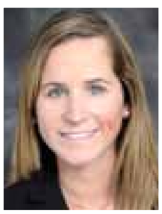

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In Re Lower Bucks Hospital, No. 13-1311 (3d Cir., July 3, 2014)

CASE SNAPSHOT

In a recent non-precedential holding, the Third Circuit Court of Appeals affirmed a decision of the bankruptcy court finding that the disclosure of a third-party release in the settlement agreement and the disclosure statement accompanying a plan of reorganization was inadequate, and therefore the bankruptcy court was justified in striking the release provision from both the settlement agreement and the plan.

FACTUAL BACKGROUND

The chapter 11 debtor brought an action against the indenture trustee as the holder of secured notes, seeking a declaration by the bankruptcy court that the liens of the indenture trustee were voidable because of faulty financing statements that were ultimately corrected - but within the preference period. The indenture trustee asserted that the bonds were secured by the hospital's gross revenues. However, the hospital had changed its name after the original financing statements were filed. The original financing statements were not corrected to reflect the new name of the debtor until long after its name change, and the corrected financing statements were filed within 90 days of the bankruptcy filing.

Ultimately the case was settled and the settlement was reduced to a written agreement. The settlement agreement contained a release of the indenture trustee that was binding not only upon the debtor and the creditors committee, but also upon the bondholders who were not parties to the agreement. The proposed settlement was presented to the bankruptcy court judge as an attachment to a motion filed under Bankruptcy Rule 9019 seeking to have the agreement approved. Evidently neither the counsel to the debtor nor the counsel to the indenture trustee brought the contents of the third-party release to the bankruptcy judge's attention, and the judge approved the settlement.

Not long after the settlement was approved, the debtor filed its proposed plan of reorganization and disclosure statement. Those documents included the same third-party release, releasing the indenture trustee of any and all wrongdoing and causes of action by all creditors, including the bondholders. In neither document was the release highlighted or emphasized. At the disclosure statement hearing, the bankruptcy judge was not made aware of the release, which had not been highlighted, and was not conspicuous. The judge approved the disclosure statement and it was thereafter distributed to creditors, together with the plan.

Soon after the disclosure statement was approved and disseminated, a bondholder filed a motion asking the bankruptcy court to reconsider its earlier order approving the settlement agreement. The same bondholder then filed a putative class action in the Eastern District of Pennsylvania alleging that the bond trustee breached its fiduciary duties to the bondholders by failing to maintain proper financing statements with respect to their security interests in the debtor's gross revenues. The objecting bondholder also filed an objection to the plan, arguing that the third-party release was an "impermissible, noncrucial, nondebtor third party release" that was not properly disclosed.

Upon reviewing the objector's motion, the bankruptcy court entered an order amending its prior order approving the settlement agreement. In his restated order, the bankruptcy judge made clear that the bondholders retained their right to bring claims against the indenture trustee, thus rendering the third-party release ineffective as to the bondholders.

At the plan confirmation hearing, the parties agreed to sever from the plan the third-party release and to have that considered at a separate hearing. The plan was then confirmed without the third-party release. At the hearing on the third-party release, the bankruptcy court judge found that the disclosure of that release had been inadequate, both in the settlement agreement and in the disclosure statement, and thus denied the motion to approve the release. His opinion highlighted his view that the parties had been intentionally tight lipped about the

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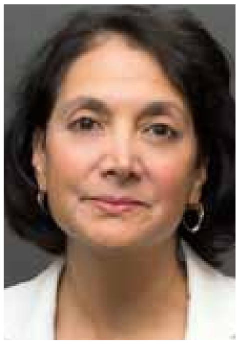
LAWYERS WHO SIGN PROOFS OF CLAIMS FOR CLIENTS MAY BE WAIVING THE PROTECTIONS OF THE ATTORNEY-CLIENT PRIVILEGE AND THE WORK PRODUCT DOCTRINE



Amy Tonti
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All states have adopted some form of the "attorney-client privilege" and the "work-product doctrine." The "attorney-client privilege" generally is codified such that "a client has a privilege to refuse to disclose and to prevent any other person from disclosing confidential communications made for the purpose of facilitating the rendition of professional legal services to the client." This privilege protects not just conversations between the client and the lawyer directly, but also conversations involving representatives of either the client or the lawyer, as well as conversations with lawyers representing another party (concerning a matter of common interest between them). An attorney's "mental impressions, conclusions, opinions, or legal theories" are protected as intangible work-product.

In most bankruptcy cases, creditors are required to file a Proof of Claim to preserve claims in a bankruptcy case. The Official Form B-10 provides: "I declare under penalty of perjury that the information provided in this claim is true and correct to the best of my knowledge, information, and reasonable belief." Signing a Proof of Claim is an assertion of personal knowledge of the facts alleged in the Proof of Claim. Federal Rule of Bankruptcy Procedure 3001(f) provides that a properly filed Proof of Claim is prima facie evidence as to the claim's validity. Under Bankruptcy Code section 502(a), a Proof of Claim is deemed allowed unless an objection is filed.

The phrase "to the best of my knowledge, information, and reasonable belief" is also a standard governing complaints and other pleadings, as well as affidavits. However, a Proof of Claim, similar to an affidavit, is prima facie evidence of the facts asserted therein. The burden is on an objecting party-in-interest to rebut the factual assertions contained in a Proof of Claim filed in accordance with Fed. R. Bankr. P. Rule 3001. Accordingly, the factual assertions contained in the Proofs of Claim are outcome determinative.

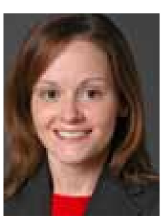
In a recent case from the U.S. Bankruptcy Court for the Southern District of Texas, *In re Gabriel G. Rodriguez*, 2013 WL 2450925 (Bankr. S.D. Tex. June 5, 2013), the lawyer for a creditor signed the creditor's Proof of Claim. Litigation ensued regarding the legitimacy of the facts set forth relating to the claim asserted in the Proof of Claim, and the debtor sought to depose the creditor's lawyer – as the signer of the Proof of Claim with respect to those facts.

The creditor and the creditor's lawyer asserted the attorney-client privilege and the work-product doctrine as the basis for the creditor's lawyer's refusal to answer a substantial number of questions regarding the claim asserted in the Proof of Claim. The court ruled that the Texas attorney-client privilege and the federal work-product privilege govern these issues.

The protection afforded by the attorney-client privilege may be waived either by consent or offensively. Generally, there are three elements for the application of offensive waiver: (1) the party asserting the privilege must be seeking affirmative relief; (2) the privileged information must be outcome determinative; and (3) disclosure of the confidential communication must be the only means by which the aggrieved party may obtain the evidence.

The court found that because the Proof of Claim seeks the allowance of the claim therein asserted and the facts of the Proof of Claim are determinative as to its allowance, the disclosure of the confidential communication from the person who signed the Proof of Claim is the person who must give the evidence regarding the content therein, and the attorney-client privilege had been waived. Similarly, because the creditor's lawyer signed the Proof of Claim, therein making factual assertions, the lawyer became a fact witness. As a result, the court held "questions which would normally be an improper intrusion into areas protected by the work-product privilege may now be proper questions seeking the basis for factual assertions made by a fact witness."

CROSS-BORDER INSOLVENCY: THE RISE OF THE SCHEME OF ARRANGEMENT



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Re Zlomrex International Finance SA [2013]EWHC 4605 (Ch)

Re Apcoa Parking (UK) Ltd and others - [2014] All ER (D) 49 (Apr))

BACKGROUND

Recently, the issue of restructuring foreign-law obligations using English schemes of arrangements has come to the fore, with various cases coming before the English High Court. This trend is, in part, because of a considerable increase in New York law high-yield bonds being issued into Europe. Although defaults on these bonds have been rare, as defaults on these bonds begin to rise, we can expect to see these restructurings becoming more commonplace.

Two such restructurings to come before the English courts this year are *Re Zlomrex International Finance SA*, which was decided in February, and *Re Apcoa Parking (UK) Ltd and others*, which was decided in April.

The evolution of this line of case law suggests that it is easier for companies with no clear links to the UK to choose England as the jurisdiction for their restructuring, thus allowing them to use a scheme of arrangement, rather than a formal insolvency process that is often the only option available in other European jurisdictions.

SCHEMES OF ARRANGEMENT

A scheme of arrangement is a court-supervised process under the Companies Act 2006, which aims to implement an agreement between a debtor and its creditors. It is *not* an insolvency process – which are largely governed by the Insolvency Act 1986, are usually precipitated by an event of default under finance documents,

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and, generally, involve the company losing control of its day-to-day management, with an insolvency practitioner taking over the company.

An English court has jurisdiction to sanction a scheme of arrangement in a company that has a "sufficient connection" to England. Two methods are often used to establish this sufficient connection:

1. Centre of Main Interests ("COMI"); or
2. Governing Law and Jurisdiction clauses in underlying finance documents

In the cases before the English courts recently, the interpretation of both of these methods have been widened, making the English courts more accessible to foreign companies wishing to make use of a scheme of arrangement. We will look at the two recent cases in more detail below.

Re Zlomrex International Finance SA

In this case, the English High Court sanctioned a scheme of arrangement for a French company with debts governed by New York loan documents. The case discusses the COMI criteria in the context of establishing jurisdiction, and looks at the court's approach to authorising a scheme that compromises foreign-law obligations, where the scheme itself is drafted so that it may take effect without being formally recognised by those foreign-law jurisdictions.

JURISDICTIONAL ISSUES

Zlomrex International Finance SA is registered in France and had, just before the hearing, moved its principal place of business and its principal office to London. Zlomrex had issued €118 million notes due 1 February 2014, which were subject to New York law and the non-exclusive jurisdiction of the New York courts. Zlomrex made no secret of the fact that it had moved its offices in order to come under the jurisdiction of the English courts for the purpose of the approval of a scheme of arrangement for the New York law-governed notes.

Continuing the recent, flexible approach of the English courts when dealing with jurisdiction, the court was satisfied that Zlomrex established a sufficient connection with England for the English courts to have jurisdiction to order a scheme of arrangement, as long as all other factors justified making such an order.

Re Apcoa Parking (UK) Ltd and others

In this case, the High Court sanctioned a scheme of arrangement in a foreign company that had no previous connection to the UK. The sole basis for establishing jurisdiction to approve the scheme was the amendment of the governing law and jurisdiction clauses of the company's principal finance documents to make them subject to English Law.

FACTUAL BACKGROUND

The Apcoa Parking Group is based in Germany and operates in a number of European countries. Apcoa was financed through a facilities agreement, due to mature 25 April 2014; however, by this date the group's ongoing restructuring was not going to be completed. Apcoa, therefore, wanted to use a scheme of arrangement to extend their debt's maturity date.

JURISDICTIONAL ISSUES

In recent years, a number of debt restructurings of non-UK incorporated companies have been accomplished, where English law governed the underlying finance documents that were the basis for the scheme of arrangement.

The existing case law in this area concerned finance documents that contained an English law and jurisdiction clause when they were negotiated and executed. Apcoa's finance documents, however, were governed by German law. Apcoa amended those finance documents to alter the governing law and jurisdiction clause from German law to English law in order to take advantage of an English law scheme of arrangement.

The court determined that through this alteration of the governing law clauses in the finance documents, there was a sufficient connection with the UK for them to claim jurisdiction and sanction a scheme of arrangement. It must be noted, however, that the judge did highlight the importance of the creditors being aware, at the time of the alteration of the finance documents, that the amendment was done in order to effect a scheme of arrangement under English law. In this case, Apcoa produced telephonic testimony that each of the creditors was fully informed, which was accepted as being sufficient by the court.

CONCLUSION

The *Zlomrex* case makes it clear that the courts will continue their flexible approach to the interpretation of a company's COMI. It also leaves open the possibility of an English scheme of arrangement compromising foreign-law obligations, without the scheme being approved by those foreign-law jurisdictions, which could lead to problems if creditors attempt to enforce their rights (which are now subject to the English scheme) in a different jurisdiction. Whether schemes will be allowed to progress without this recognition, and how such arrangements will work in practice, is yet to be seen.

The *Apcoa* judgment has established a relatively simple route for foreign companies to determine the jurisdiction of the court, even where there previously was no connection to the UK. This has widened the potential use of schemes of arrangement significantly as a company no longer needs to shift its COMI to the UK and can simply amend its finance documents.

It is clear that the use of an English-law scheme of arrangement has become an important part of a debtor's insolvency toolkit, even in circumstances where a link to the UK is not immediately apparent. Following these recent decisions, we can only expect the use of this mechanism to continue to gain in popularity and become more widespread.

EN BANC 8TH CIRCUIT FINDS TRADEMARK LICENSE AGREEMENT EXECUTED WITH APA NOT AN EXECUTORY CONTRACT

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In re Interstate Bakeries Corp., 751 F.3d 955 (8th Cir. 2014)

CASE SNAPSHOT

In an *en banc* decision, the Eighth Circuit revisited an earlier divided Eighth Circuit Court of Appeals' 2012 decision (discussed in February 2013 CR&B Alert), which found that a license agreement with outstanding obligations was an executory contract, even though the license agreement was paired with a $20 million asset purchase agreement that was substantially consummated. The Eighth Circuit, *en banc*, reversed the earlier decision, finding that the license agreement could not be analyzed separately from the contemporaneously signed asset purchase agreement, and the fact that the licensee had certain ongoing quality obligations under the license agreement, by itself, was insufficient to render the license agreement an executory contract in light of the consummated sale.

FACTUAL BACKGROUND

In 1995, Interstate Bakeries was ordered pursuant to an antitrust judgment to grant perpetual royalty-free licenses of certain of its products (comprising Hostess and Wonder brands). In 1996, Interstate Bakeries contemporaneously executed an asset purchase agreement and license agreement with Lewis Brothers Bakeries, whereby Interstate sold certain operations and assets to LBB for $20 million, and also granted a perpetual, royalty-free, exclusive license to use certain brands and trademarks. In 2004, Interstate and affiliates filed petitions for chapter 11, and in 2008, Interstate contended that the license agreement was executory, subject to assumption or rejection by the estate. LBB filed an adversary proceeding, seeking a declaratory judgment that the license agreement was not an executory contract. The bankruptcy court held that the license agreement was executory, the district court affirmed, and LBB appealed to the Eighth Circuit Court of Appeals. The Eighth Circuit affirmed, in a divided opinion, finding that the license agreement was a separate contract with outstanding terms requiring LBB to maintain the quality of the licensed products, and, thus, the license agreement was executory. In a dissenting opinion, Justice Colloton argued that the license agreement was integrated with the asset purchase agreement, and that all material obligations of the integrated agreement had been substantially performed, so that the license agreement was not truly executory. The antitrust division of the Department of Justice moved for a rehearing *en banc*, which was granted.

COURT ANALYSIS

Justice Colloton, who wrote the prior dissenting opinion, now wrote for the majority in yet another divided opinion. The court first analyzed the question of what precisely constituted the agreement at issue. Disagreeing with the prior decision, the court found that the contemporaneously executed asset purchase agreement and license agreement formed a single integrated contract, and that the prior decisions erred by looking at the license agreement as a stand-alone contract. In fact, the agreements themselves expressly stated that the two agreements comprised a single integrated contract.

The court held that in order for a contract to be executory under Bankruptcy Code section 365, a "bankruptcy court must find that both parties have so far underperformed that a failure of either to complete performance would constitute a material breach excusing the performance of the other." The court found that the prior decisions erred by finding that the license agreement was executory merely because the remaining obligations of LBB were material, namely LBB's obligations to maintain the quality of the licensed products. The court held that the "essence" of the agreement was the sale of the subject products, for which LBB paid $20 million, of which $8 million was allocated for intangible assets, including the subject license. LBB paid the purchase price, and the court found that its remaining obligations were immaterial compared "in the context of the entire agreement." Thus, the license agreement was not executory and not subject to rejection by the debtor.

Notably, the 2012 Eighth Circuit decision attempted to distinguish itself from the factually similar decision in *In re Exide Technologies*, 607 F.3d 957 (3d Cir. 2010), in which the Third Circuit found that a perpetual license agreement paired with a consummated sale was not an executory contract. Here, *en banc*, the Eighth Circuit now aligned itself with the Third Circuit's decision in *Exide*.

PRACTICAL CONSIDERATIONS

The Eighth Circuit's prior decision cast considerable uncertainty as to whether "perpetual licenses" paired with a sale would, in fact, continue to be perpetual in the bankruptcy world. This most recent decision should give more comfort to licensees that have fully consummated a sale in connection with the perpetual license; however, given the divided nature of the opinion, any licensees should seek the advice of experienced bankruptcy counsel before drafting any license agreements.

Perhaps most interesting is that by finding that the contract was not executory, the Eighth Circuit side-stepped the issue of whether the rejection of a trademark license agreement terminates the licensee's use of the trademark. The Eighth Circuit acknowledged the developing split in authority between the Third Circuit's decision in *Lubrizol Enterprises* (finding that trademark license rights are terminated upon rejection of the license agreement) and the Eighth Circuit's decision in *Sunbeam Enterprises* (disagreeing with *Lubrizol*, and finding that rejection did not necessarily terminate a trademark license). Congress is currently considering the expansion of Bankruptcy Code section 365(n) protections to trademark licenses in the "Innovation Act of 2013," but uncertainty still remains about the rights of trademark licensees in bankruptcy.

release despite numerous opportunities to bring the existence and breadth of the release provision to his attention. While the bankruptcy court did not accuse the attorneys for the debtor and indenture trustee of intentionally misleading or deceiving the court, the court did find the actions of counsel very troubling and concluded that the third-party releases were not made clear to him or to the parties they were intended to bind. He also found that the bondholders were not bound by the third-party releases based upon his finding that the disclosure of the third-party release provisions in the settlement agreement and disclosure statement was inadequate.

The district court heard the initial appeal of the bankruptcy court's decision and affirmed same. The Third Circuit analyzed the bankruptcy court's decision using the abuse of discretion standard. However, it did exercise de novo review over the procedural aspects of the bankruptcy court's decision to revisit and ultimately amend its earlier determination about the adequacy of disclosure within the settlement agreement and the disclosure statement.

COURT ANALYSIS

The Third Circuit noted that the third-party release acts as an injunction because in releasing the bond trustee from any liability to creditors, it essentially enjoins bondholders under the applicable bond documents from bringing actions against the trustee. Because the release provision functions similarly to an injunction, the court held that Federal Rule of Bankruptcy Procedure 3016(c), which governs the manner in which injunctions must be disclosed, also applies to a release that essentially serves the same purpose. Bankruptcy Rule 3016(c) requires that any injunction contained within a plan and disclosure statement must describe in specific and conspicuous language (bold, italic or underlined texts) any acts to be enjoined and the entities subject to the injunction.

The court noted that based upon the facts, the bankruptcy judge did not abuse his discretion in denying approval of the third-party release. The court agreed with the bankruptcy court that the disclosure statement's failure to highlight the third-party release or to italicize, underline or boldface it was sufficient to render its disclosure inadequate. Further, the plan was similarly deficient in terms of adequately disclosing the third-party release, especially in light of all of the other information contained therein. The release was not included within key sections of the plan, such as: (1) Summary of Key Terms of the Plan; (2) Summary of Distributions Under the Plan; (3) The Bond Trustee Litigation; (4) Treatment of Claims Against the Debtors; and (5) Conditions Precedent to Confirmation of the Plan.

The court also rejected the indenture trustee's argument that it was incorrect for the bankruptcy court to reverse its initial ruling approving the settlement agreement in toto. Under Federal Rule of Bankruptcy Procedure 9024, which incorporates Rule 60(b) of the Federal Rules of Civil Procedure, bankruptcy courts, like district courts, may revisit and reconsider prior orders in the case of "mistake, inadvertence, surprise….excusable neglect," "newly discovered evidence" or "any other reason that justifies relief." Because the bankruptcy judge was unaware of the release that was due "in no small part to the parties' failure to disclose adequately or otherwise draw the Court's attention to the" release provision, he was correct to revisit his earlier order approving the agreement that contained the release.

While the Third Circuit noted that there are non-consensual third-party releases that are appropriately included in plans of reorganization, such releases must be supported by a finding that the release is "both necessary to the plan and given in exchange for fair consideration." *In re Continental Airlines*, 203 F.3d 203, 214. (3d Cir. 2000). In *Continental*, the court identified the hallmarks of a permissible non-consensual release as "fairness, necessity to the reorganization, and specific factual findings to support these conclusions." *Id.* at 214. In this case, because disclosure of the non-consensual third-party release was not adequate, there was no showing that the release was fair to the parties being impacted by it, i.e., the bondholders.

PRACTICAL CONSIDERATIONS

While this decision may be non-precedential, it is very important nonetheless. The Third Circuit made it quite clear that the burden is on the parties desiring the inclusion of a third-party release to make sure it is adequately disclosed to those persons affected by it, and "failure to do so in a clear and conspicuous manner risks excision of the release from the plan."

LLC RIGHT OF FIRST REFUSAL AN EXECUTORY CONTRACT

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In re Ichiban, Inc., No. 06-10316-RGM (Bankr. E.D. Va., Jun. 30, 2014)

CASE SNAPSHOT

The court considered whether a right of first refusal included in a limited liability company's operating agreement was an executory contract that may be assumed or rejected under section 365(a). The bankruptcy court found that the right of first refusal was an executory contract that either expired by its own terms or was rejected by the trustee, and the court granted the trustee's motion to sell a membership interest and promissory note over the company's objection.

FACTUAL BACKGROUND

The bankruptcy estate included a 16.333 percent membership interest in a limited liability company and a $600,000 promissory note payable to the debtor by the company. After a prospective bidder expressed an interest in purchasing these assets, the trustee—in order to obtain the best price—proposed to sell the assets as a single lot at public auction. The company objected on the ground that its operating agreement contained a right of first refusal—first to the company, and then to its members. According to the company, it had the right at the conclusion of an auction to purchase the membership interest at the highest bid. The parties agreed that the operating agreement contained a right of first refusal, but disputed whether it was executory or non-executory. If it was executory, it was rejected; but if it was non-executory, unless it expired by its own terms, it may not be rejected and remains enforceable.

COURT ANALYSIS

The court began its analysis by noting that there is no *per se* rule that characterizes all limited liability company operating agreements as either executory or non-executory. Rather, each is individually analyzed. The court observed that the Fourth Circuit in *Lubrizol Ent., Inc. v. Richmond Metal Finishers, Inc. (In re Richmond Metal Finishers, Inc.*), 756 F.2d 1043, 1045 (4th Cir. 1985) adopted the following definition: "a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing performance of the other." With that definition in mind, the court considered whether both parties had unperformed obligations.

Turning to the language of the right of first refusal provision in the operating agreement, a selling member "first must offer to Transfer the Subject Interest to the Company at the Sales Price." The court found that if a selling member fails to do so, the member is in material breach of the operating agreement.

The company argued that a naked right of first refusal—i.e., a non-selling member's right to purchase a selling member's interest where the right automatically expires on the failure to affirmatively exercise the right within a reasonable time period, and where the non-selling member's only obligation if it exercises the right is to pay the purchase price—is not an executory contract. The court agreed that a naked right of first refusal was not an executory contract, noting that the failure of the non-selling member to exercise the right of first refusal is not a breach because the non-selling member is under no obligation to exercise the right.

The contract at hand, however, provided that if the company did not exercise its right of first refusal, unperformed obligations remained. Turning again to the specific language of the operating agreement, the court held that the failure of the company to give required contractual notice was a material breach that prejudiced the selling member because the member could not proceed with the transaction without other members exercising their right of first refusal or allowing the right to expire. The agreement imposed additional obligations, including: members were required to agree on the sales price; if the sales price could not be agreed upon, the members must select two appraisers to determine the value; and members were required to execute additional documents in connection with the sale "to preserve the limited liability of the members."

Regardless of whether each obligation was viewed as a separate obligation or a single comprehensive transaction, the court held that the right of first refusal in the operating agreement was an executory contract. The court explained that "[t]he transaction is exhaustively formulated with numerous steps and obligations. While some may not individually constitute a material breach if not performed, they are part and parcel of a single transaction that is executory on the part of all parties."

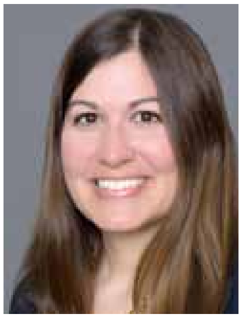
Next, the court considered whether the right of first refusal had expired or been rejected. Under Bankruptcy Code section 365(d)(1), the trustee has 60 days to assume or reject a contract for personal property; thus, the trustee argued that its failure to do so was a rejection of the operating agreement's right of first refusal. The court agreed. Moreover, the court found that the company's time for exercising the right of first refusal had expired because the company failed to act within the 30-day period provided in the operating agreement, when measured from the date the involuntary petition was filed, thus waiving its right of first refusal. Based on the state of the record, however, the court could not determine whether members' right of first refusal expired.

The court held that the trustee could exercise his discretion to sell the membership interest and the note as a package or separately, concluding that the operating agreement was executory and that the right of first refusal—if it had not already expired—was rejected when the trustee failed to assume it.

PRACTICAL CONSIDERATIONS

If a contract is executory, the trustee may reject a right of first refusal provision; but if the contract is non-executory, the provision may not be rejected and remains enforceable (unless the provision expired earlier). Because limited liability company operating agreements are not subject to a *per se* rule characterizing such agreements as executory or non-executory, courts must consider the particular contract language on a case-by-case basis.

LENDER NOT ENTITLED TO PRE-PETITION DEFAULT INTEREST DUE TO FAILURE TO EXERCISE OPTION TO ACCELERATE



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In re Shree Mahalaxmi, Inc. d/b/a Super 8, Case No. 13-50040-CAG (Bankr. W.D. Tex., Feb. 5, 2014)

CASE SNAPSHOT

The bankruptcy court found that a secured lender's claim for default interest was not mature and earned as of the petition date. Although an event of default occurred under the loan documents when the debtor encumbered the property with two junior liens, the loan documents did not provide for the imposition of default interest upon the occurrence of a nonpayment default. Furthermore, the secured lender failed to exercise its option to accelerate the debt that could have triggered a payment default. Therefore, the default interest was not mature and earned as of the petition date, and the secured lender was not entitled to include pre-petition default interest in its proof of claim.

FACTUAL BACKGROUND

Debtor Shree Mahalaxmi, Inc. d/b/a Super 8 is a Texas corporation that owns and operates a hotel property. In 1996, the debtor received a loan from Merrill Lynch Credit Corporation in the amount of $1,650,000 that was secured by a deed of trust. Several years after the loan was made, the debtor further encumbered the property by placing two junior liens on the hotel in favor of a third-party bank.

The debtor filed for chapter 11 bankruptcy January 7, 2013. On May 10, 2013, U.S. Bank, National Association, as Trustee for the registered holders of certain mortgage pass-through certificates (the "Trust"), filed a proof of claim in the debtor's bankruptcy in the amount of $618,878.19 for obligations due and owing under the loan from Merrill Lynch. After the Trust filed its proof of claim, the special servicer for the loan put the note up for auction and discovered the two junior liens; the Trust was then informed of the two junior liens. The Trust then amended its proof of claim to include pre-petition default interest on the basis that the junior liens triggered a default under the loan documents, thereby increasing the claim by approximately $400,000.

The debtor objected to the Trust's amended proof of claim, arguing that the loan documents required prior notice and an opportunity to cure before imposing default interest, and the note did not provide for automatic accrual of default interest. In response, the Trust argued that there was no requirement for notice, and that the loan documents did not provide any grace periods for this type of default.

COURT ANALYSIS

The court began its analysis by noting that pre-petition claims for interest and fees are allowable under section 502 of the Bankruptcy Code as part of an underlying secured claim. However, section 502 provides that a claim for pre-petition interest is allowed only if it is matured and earned as of the petition date. Therefore, the court had to determine whether the Trust's claim for default interest was matured and earned as of the date the bankruptcy was filed.

The court found that an event of default occurred under the loan documents when the debtor encumbered the property with the two junior liens, a fact that the debtor did not dispute. However, the court interpreted the loan documents to require a payment default to trigger default interest. Specifically, the note provided (with a similar provision in the deed of trust):

> Should the ... (ii) principal amount or any amount thereof, together with any other amounts due and payable hereunder, not be promptly paid on the maturity date or any earlier date when the same shall be

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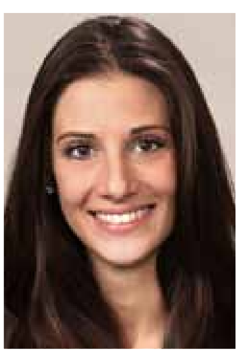
NEW VALUE CONTRIBUTION BY ITSELF NOT ENOUGH TO SATISFY NEW VALUE EXCEPTION



Chrystal Puleo
Associate, New York

In re RAMZ Real Estate Co., LLC (Bankr. S.D.N.Y., 2014)

CASE SNAPSHOT

The U.S. Bankruptcy Court for the Southern District of New York held that a class of claims consisting solely of a secured tax claim was impaired for purposes of voting on the debtor's chapter 11 plan, where the plan provided for the full payment of the tax claim but allowed for the payment of post-petition interest at less than the statutorily provided interest rate, and that such impairment was not artificial for purposes of satisfying the requirements of section 1129(b) of the Bankruptcy Code. The court went on, however, to deny confirmation of the debtor's plan, after finding that the chapter 11 debtor failed to meet its burden under the new value exception to the absolute priority rule.

FACTUAL BACKGROUND

The debtor, RAMZ Real Estate Co., LLC, owned two pieces of commercial real property in upstate New York. One of the properties, in Kingston, N.Y., was encumbered by a first mortgage in favor of Community Preservation Corporation (CPC) in the amount of $744,000. The debtor commenced its chapter 11 case after CPC brought a foreclosure action in state court, and the bankruptcy court entered an order valuing the Kingston property at $485,000, significantly less than the outstanding first mortgage debt.

When the debtor filed its chapter 11 plan of reorganization, the plan provided for the treatment of seven classes of claims, three of which were impaired, and two of which were held by CPC. Class 3 consisted of the secured portion of CPC's claim, and Class 6 consisted of CPC's unsecured deficiency claim, along

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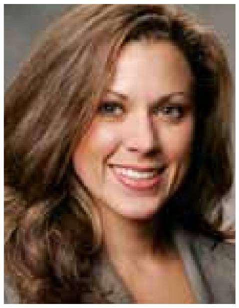
COURT FINDS DEBTOR GERRYMANDERED TRADE CREDITOR CLASS, REJECTS 'LEGITIMATE BUSINESS JUSTIFICATION' RATIONALE



Alison Wickizer Toepp
Associate, Richmond

CWCapital Asset Management, LLC v. Burcam Capital II, LLC, Nos. 5:13-cv-278-F and 5:13-cv-279-F (E.D.N.C. Jun. 24, 2014)

CASE SNAPSHOT

In the case below (which was discussed in our June 2013 Alert), the secured creditor cast 18 ballots against approval of the plan—one for each of its secured claims (Class 3 and Class 4) and one for each of the 16 unsecured claims it had purchased or had otherwise been assigned. Only two votes—one each from Class 5 and 6—were cast for plan approval; the remaining 15 creditors did not vote. Thereafter, the debtor filed a modified plan to create a separate class of unsecured claims comprised solely of claims the secured creditor had purchased. Relying on the cramdown provisions of section 1129, the bankruptcy court—over the secured creditor's objections—confirmed the debtor's modified chapter 11 plan and denied the secured creditor's motion to dismiss the chapter 11 case. On appeal, the U.S. District Court for the Eastern District of North Carolina considered whether the debtor's separate classification of the secured creditor's unsecured claims was permissible. Taking the totality of the evidence into consideration, the district court held the bankruptcy court committed clear error when it found that the debtor had a legitimate business justification (purportedly, to pay trade creditors earlier than other unsecured creditors) for creating a separate class after the votes had been cast.

FACTUAL BACKGROUND

The debtor, the owner of a large commercial real estate development, financed the purchase of the development with two promissory notes secured by deeds of trust on the property. The two loans are referred to as "Note A" and "Note B." The debtor scheduled the loans as $11.4 million and $782,000, respectively, while the secured creditor filed proofs of claims in the amounts of $14 million and $1.1 million, respectively. The property was valued at between $17.3 million and $18.5 million. The unsecured claims totaled less than $46,000.

The debtor's chapter 11 plan divided the unsecured claims into two classes: general unsecured (Class 5) and small unsecured (Class 6). Secured claims were divided into Class 3 and 4. The plan provided for full payment to all creditors. In an effort to block the plan, the secured creditor (holder of the Class 3 and 4 claims) acquired 16 unsecured claims that comprised approximately 68 percent of the unsecured claims (approximately $31,280 of the total $46,000). The secured creditor filed ballots for each of those claims rejecting the plan. Only two creditors, with claims totaling approximately $6,000, voted to accept the plan. The majority of unsecured creditors did not cast ballots. None of the trade creditors cast votes.

The votes were not sufficient to confirm the plan. The debtor obtained a continuance of the confirmation hearing and used that time to modify its plan to create a third class of unsecured claims comprised solely of the unsecured claims acquired by the secured creditor—thus placing all the rejecting votes in one category. The modified plan could then be confirmed under Bankruptcy Code section 1129, in a process known as a "cramdown," over the dissenting votes of the secured creditor that owned approximately 68 percent of the unsecured claims, and that held secured claims representing nearly 80 percent of the total value of the estate.

The secured creditor argued that the plan should be dismissed, because the debtor created the separate class solely to manipulate the vote to confirm the plan. The debtor argued that the separate classification was appropriate because the debtor needed to pay trade creditors on a shorter time frame than the claims owned by the secured creditor in order to maintain goodwill with the trade creditors. The bankruptcy court accepted the debtor's argument, finding that the debtor "articulated a 'legitimate business reason' for the separate classification" of the secured creditor's unsecured claims.

COURT ANALYSIS

The question before the district court on appeal was whether the separate classification of the secured creditor's unsecured claims was permissible. The district court based its analysis in large part on *In re Bryson Properties XVIII*, 961 F.2d 496 (4th Cir. 1992), a case in which the Fourth Circuit held that although a debtor has some flexibility to place unsecured claims into different classes, the debtor's discretion is not unlimited. Specifically, the Fourth Circuit, building on authority from other circuits, held that "although separate classification of similar claims may not be prohibited, it 'may only be undertaken for reasons independent of the debtor's motivation to secure the vote of an impaired, assenting class of claims.'" 961 F.2d. at 502.

If a debtor can articulate a "legitimate business justification" for separate classification of unsecured claims, courts generally allow separate classification. The district court noted that the justification advanced by the debtor—the need to pay trade creditors on a different timetable than other unsecured creditors—is the "most frequently-advanced 'legitimate business justification.'"

Noting that "in the appropriate case paying trade creditors on a shorter time frame than larger institutional creditors is a legitimate business justification for separate classification of otherwise similar unsecured claims," the district court nonetheless held that the bankruptcy court's findings were clearly erroneous because "[t]he only evidence supporting [debtor's] purported justification in this case was counsel for the debtor's proffer at the confirmation hearing that [debtor] 'desired' to pay trade creditors first and testimony from the debtor's principal… that '[the secured creditor is] different from…other trade creditors that we want to continue using.'" In the district court's view, neither the debtor's counsel nor its principal could speak for the trade creditors, and "both had strong incentives to oversell [debtor's] business justification." Moreover, none of the trade creditors even cast a vote.

The district court also considered that the debtor only sought to create a separate class of claims after it learned the secured creditor had purchased 16 claims and cast ballots for each of those claims rejecting the plan. The district court reasoned: "This is obvious gerrymandering. If paying the trade creditors was so important to [debtor], it could have classified them differently from the beginning." As an additional consideration, the trade creditors' claims totaled less

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> due and payable (whether by acceleration or otherwise), then in such event, the rate of interest to be paid on the principal amount and all such other amounts shall be increased to the default rate and shall be computed from the date such amounts were initially due and payable through the date, if any, upon which such amounts are actually and fully paid. ... The foregoing provisions shall not be construed as a waiver by holder of its right to pursue any other remedies available to it under the deed of trust or any other loan document, nor shall it be construed to limit in any way the application of the default rate.

Under the loan documents, the court explained that the imposition of default interest was conditioned upon a payment default—whether at an accelerated due date or otherwise. Because the imposition of the junior liens was not a payment default, the court found that default interest did not automatically begin to accrue.

Although default interest did not automatically begin to accrue for a nonpayment default, the court found that the loan documents provided the option to accelerate the debt as a remedy for an event of default. If the borrower did not pay the amount due at the accelerated maturity date, the loan documents provided that the lender may begin imposing the default rate of interest. Thus, to trigger default interest for a nonpayment event of default, the court found that the lender first had to exercise its option to accelerate the loan.

As such, the court had to then determine whether the Trust had exercised its option to accelerate the loan. The court explained that under applicable state law, acceleration required two notices by the lender: (1) notice of intent to accelerate and (2) notice of acceleration. The court found that the Trust did not effectively accelerate the debt before the debtor filed its petition, which, given that the Trust was not aware of the default prior to bankruptcy, was not surprising.

The court then turned to the waiver provision in the note to determine whether the debtor had waived its two separate rights to notice of intent to accelerate and notice of acceleration. The note contained a standard waiver provision, providing in pertinent part that: "Maker hereby expressly waives the right to receive any notice from holder with respect to any matter for which this note does not specifically and expressly provide for the giving of notice by holder to maker." The court concluded that, at best, this waived the notice of acceleration, but was not sufficient to waive the notice of intent to accelerate. As such, the court found that the Trust's claim for default interest did not accrue pre-petition, and the Trust was not entitled to include pre-petition default interest in its proof of claim.

PRACTICAL CONSIDERATIONS

Lenders often assume that default interest will begin to accrue when there is an event of default. However, as demonstrated by this case, the loan documents may not provide for the automatic imposition of default interest upon the occurrence of *any* event of default. Therefore, parties should be careful when this issue arises to review the terms of the loan documents.

New Value Contribution By Itself Not Enough To Satisfy New Value Exception—continued from page 8

with the debtor's other unsecured claim. The plan provided for a distribution of approximately 10 percent to the holders of claims in Class 6 over the course of 60 months. Class 4, the remaining impaired class, consisted solely of a secured property tax claim held by Ulster County, New York.

Pursuant to the debtor's plan, Class 7, which was unimpaired, contained the interests of the debtor's sole existing equity holder. The plan provided for the existing equity holder to retain 100 percent of his ownership interest, although he would not receive any dividends or payments under the plan. CPC (Class 3 and Class 6) voted to reject the plan and filed an objection to confirmation of the debtor's plan, arguing, among other things, that the plan contained classes that were artificially impaired and that the plan violated the absolute priority rule. Class 4, the tax claim, was the only impaired class of creditors that voted to accept the plan.

COURT ANALYSIS

In its plan objection, CPC first argued that the debtor's plan could not be confirmed because Ulster's claim was not impaired for purposes of section 1129, since Ulster was to be paid in full over five years at 9 percent interest, instead of the statutory requirement of 12 percent interest. CPC argued that this impairment of Ulster's claim was "artificial" and manufactured solely to obtain approval by at least one impaired class of creditors.

The bankruptcy court considered the language of section 1124 of the Bankruptcy Code, which provides, in relevant part, that a claim is impaired unless the plan "leaves unaltered the legal, equitable, and contractual rights to which such claim or interest entitles the holder of such claim or interest…." The court found that where a section of the Bankruptcy Code alters a creditor's claim, that claim is not considered "impaired" by the plan, as it is not the plan, but instead the Bankruptcy Code, that alters its treatment. Looking at section 511 of the Bankruptcy Code, which provides that the rate of interest to be paid on tax claims is to be determined under applicable nonbankruptcy law, the bankruptcy court held that because Ulster was receiving less interest on its claim than it was entitled to receive under New York Real Property Tax Law, the claim was impaired for purposes of voting on the debtor's plan.

The court also concluded that the debtor had legitimate business purposes for impairing Ulster's claim and, therefore, its claim was not "artificially impaired." In particular, the court found that the difference in the interest rates of 3 percent was not de minimis, especially "in light of the current financial situations that many government entities have faced in the last several years." The court further noted that Ulster could have demanded to be paid the full 12 percent interest and yet it chose to accept the plan. The court also went on to suggest that an examination into the debtor's possible motivations for impairing a claim may be irrelevant, stating that "nothing in the Code prevents a debtor from negotiating a plan in order to gain acceptance and nothing requires a debtor to employ effort in creating unimpaired classes."

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TROUBLING ACTIONS OF CHAPTER 15 FOREIGN REPRESENTATIVE DO NOT RISE TO STATUTORY CONDITIONS TO WITHDRAW RECOGNITION

Chrystal Puleo
Associate, New York

In re Cozumel Caribe, S.A. de C.V., 508 B.R. 330 (Bankr. S.D.N.Y. 2014)

CASE SNAPSHOT

The U.S. Bankruptcy Court for the Southern District of New York held that U.S. courts cannot withdraw recognition of a chapter 15 proceeding as a sanction for misconduct; they can do so only when the grounds for granting recognition no longer hold, or when continued recognition would be "manifestly contrary to U.S. public policy."

FACTUAL BACKGROUND

The debtor, Cozumel Caribe, and seven non-debtor affiliates are Mexican companies that own and operate resort properties in Mexico, in particular, the Hotel Park Royal Cozumel. CT Investment Management Co., LLC (CTIM) loaned $103 million to the debtor, secured in part by hotel revenues that were to be deposited into various lockbox accounts, including one in New York containing about $8 million that was controlled by CTIM. The debtor's principal and certain of the non-debtor affiliates guaranteed the debtor's obligations to CTIM pursuant to a guarantee agreement that was governed by New York law and provided for New York jurisdiction.

In 2010, Cozumel Caribe filed a "concurso mercantile," a commercial bankruptcy proceeding in Mexico. The debtor and the non-debtor affiliates stopped making payments to CTIM after the bankruptcy filing, and ceased depositing hotel revenues into the CTIM lockbox. CTIM attempted to sue the guarantors in both Mexican and New York courts to recover the debt and was unsuccessful. On May 27, 2010, the Mexican court entered an ex parte order barring CTIM or any other party from taking any action to collect any of the debt from the property of Cozumel Caribe or its non-debtor affiliates, specifically any funds in the CTIM lockbox account; and the U.S. District Court for the Southern District of New York granted comity to stay CTIM's actions against the guarantors.

The debtor then commenced a chapter 15 case in the U.S. Bankruptcy Court for the Southern District of New York, which recognized the concurso mercantile proceeding as a foreign main proceeding. CTIM filed an adversary proceeding in the bankruptcy court seeking to recover the lockbox funds; however, the bankruptcy court granted comity to stay the adversary proceeding.

A year later, CTIM moved for the bankruptcy court to terminate its recognition of the debtor's foreign proceeding pursuant to section 1506 of the Bankruptcy Code, which allows a court to refuse to grant recognition of a foreign proceeding if doing so would be "manifestly contrary to U.S. public policy," and section 1517(d), which allows for recognition of a foreign proceeding to be modified or terminated "if it is shown that the grounds for granting it were fully or partially lacking or have ceased to exist." CTIM alleged that the continued recognition of the concurso mercantile proceeding would be manifestly contrary to U.S. public policy because the debtor (1) took inconsistent positions in the U.S. and Mexican proceedings on the issue of the amount of CTIM's claim; (2) used the bankruptcy court's recognition order to block enforcement of the guarantee action against non-debtor affiliates; (3) tried to void the guarantee in a Mexican court; (4) attempted to transfer assets and cash to a new company for no consideration in violation of the guarantee agreement; (5) engaged in conduct that delayed the concurso mercantile proceeding, causing an indefinite suspension of CTIM's enforcement of rights; and (6) failed to properly update the bankruptcy court on the status of the proceedings in Mexico.

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Court Finds Debtor Gerrymandered Trade Creditor Class, Rejects 'Legitimate Business Justification' Rationale—continued from page 9

than $15,000, and the debtor at the time of the hearing had more than $650,000 cash on hand that, in the district court's view, "could have [been] used to pay the trade creditors immediately," if the debtor truly was concerned with maintaining important relationships with its trade creditors.

The district court further found that the bankruptcy court erred as a matter of law. The district court explained that "[t]he bankruptcy court's opinion, which wholly credited the debtor's proffered justification despite substantial record evidence of gerrymandering, suggests that paying trade creditors more quickly is essentially a *per se* permissible business justification. That is not the law in the Fourth Circuit."

Finally, the district court rejected the debtor's arguments that separate classification was warranted because the trade creditor claims received different treatment under the modified plan, holding that under *Bryson Properties*, both different treatment and a legitimate business purpose are required.

The district court reversed the bankruptcy court's orders denying the secured creditor's motion to dismiss and confirming the modified plan, and remanded with instructions that the debtor still may pursue an argument that the secured creditor's no votes were in bad faith—however, the district court instructed that such an argument should be asserted by "a motion under section 1126(e), not a transparent attempt to gerrymander the votes under section 1122."

PRACTICAL CONSIDERATIONS

A debtor's efforts to create a separate class must take into account the totality of the circumstances. Mere assertions by counsel and the debtor's principal that the debtor desires to pay trade creditors as a legitimate business justification will not suffice, particularly when the separate class was created only after votes were cast rejecting the proposed plan.

PROSPECTIVE DIP LENDER ALLOWED BREAK-UP FEE, BUT NOT ADMINISTRATIVE PRIORITY

Christopher Rivas
Associate, Los Angeles

In re C&K Market, Inc., 2014 WL 1377573 (Bankr. D. Or. 2014)

CASE SNAPSHOT

A prospective DIP lender that had executed a pre-petition term sheet with the debtor sought administrative expense priority for its pre-petition break-up fee under Bankruptcy Code section 503(b), when the debtor ultimately signed a deal with an alternative DIP lender. The bankruptcy court allowed the rejected DIP lender a pre-petition claim for the break-up fee, but denied the claim any administrative priority.

FACTUAL BACKGROUND

Debtor C&K operated grocery stores and pharmacies in Southern Oregon and Northern California. Facing financial difficulties, C&K entered into "arduous" negotiations for a DIP facility with its primary lender, U.S. Bank, in the summer of 2013. Facing difficulties in the negotiations, C&K negotiated and signed a term sheet with an alternative lender, Sunstone Business Finance, the terms of which included a $250,000 break-up fee, which would be granted administrative priority in the event C&K entered into a DIP loan with another lender. The Sunstone term sheet provided for financing in the range of $5 million to $7.5 million.

Ultimately, C&K obtained DIP financing on more favorable terms with U.S. Bank. Upon filing for bankruptcy protection, Sunstone filed a proof of claim for the break-up fee and sought administrative priority for the fee pursuant to Bankruptcy Code sections 503(b)(1)(A) and 503(b)(3). U.S. Bank objected to the claim, arguing that there should be no pre-petition claim, let alone a priority claim.

COURT ANALYSIS

The bankruptcy court addressed two issues: the validity of the claim and the priority of the claim. The court found that Sunstone had a valid claim for $250,000, disagreeing with U.S. Bank's arguments that: (1) the break-up fee was a fraudulent transfer; (2) the term sheet was missing material terms, including the amount of financing and was "vague and illusory"; and (3) the break-up fee was excessive and not in the best interests of the estate. The court addressed each objection in turn, finding that (1) there was no "transfer," just the agreement to pay a fee in the future; (2) the term sheet's range of financing figures was sufficiently specific for a term sheet; and (3) there was no admissible evidence of what a reasonable break-up fee would have been, but there was evidence that Sunstone would not have executed the term sheet without the $250,000 break-up fee.

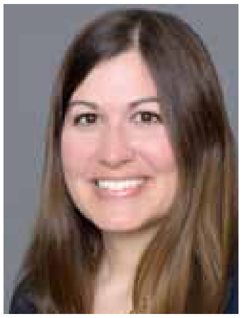
Regarding priority, the court found that Sunstone was not entitled to priority under Bankruptcy Code sections 503(b)(1)(A) or 503(b)(3). The court found that administrative priority was warranted under Bankruptcy Code section 503(b)(1)(A) only where the claim "(1) arose from a transaction with the debtor-in-possession as opposed to the preceding entity (or, alternatively, that the claimant gave consideration to the debtor-in-possession); and (2) directly and substantially benefitted the estate." The court found that Sunstone failed to satisfy these criteria because its claim arose pre-petition, and that, in any case, Sunstone's term sheet did not benefit the estate because U.S. Bank did not know the terms of the deal with Sunstone, and U.S. Bank's decision to enter into a more favorable DIP financing arrangement with C&K did not appear to be influenced by the proposed deal with Sunstone.

As to Bankruptcy Code section 503(b)(3), only "substantial contributions" to the case warranted priority, and only if the claim was an "actual, necessary expense" of the claimant. The court disposed of Sunstone's claim under this subsection, finding that the break-up fee was not "an actual expense of Sunstone—it's not an expense at all."

PRACTICAL CONSIDERATIONS

Break-up fees are a common term of any negotiated DIP financing, just as with break-up fees for stalking horse bidders. However, such fees often receive strict scrutiny by bankruptcy courts, particularly where they arise from pre-petition negotiations. Potential DIP lenders should be aware that, although they may be entitled to a fee as a bankruptcy claim, if the fee arose pre-petition, they may not be entitled to anything more than general unsecured status.

COURT REJECTS CREDITOR'S COMPLAINT SEEKING RECHARACTERIZATION



Melissa Mickey
Associate, Chicago

In re Optim Energy, LLC, et al., Case No. 14-10262(BLS) (Bankr. D. Del., May 13, 2014)

CASE SNAPSHOT

The bankruptcy court in Delaware denied an unsecured creditor's motion for derivative standing to pursue claims for recharacterization, equitable subordination and breach of fiduciary duties on behalf of the debtors against pre- and post-petition lenders, who were also the debtors' equity sponsors. The court held that the unsecured lender failed to state colorable claims in the proposed complaint against the secured lenders.

FACTUAL BACKGROUND

In January 2007, Cascade Investments, LLC, through its wholly owned subsidiary ECJV Holdings, LLC and PNM Resources, Inc., formed Optim Energy, LLC. Optim and its subsidiaries – the debtors in this case – own and operate three power plants in Texas. ECJV owns 100 percent of Optim and indirectly owns the other debtors.

Optim entered into an unsecured credit facility with Wells Fargo, and Optim's obligations under this credit facility were guaranteed jointly and severally by Cascade and ECJV. The debtors entered into a guaranty reimbursement agreement under which they agreed to reimburse Cascade and ECJV for any payments made to Wells Fargo pursuant to the credit facility guarantees. As a result of the reimbursement agreement, the debtors were required to pay quarterly fees to Cascade, as collateral agent, and Cascade and ECJV took security interests in substantially all of the debtors' assets. Additionally, Wells Fargo, Cascade and ECJV agreed that the guarantee claims of Cascade and ECJV would be subordinate to those of Wells Fargo.

In 2011, PNMR, Cascade and ECJV restructured Optim, which led to capital contributions by ECJV that were used to pay down the Wells Fargo credit facility. Pursuant to the restructuring agreement, ECJV's ownership in the debtors was increased to 99 percent and PNMR's ownership was reduced to 1 percent. The restructuring agreement also gave ECJV the option to purchase PNMR's remaining 1 percent interest in Optim for fair market value. ECJV exercised this option January 3, 2012, purchasing PNMR's interest for a price of $0.

In 2013, the debtors fell behind on certain payments to Cascade for guaranty fees, and the parties entered into a forbearance agreement that expired February 14, 2014. On February 11, 2014, as the debtors were preparing to file for bankruptcy, Cascade wired funds to Well Fargo for the outstanding amounts due on the debtors' loan. This triggered the debtors' obligations to Cascade and ECJV under the guaranty reimbursement agreement and security agreement. On February 14, 2014, the debtors filed for bankruptcy. Following the bankruptcy filing, the bankruptcy court approved debtor-in-possession financing from Cascade and ECJV in an order setting deadlines for parties to challenge the pre-petition indebtedness.

Walnut Creek, the debtors' largest non-insider general secured creditor, filed a motion asking the bankruptcy court to grant it standing to challenge the debtors' pre-petition indebtedness. Walnut Creek argued that it had colorable claims

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Troubling Actions of Chapter 15 Foreign Representative Do Not Rise to Statutory Conditions to Withdraw Recognition—continued from page 11

COURT ANALYSIS

While the bankruptcy court expressed concern about the debtor's inconsistent positions on the amount of CTIM's claim, the court found that CTIM could not use the bankruptcy court to "invalidate or circumvent proceedings in the Mexican courts." The court found CTIM's interests were sufficiently protected as long as the lockbox funds remained in New York, and encouraged CTIM to seek relief from the Mexican court, where its remedies had not yet been exhausted.

The bankruptcy court denied CTIM's motion to terminate recognition of the concurso mercantile proceeding, because it found that CTIM had not shown that the grounds for the original grant of recognition had ceased to exist under section 1517(d), or that continued recognition would be manifestly contrary to U.S. public policy under section 1506. The court noted that the public policy exception embodied in section 1506 should be "narrowly interpreted."

The court also denied CTIM's motion because it found that any decisions made by the Mexican court were not yet final and may be subject to further proceedings. The court said that if and when the debtor sought comity of a Mexican Order or Judgment on CTIM's claim, it would consider whether the relief is available under chapter 15 of the Bankruptcy Code; however, it need not decide whether to extend comity until those orders or judgments are final.

The court did suggest that the debtor's actions and inconsistencies may warrant sanctions, but a request for sanctions was not currently before the bankruptcy court, and termination of the recognition of the concurso mercantile proceeding was not an appropriate sanction. Likewise, the court found that enforcement of the guarantee agreement was not an issue pending before the court; nor was any claim that CTIM had with non-debtor affiliates that were allegedly transferring assets to a new company.

Lastly, the bankruptcy court imposed quarterly status reports on the foreign representative of the Mexican proceedings in the chapter 15 case.

PRACTICAL CONSIDERATIONS

The bankruptcy court applies a high standard to terminate recognition of a foreign main proceeding under chapter 15. In addition, once a bankruptcy court extends comity to a foreign court order, U.S. creditors may need to wait until that order is final before challenging its validity in chapter 15. While misconduct by a foreign representative or other interested party is not sufficient cause to terminate recognition, a bankruptcy court may design its own remedies. For example, in this case, the court raised the issue of sanctions against the foreign representative and imposed stricter reporting requirements on the foreign main proceeding.

against Cascade and ECJV arising out of an inequitable scheme by Cascade and ECJV to transform themselves from equity holders to senior secured lenders. Specifically, Walnut Creek argued that it had claims for (1) recharacterization of Cascade and ECJV's alleged debt as equity; (2) equitable subordination of Cascade and ECJV's claims; and (3) damages for ECJV's breach of fiduciary duties and Cascade's aiding and abetting ECJV's breach of fiduciary duties.

COURT ANALYSIS

The court began its analysis by considering whether Walnut Creek's claims were "colorable." A colorable claim is one that is able to survive a motion to dismiss for failure to state a claim, which requires that a claim for relief be "plausible on its face."

First, the court considered whether Walnut Creek's claims for breach of fiduciary were colorable. The court noted that Optim Energy's operating agreement eliminated any fiduciary duties owed by its members to Optim Energy, any other member, or any other party. Because this is permitted under the Delaware Limited Liability Company Act, the court found that Walnut Creek's breach of fiduciary duty claims were not sustainable.

Second, the court considered Walnut Creek's claim that Cascade and ECJV intended their secured claims to be characterized as equity contributions. In support of its claim for recharacterization, Walnut Creek made the following arguments: (1) the debtors were inadequately capitalized at the time of execution of the agreements with Cascade; (2) Cascade and ECJV guaranteed the debtors' obligation under the Wells Fargo credit facility when no prudent lender would have done so; (3) the debtors granted Cascade and ECJV security interests on substantially all of their assets at a time when the debtors did not owe Cascade and ECJV any debt; (4) on at least one occasion, Cascade and ECJV waived payment of their fees under the guaranty agreement; (5) the debtors' obligations under agreements with Cascade were subordinated to the debtors' obligations under the Wells Fargo credit facility; and (6) Cascade and ECJV made various capital contributions in the form of equity investments to the debtors for the purpose of paying down the Wells Fargo credit facility.

The court addressed each of these arguments in turn, and did not find sufficient evidence that Cascade and ECJV intended their secured claims to be disguised as equity transactions. For each of Walnut Creek's specific arguments, the court made the following findings: (1) the debtors were adequately capitalized during the 2007 transactions given the existence of the Wells Fargo credit facility along with the fact that they were able to satisfy their operating costs and obligations during the seven years before the bankruptcy filing; (2) Walnut Creek failed to allege sufficient facts to show that no prudent lender would have guaranteed the Wells Fargo credit facility; (3) the security interests granted by the debtors to Cascade and ECJV were not unusual and were granted in connection with the credit facility and guaranty reimbursement agreement; (4) the waiver of fees and entry into a forbearance agreement supports the existence of a true creditor relationship because it is legitimate for a lender to take actions to protect its existing loans, including granting forbearance; (5) the subordination agreement provides for the subordination of Cascade and ECJV's claims against the debtors to Wells Fargo's claims, not to all of the debtors' obligations; and (6) the capital contributions made by Cascade and ECJV were unrelated to the guaranty reimbursement agreement and the guarantees made by Cascade and ECJV, and the contribution agreements clearly stated that the parties intended the payments as equity.

Finally, the court held that Walnut Creek's claim for equitable subordination was not colorable. Under section 510(c)(1) of the Bankruptcy Code, a court may subordinate all or part of an allowed claim to all or part of another allowed claim. Equitable subordination is a drastic remedy, and courts require some showing of inequitable conduct. For purposes of evaluating inequitable conduct, insiders are held to a higher standard. The court found that Walnut Creek failed to allege any inequitable conduct in the proposed complaint, even under the heightened standard for insiders. As such, the court dispensed with Walnut Creek's claim for equitable subordination and denied Walnut Creek's motion for derivative standing.

PRACTICAL CONSIDERATIONS

This case affirms that a creditor must allege substantial facts to support its claims when seeking derivative standing to pursue those claims on behalf of a debtor. This should give equity sponsors some comfort that they will be protected from individual creditors' attacks provided the loans are well documented, and the lender has not engaged in any inequitable conduct.

OVERSECURED CREDITOR AWARDED POST-PETITION INTEREST AT CONTRACTUAL DEFAULT RATE

Sarah Kam
Associate, New York

In re Residential Capital, LLC, et al., 508 B.R. 851 (Bankr. S.D.N.Y. 2014)

CASE SNAPSHOT

The U.S. Bankruptcy Court, Southern District of New York granted the oversecured creditor's motion for post-petition interest at the default rate governed by its contract and counsel fees and expenses. Although the debtors were insolvent and an award of post-petition interest to the oversecured creditor would be at the expense of general unsecured creditors, the bankruptcy court held that such an award was not precluded on equitable grounds.

FACTUAL BACKGROUND

The lender entered into a pre-petition revolving credit facility with one debtor, as borrower, and another debtor, as guarantor. The debtors and the lender amended the loan agreement several times, extending the maturity date and making other changes. The final amendment, made with the understanding that the debtors were preparing to file bankruptcy, extended the maturity date of the loan until a date after the petition date, and increased the default interest rate.

The debtors filed for chapter 11 relief. After the bankruptcy court entered an order approving the sale of the debtors' mortgage origination and servicing platform to a third party, and authorizing the debtors to apply a portion of the sale proceeds to satisfy their obligations under the loan agreement, the debtors paid the lender the outstanding principal, plus interest at the contractual non-default rate. The lender, an oversecured creditor, sought post-petition interest at the default rate set forth in the loan agreement. Under the loan agreement, the debtors' bankruptcy filing and their subsequent failure to repay the outstanding loan balance on the maturity date constituted events of default. The post-confirmation liquidating trust objected to an award of interest at the contractual default rate.

COURT ANALYSIS

Section 506(b) of the Bankruptcy Code provides that an oversecured creditor is entitled to interest on its secured claim "and any reasonable fees, costs or changes provided under the agreement which such claim arose." The court noted that, "The oversecured creditor may receive post-petition interest up to the value of its equity cushion, i.e., the difference between the value of the allowed claim and the value of the collateral securing the claim."

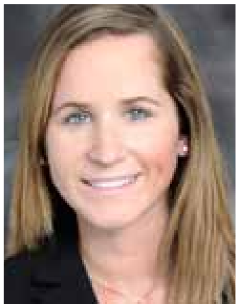
The bankruptcy court concluded that the harm to unsecured creditors did not overcome the rebuttable presumption that the contract default rate applies. Although every dollar paid to the lender would be one dollar less for unsecured creditors, such a result was not inequitable. All creditors benefited as a result of the debtors' ability to continue to operate as a going concern, which was only possible when the debtors obtained sufficient financing to conduct their business. The final amendment to the loan agreement was a piece of the debtors' post-petition financing that enabled them to continue operations and maximize proceeds from the sales of their main businesses, thereby maximizing recoveries for both secured and unsecured creditors alike.

The bankruptcy court held that the lender was entitled to recover interest at the contractual default rate for the period after the loan facility matured and when it was paid. The bankruptcy court also awarded the lender legal fees in connection with pursuing such interest. However, the bankruptcy court concluded that granting the default rate would be inequitable for the 16-day period between the petition date and the loan maturity date. During that time, the debtors were current on the loan. A debtor should not be penalized for filing for bankruptcy by awarding default interest when the only default was the filing itself. Thus, the lender was limited to the contractual non-default rate for that 16-day period.

PRACTICAL CONSIDERATIONS

In determining the interest to be awarded to an oversecured creditor, two guiding principles apply: (1) courts apply a rebuttable presumption that the contractual default rate applies; and (2) courts have limited discretion, which should be exercised sparingly, to modify the contract rate.

UNTIMELY RECORDED MORTGAGE COSTS REFINANCE LENDER IN PREFERENCE ACTION, EARMARKING DOCTRINE NOT APPLICABLE



Lauren Zabel
Associate, Philadelphia

Collins v. JPMorgan Chase Bank (In re Flannery), Case No. 12-31023 – HJB (Bankr. D. Mass., July 2, 2014)

CASE SNAPSHOT

The court found that a refinanced mortgage granted to Chase by the debtors was avoidable as a preferential transfer under section 547(b). In so holding, the court found that Chase, which had failed to timely record the refinanced mortgage, received more as a result of the granting and perfection of the refinanced mortgage than it would have under a hypothetical chapter 7 liquidation if the transfer had not occurred.

FACTUAL BACKGROUND

In 2004, the debtors took out a loan secured by a mortgage on their principal residence. Thereafter, the debtors obtained a home equity line of credit (HELOC) secured by a second lien on their principal residence. In 2012, the debtors refinanced the 2004 loan under the Home Affordable Refinance Program and granted Chase a first priority mortgage on their principal residence. A discharge of the 2004 mortgage was recorded immediately after the refinanced loan closed, but the refinanced mortgage was not recorded until several months later. Within 90 days of recording the refinanced mortgage, the debtors filed a petition under chapter 7 of the Bankruptcy Code. At that time, the debtors' home was valued at approximately $145,300. There was approximately $162,000 outstanding under the HELOC and approximately $75,000 outstanding under the refinanced loan.

COURT ANALYSIS

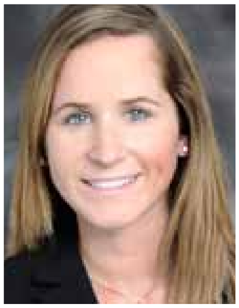
Section 547 of the Bankruptcy Code allows a bankruptcy trustee to avoid certain pre-petition "transfers" of property of the debtor made within 90 days of the bankruptcy filing. Transfers are avoidable when five factors are met, including when the transfer was made (1) to a creditor; (2) on account of antecedent debt; (3) while the debtors were insolvent; (4) within 90 days of the filing of the bankruptcy petition; and (5) which enabled the creditor to receive more than it would have under chapter 7 had the transfer not been made. In this instance, the parties agreed that the first four factors were met but disagreed on whether the transfer enabled Chase to receive more than it would have under a chapter 7 liquidation if the transfer had not been made.

Chase argued that the transfer was not a voidable preference because the "earmarking doctrine," which applies when a third-party lender lends money to a debtor specifically to pay a selected creditor, should be applied to this case. The court rejected this argument, finding that a precedential First Circuit decision specifically held that the earmarking doctrine does not apply to refinanced loans because a refinancing transaction involves the extension of a new loan in exchange for a new mortgage that is likely on different terms from the prior mortgage. In a hypothetical chapter 7 liquidation, with a properly perfected refinanced mortgage, Chase would have been paid in full. Given the value of the secured debt vis-à-vis the value of the debtors' residence, Chase, without a perfected lien on the refinanced mortgage, did not stand to receive anything in a hypothetical chapter 7 liquidation. For that reason, the court held that Chase received more than it would have in a hypothetical chapter 7 liquidation, and avoided the transfer.

PRACTICAL CONSIDERATIONS

Although a lender cannot do much to mitigate preference exposure caused by a bankruptcy petition filed within 90 days of a loan transaction, the lender should be sure to promptly record any mortgages or file any UCC financing statements in order to mitigate preference exposure caused by delay. Additionally, a refinance lender should not expect to be able to rely on the earmarking doctrine in a voidable preference action.

DENYING MOTION TO DISMISS, COURT FINDS SUBSIDIARY EXERTED CONTROL OVER PARENT, CREATING FIDUCIARY DUTIES



Lauren Zabel
Associate, Philadelphia

Burtch v. Owlstone, Inc. (In re Advance Nanotech, Inc.), 2014 WL 1320145 (Bankr. D. Del., Apr. 2, 2014)

CASE SNAPSHOT

The bankruptcy court denied a subsidiary's motion to dismiss claims alleging breach of fiduciary duties owed to its bankrupt parent company, finding that it is possible for a subsidiary to exercise actual control over its parent such that fiduciary duties are imposed upon the subsidiary, and, in this instance, sufficient facts were alleged to support such a claim. In addition, the bankruptcy court held that the trustee alleged sufficient facts to support a claim that the debt owed by the bankrupt parent company to its subsidiary should be subordinated to the debts owed by the debtor to its other creditors.

FACTUAL BACKGROUND

The debtor, AVNA, was the majority owner of the equity and debt of Owlstone. In 2007 and 2008, the debtor issued certain Senior Secured Notes secured by its Owlstone stock. Ultimately, the CEO and CFO of Owlstone also became the CEO and CFO of AVNA (together, the "AVNA/Owlstone Executives"), and pursued efforts to raise funds for both companies. The AVNA/Owlstone Executives successfully obtained a bridge loan for AVNA from one of AVNA's noteholders. Thereafter, an executive of the bridge loan lender proposed a financing deal for Owlstone, which would result in AVNA either defaulting on its Senior Secured Notes, offering a debt-to-equity deal to its Noteholders or consolidating into Owlstone. Although this restructuring transaction was initiated, it ultimately failed, and Owlstone instead sold its stock, which resulted in a dilution of AVNA's equity position in Owlstone from more than 80 percent to less than 40 percent. Thereafter, AVNA defaulted on its Senior Secured Notes, and an involuntary bankruptcy proceeding was initiated.

COURT ANALYSIS

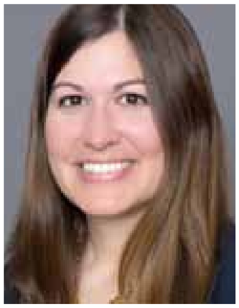
With respect to the fiduciary duty claims, the court held that although subsidiaries typically do not exercise control over their parent companies, such a scenario is certainly possible and, where sufficient control is exercised by the subsidiary over the parent, fiduciary duties would be imposed upon the subsidiary. Here, because AVNA was merely a holding company and shared officers with Owlstone, the court found that the complaint stated a plausible claim that Owlstone exercised actual control over AVNA and, therefore, had a fiduciary duty to it. In addition, because the complaint alleged that the AVNA/Owlstone Executives controlled AVNA's efforts to find funding, the court found that sufficient facts were alleged to support a claim that Owlstone breached fiduciary duties owed to AVNA.

With respect to the equitable subordination claim, the court noted that equitable subordination is appropriate where there is: (1) inequitable conduct by the claimant; (2) resulting in injury to other creditors or an unfair advantage to the claimant; and (3) equitable subordination is consistent with the Bankruptcy Code. In analyzing the first element, an "insider's" conduct is analyzed less vigorously. Here, because Owlstone met the statutory definition of an "insider" set forth in the Bankruptcy Code, the court found that the lesser standard for analyzing "inequitable conduct" was applicable, and found that the complaint alleged sufficient facts to support each element of the equitable subordination claim.

PRACTICAL CONSIDERATIONS

When designing corporate structures, companies should be cognizant that the ability of a subsidiary to exert control over the parent entity could result in the imposition of fiduciary duties owed by the subsidiary to the parent. Steps should be taken to either minimize control exerted by a subsidiary over its parent or to honor the fiduciary duties owed. In the latter situation, it would be wise to develop protocols to ensure that such fiduciary duties are being honored.

CREDITOR NOT REQUIRED TO CREDIT DEBTOR FOR AMOUNTS RECEIVED FROM NON-DEBTORS UNTIL PAID IN FULL



Melissa Mickey
Associate, Chicago

In the Matter of Biovance Technologies, Inc., In the Matter of Julien, Case Nos. BK 10-82441 and 82442 (Bankr. D. Neb., June 23, 2014)

CASE SNAPSHOT

The bankruptcy court found that a creditor does not need to credit a bankrupt debtor immediately for amounts received from other obligors on its claims against the bankrupt debtor. A creditor may seek the entire amount due in its proof of claim until the creditor has been paid in full despite receiving payments from third parties.

FACTUAL BACKGROUND

Debtors William Edward Julien and Biovance Technologies, Inc. each filed chapter 11 bankruptcy cases. On October 15, 2010, creditor American National Bank filed a proof of claim in the *Julien* case pertaining to the debtor's liability as a guarantor of two equipment leases. ANB was the lessor under both of the equipment leases. Biovance Texas, LLC was the lessee under one of the equipment leases, and debtor Biovance Technologies, Inc. was the lessee under the second equipment lease.

During the bankruptcy cases, ANB filed a lawsuit against the former controller of Biovance Texas, and a vendor, asserting claims that arose in connection with the equipment lease between ANB and Biovance Texas. ANB received a settlement of $50,000 in the lawsuit. ANB did not credit this amount to its claims that were filed in the *Julien* and *Biovance* cases.

The debtors each filed objections to ANB's claims, and ANB filed a motion for summary judgment in both the *Julien* and *Biovance* cases. In their opposition to ANB's motion for summary judgment, the debtors argued, among other things, that ANB must apply the $50,000 settlement payment to its proof of claim.

COURT ANALYSIS

The court began its analysis by reviewing case law cited by ANB where courts have held that a creditor can "assert a claim against the debtor for the full amount of the debt, not merely for the balance required to make the creditor whole." Based on this authority, ANB argued that it was not required to credit the $50,000 it received from third parties to its claims against the debtors.

ANB acknowledged that it was entitled to only one recovery of the full amount; however, ANB claimed that until it received full recovery, it was entitled to assert the entire indebtedness against all parties who are liable.

In response, the debtors argued that because the confirmed plan provided for payment in full of all claims, ANB must immediately credit the third-party settlement amount it received. The court disagreed with the debtors' objection, finding that the confirmed plan is not a recovery or payment in full. Instead, the court found that the confirmed plan was a promise to pay. The court further found that the authority cited by ANB was clear that ANB was entitled to assert the balance due on the equipment leases against all responsible parties until ANB has received payment in full. Accordingly, the court held that ANB was not required to apply the $50,000 settlement payment to its claims, and the court granted ANB's motion for summary judgment.

PRACTICAL CONSIDERATIONS

The bankruptcy court reaffirmed the long-standing principle that a creditor filing a proof of claim may seek the entire amount of the claim despite receiving partial recovery from third parties, until the creditor has received payment in full. This allows creditors to simultaneously pursue more than one avenue of potential recovery for the entire amount of the debt. Creditors should keep this principle in mind when collecting on a debt because it allows creditors to more effectively pursue full recovery, and improves their chances of recovering more of the debt owed to them.

BANKRUPTCY COURT REFUSES TO DISMISS DEBTORS' ADVERSARY COMPLAINT ALLEGING LENDER NOTE SALE SCHEME

Sarah Kam
Associate, New York

11 East 36th LLC v. First Central Savings Bank (In re 11 East 36th LLC), Adv. Pro. No. 14-01819, 2014 2903660 (Bankr. S.D.N.Y. June 26, 2014)

CASE SNAPSHOT

The U.S. Bankruptcy Court for the Southern District of New York entered an order denying the defendants' motion to dismiss the debtor's claims for breach of contract against the original lender, breach of the implied covenant of good faith and fair dealing against the original lender, and breach of contract against the note buyer as assignee of the note and mortgage.

FACTUAL BACKGROUND

The debtor and its affiliates owned and developed certain condominiums, including 20 residential units, two commercial units, and one cellar unit. The units were encumbered by a blanket mortgage agreement securing a $10 million note held by defendant note buyer, as assignee of the original lender.

The debtor alleged that in 2011 it identified a purchaser for two of the units encumbered by the mortgage that would have allowed it to pay down 45 percent of its indebtedness. The debtor alleged that the original lender told the debtor that the release of the units upon the sale would not be a problem, but ultimately refused to release the units, which resulted in the loss of the purchaser. After the loss of the purchaser, the lender advised the debtor that it was in default for failure to pay real estate taxes.

The debtor alleged that the lender's improper actions were part of a scheme involving the sale of the note to the note buyer. The debtor alleged that the lender deliberately misrepresented to potential buyers that although the note was listed as non-defaulted and performing, the purchaser could immediately declare the debtor in default and trigger the default interest rate of 24 percent. The debtor alleged that a significant pay-down of the note in connection with the sale of the two units would have negatively impacted the ability of the lender to market the loan.

COURT ANALYSIS

As to the claim for breach of contract, accepting the allegations in the complaint as true, the bankruptcy court concluded that the facts alleged sufficiently stated a plausible claim. The complaint alleged that the debtor was not in default under the mortgage agreement at the time the lender was required to release the two units, and that the debtor was damaged by the loss of a potential buyer as well as by its resulting inability to pay down the principal amount of the loan.

As to the claim for breach of the implied covenant of good faith and fair dealing, the bankruptcy court concluded that the facts alleged sufficiently stated a plausible claim. The complaint alleged a fraudulent scheme concocted to intentionally violate the mortgage agreement by declaring a wrongful default in order to accelerate the loan and deny the release of the units.

As to the claim for breach of contract against the note buyer as assignee of the note and mortgage agreement, the bankruptcy court concluded that because the debtor adequately pleaded claims for breach of contract and breach of the implied covenant of good faith and fair dealing against the original lender, the debtor, to the extent the note buyer stands in the original lender's shoes as assignee of the note and mortgage agreement, had adequately pleaded this claim on a contractual theory.

PRACTICAL CONSIDERATIONS

Dismissal under Fed. R. Civ. P. 12(b)(6) is only appropriate where it appears beyond doubt that the plaintiff can prove no set of facts in support of its claim that would entitle it to relief.

ASSIGNMENT OF LOAN TO HEDGE FUND VIOLATED AGREEMENT TERMS; SUBSEQUENT ASSIGNMENT TO THREE FUNDS ALSO DISALLOWED

Christopher Rivas
Associate, Los Angeles

Meridian Sunrise Village LLC v. NB Distressed Debt Investment Fund Limited, et al., 2014 WL 909219 (W.D. Wash., March 7, 2014)

CASE SNAPSHOT

The debtor borrowed $75 million from a lender and, as part of the negotiations, the parties agreed that the debts were only assignable to commercial lenders, and not to hedge funds or distressed debt investors. Part of the debt was nevertheless assigned to a hedge fund, which attempted to vote against the debtor's chapter 11 plan. The court confirmed the plan over the hedge fund's objections and rejected the hedge fund's attempts to vote against the plan, finding that the fund had no voting rights as a result of the assignability restrictions in the loan agreement.

FACTUAL BACKGROUND

Meridian Sunrise Village borrowed $75 million from U.S. Bank for construction of a shopping center. Meridian negotiated to restrict the ability of the bank to assign the loan to only "Eligible Assignees," which were defined in the agreement as "commercial banks, insurance companies, financial institutions, or institutional lenders." Meridian made it clear during the parties' negotiations that it did not want the loans to be assignable to hedge funds or distressed debt investors. Soon thereafter, and consistent with the agreement, U.S. Bank assigned portions of the loan to a group of other commercial banks.

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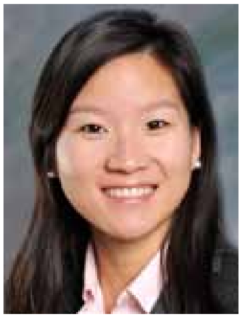
MULTIPLE AGREEMENTS DO NOT CONSTITUTE A SINGLE INTEGRATED CONTRACT, ALLOWS DEBTOR TO ASSUME JUST ONE CONTRACT



Lucy Qiu
Associate, Wilmington

In re Physiotherapy Holdings, Inc. et al.,
2014 WL 1053117
(Bankr. D. Del. March 19, 2014)

CASE SNAPSHOT

Judge Gross of the U.S. Bankruptcy Court for the District of Delaware held that the debtor-licensee was entitled to assume a software license agreement while rejecting five other agreements with the lessor. The court relied on the express language in the various agreements to find that the agreements did not constitute one fully integrated contract.

FACTUAL BACKGROUND

Prior to the bankruptcy filing, Physiotherapy Holdings, Inc., the debtor, and lessor Huron Consulting Services, LLC, entered into six agreements related to consulting services. One of these agreements was the License Agreement, which the debtors conceded was absolutely necessary for the continued operation of their business. Accordingly, the debtors sought to assume the License Agreement. Another such agreement, the Master Agreement, contained broad indemnification language that would likely expose the debtors to future claims against Huron (the License Agreement contained much narrower indemnification language). Huron argued that the debtors could only assume all six agreements together, and could not "cherry-pick" which agreement to assume.

COURT ANALYSIS

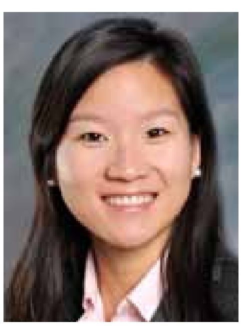
As a threshold matter, the court found that the debtors were within their sound business judgment to assume the License Agreement. Additionally, Huron's consent was not necessary for such assumption under the express terms of the License Agreement, which permitted non-consensual assignment.

Turning to the main point of dispute, the court held that the debtors could assume the License Agreement while rejecting the other agreements, including the Master Agreement, as each constituted wholly separate agreements. The court set forth its reasons for this determination. First, the agreements were all executed at different times. Second, the fact that the License Agreement contained its own separate indemnity provision supported that it was a separate agreement from the Master Agreement, which contained different indemnity language. Importantly, the court found that the "integration clause" that Huron highlighted "did not reduce the separate License Agreement to a mere component of the Master Agreement. Instead, the integration clause simply means all of the Agreements between the parties are reflected in the Agreements as written, thereby eliminating parol evidence." Lastly, the court also focused on the fact that there was language in the License Agreement and Master Agreement that stated that in the event of a contradiction between the two, the Master Agreement would take a back seat.

PRACTICAL CONSIDERATIONS

This case should provide caution to those lessor creditors that execute multiple agreements with the same lessee. Broad integration language does not necessarily mean that all agreements are to be treated as a single contract, so careful and consistent drafting is required to ensure predictable outcomes.

COURT UPHOLDS MORTGAGE DRAGNET CLAUSE



Lucy Qiu
Associate, Wilmington

In re Presser, 504 B.R. 452 (Bankr. S.D. Ohio 2014)

CASE SNAPSHOT

The bankruptcy court held that the "dragnet clause" of the joint debtors' mortgage applied to a later guaranty executed by one of the debtors. In doing so, the court relied on the express language of the mortgage and Ohio's statute regarding open-end mortgages. A dragnet clause in a mortgage usually provides that the mortgage secures all the debts that the mortgagor may at any time owe to the mortgagee.

FACTUAL BACKGROUND

In 1992, joint debtors, husband and wife Millard and Jennifer Presser, executed a $160,000 note in favor of Bank One, N.A., secured by an open-end mortgage covering various real estate (the "First Mortgage").

A few years later, a business owned by the debtors executed a $75,000 promissory note in favor of Bank One. The husband guaranteed all the business's debts owed to the bank, but had checked a box on the guaranty stating that it was "not supported by other security documents" (the "First Guaranty").

In 1997, the debtors granted another open-end mortgage to the bank (the "Second Mortgage" and together with the First Mortgage, the "Mortgages") to secure a $200,000 note. Both Mortgages included the following language concerning the debts secured by the Mortgages, "OTHER DEBTS. Payment by Mortgagor to Mortgagee of all other liabilities and indebtedness, direct or contingent, now or hereafter owing by Mortgagor to Mortgagee."

In 1998, the business executed another $75,000 note to the bank, which was also guaranteed by the husband (the "Second Guaranty"), but which did not state whether or not it was secured.

In 2007, a judgment creditor filed a Certificate of Judgment for a $150,000 judgment, creating a lien against all real property owned by husband and the business.

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Court Upholds Mortgage Dragnet Clause—continued from page 20

The main issue before the court was whether or not the Mortgages secured all debts owed by the debtors, individually or collectively—including, specifically, the Second Guaranty. Determination of this issue would dictate to whom plan payments should be made relating to the proceeds of the disposition of the mortgaged properties.

The judgment creditor argued that (1) the Mortgages only secured the joint liabilities of the debtors and not their individual liabilities; and (2) the bank failed to indicate in the guaranties that the Mortgages secured the husband's liability thereunder.

COURT ANALYSIS

As a threshold issue, the court found that the Mortgages complied with Ohio's statutory requirements for open-end mortgages by (1) identifying the Mortgages as open-end mortgages; (2) stating a maximum amount of debt; and (3) indicating that the Mortgages secure future advances.

The court then went on to rely on the language of the Mortgages to find that they were sufficiently broad to include the Second Guaranty. The court pointed out that the term "mortgagor" is inclusive of obligations owed by either husband or wife, jointly and severally. Moreover, the Ohio statute governing open-end mortgages contains no additional requirement that the Guaranties specifically refer to the Mortgages.

The court noted that previously, there was a judicial requirement to show that it was the parties' intent to include discretionary future advances. However, the related court decision was issued before the state statute was enacted, which appears to provide a comprehensive set of rules for open-end mortgages. Accordingly, the court could not impose greater requirements than the requirements chosen by the state legislature. The court also noted that the result might be different if the First Guaranty was at issue, since there was specific language providing that no security supported that obligation.

PRACTICAL CONSIDERATIONS

Practitioners should be careful to look to state law to determine whether a specific "dragnet clause" will be enforceable. Though such clauses are generally disfavored by courts, state statute and/or cases may provide insight into the exact requirements. Additionally, the fact that a mortgage may be granted by joint debtors does not prohibit the debts of one of the debtor's from being subject to the mortgage's "dragnet clause."

Assignment of Loan to Hedge Fund Violated Agreement Terms; Subsequent Assignment to Three Funds Also Disallowed—continued from page 19

Years later, Meridian committed non-monetary defaults under the loan agreement, and U.S. Bank requested that Meridian lift the assignment restrictions so that the debt could be sold to a hedge fund. Meridian refused to lift the restrictions, and U.S. Bank began assessing default interest. Meridian immediately filed for protection under chapter 11, and proposed a chapter 11 plan to reorganize its debts.

Over Meridian's objections, one member of the lender group, after the petition date, assigned its share of the debt to a hedge fund, which broke up the debt among three affiliated hedge funds. The hedge funds sought to veto the plan and attempted to assert three "no" votes, based on the fact that the debt was split among the affiliates post-assignment during the pending bankruptcy case. On Meridian's motion, the bankruptcy court enjoined the hedge funds from voting, and confirmed the plan. The hedge fund appealed to the district court.

COURT ANALYSIS

On appeal, the district court affirmed the bankruptcy court's confirmation of the plan. The district court first analyzed the assignment provision and applied the rules of contract interpretation to ascertain the intention of the parties. The court found that a court may refer to extrinsic evidence to determine the meaning of the words used, including the circumstances surrounding the making of the contract and the reasonableness of the parties' interpretations. The hedge fund argued it was an Eligible Assignee because it was a "financial institution" under the loan agreement. The court disagreed, finding that Meridian clearly intended to restrict the bank's ability to assign the loan agreement to distressed debt investors, and ruled that the hedge fund's broad interpretation of the term "financial institution" defeated the entire purpose of the assignment restrictions. The court also noted that U.S. Bank itself interpreted the assignment restrictions as Meridian did, which is why it requested that Meridian lift the restrictions in the first place. Accordingly, the district court found that the bankruptcy court properly precluded the hedge funds from voting on the plan.

In the alternative, the court ruled that the hedge funds' votes could only count as a single vote, in any case. The court found that a "creditor does not have the right to split up a claim in such a way that artificially creates voting rights that the original assignor never had." Otherwise, "any voter could veto the Plan by assigning its claim to enough assignees." Accordingly, the district court found that the hedge fund's single vote was insufficient to veto the plan, even if it were counted.

PRACTICAL CONSIDERATIONS

Distressed debt investors and hedge funds should engage experienced bankruptcy counsel before purchasing debts, particularly debts already in bankruptcy, in order to determine whether the loan is assignable, and whether the investor will actually have voting rights in bankruptcy.

SECTION 511(A) PROTECTION UPHELD FOR TAX CLAIM CERTIFICATE HOLDERS

Brian Schenker
Associate, Philadelphia

In re Blackpool Investors Group, LTD., 509 B.R. 470 (Bankr. D.N.J. 2014)

CASE SNAPSHOT

A split of authority continues to exist in the U.S. Bankruptcy Court for the District of New Jersey regarding whether the holder of a New Jersey tax sale certificate related to a debtor's delinquent real property taxes has a "tax claim" in the debtor's bankruptcy case under section 511(a) of the Bankruptcy Code. The court here held that the certificate holder did have a "tax claim" within the meaning of section 511(a), and was thus entitled to the statutory rate of interest.

FACTUAL BACKGROUND

The debtor owed delinquent real property taxes to the local municipality. The municipality sold its tax claim to City Life, which objected to the debtor's proposed plan to pay the tax claim at a reduced interest rate of 1.25 percent. Under New Jersey law, the applicable interest rate to a tax sale certificate is 8 percent on the first $1,500 of the claim and 18 percent on the balance.

A holder of a tax claim under section 511(a) is entitled to interest on its claim at the rate determined under applicable non-bankruptcy law, which rate may not be modified in a debtor's plan of reorganization. In comparison, a secured claim not protected by section 511(a) may receive under a "cram down" plan of reorganization, interest at a rate equal to only the national prime rate adjusted for the risk of nonpayment.

In New Jersey, delinquent real property taxes constitute a lien on the related real estate, and the delinquent amounts accrue interest at the statutorily prescribed rate. Through the tax sale process, municipalities obtain a revenue stream from tax-dormant properties by selling tax certificates related to such properties. The buyer of a tax sale certificate pays to the municipality the amount of real property taxes owed. The buyer then holds a lien against the related real estate securing the amount paid, plus interest at the statutorily prescribed rate. While the holder of a New Jersey tax sale certificate has a secured claim under the Bankruptcy Code, the unresolved issue is whether such secured claim is also a tax claim within the meaning of section 511(a) and is protected against modification in a plan of reorganization.

COURT ANALYSIS

Two lines of cases had previously been issued by the District of New Jersey Bankruptcy Court - the *Princeton Office Park/ Burch* line holds that tax sale certificate claims are not tax claims within section 511(a), and the *Kopec / Curry* line holds that they are 511(a) tax claims.

The *Princeton* cases essentially rest on the reasoning that for a person to have a tax claim, the person must have a claim for a tax. Relying on New Jersey authorities, this line of cases concluded that the delinquent real property taxes are treated as paid in full upon the sale of the tax certificate. Thus, the tax sale certificate holder is not actually conveyed the claim for the delinquent taxes. Additionally, the holder's claim arises from the holder's satisfaction in full of the property owner's delinquent taxes and, therefore, the holder's claim is not for a tax but for a redemption amount. This rationale leaves the holder with a secured redemption claim, i.e., a statutory lien against the related real estate that can be redeemed by the property owner remitting to the holder a sum equal to the amount of delinquent taxes the holder has paid, plus interest at the statutorily prescribed rate. Therefore, the *Princeton* line concludes that a holder of a New Jersey tax sale certificate does not have a tax claim within the meaning of the Bankruptcy Code and is not protected by the anti-modification protections of section 511(a). Consequently, the statutory interest rate applicable to the holder's tax sale certificate could be modified in a debtor's plan of reorganization.

The *Kopec* line reaches the opposite conclusion, holding that a holder of a New Jersey tax sale certificate does have a "tax claim" under section 511(a) of the Bankruptcy Code, and is entitled to interest on its claim at the statutorily prescribed rate. Three primary concerns with the reasoning of the *Princeton* line compelled a different outcome.

First, New Jersey statutory language indicates that (1) the delinquent real property taxes are not treated as paid in full upon payment by the tax sale certificate holder, and (2) the lien obtained by the tax sale certificate holder secures its interest in the delinquent taxes. This language strongly supports the conclusion that the holder's claim is based on the delinquent taxes. Second, these cases took issue with the position that a brand new redemption claim, divorced from the delinquent taxes, arises upon the sale of the tax certificate. The property owner is not personally obligated to repay the tax sale certificate holder – the liability for the debt, and the holder's recourse therefore, is limited to the real estate. Thus, the tax sale certificate holder acquires both the debt to the municipality for the delinquent taxes and the lien of the municipality securing such debt. Finally, the meaning of "tax claim" in section 511(a) is broader than merely "a claim for a tax." Section 511(a) uses the term "creditor" rather than "governmental unit" as the person who may hold a tax claim, indicating that "tax claims" are not limited to only claims for taxes owed to taxing authorities, but also include claims of third parties related to taxes.

In the current case, the Honorable Rosemary Gambardella undertook an exhaustive review of the competing opinions and the parties' thorough arguments. Judge Gambardella ultimately found the *Kopec / Curry* line persuasive and adopted their reasoning and conclusions. Thus, this court held that a holder of a New Jersey tax sale certificate does have a "tax claim" under section 511(a) of the Bankruptcy Code and is entitled to interest on its claim at the statutorily prescribed rate.

PRACTICAL CONSIDERATIONS

At the time of Judge Gambardella's decision, the *Princeton Office Park* decision was in the process of being appealed to the U.S. Court of Appeals for the Third Circuit after being affirmed by U.S. District Court for the District of New Jersey (which substantially adopted the bankruptcy court's reasoning and conclusions). In connection with that appeal, the Third Circuit certified the following question to the Supreme Court of New Jersey: "Whether, under New Jersey law, a tax sale certificate purchaser holds a tax lien?" Judge Gambardella issued her opinion before the Supreme Court of New Jersey had answered that question.

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Section 511(a) Protection Upheld for Tax Claim Certificate Holders—continued from page 22

On June 25, 2014, the Supreme Court of New Jersey answered the question posed to it by the Third Circuit in the affirmative, concluding that the holder of a New Jersey tax sale certificate possesses a tax lien on the related real estate. The Supreme Court reached this answer by construing certain New Jersey statutory language in accordance with its overarching and fundamental objective to promote the sale of tax sale certificates as attractive investments and thereby increase municipal revenue. In sum, the Supreme Court found five statutory provisions that supported the conclusion that the holder of the tax sale certificate is conveyed the lien of the municipality which is referred to generally and specifically as a tax lien. The Supreme Court found that this language "demonstrates that the certificate's owner holds a tax lien based on a tax debt, not another form of lien independent of the property owner's obligation to pay taxes."

Based on the Supreme Court's decision, it is likely that the Third Circuit will agree with Judge Gambardella, and the *Kopec / Curry* line of cases, and conclude that a holder of a New Jersey tax sale certificate does have a "tax claim" under section 511(a) of the Bankruptcy Code and is entitled to interest on its claim at the statutorily prescribed rate. The issue, however, will remain unresolved until such time as the Third Circuit renders its decision.

New Value Contribution By Itself Not Enough To Satisfy New Value Exception—continued from page 10

CPC also argued in its plan objection that the debtor's plan could not be confirmed because it violated the absolute priority rule, as the holders of unsecured claims in Class 6 – CPC's deficiency claim – were not receiving payment in full, while existing equity in Class 7 was retaining 100 percent ownership of the debtor. The bankruptcy court looked at section 1129(b)(1) of the Bankruptcy Code, which provides that the objection of a rejecting creditor may be overridden only "if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan." The absolute priority rules requires that a plan may only be found to be "fair and equitable" under section 1129(b)(2)(B) if the allowed value of the claim is paid in full or, in the alternative, if "the holder of any claim or interest that is junior to the claims of such [impaired unsecured] class will not receive or retain under the plan on account of such junior claim or interest any property."

To satisfy the "new value exception," a debtor must show that the capital contribution by old equity is: (1) new; (2) substantial; (3) money or money's worth; (4) necessary for a successful reorganization; and (5) reasonably equivalent to the property that old equity is retaining or receiving. The court rejected the debtor's assertion that the proposed $15,000 contribution from the equity holder satisfied the new value exception. The court rested its conclusion on the fourth prong of the test, under which the debtor has the burden of showing that the funds are necessary for reorganization, that it was "necessary" for the old equity to be the source of those funds, and that equity in a reorganized debtor must be determined in accordance with the market. The bankruptcy court, relying on the Supreme Court case, *Bank of Am. Nat'l Trust & Savs. Ass'n v. 203 N. LaSalle St. P'ship*, 526 U.S. 434, 441-42 (1999), found that the debtor failed to meet the requirements of the fourth prong because it failed to either provide for a competing plan or to give any other party an opportunity to bid on the interest sought by the new equity. Therefore, the debtor's plan could not be confirmed under section 1129 of the Bankruptcy Code.

PRACTICAL CONSIDERATIONS

Secured lenders should take note of the court's finding that the tax claim class was impaired because the rate of post-petition interest was less than the statutory rate, and that this impairment was not "artificial." This decision may provide some help to arm debtors in efforts to cram down reorganization plans. This decision also makes clear that a contribution of new value is not, by itself, sufficient to satisfy the new value exception to the absolute priority rule.

COUNSEL'S CORNER: NEWS FROM REED SMITH

Andrea Pincus will present "The Bankruptcy Safe Harbors: Calm or Shark-Infested?" at the 90th Annual International Energy Credit Association Fall Conference, Desert Springs JW Marriott, Palm Springs CA, Tuesday October 7, 2014. The program will focus on the current legal landscape with respect to the enforceability of certain provisions in so-called safe harbored contracts (forward contracts, commodities contracts, swaps, master netting agreements) in a bankruptcy context.

Amy Tonti presented at the 19th Annual Bankruptcy Institute on September 3 in Pittsburgh, PA, addressing Successor Liability issues arising from asset sales conducted by the Bankruptcy Court.

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