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Company May Not Avoid Shareholder Approval Of Asset Sale Through Bankruptcy

Delaware companies take note: a state court has ruled that companies in apparent good financial health may not use the bankruptcy process to avoid shareholder approval of an asset sale—even in situations in which a shareholder vote may be difficult to obtain.

In *Esopus Creek Value LP v. Hauf,* 2006 WL 3499526 (Del. Ch. Nov. 29, 2006), the Delaware Court of Chancery was presented with the question of whether a solvent Delaware corporation that is considering an asset sale could avoid compliance with Delaware law and its own certificate of incorporation requiring approval by the common stockholders of the sale, by seeking approval of the sale from a bankruptcy court.

The corporation had not filed the required 10-K annual reports for several years, even though it was not suffering from financial difficulties. Federal regulations prohibit calling a stockholder meeting if the required filings with the Securities and Exchange Commission (SEC) are not complete. The corporation maintained "that the only reason that it was not current in its securities filings is because of its auditor's mismanagement and continued obstinacy pertaining to small disagreements with the company's financial statements that do not greatly affect the overall value of a stockholder's stake in the company."

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Flash Alert

Lender Liability: Duty of Disclosure Addressed

A federal district court in Tennessee has issued a ruling that follows a recent trend toward declining to hold lenders liable for a duty to disclose information concerning borrowers to third parties unless the bank has a fiduciary obligation to do so. In *National Bank of Tennessee v. McDonald,* 2006 U.S. Dist. LEXIS 79610 (E.D. Tenn. Oct. 31, 2006), the court held a bank does not owe a duty of disclosure to a loan guarantor.

The *Alert* recently covered other decisions addressing the circumstances under which a lender has a duty to disclose information about a borrower

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Want To Avoid Successor Liability? Then Market Aggressively

A company's failure to meaningfully market its assets led to the dismissal of its attempted chapter 11 reorganization. As a result, a Massachusetts court held in a detailed opinion that an acquiring company was the successor to the company it acquired, and therefore liable for an $8.8 million debt.

Upon cross-motions for summary judgment, the Superior Court in *Milliken & Co. v. Duro Textiles, LLC,* 19 Mass L. Rptr. 509, 2005 WL 1791562 (Mass. Super. June 14, 2005) held that Duro Textiles

**Endnotes begin on page 20.*

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Enron News

SWAP Agreements Should Be Netted Following Rejection

Following the rule that SWAP agreements should be netted after contract termination, a New York bankruptcy court has held that such agreements also should be netted following rejection in bankruptcy.

"Although rejection of an agreement does not equal termination," Bankruptcy Judge Arthur J. Gonzalez acknowledged in *In re Enron Corp.,* 349 B.R. 96 (Bankr. S.D.N.Y. Aug. 2, 2006), "this does not affect the determination of…rejection damages. Termination of swap agreements generally requires that the parties' positions be netted."

"Rejection leads to a similar result," he stated.

The case concerned three natural gas purchasing agreements between Enron North America Corp. ("ENA") and the Citrus Trading Corp. The contracts involved either a direct agreement by Citrus to purchase gas from an Enron entity, or a gas purchasing agreement to which Enron became a successor party.

One of the agreements was valuable to Enron because it was in-the-money to Enron; the other two were valuable to Citrus because they were in-the-money to Citrus.

Enron filed an objection to Citrus's proof of claim, claiming it was entitled to a set-off against Citrus's in-the-money positions under the two agreements, because the three agreements constituted a single agreement.

Citrus argued that no set-off should occur because the agreements were separate and governed by different master agreements. The rejection of a contract by the debtor under section 365 of the Bankruptcy Code results in a claim for breach of contract held by the other party, and the end of any contract obligations owed by the other party, Citrus noted.

Hence, Citrus argued, it did not owe anything under the agreement at issue.

Enron pointed out that previously in the case, Citrus had argued ENA should not be able to cherry-pick different pieces of the transaction, assuming those pieces ENA deemed favorable and rejecting those pieces it deemed unfavorable. Thus, argued Enron, Citrus could not now take a contrary position.

The court agreed with Enron that the in-the-money positions under the three contracts should be netted to determine the amount of Citrus's claim.

"Rejection of a contract by the debtor amounts to a breach immediately prior to the petition date," the court stated. "Under general contract law, damages are intended to give the benefit of the bargain to nonbreaching parties by awarding a sum of money that will put them in as good a position as they would have been had the contract been performed."

Noting the rule that termination of a contract requires netting, the court

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CIRCUITS

Consultant Ruled a Creditor Not a Shareholder; Subordination Overturned

A business consultant who contracted to receive a percentage of a company's shares in exchange for helping the company go public—but never actually received those shares and obtained a money judgment against the company instead—was not a holder of equity for purposes of subordination under the Bankruptcy Code, the U.S. Court of Appeals for the Ninth Circuit has determined.

The ruling in *Racusin v. American Wagering, Inc. (In re American Wagering, Inc.),* 465 F.3d 1048 (9th Cir. 2006) reverses a decision by a bankruptcy appellate panel, and is in line with an oral decision issued by the bankruptcy court to allow the business consultant's claim.

The Ninth Circuit's decision follows nearly a decade of litigation between the parties. In 1994, Leroy's Horse and Sports Place hired Racusin as a financial advisor to assist it with an initial public offering. Leroy's became a subsidiary of American Wagering, Inc., which would become the publicly owned entity after the IPO. The agreement between Racusin and Leroy's called for Racusin to be paid a commission of 4 percent of the final evaluation in the form of common stock and $150,000 in cash.

In 1996, while the IPO was pending, Leroy's sued Racusin, seeking a determination that the contract was unenforceable. Racusin removed the case to federal court and counterclaimed for breach of contract. After obtaining an initial judgment of just more than $700,000, he appealed on the ground that he was entitled to a jury trial and won. In a subsequent jury trial, Racusin was awarded stock worth more than $2.03 million.

Racusin again appealed, claiming the court should not have awarded specific performance when he sought money damages. The Ninth Circuit agreed and remanded the case for the district court to calculate the monetary value of the shares awarded. On remand, Racusin was awarded $2.3 million.

Shortly after Racusin was awarded the damages, but six years after he first had obtained a judgment against Leroy's, the latter and American Wagering each filed for chapter 11 bankruptcy protection. Racusin filed a claim for $2.28 million, which included a set-off for cash received. The debtors brought an adversary proceeding alleging that Racusin's claim should be subordinated under 11 U.S.C. § 510(b), which mandates subordination of "a claim…for damages arising from the purchase or sale of…a security."

In an oral ruling, the bankruptcy court granted summary judgment to Racusin. The bankruptcy appellate panel reversed and held the claim should be subordinated.

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CIRCUITS

Mortgage Assignee's Interest Ruled Superior to Trustee's Lien

The U.S. Court of Appeals for the Sixth Circuit has held that as the assignee of a debtors' mortgage loan, a bank's security interest was superior to the Chapter 13 Trustee's interest as a judicial lien creditor. The ruling in *Rogan v. Bank One, National Association (In re Cook),* 457 F.3d 561 (6th Cir. 2006) affirmed the holdings of two lower courts.

In December 2000, the debtors entered into a loan transaction with NCS Mortgage Lending Company ("NCS"), which was secured by a properly recorded mortgage. NCS' interest in the mortgage and note subsequently were assigned to First Greensboro Home Equity, Inc. ("First Greensboro"). First Greensboro executed an Assignment of Note but left the space for the name of a future assignee blank. The mortgage and note subsequently were assigned a number of times, ultimately ending up in a securitized trust of mortgage loans for which Bank One acted as Trustee.

An Assignment of Mortgage to Bank One, as Trustee, was not recorded, however, until after the debtors filed their petition for relief in bankruptcy, even though the actual transfer occurred pre-petition.

The debtors listed Bank One as a secured creditor on their bankruptcy schedules and Bank One thereafter filed a proof of claim in the debtors' bankruptcy case. In his capacity as the bankruptcy trustee, Rogan objected to the proof of claim on

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CIRCUITS

Debtor's Loan Discharged Despite False Loan App. Statements

Lender Had Duty To Investigate Claim to Promissory Note

In a harsh decision for the lender, the U.S. Court of Appeals for the Tenth Circuit has determined that a debtor's loan may be discharged in chapter 7 bankruptcy—despite the borrower's admission that his personal financial statement contained materially false representations about his financial condition.

In *First National Bank v. Cribbs (In re Cribbs),* 2006 U.S. App. LEXIS 17090 (10th Cir. July 7, 2006), the Tenth Circuit determined that the lender should have undertaken at least a minimal investigation into the legitimacy of a promissory note the borrower claimed was owed to him. In fact, the note did not exist.

The order and judgment by the Tenth Circuit was issued without oral argument as an unpublished opinion, which is not precedential. Therefore, the decision may reflect the thinking of the court, but does not legally bind future parties.

Promissory Note

In 2000, Cribbs sought a construction loan from First National Bank ("FNB") to finance an assisted living center project in Oklahoma (the "Purcell Project"). He submitted a financing statement that included among its list of assets a promissory note for $483,630, which Cribbs claimed one of his closely held businesses, Phoenix Health Services, Inc., owed to him on another assisted living center project in Mustang, Okla. ("Mustang Project").

Cribbs also orally represented that he would contribute the proceeds from the Mustang Project, but omitted from his statement the fact that Phoenix owed his wife's trust $600,000. A commercial bank officer at FNB reviewed the prospectus for the Purcell Project, inspected

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CIRCUITS

Creditor Carries Burden of Proof in Claims Dispute

In *Litton Loan Servicing, LP v. Garvida,* No. 04-17846 (9th Cir. BAP July 31, 2006), the Bankruptcy Appellate Panel of the U.S. Court of Appeals for Ninth Circuit addressed two independent but related questions: (1) what procedure is necessary to object to a properly filed proof of claim, and (2) who bears the burden of proof, and the correlative risk of nonpersuasion, with regard to a disputed claim.

The court concluded that an adversary proceeding is not required to determine the validity of a claim as long as certain procedural safeguards are in place. Further, based on applicable nonbankruptcy law, the court held that the creditor bears the burden of proof in a claim objection proceeding.

The debtors filed for chapter 13 bankruptcy protection to prevent Litton Loan Servicing, LP ("Litton") from foreclosing on their home. Litton filed a proof of claim asserting that the total amount of the debt at the time of filing was $238,188.46, comprised of unpaid principal and accrued interest, with interest continuing to accrue at the contract rate of 8 percent. On Oct. 15, 2004, the debtors' chapter 13 plan was confirmed by the court, and the debtors thereafter began making payments pursuant to the terms of their confirmed plan.

In December 2004, the debtors negotiated a mortgage refinance with another lender. The debtors filed a motion with the court requesting permission to refinance their mortgage and pay Litton in full. The court granted the motion and required the debtors' escrow company

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CIRCUITS

Claim for Failed Stock Trade Is Subject to Mandatory Subordination

In a case of first impression, the U.S. Court of Appeals for the Second Circuit has held that a claim for damages based on a chapter 11 debtor's failure to issue shares of its common stock in exchange for a claimant's stock in another company pursuant to a termination agreement is subject to mandatory subordination.

In *Rombro v. Dufrayne (In re Med Diversified, Inc.),* 461 F.3d 251 (2d Cir. 2006), the court held that the claim "arose from" the purchase of the debtor's stock within the meaning and purpose of the Bankruptcy Code's subordination provision.

David Rombro was an executive employee at Med Diversified, Inc. (the "Debtor"). Following certain disputes, the parties entered into a termination agreement under which the Debtor agreed to issue to Rombro shares of its common stock in exchange for stock that Rombro held in another company. The agreement provided that, except for the stock exchange and minor payments, the Debtor did not owe Rombro any other salary and benefits, and that the parties release any claims, other than a claim for a breach of the agreement itself, arising out of Rombro's employment and termination.

The stock trade never occurred, and Rombro brought suit for breach of contract and fraudulent inducement.

The Debtor filed for relief under chapter 11 of the Bankruptcy Code, obtaining an automatic stay of Rombro's lawsuit. Rombro filed a timely proof of claim against the Debtor. The trustee for the Creditors' Trust filed a complaint against Rombro and, subsequently, moved for summary judgment, seeking a finding that Rombro's claim was subject to mandatory subordination pursuant to section 510(b) of the Bankruptcy Code. That section provides that "a claim arising from rescission of a purchase or sale of a security of the debtor…for damages *arising from the purchase or sale of such a security*…shall be subordinated to all claims or interests that are senior to or equal the claim or interest represented by such security…."

Rombro filed a cross-motion for summary judgment, seeking a determination that his claim was not subject to subordination, but rather was a general unsecured claim for compensation.

The bankruptcy court granted the trustee's motion for summary judgment and subordinated Rombro's claim. The judge held that section 510(b) should be construed broadly, such that a claim "arises from" a purchase of a debtor's stock if that purchase is part of the causal link leading to the injury. Here, the causal link was the Debtor's alleged failure to issue shares of its stock.

Rombro appealed the decision to the district court, which affirmed the order, holding that even though Rombro never actually received any shares in the Debtor, he had bargained for a position as share-

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DIST. COURTS

Right to Set-off Defense Waived by Actions After Set-off

A federal district court in Michigan has held that JPMorgan waived its defense of set-off to a garnishment action because of actions it took after it exercised the setoff. See *C&H Sugar Company, Inc. v. Solstice Industries, Inc.,* No. 05-CV-74265 (E.D. Mich., Aug. 14, 2006).

C&H Sugar Co., a judgment creditor of Solstice Industries, caused of a writ of garnishment to be issued against JPMorgan for the funds Solstice maintained in a commercial checking account with JPMorgan. JPMorgan responded that no funds were available to be garnished, and then set-off almost the entire account against the debts Solstice owed to JPMorgan, leaving an account balance of $761.

Within days of exercising the setoff, JPMorgan permitted Solstice to draw on the account and honored checks written on the account. JPMorgan acknowledged that it continued to do business with Solstice by allowing it to borrow additional funds, write checks, use the ATM, and deposit funds in the same account. JPMorgan insisted, however, that it did not permit Solstice to draw any of the amounts JPMorgan had setoff against the Debtor's commercial loan obligations.

C&H Sugar Co. argued that JPMorgan's actions following the setoff were inconsistent with a creditor's efforts to setoff against debt, and that JPMorgan, therefore, waived its right of setoff.

The court agreed. Under Michigan law, a garnishee bank with which a deposit account is maintained may exercise any right of recoupment or setoff against a secured party that holds a security interest in the deposit account. The court determined, however, that a garnishee bank's treatment of a debtor's assets that is inconsistent with the claimed setoff constitutes a waiver of the setoff right in the face of the garnishor's claim. While there are several ways for a garnishee to waive its right of setoff, the most obvious and usual situation is to permit the debtor to draw on the account and to honor checks drawn on the account following service of the writ of garnishment. Such conduct infers an admission by the garnishee of indebtedness to its depositor inconsistent with the assertion of setoff.

JPMorgan argued that actions taken after an account is frozen or setoff against are no longer subject to garnishment statutes, and therefore JPMorgan was not liable to C&H Sugar Co. JPMorgan also argued that its actions did not rise to the level of fraud or contempt necessary to waive its right to setoff.

In dismissing these arguments, the court noted that courts uniformly have held that actions subsequent to the garnishment can act as a waiver of a setoff

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BANKR. COURTS

Court Allows Nondebtor To Withhold Postpetition Services

Can the nondebtor party to an executory contract withhold services to the debtor postpetition if the debtor breached the contract prepetition?

Many view this as a settled area of bankruptcy law, and believe that the answer is "no" as long as the debtor is performing postpetition. Commentators of this view question how a debtor could ever reorganize if nondebtors did not have to perform under contracts postpetition, particularly if the debtor's business is entirely dependant upon the contract at issue.

In *In re Lucre,* 339 B.R. 648 (Bankr. W.D. Mich. 2006), the debtor was a telecommunications provider that relied exclusively on a supply contract with Michigan Bell Telephone Company (MBTC). Without MBTC's performance under the supply contract postpetition, the debtor was out of business. The debtor claimed that as long as it performed under the contract postpetition, MBTC had to perform postpetition until the debtor decided at plan confirmation whether to assume or reject the contract.

The *Lucre* court disagreed. It held that:

(a) Section 541 of the Bankruptcy Code does not transfer the entire supply agreement to the debtor's estate. It transfers the debtor's rights under the contract thus, MBTC's right to cease performance under the contract is not property of the estate and therefore is not stayed.

(b) Section 365 of the Bankruptcy Code does not compel MBTC to continue to

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Consultant Ruled a Creditor Not a Shareholder; Subordination Overturned—continued from page 2

'Arising From' Securities Sales

The Ninth Circuit reversed the BAP, concluding that Racusin's claim should not be subordinated because it was not one "for damages arising from the purchase or sale of a security." The court based its decision on the fact that the stock never was tendered to Racusin, resulting in a lawsuit for breach of contract seeking damages based on the value of the stock.

"Racusin received a money judgment for the breach and initiated legal action to receive that award long before the bankruptcy proceeding at issue here commenced," noted the court. "Accordingly, his claim in the bankruptcy proceeding is more akin to that of a creditor than an investor...."

The court specified that not all suits for breach of contract automatically qualify as debts that survive a subordination challenge.

"That the claim is for breach of contract is not sufficient alone to prevent subordination," the court stated. "[A] number of courts, including this one, have held that breach of contract claims may be subordinated under section 510(b) where there exists 'some nexus or causal relationship between the claim and the purchase of the securities....'"

"[B]ut we also made clear that a claim should only be subordinated when it will accomplish the purpose of section 510(b)," the court explained. The purpose of 510(b) was to distinguish shareholders, who are expected to bear the risks of their investments, from creditors, who are entitled to be paid ahead of shareholders.

The court distinguished *Racusin* from cases in which breach of contract claims had been subordinated because Racusin never was offered the shares due him under the agreement.

"His potential opportunity for profit as a shareholder was eliminated long before the bankruptcy," the court wrote. "The lengthy time period between Racusin's first favorable judicial ruling and the filing of the bankruptcy petition distinguish this case from others with much shorter time frames…."

Editor's note: For a different result, see "Claim for Failed Stock Trade Is Subject to Mandatory Subordination," p. 4.

Right to Set-off Defense Waived by Actions After Set-off—continued from page 4

defense. The court determined that fraud and contempt are not necessary to reveal that the garnishee bank acted inconsistent with an asserted setoff. The court also concluded that JPMorgan failed to properly setoff against the account and comply with the garnishment. The bank only partially setoff against the amounts in the account, and instead of paying the balance to C&H Sugar Co., permitted Solstice to continue to access and use the funds.

The court also dismissed JPMorgan's alternative argument that its security interest in the deposited funds as collateral for repayment of the commercial loans trumped C&H Sugar Co.'s rights as a judgment creditor. While the court acknowledged that JPMorgan correctly stated the laws of priority among secured creditors, the court held that nothing in Michigan law provides that a perfected security interest alone is a valid defense against a Writ of Garnishment. Therefore, the court concluded that JPMorgan was liable to C&H Sugar Co. on the writ of garnishment.

- Jeanne S. Lofgren

Jeanne is an associate in the firm's Pittsburgh office.

UCC Corner

Transition Rules Require Description of Collateral in 'New' Financing Statements

Financing statements subject to transition under the revised Uniform Commercial Code may require a description of the collateral for the security interest at issue to remain perfected.

In ***Deusterhaus Fertilizer, Inc. v. Capital Crossing Bank (In re Deusterhaus Fertilizer, Inc.),*** 347 B.R. 646 (Bankr. C.D. Ill. 2006), the bankruptcy court assessed a secured party's perfected status under the transition rules for Article 9 of the UCC. The court was faced with a secured party that had properly perfected its security interest under Article 9 as in effect prior to July 1, 2001.

However, after the secured party originally perfected its interest, the UCC was amended. Under the new law, the proper place for filing a financing statement in order to perfect a secured party's interest in collateral was changed. *In re Deusterhaus Fertilizer, Inc.* resolved a dispute over whether the secured party properly complied with the applicable transition rules in order to maintain the perfection of its collateral interest.

As required by old Article 9, the secured party filed a financing statement that described the collateral in the state where the collateral was located. Such filing properly perfected the secured party's interest. Upon adoption of the new Article 9 of the UCC (effective July 1, 2001), the secured party filed a new financing statement, in lieu of a continuation statement for the original financing statement filed under the old law.

The new financing statement described the debtor and was filed in the state in which the debtor was organized. Despite this proper recordation, the new financing statement did not have a description of collateral; it simply referenced the filing data for the old financing statement in its collateral reference.

The court concluded that the failure to include a description of the collateral in the new financing statement in lieu of a continuation statement failed to render the new financing statement valid under the new Article 9. As a result, the secured party became unperfected upon the expiration of the perfection period for the original financing statement.

The court specifically held that the transition rules under new Article 9 require that the new filing include a complete financing statement together with a description of the collateral.

This case raises substantial issues for secured lenders. In particular, it is important that secured lenders "recheck" financing statements that were filed in lieu of a continuation statement to confirm that such filings do, in fact, contain a specific identification of collateral. Absent inclusion of a description of the collateral, the new financing statement may not be effective and, therefore, the secured party could lose its perfection.

- Derek J. Baker

Derek is a partner in the firm's Philadelphia office.

SWAP Agreements Should Be Netted Following Rejection—continued from page 2

stated that "rejection requires netting too because, if Citrus received rejection damages only based on its in-the-money positions under the swap agreement without taking into account ENA's in-the-money position under the same swap agreement, Citrus would receive more than what it bargained for.

"ENA's in-the-money positions must therefore be taken into consideration to compute Citrus's rejection damages."

The decision emphasizes the rule that contracts must be rejected in their entirety, and that to the extent netting is possible, it should be applied in establishing rejection damages.

Want To Avoid Successor Liability? Then Market Aggressively—continued from page 1

("Textiles") was the successor to Duro Industries ("Duro"), and therefore liable for the payment of the debt owed by Duro to Milliken. A bench trial followed on the issues of whether Milliken was guilty of "unclean hands" or "lack of innocence."[1] The trial also assessed the liability of the equity owners of Textiles for Milliken's debt under veil-piercing theories.

Duro was once a significant force in the domestic textile industry. Following a series of transactions that began in December 2000, with Patriarch[2] buying a minority interest in the syndicated secured debt of Duro, Patriarch became the holder of Duro's secured debt, and an owner of 51 percent of the equity. This occurred by July of 2002, when Duro was in the zone of insolvency. Prior to this time, Patriarch had no power to control the board of directors, officers or management of Duro, and did not attempt to do so.

Milliken, a textile giant, was a major and long-term supplier to Duro. In May 2001, Duro owed Milliken $2.2 million, with $100,000 on "bill and hold." By September 2001, Duro's debt to Milliken never had gone below $8 million. Between May 2001 and July 2002, Milliken was aware of Duro's financial issues. During the same period, Milliken began to develop products that could be direct competitors of some of Duro's products.

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Want To Avoid Successor Liability? Then Market Aggressively—continued from page 6

During the summer of 2002, an effort was made to effectuate a consensual restructuring, which included a proposal made by Patriarch to cut its secured debt[3] and to infuse new capital, provided that it would receive additional equity. The plan also called for the trade creditors to accept a substantial discount. Milliken, put off by a "take it or leave it" meeting with Patriarch's management that occurred Aug. 6, 2002, chose not to accept the restructuring proposal. Following that meeting, Milliken demanded full payment of its outstanding balance.

On Aug. 9, 2002, given the company's tight cash, and failing to achieve a consensual restructuring, the Board of Directors of Duro voted to file a chapter 11 petition. The goal was to have Duro continue as a going concern. Patriarch planned on being a stalking horse bidder, and believed that it would acquire Duro by credit bidding its secured debt. Patriarch also planned to offer DIP financing to enable Duro to continue to operate until the sale could be concluded. Patriarch made an offer to pay the unsecured creditors $700,000; the Creditors' Committee believed that Patriarch should pay $1.7 million to the unsecured creditors.

Because an agreement was not reached, the Committee and the United States Trustee challenged the debtor's marketing efforts. "Milliken's counsel advocated for the immediate dismissal of the chapter 11, arguing that the marketing was a sham designed to guarantee a sale to the secured lender and shareholder—Patriarch."[4] The bankruptcy court found that there was no meaningful marketing of the assets and dismissed the chapter 11 proceeding. Milliken stopped supplying Duro.

Immediately after the chapter 11 dismissal, Patriarch scheduled a foreclosure sale pursuant to Article 9 of the Uniform Commercial Code. A newly formed affiliate of Patriarch was the winning bidder[5]; the purchase was financed by a secured term loan of $22.5 million extended by the previous Patriarch lenders. Following the sale, management remained the same, as did the operations.

Had the marketing process been adequate and the chapter 11 case not been dismissed, the trade debt could have been eliminated. However, the chapter 11 case was dismissed, and the state court found Textiles to be the successor of Duro.

Following the sale, Textiles needed more cash, and Patriarch lent an additional $20 million in working capital. Patriarch and Duro maintained that Milliken should not be able to successfully assert successor liability because it inequitably created the debt at issue out of an anti-competitive purpose.

The court disagreed, determining instead that Milliken acted for a proper business purpose and not with a dishonest or fraudulent intent to harm Duro.

The defendants also asserted that Milliken acted inequitably in failing to accept the restructuring offer made by Duro in 2002 prior to the chapter 11 filing.

The court found that "Milliken acted in accordance with its own business interests and not out of ill will or a dishonest purpose."[7] "Similarly, Milliken's post-bankruptcy refusal to supply Duro with product was based on a legitimate souring of the relationship, no doubt fueled by [Patriarch's] abrasive conduct as well as what had transpired in the bankruptcy court…. Milliken's suit was a proper attempt, made in good faith, to collect a trade debt validly owed.[8]

In addition, the court concluded that Milliken was an "innocent creditor," and entitled to recover from Textile, as the successor to Duro.

Corporate Veil Not Pierced

Despite its support of Milliken's position, the court refused to pierce the corporate veil and denied Milliken recovery against Patriarch. Importantly, the court found that there was no common ownership between Patriarch and Textiles. "Patriarch is wholly owned by Tilton, while Textiles is comprised of Ark I and AIP, investment funds owned almost entirely by outside investors," the court stated.[9]

The court did consider "pervasive control" as a factor that weighed heavily toward piercing the veil, noting that Lynn Tilton was both the principal of Patriarch and the president of Duro Textile Management, Inc. (the general partner of Textiles). Nonetheless, evidence at trial established that Patriarch did not exercise control over the day-to-day operations of Textiles. There was no blurring or intermingling of the business activities, assets or management between Patriarch and Textiles.

As to the "thinly capitalized" prong of piercing, the court concluded Milliken was no worse off after the sale than it was before the sale. The court found no evidence that Patriarch was siphoning away Duro's or Textiles' corporate assets.[10]

Milliken also argued that the corporate veil should be pierced because "Textiles was formed for the fraudulent purpose of allowing the Ark Lenders to cleanse Duro of its unsecured debt."

"Although this court has concluded that the status of the Ark Lenders as majority shareholders of Duro Industries warrants the imposition of successor liability on Duro Textiles, such liability was imposed under the *de facto* merger and mere continuation theories and not on the basis of fraud," the court stated. "This is not one of those rare cases in which piercing the corporate veil is warranted in order to prevent gross inequity.

"The Article 9 sale which the Ark Lenders, as secured creditors, had every right to conduct created no injurious consequences because Milliken is entitled to judgment against Duro Textiles for the amount owed to it by Duro Industries," the court further stated. "There is no credible evidence that the Article 9 sale of the assets of Duro Industries to Duro Textiles left Milliken in any worse posi-

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Creditor Carries Burden of Proof in Claims Dispute—continued from page 3

to pay off the plan in full. The refinance escrow closed and sent Litton a check for $213,372.60, the figure provided by Litton to satisfy its claim. After closing, however, Litton rejected the escrow payoff check and demanded an additional $30,004.22, for a total of $265,961.06.

Assuming that the Litton demand was correct, the debtors proposed a plan modification whereby they would pay their new mortgage outside the plan, and pay Litton through the plan at $1,000 a month without interest until the debt was satisfied. Litton objected to the debtors' failure to provide for a payment of interest on the balance. At the confirmation hearing for the modified plan, the debtors stated they would adjust their plan to pay whatever an accounting showed was owed to Litton.

The court directed Litton to provide such an accounting to the debtors. At a second hearing, the court was dissatisfied with the information provided by Litton detailing the amount due on the account. The hearing was continued, and Litton was persuaded by the court to accept the remaining escrow proceeds as partial payment of its claim.

Acceding to Litton's interest demand, the debtors proposed a third amended plan, under which they would make monthly plan payments totaling $23,348.36 that would be sufficient to extinguish Litton's claim. Litton once again objected, and filed an amended proof of claim for $33,435.46. Litton's proof of claim was not supported by any documentation. At a subsequent hearing, the debtors offered evidence received from Litton that indicated the total owing on the claim as of that date was $15,149.04.

When the court once again requested that Litton provide a breakdown of its numbers so it could determine which of the payoffs was correct, Litton's counsel merely responded that the debtors were working off of a "different" payoff. Finding that Litton had not carried the burden of proof with regard to the amount of its claim—despite multiple opportunities to do so—the court ruled that the remaining amount due and owing on the account was $19,149.04. An order was entered to this effect, and the modified plan was confirmed. A timely appeal was thereafter filed.

The BAP first examined whether a debtor could object to the validity of a claim through a chapter 13 plan, or whether a formal objection was necessary pursuant to Rule 3007 of the Federal Rules of Bankruptcy Procedure. Noting that Fed. R.Bank.P. 3007 sets forth the procedure for objecting to a proof of claim under section 502(a) through an adversary proceeding, the court nonetheless found that an adversary proceeding is not necessarily required. It is permissible to object to a claim through a proposed plan as long as proper notice is given, the court held.

In the current case, Litton was provided ample notice and had the same opportunity to litigate one-on-one as it would have had in an adversary proceeding claim objection under Rule 3007, the court noted. Litton received notice that the debtors objected to its proof of claim, and actively participated in the process. Further, at no point did Litton object or question the procedure being utilized, and only raised the issue of procedural infirmity on appeal.

Based on Litton's failure to insist on a separate claim objection proceeding, and because of the close resemblance of the two-party confirmation proceeding to a claim-objection proceeding, the court determined that Litton had waived the issue. Neither the interests of third parties nor the expectations or rights of third parties was affected by the incorrect procedure. The court found any procedural error harmless and refused to reverse a lower court for reasons that, while not in conformity with the letter of the Bankruptcy Rules, had no effect on any substantial rights.

The court then turned to the issue of whether the bankruptcy court had properly allocated the burden of proof, noting that nonbankruptcy law governs the substance of claims. The court found that the initial burden is on the creditor to demonstrate a prima facie showing of the existence of indebtedness or an obligation to pay. The creditor must then show that payment received was not sufficient to extinguish the debt or satisfy the lien. Based on this standard, the creditor has the burden of proving the final mortgage payoff amount, especially any charges in addition to principal and interest.

The court noted that Litton filed a proof of claim, which is prima facie proof of a claim's validity under Fed.R.Bankr. P.3001(f). This prima facie proof did not, however, shift the burden of proof. To the contrary, Rule 3001(f) merely establishes an evidentiary presumption that shifts the burden of going forward, but does not affect the ultimate burden of persuasion which rests on the creditor. As such, the debtors were charged with presenting evidence to rebut Litton's proof of claim. Once the debtors provided their counter-evidence rebutting Litton's claim, the burden of going forward shifted back to Litton to put forth further evidence to support its claim and rebut the debtors' evidence.

The ultimate burden of proof as to the validity of the claim always rested on Litton, which proved unwilling or unable to meet this burden. It failed to provide an accounting as to how its initial claim grew over the course of the proceeding, and failed to account for the money it did receive through the debtors' chapter 13 plan. Litton's only evidence was a list of payments that was neither itemized nor explained, and which the court regarded as unintelligible.

Having granted Litton multiple opportunities to prove its case, the bankruptcy court finally declared the evidentiary record closed. At that point it was up to the bankruptcy court to examine the conflicting evidence and make a determination. The bankruptcy court was within its rights to examine the evidence, including Litton's unsubstantiated figures, and make a determination

(continued on page 11)

Want To Avoid Successor Liability? Then Market Aggressively—continued from page 7

tion than it would have been in had the assets been sold to an entity other than the one owned by the majority shareholders of Duro Industries."[11]

- Amy M. Tonti

Amy is a partner in the firm's New York office.

Claim for Failed Stock Trade Is Subject to Mandatory Subordination—continued from page 4

holder and all of its resulting benefits and risks. The court found that "[Rombro] cannot expect to both reap a shareholder's benefits when the Debtor was profitable and then avoid a shareholder's risks by gaining creditor status when Debtor went bankrupt." Rombro appealed.

The Second Circuit affirmed the lower courts' decisions, finding that Rombro's claim "arose from" the purchase of the Debtor's stock. In reaching its conclusion, the court looked outside the ambiguous "arising from" language in section 510(b). The court found that the Congressional intent behind mandatory subordination was that: (1) shareholders and general creditors have different risk and return expectations; and (2) creditors rely on the equity cushion provided by shareholder investments.

The Second Circuit found that Rombro's actions satisfied the first rationale, as he took on the risk and return expectations of a shareholder when he agreed to exchange shares in another company for shares in the Debtor. In the Termination Agreement, Rombro did not bargain for cash, but instead bargained to become a shareholder in the Debtor; by forgoing "the significant cash compensation to which he was otherwise due upon termination, he became bound by the choice he made to trade the relative safety of cash compensation for the upside potential of shareholder status…."

The court's argument was influenced by decisions in the Third and Ninth Circuits, which addressed similar claims and found that those who bargain to become investors or shareholders should be treated as such. The court stressed, however, that its rationale does not require subordination simply because a claimant happens to be a shareholder, but rather, the claim must also be causally related to the purchase or sale of stock and subordination must further the policies' underlying section 510(b).

- Debra S. Turetsky

Debra is an associate in the firm's New York office.

Editor's note: For a different result, see "Consultant Ruled a Creditor Not a Shareholder; Subordination Overturned," p. 2.

Mortgage Assignee's Interest Ruled Superior to Trustee's Lien—continued from page 3

the ground that Bank One did not have a perfected security interest and that Rogan's interest as judicial lien creditor therefore was superior.

Bank One responded by amending its proof of claim and changing the name of the interest holder to Bank One National Association, as Trustee for ARC 2001-BC6 Trust, and submitting copies of the original promissory note and NCS mortgage, various assignments, and an affidavit from Bank One's agent that the debtors' note and mortgage were assigned to Bank One, as Trustee.

Rogan then filed an adversary proceeding in which he sought a declaratory judgment that Rogan's security interest as a judicial lien creditor was superior to Bank One's interest. In response, the attorney for Bank One, as Trustee, filed an affidavit in which she averred that she was in possession of the original note.

The Sixth Circuit held that when First Greensboro used a blank endorsement on the note, the interest became payable to the bearer pursuant to Kentucky law. Because Bank One averred that it had possession of the original note, Bank One had priority over other lien holders. The court also held that Bank One did not need to file an assignment of mortgage to perfect its interest because the recordation of the original mortgage by NCS was sufficient constructive notice that a mortgage lien existed on the debtors' real property.

The court further held that Bank One's postpetition recordation of the assignment of mortgage did not violate the automatic stay because Bank One did not attempt to transfer legal title to the property, but only recorded evidence of its equitable interest in the property, which is not an interest that belonged to the debtors.

- Barbara K. Hager

Barbara is an associate in the firm's Philadelphia office.

Company May Not Avoid Shareholder Approval of Asset Sale Through Bankruptcy—continued from page 1

Catch-22

The corporation's certificate of incorporation and the applicable Delaware corporate laws require that a sale of substantially all of the corporation's assets be approved by a vote of the corporation's common stockholders. Thus, the company was faced with a dilemma: if the corporation could not file the required filings with the SEC, and hence not solicit the vote of the common stockholders, how could the corporation sell its assets?

In its opinion, the court noted that "[t]o circumvent this apparent dead end, the board of directors adopted a plan to file a bankruptcy petition once the asset sale agreement [was] signed, and thereafter seek approval of the sale from the bankruptcy court, without a meeting and without a vote by the common stockholders."

To comply with the Bankruptcy Code provisions for confirmation of a plan that would include the sale, the debtor corporation would need to obtain the support of at least two-thirds of the preferred stockholders. See §§ 1126(d) and 1129(a)(7)(A) of the Bankruptcy Code. Therefore, the corporation sought a lock-up agreement whereby the preferred stockholders would support the plan in return for a certain distribution of the sale proceeds.

Solution Rejected

Several common stockholders sought a preliminary injunction to enjoin the board of directors from selling the assets without the prior approval from the common stockholders, and to bar the execution of the lock-up agreement with the preferred shareholders.

The court acknowledged that the sale might be in the best interest of the common stockholders, but found that the corporation had not sought relief from the SEC with respect to the filing issues. It also found that that the "proposed structure of the transaction results in two glaring inequities."

"First, the transaction would prevent the common stockholders from voting on a sale of the assets, a right they have under both Del. C. §271(a) and the company's certificate of incorporation," the court stated. "Second, the holders of the preferred stock are given a vote on a transaction, that if consummated outside the bankruptcy context, they would not have under the certificate of designation."

The Chancery Court stated that it would be an "abuse of the bankruptcy process for a robust and healthy company" to seek the relief suggested from a bankruptcy court. While the court agreed that the Supremacy Clause of the United States Constitution and federal preemption jurisprudence prevented it from issuing an order enjoining the board of directors from filing a bankruptcy petition, it nonetheless had the power to prevent the board of directors from binding the company to a sale that did not comply with Delaware law.

Following oral argument, the parties stipulated to an order, issued with the opinion, that prohibited the corporation and its directors from agreeing to sell the company's assets without approval of the common stockholders.

-Amy M. Tonti

Amy is a partner in the firm's New York office.

Lender Liability: Duty of Disclosure Addressed—continued from page 1

to third parties that may be adversely affected by such information. See *Commercial Restructuring & Bankruptcy Alert,* December 2006, p. 1, "Courts Address Whether Lenders Must Warn of Fraud," at www.reedsmith.com.

In *National Bank of Tennessee,* the bank sued the guarantor of a corporate debt and moved for summary judgment. The guarantor resisted summary judgment and argued that the bank breached its fiduciary duty owed to the guarantor when it failed to disclose to the guarantor that, among other things, the borrower was delinquent in payments to the bank at the time the guaranty was signed.

The court held that the bank did not have a duty to disclose this information to the guarantor because a fiduciary relationship did not exist between the guarantor and the bank. As stated by the court, absent special circumstances, the bank is not under an obligation to "hold the guarantor's hand throughout the execution of the guaranty."

However, an exception to this rule, according to the court, exists if the "guarantor makes specific inquiries of the lender." Once that occurs, one treads into the murky waters of either disclosing nothing or disclosing all material information. Stay tuned.

- Peter S. Clark II

Peter is firmwide head of Reed Smith's Commercial Restructuring & Bankruptcy Group.

Debtor's Loan Discharged Despite False Loan App. Statements—continued from page 3

the Mustang Project, and contacted the bank handling the Mustang Project loan, which confirmed that the debtor's company was current on its obligations.

However, FNB's loan officer never asked to see the promissory note, nor attempted to take a security interest in or an assignment on the note.

FNB funded the loan for nearly $3 million, for which Cribbs and certain co-investors each executed a personal guaranty. The bank also extended a second loan for more than $100,000 for fixtures and equipment that was secured by Cribbs' personal guaranty.

Cribbs' company defaulted on both loans, and Cribbs and the other investors refused to honor their guaranties. FNB obtained a judgment against Cribbs on both loans in Oklahoma state court. Cribbs then filed a petition for bankruptcy under chapter 7.

FNB initiated an adversary proceeding to have the debt excepted from discharge. The bankruptcy court held the debt was dischargeable because FNB failed to establish that it actually and reasonably relied on Cribbs' financial statement, even though Cribbs had acted with intent to deceive. The Bankruptcy Appellate Panel for the Tenth Circuit affirmed and FNB appealed.

Tenth Circuit Review

On appeal, the Tenth Circuit first noted that the law provides for an exception from discharge for debts obtained by the use of a written statement:

(i) that is materially false;

(ii) that respects the debtor's or an insider's financial condition;

(iii) on which the creditor…reasonably relied; and

(iv) that is made with the intent to deceive.

See Bankruptcy Code § 523(a)(2)(B).

"Cribbs concedes that his personal financial statements contained materially false representations about his financial condition," the court noted. But the court concluded that FNB could not show that it had "reasonably relied" on the debtor's representations concerning the promissory note.

The bankruptcy court found that FNB's decision to make the loan was based primarily on the guaranties provided by the co-investors. Further, "[t]he [bankruptcy] court noted that, despite insisting that the decision to extend the loans was based on the Note, FNB never even asked to see the Note or to take an assignment on it," the Tenth Circuit stated.

The bankruptcy court held that FNB did not "actually rely" on Cribbs' financial statement. The support of the new guarantors resolved the bank's concerns regarding the lack of adequate liquid capital, which was the reason the bank had denied the debtor's first loan application.

In addition to disputing FNB's claim that it relied on Cribbs' claim to the promissory note, the Tenth Circuit examined whether reliance upon the note would have been "reasonable," and concluded under the facts of the case that it would not.

"Relevant factors a court must consider include the creditor's standard lending practices, the standard in the creditor's industry, and the surrounding circumstances at the time the debtor applies for credit, including whether there are any 'red flags' in the application, whether there was an ongoing business relationship, and whether further investigation would have revealed inaccuracies in the debtor's application," the Tenth Circuit stated.

The court found that FNB's lack of diligence as to the note rendered reliance on Cribbs' financing statement unreasonable, the court concluded.

While the case is not precedential, it reinforces the relatively high standards that must be met when prosecuting a claim for nondischargeability of a debt for the debtor's use of a falsified financial statement. Not only must fraud be demonstrated, but the creditor must be prepared to show that it reasonably relied on the financial statement as well.

Creditor Carries Burden of Proof in Claims Dispute—continued from page 8

accordingly. The lower court found that the debtors successfully rebutted the prima facie validity of Litton's proof of claim. It was at this point that Litton was required to come forward with additional evidence to prove the validity of its claim. Litton provided no such evidence and, thus, failed to sustain its burden.

The Ninth Circuit BAP concluded that Litton "had its due process opportunity and lost" by failing to provide sufficient evidence to support its claim and meet its burden of proof.

- Elizabeth McGovern

Elizabeth is an associate in the firm's Philadelphia office.

UCC Corner

Right of Set-off Trumps Secured Interest Absent Control Agreement

An appeals court in Kentucky has issued a reminder to secured lenders of the importance of drawing up control agreements that establish a lender's interest in a debtor's assets contained in depository accounts.

In *Kentucky Highlands Inv. Corp. v. Bank of Corbin, Inc.,* No. 2005-CA-000686-MR, (Kty. Ct. App. Sept. 15, 2006), the court was faced with a priority battle between a secured creditor and a depository bank. Kentucky Highlands Investment Corporation ("Highlands") was a secured creditor to Tri-tech Electronics, LLC (the "Debtor"), with a lien on substantially all of the Debtor's assets, including the Debtor's accounts receivable and all proceeds thereof. The Debtor maintained a deposit account at Bank of Corbin, Inc.

In 2002, the Debtor diverted payments from its account debtors for various accounts receivable into the deposit account maintained at the bank. After certain overdrafts and defaults by the Debtor, the bank began to effect set-offs against the deposit account. Highlands asserted that the set-offs amounted to a conversion of the proceeds of accounts receivable, which were subject to Highlands' lien.

The lower court granted the bank summary judgment, holding that its right of set-off was prior to the interest of Highlands in the proceeds of the accounts receivable. Highlands appealed.

Revised UCC Law

On appeal, the court discussed the priority between a perfected secured creditor and a depository bank in proceeds of accounts receivable deposited into a deposit account. Under former law, the secured creditor's interest would be prior to the rights of the depository bank to effect a set-off. When Article 9 of the Uniform Commercial Code was amended effective July 1, 2001, the new law resulted in a presumption of priority in favor of the depository bank, unless the perfected secured creditor took some affirmative steps to preserve its security interest vis-à-vis the depository bank.

UCC § 9-340 explicitly provides depository banks the right to exercise set-offs—even against the proceeds of a secured party's collateral deposited in the deposit account—absent a contractual control agreement to the contrary. This UCC provision subordinates the secured party's interest in the deposit account (and, by definition, the proceeds of accounts receivable deposited therein) unless and until the secured party is perfected by a control agreement.

In *Kentucky Highlands,* the court noted that the change in Article 9 shifted the burden from the depository bank (to ascertain the source of funds in the deposit account) to the secured party (to contract with the depository bank to obtain control). Finding that no control agreement was in place in favor of Highlands, the court concluded that the bank's set-off was prior to the interest of Highlands in the proceeds in the deposit account, and did not constitute a conversion of the funds.

This decision reinforces the common-law right of set-off in favor of a depository bank absent the bank's agreement to subordinate that right to a perfected secured creditor by entering into a control agreement. The decision illustrates a secured party's need to negotiate a control agreement with a depository bank, where its borrower maintains its deposits in order to achieve priority.

In practice, most depository banks will not waive the right of set-off even in the face of a control agreement. However, such control agreements do create a way to ensure that the secured creditor will obtain a priority over the interests of a judgment creditor via garnishment or a similar state attachment process.

- Derek J. Baker

Derek is a partner in the firm's Philadelphia office.

Court Allows Nondebtor To Withhold Postpetition Services—continued from page 5

perform under the contract. All Section 365 does is create a series of rules on assumption or rejection of the contract.

(c) Section 362 of the Bankruptcy Code does not stay MBTC from ceasing services postpetition. According to the court, Section 362 stays certain "acts," and MBTC's desire to do nothing is not an "act."

(d) Section 361 of the Bankruptcy Code is not relevant. The fact that the debtor will perform postpetition is not "adequate protection" for MBTC's performance because MBTC's property rights under the contract are not property of the estate and therefore are not impacted by the bankruptcy filing or the adequate protection provisions.

The debtor argued that this was an extreme result and one that dooms any reorganization for a debtor in this predicament.

The court was sensitive to this, yet said that Congress does not guaranty all debtors success under chapter 11. The court also acknowledged that its holding may be at odds with other rulings (See, *In re Pittsburgh-Canfield Corp.*, 283 B.R. 231 (Bankr. N.D. Ohio 2002) – gas supplier must continue to supply debtor postpetition until contract is rejected), yet it was of the view that those courts misinterpreted the postpetition operation of executory contracts.

- Peter S. Clark II

Peter is firmwide head of Reed Smith's Commercial Restructuring & Bankruptcy Group.

UCC Corner

Assignments of Equipment Lease Payment Streams Were Loans, Not Sales

The Bankruptcy Appellate Panel of the Ninth Circuit has ruled that assignments of equipment lease payment streams were not automatically perfected. Because the debtor failed to perfect the assignees' interests in the payment streams, the bankruptcy trustee could bring an action to avoid those interests.

In ***Netbank, FSB v. Kipperman (In re Commercial Money Center, Inc.),*** 2006 WL 2505205 (9th Cir.BAP Aug. 25, 2006), the court addressed an issue of "apparent first impression for the BAP or any court of appeals," determining that payment streams stripped from the underlying equipment leases were payment intangibles, not chattel paper.

Commercial Money Center, Inc. ("CMC") leased equipment to lessees with subprime credit. CMC then packaged groups of leases together and assigned its contractual rights to future lease payments to entities such as Net.B@nk, Inc., FSB ("NetBank"). CMC also obtained surety bonds guaranteeing the payments and assigned its rights under the bonds to NetBank. In addition, CMC granted NetBank a security interest in the underlying leases and other property.

CMC assigned NetBank an interest in the payment streams as well as the underlying leases, but it separated the two interests, the court summarized. In exchange, CMC received more than $47 million in transactions involving 17 pools of leases. Seven lease pools were at issue in the instant case.

CMC was required to perfect its own security interest in the leased equipment. It also was supposed to list NetBank in financing statements and lease documents as the "assignee" of those security interests; indicate NetBank's interests on the lease documents; and deliver to NetBank evidence that it had filed financing statements and obtained the Surety Bonds.

After CMC filed for bankruptcy, the chapter 7 trustee filed a complaint seeking declaratory relief and avoidance of NetBank's interests. He alleged that the debtor did not fulfill its obligations to perfect NetBank's interests in the payment streams, and that NetBank did not satisfy the requirements for perfection either.

The Nevada UCC requires two conditions for automatic perfection to apply: (1) the payment streams must be payment intangibles; and (2) the transaction must be a sale.

The bankruptcy court ruled that the payment streams were "chattel paper" and therefore NetBank was required to perfect its interests under the rules applicable to chattel paper. The court ruled, in the alternative, that even if the payment streams were not chattel paper, NetBank could not benefit from the automatic perfection rule applicable to sales of payment intangibles because the transactions at issue were loans.

Payment Intangibles

The Ninth Circuit BAP disagreed with the bankruptcy court on the first issue, and held that the payment streams were payment intangibles, not chattel paper.

The UCC "defines chattel paper to mean the 'records' that 'evidence' certain things, including monetary obligations," the court stated. "Payment streams stripped from the underlying leases are not records that evidence monetary obligations—they are monetary obligations.

"Therefore, we agree with NetBank that the payment streams are not chattel paper," the court concluded.

Sale or Loan

The court next addressed whether the assignment of the payment streams were loans or sales, and agreed with the bankruptcy court that the transactions amounted to loans.

"Whether a transaction is a sale or a loan is based on the intentions of the parties as 'determined from all the facts and circumstances surrounding the transactions at issue,'" the court stated.

NetBank cited numerous alleged characteristics indicating that each transaction was a sale.

However, "despite NetBank's arguments, the transactions bear far more hallmarks of a loan than a sale," the court concluded.

These included the requirement that CMC pay NetBank a minimum fixed amount, plus any additional interest and principal amounts owing to NetBank, regardless of what was paid by the lessees. The debtor also bore all the costs of collection from the lessees, and NetBank paid no fees for this expense or any other costs of servicing the leases.

"In other words, NetBank (1) has none of the potential benefits of ownership and (2) is contractually allocated none of the risk of loss," the court stated.

CMC Misdeeds

NetBank also contended it would be inequitable to permit the trustee to benefit from CMC's failure to perfect on behalf of NetBank.

"This is a red herring," the court responded. "NetBank is a sophisticated commercial entity and nothing prevented it from verifying that financing statements had been filed, or from taking possession of the leases."

ReedSmith

UCC Corner

Calling Borrower "Mike" Leads to Failure To Perfect

In the latest example of a party mistakenly identified on a UCC-1 financing statement, the court determined that a statement was "seriously misleading" and ineffective to perfect the creditor's security interest because a creditor used the borrower's nickname "Mike" rather than his full name "Michael." See *Genoa National Bank v. Southwest Implement, Inc. (In re Borden),* 2006 WL 3095640 (Bankr. D. Neb. Nov. 2, 2006).

In *Genoa National Bank,* the bank had filed a UCC financing statement in 2002 to reflect a lien on all of the personal property of Michael Borden and his wife (the "Debtors"), including all machinery and equipment then owned and thereafter acquired. The financing statement was recorded under the name "Michael R. Borden."

In 2004, Mr. Borden purchased a combine and drill from Southwest Implement, which filed UCC financing statements with the Nebraska Secretary of State under the name of "Mike Borden."

Michael & 'Mike'

Mr. Borden's legal name is Michael Ray Borden, and he is identified by that name or by "Michael R. Borden" on many legal documents such as a birth certificate, driver's license, etc. He did sign his name on some forms as "Mike Borden."

The bank argued that using "Mike Borden" on the financing statements rendered them seriously misleading under the Nebraska UCC and therefore Southwest Implement's security interest was unperfected. In support of its position, the bank noted that the financing statements naming "Mike Borden" do not appear among the results when the UCC records are searched for "Michael Borden."

Southwest argued in response that the financing statements were not misleading because Mr. Borden was commonly known, including among Genoa Bank personnel, as "Mike."

New UCC Rule

Upon review, the Bankruptcy Court for the District of Nebraska noted that a financing statement is effective even if it contains minor errors or omissions, unless the errors or omissions render the financing statement "seriously misleading." The test of whether an error in a debtor's name is a fatal defect is whether a search for the UCC statement in the records of the state's filing office under the debtor's correct name—using the filing office's "standard search logic"—would disclose the financing statement.

"This differs from the earlier test of whether a reasonably diligent searcher would be able to locate the financing statement," the court noted. "Revised Article 9 rejects the duty of a searcher to search using any names other than the name of the debtor indicated on the public record ...."

"It is not much of a burden on a party taking a security interest from an individual known as 'Mike' or 'Bill' to ask if the individual's 'correct name' is 'Michael' or 'William,'" the court concluded.

In its decision, the court mentioned a list of documents in which the Debtor had listed his full name. These included a birth certificate, driver's license, real estate deeds, bank accounts, tax returns, and a bankruptcy petition.

STATES

Lender Shielded From RICO Claim by Careful Commitment Letter

The District Court for the District of New Jersey has held in an unpublished opinion that a lender may protect itself against Racketeer Influenced Corrupt Organization Act ("RICO") claims through the careful drafting of its loan commitment documentation.

In *Kennedy Funding, Inc. v. Lion's Gate Dev., LLC,* Civ. No. 05-4741 (DRD) (D.N.J. April 17, 2006), Kennedy Funding, Inc. ("KFI") filed a complaint against Lion's Gate Development, LLC ("Lion's Gate"), alleging claims for, among other things, breach of contract and fraud arising from a loan agreement in which KFI agreed to loan Lion's Gate $18.2 million as part of a real estate transaction.

Lion's Gate filed a counterclaim and third-party complaint against, among others, KFI and several of its officers (the "Officers"). In pertinent part, the counterclaim and third-party complaint later were amended to allege that KFI and the Officers violated New Jersey's RICO Act. KFI moved for judgment on the RICO claims alleged by Lion's Gate.

Through KFI, the Officers were engaged in commercial real estate lending. Per the court, the Officers made "extravagant" claims on their Web site related to KFI's ability to quickly close multimillion dollar deals.

Lion's Gate approached KFI for a loan to purchase real estate in Arizona, and on or around July 28, 2005, the parties began negotiating terms for the loan agreement. The final draft, dated Aug. 10, 2005, provided for a loan amount of $18.2 million and a closing date of Aug. 15, 2005, with "time being of the essence." Pursuant to the commitment agreement, Lion's Gate forwarded $536,000 by wire transfer to KFI's attorneys to be held in escrow.

The Lion's Gate counterclaim and third-party complaint alleged that KFI falsely issued the commitment letter, because KFI neither had the $18.2 million in its accounts nor had the funds available to make the loan. Lion's Gate further alleged that to avoid closing on the

(continued on page 16)

UCC Corner

Assignment of Media Placement Invoices Is Governed by the UCC

The U.S. District Court for the Northern District of Georgia has held that an account debtor did not have an affirmative right to sue a contract assignee of account receivables under a factoring agreement. See *Novartis Animal Health US, Inc. v. Earle Palmer Brown, LLC,* 424 F. Supp. 2d 1358 (D. Ga. 2006)

The dispute arose out of the alleged misappropriation of funds by defendant Earle Palmer Brown, LLC ("EPB"), which were provided by Novartis Animal Health US, Inc. ("Novartis"), to pay for an advertising campaign. Novartis, a provider of pharmaceutical products and services to the animal health industry, and EPB, an advertising agency, entered into an advertising agreement for the provision of general advertising services.

Pursuant to the agreement, Novartis and EPB agreed to an advertising plan that provided a budget of $9.4 million to pay various media outlets for the planned advertisements (the "Media Placement Money"). Novartis and EPB agreed to an advance billing schedule under which EPB issued three invoices to Novartis totaling $9.4 million (the "Media Placement Invoices"). Novartis issued several checks in payment of the Media Placement Invoices.

Defendant Panoramic Communications, LLC ("Panoramic"), EPB's parent, had entered into a factoring agreement with defendant UPS Capital Corporation ("UPSC"), under which Panoramic assigned all of its accounts receivable, including the Media Placement Invoices, to UPSC. Novartis claimed that Panoramic and UPSC conspired with EPB to misappropriate the Media Placement Money.

UPSC contended that the provisions of Article 9 of the Uniform Commercial Code governing factoring preclude Novartis's claims and entitle it to summary judgment. Specifically, UPSC argued that under UCC § 9-404, account debtors such as Novartis cannot recover payments made to contract assignees such as UPSC. UPSC also pointed to the explicit language of UCC § 9-404, which states that "the claim of an account debtor against an assignor may be asserted against an assignee…only to reduce the amount the account debtor owes." O.C.G.A. § 11-9-404(b).

In response, Novartis argued that because Novartis did not assert any claims against UPSC under the UCC, UPSC's argument is irrelevant. Novartis also argued that the evidence showed that UPSC took the assignment of the Media Placement Invoices in bad faith because it knew the Media Placement Money did not belong to EPB. Because UPSC was not an innocent assignee, Novartis argued, Novartis's claims for an affirmative recovery against UPSC are not dependent on any rights or causes of action provided under the UCC, but are based instead on UPSC's knowing and unlawful participation in EPB's fiduciary fraud.

The court found that "(1) Article 9 of the UCC applies to the factoring of the Media Placement Invoices; (2) Article 9 does not permit an account debtor like Novartis to make an affirmative recovery from an assignee like UPSC; and (3) the evidence does not support Novartis's claim that UPSC acted in bad faith." Accordingly, the court concluded that UPSC was entitled to summary judgment.

- Scott M. Esterbrook

Scott is an associate in the firm's Philadelphia office.

STATES

Bank Not Liable for Breach of Duty of Care

The Wisconsin Supreme Court of Wisconsin has held that a lender's duty of ordinary care to subcontractors and suppliers did not require the lender to ensure that the plaintiff received payments for its services before loan proceeds were disbursed. In *Hoida, Inc. v. M&I Midstate Bank,* 717 N.W. 2d 17 (Wis. 2006), the court further found that even if the plaintiff could show that the defendants did owe it such a duty, any recovery would be barred by public policy.

In October 1996, Villager at Nashotah LLC ("Villager") borrowed approximately $1.32 million from M&I Midstate Bank ("M&I") to fund the construction of an eight-unit apartment building. The loan was secured by four separate mortgages. M&I entered into an oral agreement with McDonald Title ("McDonald") to provide the loan disbursements following withdrawal requests by Packard Construction ("Packard"), Villager's general contractor.

To receive a disbursement, Packard was required to provide McDonald a written Application and Certification for Payment form that contained Packard's itemized application for payment, the project architect's signed certificate for payment, and Villager's signed certificate as owner/borrower, authorizing payment. The loan agreement stated that M&I was not responsible for any aspect of the construction or the procurement of lien waivers and had no obligation or liability to contractors, subcontractors, laborers or materialmen.

M& I was given the right, but was under no obligation, to inspect the construction project at any time. Villager was required to forward notices to M&I at any time that an individual or business providing goods or services to the project gave notice or made a demand

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Lender Shielded From RICO Claim by Careful Commitment Letter—continued from page 14

loan, KFI falsely stated that Lion's Gate had not met the conditions called for in the commitment agreement. Lion's Gate further claimed that KFI imposed additional conditions that had to be met before closing but could not be timely satisfied—such as requesting that Lion's Gate procure soil samples just prior to the closing date.

RICO Claims

In its review of the RICO claims, the court noted that Lion's Gate failed to establish a pattern of racketeering on behalf of KFI or the Officers. The court further observed that the wording of the loan commitment letter provided KFI with "virtually unlimited discretion" in determining whether Lion's Gate had satisfied the terms of the agreement.

The court observed that the loan commitment letter contained broad and protective language such as:

- "Borrower must … produce such evidence as Lender may require to

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Bank Not Liable for Breach of Duty of Care—continued from page 15

relating to the project. Finally, M&I was given the right to complete construction if any breach of the contract occurred.

Packard purchased prefabricated wood from Hoida Inc. ("Hoida") for use throughout the project. Pursuant to Hoida's invoices, Packard was to pay the invoices within 15 days of receipt. Packard failed to pay any of the 51 invoices sent by Hoida. On June 6, 1997, Hoida served Villager with a Written Notice of Intent to File Construction Lien based on its failure to pay the invoices. On July 7, 1997, McDonald sent a letter to Villager informing it that two subcontractors, including Hoida, had filed notices of Intent to File Liens.

McDonald received no response from Villager. Throughout the month of July, McDonald became increasingly concerned about the construction project based on a variety of factors, including Packard's failure to provide construction breakdowns and lien waivers, and the general lack of progress on the project. On July 28, Hoida filed a Claim for Lien on the project. M&I subsequently commenced foreclosure on Villager's mortgages.

In May 2001, Hoida sued M&I and McDonald, alleging that they failed to protect Hoida against the losses that it incurred. The circuit court granted summary judgment for M&I and McDonald. The trial court found that Hoida failed to state a claim for relief and could not show that there was an affirmative duty to collect lien waivers. Hoida appealed. The court of appeals affirmed.

Hoida then appealed to the Wisconsin Supreme Court. The court concluded that public policy considerations precluded recovery.

Hoida claimed that McDonald and M&I were negligent and breached their duty of care by failing to perform certain tasks. Hoida alleged that M&I and McDonald owed it a duty of ordinary care, which included identifying the subcontractors and materialmen for the project; verifying that sufficient work on the project had been completed to justify disbursement, and collecting lien waivers from Hoida before disbursing advances. Hoida claimed these tasks constituted basic industry standards, and if a lender did not complete these tasks it was reasonably foreseeable that subcontractors or materialmen would be harmed.

The Supreme Court found that McDonald was not bound by the standard set forth by Hoida and that it did not breach its ordinary duty of care to Hoida. Further, even if McDonald had breached its ordinary duty of care, such a claim would be barred on public policy grounds, the court concluded. Wisconsin employs the near universal standard for negligence. There must be: (1) the existence of a duty of care; (2) breach; (3) causal connection between defendant's breach and plaintiff's injury; and (4) actual loss or damage resulting from the breach.

State courts have reserved the right to deny a negligence claim based upon public policy. There are six public policy factors that Wisconsin courts use to limit liability in negligence claims: (1) injury is too remote; (2) recovery is wholly out of proportion to the culpability of the negligent tortfeasor; (3) the harm caused is highly extraordinary given the negligent act; (4) recovery would place too unreasonable a burden on the negligent tortfeasor; (5) recovery would be too likely to open the way to fraudulent claims; and (6) recovery would enter into a field that has no sensible or just stopping point.

Finding that allowing Hoida to recover would place too unreasonable a burden on McDonald, which acted solely at the discretion of M&I, the Supreme Court concluded that Hoida's claim was barred based on public policy grounds. M&I could not be required to track and check every aspect of Packard's dealings with subcontractors and suppliers. Not only would this task be never-ending, but it also would place an unreasonable burden on M&I. As such, even if Hoida could show that M&I and McDonald breached its duty of ordinary care, public policy precluded recovery by Hoida.

- Elizabeth A. McGovern

Elizabeth is an associate in the Philadelphia office.

Quick Check
U.S. Courts of Appeal

Utility Services—*Darby v. Time Warner Cable, Inc. (In re Darby),* No. 05-20931 (5th Cir., Nov. 14, 2006)

The U.S. Court of Appeals for the Fifth Circuit has held, in an issue of first impression in the circuit, that a cable service provider was not a utility under section 366 of the Bankruptcy Code. Therefore, the cable company was not obligated to provide services to a bankrupt debtor, even though the debtor offered assurances of future payment. The ruling affirmed the holdings of two lower courts.

After the debtor in *Darby* filed a petition for relief under chapter 13 of the Bankruptcy Code, the debtor's cable provider, Time Warner, discontinued his cable service. The debtor offered a deposit to Time Warner to reinstate his service but Time Warner refused. The debtor thereafter filed a motion with the court seeking an order compelling Time Warner to reinstate his service under 11 U.S.C. § 366, pursuant to which utilities are required to reinstate service after receipt of adequate assurances of future payments.

Initially the court agreed with the debtor, over Time Warner's objection, and ordered the service reinstated upon the grant of a $250 super-priority claim to Time Warner in the event of default. However, Time Warner filed for reconsideration of the court's order, whereupon the bankruptcy court reversed its decision and held in favor of Time Warner.

"Utility" is not defined in the Bankruptcy Code, so in rendering its decision, the court turned to the legislative history. The legislative history states that section 366 is meant to cover utilities that have a "special position with respect to the debtor," such that the debtor cannot easily obtain service from another provider. The services discussed in the legislative history are those which are necessary to meet a minimum standard of living.

The bankruptcy court held, and the court of appeals agreed, that for a service to be "special" it must be a necessity and, because cable television is not a necessity and is not required to sustain a minimum standard of living, cable service is not a utility under the Bankruptcy Code.

While the debtor agreed that cable was not a necessity but a convenience, he argued that he could not easily obtain comparable service from another provider. The court disagreed and stated that the debtor could readily obtain service through a satellite provider for a cost equal to that which the debtor sought to offer Time Warner as adequate assurance of payment.

Quick Check
Federal District & Bankruptcy Courts

Mortgage Collateral Impairment— *McCullough v. Goodrich & Pennington Mortgage Fund,* 2006 WL 1432442 (D.S.C. May 23, 2006)

In *McCullough,* the holder of a security interest in income generated by a mortgage portfolio alleged that the defendant portfolio servicing agents negligently performed their duties, resulting in the reduction in the value of the collateral. The plaintiff sued for impairment of the collateral.

On a motion to dismiss, the U.S. District Court held that South Carolina law does not provide a cause of action for the negligent or intentional impairment of collateral. The court additionally held that precedent established by the U.S. Court of Appeals for the Fourth Circuit precludes district courts from expanding state common law to recognize a new cause of action previously unarticulated by state courts. As a result, the complaint was dismissed as a matter of law.

In dicta, the district court noted that regardless of the absence of South Carolina precedent, the allegations of the complaint were insufficient because "[a]n affirmative duty to act exists only if created by statute, contract, relationship, status, property interest or some other special circumstances," and that no such duty is imposed on a mortgage-serving agent in favor of the holder of a security interest on the mortgages being serviced.

Daubert Standard—*Howard v. General Elec. Capital Bus. Asset Funding Corp.,* No. CV-03-2487-PHX-DGC (D. Ariz. Aug. 23, 2006)

The U.S. District Court for the District of Arizona has issued an order excluding a portion of an expert's report prepared in a case filed against General Electric Capital Business Asset Funding Corporation ("GE").

In *Howard,* the plaintiff alleged that GE breached its loan commitment to the plaintiff and its implied covenant of good faith and fair dealing. GE moved to exclude virtually all of the opinions contained in a supplemental expert report. In the report, the expert opined on a number of issues related to the case.

Central to the district court's order was the court's analysis of the expert's statements in one portion of the report concluding that GE had engaged in substandard underwriting, violating industry norms.

The court noted that under the Supreme Court's Daubert decision (see *Daubert v. Merrell Dow Pharm., Inc.,* 509 U.S. 579 (1993)), a court is required to ensure that an expert's testimony is relevant and advances a material aspect of the proposing party's case. The court must be convinced that the testimony "speaks

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State Courts

Lender Liability—*Hagen v. La Jolla Bank,* D045270 (Cal. Ct. App. July 17, 2006)

In an unpublished decision, the Court of Appeal, Fourth Appellate District of California, ruled that lack of privity prevents shareholders of a borrower company from suing the company's lender for breach of contract for their individual financial losses. The court also ruled that the shareholders' tort claim against the lender for negligence and misrepresentation could not, as a matter of law, succeed because a lender has no duty to a borrower's shareholders to prevent their individual economic losses related to a financial transaction with the borrower.

In *Hagen,* the bank allegedly was tardy in funding a line of credit to Greville-Lacey, Ltd. Based on the commitment to fund the loan, its shareholders had taken individual loans and other actions that caused them financial injury when the loan did not close on time. The company did not press claims against the bank, but the shareholders did.

The shareholders' contract claim was dismissed because there was no direct contract between the shareholders and the bank. The shareholders alleged reliance on the bank's promise to the company was similarly unpersuasive because such reliance did not create a third-party contract cause of action under California law.

The bank's alleged failure to process the loan documentation in a timely fashion did not state a cause of action in favor of the shareholders because the *sin qua non* of a tort claim is duty and, under California law, a bank does not owe a duty to a borrower's shareholders, completely independent of a contract, to process a loan. That duty, the court opined, was owed, if at all, only to the borrower.

Standing—*AmSouth Bank v. Trailer Source, Inc.,* No. M2005-01189-COA-R3-CV (Tenn. Ct. App. June 22, 2006)

In Tennessee, an appeals court has paved the way to allow a secured, subordinate creditor to challenge whether a

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Federal District & Bankruptcy Courts—continued from page 17

clearly and directly to an issue in dispute" and is not misleading to the finder of fact.

In *Howard,* the court denied GE's motion regarding most of the expert's opinions expressed in the report. However, the court granted the motion with respect to expert's claims of substandard underwriting. The plaintiff had not sued GE for shoddy underwriting, and the opinions expressed in this portion of the report had no bearing on any issue to be advanced by the plaintiff at trial.

The court therefore concluded this opinion was not relevant to the case and only would serve to confuse the jury.

Mechanics' Liens—*In re Rogers & Sons Constr., Inc.,* No. 05-00901-wb (D.S.C. Feb. 15, 2006)

In a case of first impression, the U.S. Bankruptcy Court for the District of South Carolina has held that the filing of a bankruptcy petition by a general contractor operates to stay a mechanic's lien enforcement action brought by a subcontractor—even though the general contractor was not the owner of the real property against which the lien was pending.

In *Rogers,* the debtor was the general contractor on three projects upon which Warren Utilities, LLC ("Warren") performed work as a subcontractor. Rogers filed for bankruptcy protection under chapter 11, and the trustee moved for approval of a settlement that had been reached between the debtor and Paradise Island Joint Venture.

Warren claimed a mechanic's lien on real property owned by Paradise. However, Warren did not file an enforcement action seeking foreclosure of its lien. Instead, Warren filed a motion requesting relief from the automatic stay imposed as a result of Rogers' chapter 11 bankruptcy petition. Warren claimed that Rogers, as the general contractor, would be a necessary party to a state court action to enforce its mechanic's lien.

The trustee objected, arguing that the filing of an enforcement suit is not stayed by 11 U.S.C. § 362, and Warren's failure to file suit caused its lien rights to dissolve.

The court distinguished actions to perfect a mechanic's lien from actions to foreclose on such liens. Actions to perfect mechanics' liens are excepted from the automatic stay, the court noted. "Actions to enforce the liens are not excepted by section 362(b)(3), however," the court concluded.

In so holding, the court stressed the fact that the proposed enforcement action would affect the property of the debtor's estate. "[T]he limitations upon the aggregate amount of liens makes the prime contractor a necessary party to a foreclosure suit by a subcontractor who claims that that labor and materials were provided by virtue of an agreement with the prime contractor."

Thus, the court determined that the proposed enforcement action to foreclose on the mechanic's lien was subject to the automatic stay, and the statute of limitations for filing the enforcement action was tolled by the automatic stay.

State Courts—continued from page 18

priority creditor conducted a UCC sale in a commercially reasonable manner.

The ruling in *AmSouth Bank* reversed a determination that the secured creditor did not have standing to bring suit. The lower court had ruled that the subordinate creditor did not have standing to challenge the sale because the aggrieved creditor had an unperfected security interest on the date the priority creditor was entitled to provide notice of the sale.

However, the opinion issued by the appellate court recognizes that a creditor with a priority interest does owe a duty to any subordinate creditor to dispose of collateral in a commercially reasonable manner—whether the subordinate creditor holds perfected claim or not.

In *AmSouth Bank,* two creditors claimed a security interest in certain certificates of title and cash proceeds deposited in a bank account set up for the benefit of Hyundai. The bank perfected its interest in July 1999. Hyundai did not perfect its interest until Sept. 23, 2003, one day prior to the UCC sale conducted by the bank.

Prior to the date upon which Hyundai perfected its interest, the bank initiated a complaint and sought immediate possession of the certificates of title and cash proceeds deposited in the account. The bank successfully obtained the collateral and, thereafter, proceeded to sell a portion of the title certificates. This sale took place Sept. 24, 2003, and through the sale, the bank obtained an amount that Hyundai would claim was less than fair market value.

Hyundai challenged the fact that the bank had sold the certificates of title in a commercially reasonable manner. Hyundai asserted that had the bank sold the title certificates for fair market value, there would have been enough to both satisfy the bank's entire claim and a portion of Hyundai's claim. Instead, all of the collateral was used to satisfy the bank's claim, leaving nothing for Hyundai.

The bank was required to give affected parties 10-days' notice of the sale. However, the lower court ruled that Hyundai was not entitled to notice of the sale because at that time Hyundai was not a perfected creditor. Moreover, because Hyundai was not a perfected creditor on the date notice was given, the lower court also ruled that Hyundai did not have standing to challenge the commercial reasonableness of the sale.

The appeals court disagreed, determining that the timing of Hyundai's perfection was unrelated to whether Hyundai had standing to challenge the sale. Instead, the court considered relevant the fact that Hyundai did indeed hold a security interest at the time of the suit. There was no dispute that Hyundai had a valid security interest in the collateral. The fact that Hyundai had chosen not to perfect its interest in time to receive notice did not mean that the bank did not owe Hyundai a duty to conduct the sale in a commercially reasonable manner, the court concluded.

Accordingly, the appeals court reversed the lower court's decision and remanded the case to allow Hyundai the opportunity to prove its claim.

Lender Shielded From RICO Claim by Careful Commitment Letter—continued from page 16

demonstrate current full compliance with all applicable zoning, health, environmental and safety laws, ordinances and regulations…."

- "…[T]he form and substance of each and every document evidencing the Loan and the security thereof or incident thereto, must be satisfactory to and approved by Counsel to the Lender in its sole discretion."
- "…[T]he Loan Documents shall contain…terms and conditions consistent with the terms hereof as shall be satisfactory to KFI in its sole discretion…."

Given KFI's broad discretion, the court concluded that Lion's Gate could not successfully allege KFI misrepresented the terms and conditions that Lion's Gate needed to satisfy before KFI would close the loan.

- Monique Jewett-Brewster

Monique is an associate in Reed Smith's Oakland, Calif., office.

Counsel's Corner

Reed Smith's Global Expansion On Track

On January 1, Reed Smith's merger with Richards Butler became official, creating one of the world's 15 largest law firms, with more than 1,300 lawyers across three continents. The combination, which has been in the works for months, creates a firm with operations in the United States, the United Kingdom, Europe and the Middle East.

Reed Smith's Commercial Restructuring & Bankruptcy Group Comprises more than 50 professionals in 20 offices in the United States and Europe. The firm's offices in New York and Wilmington place our attorneys at the doorstep of two of the most active bankruptcy courts in the United States.

Reed Smith also is set to combine forces with Chicago-based Sachnoff & Weaver. The merger has been approved by the partners of both firms and is scheduled to go into effect on March 1.

Endnotes

Want to Avoid Successor Liability? Then Market Aggressively—continued from page 1

[1] *Milliken & Co. v. Duro Textiles, LLC, et al.,* No. CV2002-1364, slip. op. (Super. Ct. Mass. June 8, 2006) ("Opinion").

[2] Patriarch Partners LLC, Ark Investments Partners II, LP ("API", a private equity fund) and Ark CLO 2000-1 Ltd. ("Ark," a distressed debt investment fund), are affiliates that had interests in Duro; Tilton was the manager of these companies. Tilton and the Patriarch companies are collectively referred to herein as "Patriarch."

[3] Because Patriarch acquired some of the debt at a discount, the proposed reduction would result in Patriarch having a remaining secured claim in an amount slightly less than what it paid for the debt.

[4] Opinion at 51.

[5] The adequacy of the purchase price of $26.5 million was not challenged.

[6] Opinion at 60.

[7] Id. at 66.

[8] Id. at 67, 68.

[9] Id. at 71.

[10] In fact, there was no evidence that Patriarch ever received any funds from Textiles.

[11] Opinion, at 75-76.

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