CR&B Alert

COMMERCIAL RESTRUCTURING & BANKRUPTCY NEWS – DECEMBER 2011, ISSUE 4

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HIGH COURT TO RESOLVE CREDIT BIDDING DISPUTE

The U.S. Supreme Court has agreed to settle the dispute as to whether secured creditors can credit bid in connection with asset sales done pursuant to liquidating plans. The Third Circuit in the *Philadelphia Newspapers* case and the Fifth Circuit in the *Pacific Lumber* case held that secured creditors do not have a statutory right to credit bid their debt at a sale conducted under a plan of reorganization pursuant to which the debtor elects to provide the secured creditors with the "indubitable equivalent" of their secured claim. Those decisions, in effect, permit a debtor to avoid a secured creditor's right to credit bid by structuring a sale under a chapter 11 plan instead of conducting a sale under section 363 of the Bankruptcy Code. In a lengthy dissent in the *Philadelphia Newspapers* case, Judge Thomas Ambro disagreed with the findings of the majority and noted that "secured lenders have relied on their ability to credit bid in extending credit to debtors, reducing their costs and pricing in accordance with their bargains." Disagreeing with the Third and Fifth Circuits, and following Judge Ambro's reasoning in his dissent, the Seventh Circuit in the *River Road* case held that because the debtor's plan attempted to sell assets free and clear of liens without allowing the secured creditor to credit bid, it was unconfirmable. The conflicting opinions turn on different interpretations of Section 1129 of the Bankruptcy Code which allows a plan to be crammed down over the objection of a class of creditors if it is "fair and equitable." A decision by the Supreme Court is expected in the summer 2012.

Peter S. Clark, II

MF GLOBAL – U.S. AND UK

On October 31, 2011 (the "Petition Date"), MF Global, which up to that point had been one of the world's largest broker/dealer firms, was plunged into insolvency on both sides of the pond. On the Petition Date, MF Global Holdings, Ltd. and MF Global Finance USA, Inc. (the "US Debtors") each filed voluntary bankruptcy petitions under chapter 11 of the Bankruptcy Code in the Bankruptcy Court for the Southern District of New York. Contemporaneously with the U.S. bankruptcy filings, the Securities Investor Protection Corporation initiated the liquidation of MF Global, Inc., the U.S. commodities branch of MF Global, and James Giddens was appointed as the SIPC Trustee. Also on the Petition Date, MF Global UK Limited, the main UK subsidiary of MF Global Holdings Ltd., entered the new special administration regime for investment banks in the UK. Since then, other subsidiaries of MF Global Holdings Ltd. have also entered insolvency proceedings in the UK, Canada, Singapore, Hong Kong and Australia.

MF Global attributed its demise to current global economic insecurity and the resultant instability of financial markets. Circumstances, such as increased net capital requirements relating to European sovereign debt, contraction of proprietary principal activities resulting in net losses for the most recent fiscal quarter, and MF Global being downgraded to junk status by various rating agencies, were all cited as factors that contributed to its collapse.

What has happened so far?

U.S.: Dominating the headlines in the bankruptcy case has been the purported shortfall in the funds that MF Global was holding for its customers. At the first day of hearings, counsel for the US Debtors denied that any customer money held by any U.S. MF Global entity was misapplied/misdirected and stated that all money was accounted for, but recent reports indicate that as much as $1.2 billion of customer funds may be unaccounted for by the US Debtors.

The bankruptcy case is still in its infancy, so it's difficult to know what course it will take. To date, most of the activity in the United States has centered on the SIPC Trustee and his liquidation of MF Global, Inc. The SIPC Trustee has been focusing on determining the true amount of the purported shortfall, while also working to transfer the accounts and positions of MF Global, Inc.'s customers. To that end, as of November 21, the SIPC Trustee had received authority from the Bankruptcy Court to transfer 14,500 commodity accounts with 3 million open positions along with $1.5 billion in collateral, which represents approximately 60 percent of the collateral for those positions. Additionally, the SIPC Trustee is also in the process of effectuating a second bulk transfer to move a percentage of deposits in 23,300 accounts holding cash-only as of Petition Date. This transfer is dependent on the SIPC Trustee finding Futures Commission Merchants to process the transfers. The SIPC Trustee has also announced his intention to do a third transfer to "true up" the value of all claimants' distributions to 60 percent of the net equity of their accounts as of the Petition Date. Any unsatisfied claims of MF Global Inc.'s customers remaining after the transfers will need to be resolved through a yet to be determined claims process. The distributions available under that process are currently unknown.

United Kingdom: MF Global UK Limited was placed into Special Administration, a new administration regime for investment banks, and was also declared to be in default by LCH Clearnet Ltd., the London Metal Exchange, and several other UK exchanges and clearing houses. It is the first company to be placed into a Special Administration, so the progress of this case is being watched carefully.

Under the Special Administration rules, the Special Administrators' objectives are to ensure the return of client assets as soon as is practicable; to engage with exchanges, clearing houses and other authorities; and the winding up of the company for the benefit of creditors. However, this is likely to be a lengthy process. The vast numbers of client positions to be investigated, closed out and dealt with mean that the Special Administrators have a difficult task on their hands. However, information about the process the Special Administrators will follow is due to be sent to all clients shortly.

The only information that has been released so far has been limited to advice that all open client positions relating to foreign exchange had been closed as of November 4, 2011, and that the Special Administrators were working on providing closing information.

What can Reed Smith do to help?

In response to this, Reed Smith launched the MF Global Task Force October 31. The Task Force regularly posts updates on developments in the proceedings in the United States and the UK. Making the most of Reed Smith's global presence to gather information (for example, a colleague attended the first-day hearings for the chapter 11 proceedings), the Task Force keeps up to date on events as they unfold and reacts promptly to them. All of our updates and alerts can be found on the MF Global Task Force Special Topic page on www.reedsmith.com.

Elizabeth McGovern, Victoria Thompson and Kristy O'Conner

IN A CASE OF FIRST IMPRESSION, COURT GRANTS ADMINISTRATIVE PRIORITY STATUS TO POST-PETITION WITHDRAWAL LIABILITY

In re Marcal Paper Mills, Inc., No. 09-4574, 650 F.3d 311 (3d Cir., 2011)

CASE SNAPSHOT

As part of its paper manufacturing business, Marcal Paper employed truck drivers who were members of the Teamsters Union. Marcal Paper's relationship with these truck drivers was governed by a collective bargaining agreement. Pursuant to the collective bargaining agreement, Marcal Paper was required to contribute to a multiemployer defined benefit pension plan. After Marcal filed a chapter 11 bankruptcy petition, it continued to operate as a debtor-in-possession and employ the Teamster drivers under the collective bargaining agreement. Because of its ongoing employment of the Teamster drivers, Marcal continued making pension contributions on behalf of the drivers. Marcal's assets were sold 18 months into the bankruptcy proceeding, at which time the purchaser ceased to employ the Teamster drivers. The pension fund determined that Marcal had made a "complete withdrawal" as defined in ERISA, and calculated Marcal's total withdrawal liability to be nearly $6 million. The pension fund filed a claim with the Bankruptcy Court, seeking an administrative priority expense for the portion of the withdrawal liability attributable to post-petition services provided by the Teamster drivers.

In a case of first impression in the Third Circuit, the Court of Appeals analyzed the applicable ERISA and Bankruptcy Code provisions in determining whether the withdrawal liability attributed to post-petition services was entitled to administrative priority status. The appellate court ultimately held that it was.

FACTUAL BACKGROUND

As required by the terms of its collective bargaining agreement with Local 560 of the Teamsters Union, Marcal participated in the Trucking Employees of North Jersey Welfare/Pension Fund, a multiemployer defined benefit retirement fund. On November 30, 2006, Marcal filed its petition for bankruptcy, and continued operating as a debtor-in-possession. Aware that the CBA was due to expire August 16, 2007, Marcal and Local 560 executed a Memorandum of Understanding, continuing the terms of the CBA until a new contract could be negotiated. While these parties never did negotiate a new contract, Marcal continued to employ the Local 560 drivers, and continued making all required contributions to the Pension Fund. On May 30, 2008, Marcal's assets were sold to a purchaser who ceased employing the Local 560 drivers as of that date, and no further pension contributions were made.

As a consequence of the cessation of Marcal and the drivers' employment, the Pension Fund determined that Marcal had made a "complete withdrawal" from the Fund, as defined in ERISA and amended by the Multiemployer Pension Plan Amendments Act. As a result of the withdrawal, the Pension Fund assessed Marcal a $5.9 million withdrawal liability, and filed a claim in the bankruptcy case, seeking administrative priority expense status for the entire claim. After Marcal objected to the claim, the Pension Fund amended its claim and only sought the portion of the liability attributable to Teamster drivers' post-petition employment as an administrative expense.

The Bankruptcy Court denied the Pension Fund's claim, classifying the entire amount as a general unsecured claim. The District Court reversed that decision, and Marcal appealed.

COURT ANALYSIS

"[T]he question in this case is whether withdrawal liability, as defined by ERISA, as amended by the MPPAA, should be apportioned between pre- and post-petition periods and, if so, whether the post-petition portion qualifies as an administrative expense as defined by the Bankruptcy Code." The appellate court undertook an examination of the relevant bankruptcy and other federal statutes.

Section 503(b)(1)(A) of the Bankruptcy Code defines administrative expenses as "the actual, necessary costs and expenses of preserving the estate including … wages, salaries and commissions for services rendered after the commencement of the case." To qualify for priority treatment, the administrative expense must arise from a post-petition transaction with the debtor that was beneficial to the debtor's business operation in order to qualify for administrative status.

The court examined the nature of withdrawal liability and how it is calculated to determine whether the withdrawal liability qualified as an administrative expense claim as set forth in section 503 of the Bankruptcy Code.

As opposed to a defined contribution plan (where the employer is only required to make a set contribution, without regard to the ultimate retirement amount), a defined benefit plan is designed to provide the employee with a set retirement amount. Defined benefit plans, therefore, require actuarial and investment forecasts, and employers typically make contributions in an amount equivalent to the present value of the forecasts. When forecasts fall short, the pension is underfunded.

In its original form, ERISA allowed employers to withdraw from defined benefit plans and escape their obligations to provide benefits. An employer who had paid in all required contributions to a multiemployer plan could withdraw from the plan, and if the plan did not terminate within five years, the employer would have no further responsibility for any part of the unfunded liabilities of the plan.

The MPPAA was enacted, in part, to address this issue. Withdrawal liability was implemented to alleviate this problem, and make sure that employers could not avoid their obligation by withdrawing, thereby harming employees, as well as the entire fund's health. The MPPAA provides that if an employer withdraws from a multiemployer plan, then the employer is liable for its share of the "unfunded vested benefits," which are calculated as the difference between the present value of vested benefits and the current value of the plan's assets. The MPPAA sets forth various methods for this calculation, and case law has held that, broadly speaking, the employer is required to fund its proportional share of the plan's unfunded obligations. Calculations can be complex, but a withdrawing employer's liability is based largely on its contribution history of the five years preceding withdrawal.

Turning next to the section 503(b)(1)(A) requirements, the court found that drivers were required to work post-petition in order to keep Marcal

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CROSS-AFFILIATE NETTING PROVISION IN ISDA SWAP AGREEMENT IS NOT ENFORCEABLE AGAINST THE DEBTOR

In re Lehman Brothers Inc., Bankr. Case No. 08-01420 (JMP) (SIPA), 2011 WL 4553015 (Bankr. S.D.N.Y. Oct. 4, 2011)

CASE SNAPSHOT

The issue decided in this case is whether a cross-affiliate netting provision in an ISDA swap agreement is enforceable against a debtor in bankruptcy. Relying in part on authority from the District of Delaware, the United States Bankruptcy Court for the Southern District of New York held that a contractual right to a triangular (non-mutual) setoff is not enforceable against a debtor in bankruptcy because only rights to setoff mutual debts are enforceable in bankruptcy proceedings. Thus, the Bankruptcy Court found that, notwithstanding the Bankruptcy Code's safe harbor provisions for swap agreements, a cross-affiliate netting provision, i.e., a triangular setoff provision, in a swap agreement is not enforceable against a debtor in bankruptcy.

FACTUAL BACKGROUND

In 2004, UBS AG and Lehman Brothers Inc. entered into a swap agreement, comprised of a 1992 ISDA Master Agreement, a schedule, and a credit support annex, to engage in foreign exchange swaps. Each party posted collateral as security for their respective obligations. In 2008, after Lehman defaulted, UBS exercised the early termination provisions of the swap agreement.

After setting off the early termination payment owed to UBS under the swap agreement against Lehman's collateral (which setoff was not challenged by Lehman), UBS still held $76 million of Lehman's collateral. Lehman argued that, under the terms of the swap agreement, UBS was required to return the $76 million to Lehman. UBS returned all but $23 million to Lehman. UBS argued that Lehman owed $23 million to affiliates of UBS (not parties to the swap agreement) and, under the terms of the swap agreement, UBS was entitled to setoff the amount Lehman owed the affiliates against Lehman's collateral.

The swap agreement provided that, upon any early termination, the non-defaulting party ("X") may setoff any sum or obligation whether or not arising under the swap agreement owed by the defaulting party ("Y") to X or any affiliate of X, against any sum or obligation whether or not arising under the swap agreement owed by X or any affiliate of X to Y.

The SIPA Trustee, overseeing the bankruptcy and liquidation of Lehman, argued that the triangular setoff established by the swap agreement failed to satisfy the mutuality requirement for permissible setoffs set forth in section 553(a) of the Bankruptcy Code and, thus, was not enforceable in the bankruptcy proceeding. Moreover, the safe harbor provisions found in section 561 of the Bankruptcy Code for swap agreements did not change that result. Thus, the SIPA trustee sought to recover the $23 million from UBS.

UBS argued that the triangular setoff provision was valid and enforceable under New York contract law and, because the setoff right was created by contract (rather than common law), section 553(a) and its mutuality requirement did not apply or, alternatively, was satisfied. Moreover, even if the Bankruptcy Court did find that the mutuality requirement applied and was not satisfied, UBS's right to setoff was protected by the safe harbor provisions for swap agreements.

COURT ANALYSIS

The Bankruptcy Court rejected UBS' arguments, holding that a contractual right of setoff that permits netting by multiple affiliated members of the same corporate family cannot be enforced after commencement of a bankruptcy proceeding by a counterparty to the contract.

The Bankruptcy Court explained that section 553(a) of the Bankruptcy Code preserves "*any* right of a creditor to offset a *mutual* debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case…." (emphasis added). Because the section governs "any right," not just common law or contractual rights, the Bankruptcy Court concluded that the swap agreement was "inescapably" governed by section 553(a). Moreover, because the section refers to only "mutual" debts and claims, the court concluded that the only setoffs permissible in a bankruptcy proceeding are those where the debt owed by the creditor to the debtor, and the creditor's claim against the debtor, are mutual. The Bankruptcy Court explained that a debt and claim are mutual only when they are "in the same right and between the same parties, standing in the same capacity." Thus, the court held that a contractual right to a triangular setoff is not enforceable against a debtor in bankruptcy because, by definition, the claim and debt are not between the same parties, as is the case here, where UBS' affiliates are the parties with claims against Lehman, and UBS is the party owing a debt to Lehman.

The Bankruptcy Court further found that the fact that the triangular setoff right arose under a contract did not change or otherwise satisfy the strict requirement that the claim and debt be mutual. The court emphasized the language of section 553(a), saying that "The clarity of this language is conclusive – mutuality quite literally is tied to the identity of a particular creditor that owes an offsetting debt. The right is personal, and there simply is no ability to get around this language. Parties may freely contract for triangular setoff rights, but not in derogation of these mandates of the Bankruptcy Code."

The court then addressed the so-called safe harbor provisions applicable to swap agreements. Section 561 of the Bankruptcy Code provides, in relevant part, that the exercise of any contractual right to offset or net termination values, payment amounts, or other transfer obligations arising under or in connection with a swap agreement, shall not be stayed or limited by any provision of the Bankruptcy Code. Based on the fact that the legislative history for section 561 did not mention eliminating the mutuality requirement, the Bankruptcy Court concluded that this language did not do so. (Later in the opinion, when discussing nearly identical language contained in section 362(b)(17) of the Bankruptcy Code, the court appears to hold that such language does not apply under these facts because the affiliates' claims did not arise under or in connection with the swap

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Cross-Affiliate Netting Provision in ISDA Swap Agreement is Not Enforceable Against the Debtor—continued from page 4

agreement.) Thus, the Bankruptcy Court held that a triangular setoff provision is not enforceable against a debtor in bankruptcy, even if part of a swap agreement.

The Bankruptcy Court, therefore, ordered UBS to return the $23 million to Lehman immediately.

PRACTICAL CONSIDERATIONS

Absent a successful appeal by UBS or developments in subsequent case law, cross-affiliate netting or setoff rights, whether arising in a swap agreement or otherwise, do not appear to be enforceable in bankruptcy proceedings (at least in the Southern District of New York, a significant bankruptcy jurisdiction). Parties considering arrangements that rely on cross-affiliate netting or setoff rights should carefully consider the risk of their counterparty entering bankruptcy and, if the risk is great, may want to explore alternative arrangements.

Brian Schenker

In a Case of First Impression, Court Grants Administrative Priority Status to Post-Petition Withdrawal Liability—continued from page 3

operating, "unquestionably conferring a benefit on the estate." Pursuant to the Memorandum of Understanding and continuation of the CBA and pension plan, Marcal promised to provide pension benefits in exchange for that post-petition work. The court concluded that section 503(b)(1)(A) was satisfied, and the portion of withdrawal liability attributable to the post-petition work was entitled to administrative status.

Marcal put two arguments forward in support of its position that administrative expense status was inappropriate. First, it argued that some of the factors that determine the amount of withdrawal liability (such as investment performance and other actuarial factors) have nothing to do with the work performed by the covered employees. The court agreed that factors other than the work itself were involved, "but that does not alter the fact that the amount owed to the TENJ Pension Fund is based upon Marcal's decision to take advantage of work provided by covered employees…. Although Marcal paints the amount of withdrawal liability it owes as wholly subject to the whims of the market and actuarial assumptions, it ignores the fact that pursuant to Marcal's agreement to provide a defined benefit, it assumed those risks with open eyes." The court emphasized that Marcal promised a defined *benefit*, not a defined *contribution.* Withdrawal liability is intended to make up for any deficiency in the fund's assets, and any deficiency prevents the employer from keeping its promise to provide its employees with a defined retirement benefit.

Marcal's second argument was that withdrawal liability is not intended to benefit covered employees. Rather, it is intended to benefit other employers within the Pension Fund, the Pension Benefit Guaranty Corporation insurance that may have to make up any shortfall, and all employee-beneficiaries of the plan (not just those who worked for Marcal). Marcal did concede, though, that withdrawal liability is, at least in part, designed to benefit Marcal employees. The court analyzed the legislative history of the MPPAA to conclude that the "simple fact is that the plan exists for the benefit of the employees." Absent withdrawal liability, employees are harmed. "Because withdrawal liability ensures that there are enough plan assets to provide promised benefits, it is provided in consideration for the employees' willingness to continue to work."

The appellate court concluded that, consistent with decisions of other courts and legislative history, post-petition withdrawal liability should be classified as an administrative expense. The court remanded the case to the District Court with instructions for proceedings consistent with this opinion.

PRACTICAL CONSIDERATIONS

This is an important decision to consider when working with debtors-in-possession. By allowing only post-petition work and accompanying withdrawal liability to be classified as an administrative expense, "we ensure that workers are provided the full benefit of the bargain … incentivizing their work for the DIP and ensuring its continued functioning. At the same time, by limiting … withdrawal liability … to the post-petition period, we help preserve the estate and prevent it from being devoured by the entire withdrawal liability claim." Moreover, the court believed that its holding helped to fulfill Congress's objectives in enacting the MPPAA – securing the finances of pension funds and preventing withdrawing employers from negatively affecting the plan and the employee-beneficiaries. This decision agrees with reasoning set forth in a Second Circuit decision, and is a "precedential" decision of the Third Circuit. Debtors must be aware of and account for potential withdrawal liability when evaluating their relationship with their unionized employees.

Kathleen Murphy

COURT FINDS MATERIAL QUESTIONS OF FACT REGARDING BREACH OF FIDUCIARY DUTIES AND DEEPENING INSOLVENCY

Official Committee of Unsecured Creditors v. Baldwin (In re Lemington Home for the Aged), No. 10-4456 (3d Cir., Sept. 21, 2011)

CASE SNAPSHOT

The Lemington Home, a nonprofit organization, had provided residential elder care services for more than 100 years, but was in dire financial shape. By 1999, the Home was insolvent and had received "going concern" warnings from its auditor. The operation of the Home was fraught with mismanagement. Among other things, the Board of Directors and officers kept poor records, and failed to provide proper oversight and administration. Additionally, the Directors planned to transfer the Home's primary charitable asset to an affiliated nonprofit organization that was managed by the same Directors. The Directors made the decision to close the Home in January 2005; however, operations continued for an additional five months prior to filing a bankruptcy petition. The Official Committee of Unsecured Creditors brought an action against the Board and officers of the Home for breaching the fiduciary duties of loyalty and care, and for deepening insolvency. The District Court granted the defendants' motion for summary judgment, finding that the business judgment rule and the doctrine of *in pari delicto* shielded the defendants from this suit. The Court of Appeals for the Third Circuit reversed, finding that the Committee tendered sufficient factual evidence to establish genuine issues of material fact on all counts.

FACTUAL BACKGROUND

Throughout the 1980s and 1990s, the Lemington Home, a historic mainstay of the city of Pittsburgh, had encountered extensive financial troubles; without the assistance provided by local governmental and charitable organizations during this time period, the Home would not have survived. Despite this assistance, the Home was forced to file for bankruptcy in 2005 as a result, at least in part, of the gross mismanagement of the Home.

In 1997, Ms. Melody Causey, a named defendant in the adversary proceeding, was hired as the Home's chief administrative officer. By 1999, the Home was insolvent. During her tenure, the Home was the subject of numerous complaints and investigations, at least two patient deaths resulting from negligence, and was placed on probationary status by the Pennsylvania Department of Health. In 2001, a study funded by the Pittsburgh Foundation recommended that the Board of Directors replace Causey with a qualified nursing home administrator, and provided a $175,000 grant to hire a new administrator. Although the grant was accepted by the Home, Causey remained as administrator and the grant was used for other purposes. Early in 2004, Causey informed the Board that her doctor was placing her on part-time work status because of health problems. Despite the fact that state law required there to be a full-time administrator, the Board did not replace Causey.

Late in 2002, James Shealey, also a named defendant in the adversary proceeding, became the Home's Chief Financial Officer. Shealey failed to maintain a general ledger, and by 2004, the financial records of the Home were "in deplorable condition." Beginning in 2003, the Home was cited several times for deficiencies related primarily to failure to document services rendered. From 2003 until 2005, there was no Board Treasurer, and no meaningful oversight of the Home's financial records or condition. During Shealey's tenure, the Home neglected to collect more than 2,000 days of unbilled Medicare patient days.

In May 2004, Causey recommended to the Board that the Home file for bankruptcy. The Board instead opted to seek a $1 million loan from the Lemington Home Fund, which was administered by the Pittsburgh Foundation. Obtaining this loan was conditioned on the Board obtaining a viability study, which the Board declined to pursue.

Meanwhile, the Board rarely kept meeting minutes, rarely had attendance exceeding 50 percent, and relied on Shealey's advice despite being aware as early as 2004 that Shealey was not maintaining financial records. At its meeting in January 2005, the Board voted to terminate Causey and to close the Home. Although the Board voted to close the Home and considered bankruptcy, it did not approve the filing for bankruptcy for another three months. During that time, it attempted to pursue a merger with a local hospital and discussed the transfer of the Home's principal charitable asset, the Lemington Home Fund, to Lemington Elder Care, an affiliated entity that shared Board members with the Home.

On April 13, 2005, the Home filed a voluntary chapter 11 petition. Two weeks later, the Official Committee of Unsecured Creditors was appointed. The Committee retained an investigator to examine the Home's records, who discovered that there had been no submissions made for payment from Medicare since August 2004, which amounted to at least $400,000 in missing revenue. The Bankruptcy Court directed the debtor to obtain a viability study, which revealed that many department heads lacked sufficient training and experience, and that basic internal controls were lacking. At a bankruptcy status conference in August 2005, the court approved closure of the Home and transfer of its residents to other facilities because of a lack of interest by third parties in acquiring the Home.

The Committee filed an adversary complaint against the members of Board, Causey, and Shealey, alleging breaches of the defendants' fiduciary duties of loyalty and good care, and for deepening insolvency. The District Court granted the defendants' motion for summary judgment, holding that the business judgment rule and the doctrine of *in pari delicto* precluded the claims.

COURT ANALYSIS

Under Third Circuit jurisprudence and Pennsylvania law, directors and officers are fiduciaries of corporations and owe to creditors of an insolvent corporation, as well as to the corporation and shareholders, the duty to act "in good faith, in a manner [the director] reasonably believes to be in the best interests of the corporation and with such care, including reasonable inquiry, skill and diligence, as a person of ordinary prudence would use under similar circumstances." Further, directors are entitled to rely, in good faith, on reports and information provided by officers, employees, and professionals "whom the director

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Court Finds Material Questions of Fact Regarding Breach of Fiduciary Duties and Deepening Insolvency—continued from page 6

reasonably believes to be reliable and competent in the matters presented." A director is not considered to act in good faith if the director has knowledge that would cause his reliance on others to be unwarranted. State law similarly requires officers to act in the best interests of the corporation, and to exercise such care, including reasonable skill, inquiry and diligence, as would a person of ordinary prudence.

Business Judgment Rule

The business judgment rule is a defense that may be raised by officers and directors of a corporation provided there is no "breach of fiduciary duty, lack of good faith or self-dealing." The business judgment rule entitles an individual director to a presumption that his or her acts are in the best interests of the corporation. Citing state and Third Circuit jurisprudence, the court noted that underlying the business judgment rule is "the assumption that reasonable diligence has been used in reaching the decision which the rule is invoked to justify." An important factor in examining the question of the applicability of the business judgment rule is whether the Board conducted an adequate investigation, and whether the Board rationally believed that its decision was in the best interests of the corporation.

In the case at hand, the District Court found evidence that the Board held official board meetings, was assisted by and relied upon the advice of counsel, and pursued other options prior to filing for bankruptcy, was sufficient to establish the invocation of the business judgment rule. On appeal, the Court of Appeals acknowledged that such evidence often supported application of the business judgment rule as a matter of law. Nevertheless, the court held that this particular evidence was "countered by evidence that the Board received numerous red flags as to the competence and diligence of Causey and Shealey." This evidence and evidence that showed the Board eschewed a viability study and favored Lemington Elder Care over the Home, supported a rational conclusion that the Board did not exercise reasonable diligence. Therefore, evidence presented by the Committee established a genuine issue of material fact as to whether the defendants were entitled to business judgment rule protection.

In Pari Delicto

In pari delicto is a doctrine that prohibits courts from "mediating disputes among wrongdoers." In order for the doctrine to apply under Pennsylvania case law, "the plaintiff [must] be an active, voluntary participant in the wrongful conduct or transactions for which it seeks redress, and bear 'substantially equal [or greater] responsibility for the underlying illegality' as compared to the defendant." The doctrine can be invoked to prevent actions brought by corporations against directors/agents on the theory that a principal is generally liable for its director's/agent's actions that are taken within the scope of its authority, and thus both the corporation and the director or agent are bad actors. However, there is a recognized exception to the doctrine – the "adverse interest" exception – that prevents the application of *in pari delicto* when the corporation does not benefit from the wrongful acts of the wrongdoer.

Because the Unsecured Creditors Committee brought the action on behalf of the corporate debtor, the defendants argued that *in pari delicto* applied. The District Court held the adverse interest exception did not apply because the defendants did not receive any personal benefits from the alleged wrongful acts. The Court of Appeals overturned this decision, holding that the operative question was not whether the defendants received a personal benefit, but whether the corporation received a benefit. The court found that a genuine issue of material fact existed as to whether the Home received a benefit from the wrongful acts of the defendants, and therefore, summary judgment on the grounds of *in pari delicto* was improper.

Deepening Insolvency

The claim of deepening insolvency has not yet been recognized by the Pennsylvania Supreme Court. Nevertheless, Third Circuit jurisprudence holds that the Pennsylvania Supreme Court would conclude that deepening insolvency is a cognizable claim. Citing its decision, *In re Citx,* 448 F.3d 672 (3d Cir. 2006), the court stated that deepening insolvency in Pennsylvania is "an injury to [a debtor's] corporate property from the fraudulent expansion of corporate debt and prolongation of corporate life." In *Citx*, the court stated that it was necessary to show: (1) that the directors' actions caused the deepening of insolvency; and (2) fraud on the part of the directors. Under Pennsylvania jurisprudence, fraud is "anything calculated to deceive .… It is any artifice by which a person is deceived to his disadvantage." The Court of Appeals held that the Board's decisions to stop admitting patients several months before filing for bankruptcy, the failure to notify creditors of its decision to close the Home, and the Board's interest in facilitating the transfer of the Home's assets to a related entity, presented material questions of fact as to whether the Board's actions constituted fraud. Material questions of fact also existed with respect to the officers' actions, particularly the commingling of funds, continuing to conduct business as usual with vendors while being aware that the Home was insolvent, and failure to submit and collect Medicare billings.

Accordingly, the Court of Appeals vacated the District Court's decision, and remanded the matter for trial.

PRACTICAL CONSIDERATIONS

The business judgment rule is intended to allow directors and officers to utilize their best judgment in serving the corporation, freeing them from paralysis-inducing fear of being held liable when those decisions do not go as planned. This case highlights, however, that this defense is not a free pass. Directors and officers are statutorily bound to act in the best interest of the corporation and must act rationally and reasonably. Performing the bare minimum will not be sufficient to establish entitlement to business judgment protection, particularly when directors and officers are relying on information and individuals that they know are deficient.

Additionally, the case expands creditors' abilities to hold directors and officers accountable for the mismanagement of corporations. If creditors can demonstrate

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WHAT ANNA NICOLE SMITH'S BANKRUPTCY CASE MAY MEAN TO CREDIT MANAGERS EVERYWHERE

In June 2011, the United States Supreme Court issued its opinion in the case known as *Stern v. Marshall*. The U.S. Supreme Court held that filing a proof of claim in a bankruptcy case does not constitute consent to the bankruptcy court's jurisdiction over all counterclaims or actions that the bankruptcy estate may later bring against the creditor.

In fact, filing the proof of claim constitutes consent only to those claims or actions that either (1) stem from the bankruptcy case itself; or (2) are necessary to the resolution of the creditor's proof of claim.

In *Stern v. Marshall,* Anna Nicole Smith's husband, John Marshall, passed away leaving one of the largest estates in Texas history. Anna Nicole was not included in his will. She contested the probate of the will alleging, among other things, that John Marshall's son, Pierce Marshall, had fraudulently interfered with John Marshall's intention to leave Anna Nicole property under his will. While the Texas probate proceedings were going on, Anna Nicole filed a chapter 11 bankruptcy case in California. Pierce Marshall filed a proof of claim against Anna Nicole Smith's bankruptcy estate alleging that she owed him money for defaming him in the probate court and that his claim against the estate was non-dischargeable. Anna Nicole's bankruptcy estate counterclaimed against Pierce Marshall alleging that he tortiously interfered with her expectation to receive an inheritance from her late husband. The bankruptcy court disallowed Pierce's claim for defamation fairly early on in the case, leaving only the bankruptcy estate's claim against Pierce Marshall for tortious interference to be decided.

The issue in *Stern v. Marshall* was whether the bankruptcy court had jurisdiction to render a final decision on the tortious interference claim without the express consent of Pierce. The U.S. Supreme Court held that the bankruptcy court lacked jurisdiction because the tortious interference claim was not a "core" matter to the bankruptcy case. First, the Court reasoned that the tortious interference claim did not stem from the bankruptcy case itself; rather, it arose under Texas state law. Second, the Court reasoned that the tortious interference claim was not necessary to the resolution of Pierce's proof of claim. Not only had Pierce's claim already been disallowed, but many of the issues that also needed to be decided to determine if the estate had a valid claim for tortious interference simply were not needed to determine whether Pierce had a valid claim for defamation, or the allowed amount of that alleged defamation claim.

In the process of coming to its conclusion, the U.S. Supreme Court reaffirmed prior opinions that held that if an avoidance action by the estate (such as a fraudulent conveyance action or preference action) is necessary for determining the allowed amount of a creditor's claim, the bankruptcy court has jurisdiction to make a final decision on the avoidance action. The Court also upheld its prior ruling that a creditor who does not file a claim against the estate may not be forced into the bankruptcy court on a fraudulent conveyance action by the bankruptcy trustee. These rulings necessitate that the creditor filed a claim against the estate in order for a bankruptcy court to exercise jurisdiction over it. The rulings, however, left it a bit unclear whether the bankruptcy court has authority to make a final decision in a preference action against a creditor that either (1) did not file a proof of claim against the estate; or (2) has filed a claim against the estate, but the claim amount had already been determined, thus making resolution of the preference action no longer necessary to the resolution of the creditor's claim. There is some discussion in the Court's ruling that preference actions are federal bankruptcy actions, suggesting that preference lawsuits may "stem" from the bankruptcy case itself and thus, constitute core matters over which the bankruptcy court has jurisdiction, regardless of whether the creditor has filed a claim or the status of that claim.

There is, however, other case law suggesting that preference actions, by their nature, are common law actions that exist under state law. Based upon the Court's reasoning that bankruptcy courts lack jurisdiction to render decisions on common law actions, some commentators are of the opinion that the bankruptcy court may lack jurisdiction over preference actions that are not necessary to resolve a creditor's proof of claim against the estate. Based upon the foregoing, not filing a proof of claim against the estate may give you greater leverage in some courts in arguing that the bankruptcy court cannot enter a final ruling on the preference action against you. It does not mean, however, that the preference action necessarily goes away. It just means the bankruptcy estate must file its lawsuit either in a federal district court or a state court – two court systems where the judges may be far less familiar with the law on preference actions and may take considerably more time and/or resources to come to a decision on the action.

Robert P. Simons and Jeanne Lofgren

Court Finds Material Questions of Fact Regarding Breach of Fiduciary Duties and Deepening Insolvency—continued from page 7

that the corporations did not benefit from the mismanagement of the corporation and that the directors/officers acted in bad faith, those directors/officers will have greater difficulty in succeeding on motions for summary judgment. Creditors may find themselves with increased leverage in settlement negotiations, as cases against former officers and directors are more likely to survive dispositive motions.

Joseph Filloy

PRE-PETITION LIENS ON FCC LICENSE PROCEEDS CAN ATTACH TO POST-PETITION PROCEEDS

Sprint Nextel Corporation v. U.S. Bank N.A. (In re TerreStar Networks, Inc.), Case No. 10-15446 (Bankr. S.D.N.Y., Aug. 19, 2011)

CASE SNAPSHOT

Following TerreStar's bankruptcy filing, Sprint, an unsecured creditor, filed a claim for $104 million for the costs of clearing certain bandwidth per FCC requirements. Sprint sought to prime or invalidate the claims of TerreStar's secured creditors, which had an interest in the proceeds of TerreStar's FCC license (the same license that was acquired by TerreStar as a result of Sprint clearing the bandwidth). The case turned on the issue of whether a secured creditor's liens could attach to post-petition proceeds on an FCC lien that, itself, could not be subject to lien. A recent decision in the District of Colorado, *In re Tracy Broadcasting,* held there could be no such lien. The court in *TerreStar* disagreed, finding that the weight of authority in the circuit courts permitted pre-petition liens on FCC license proceeds, whether the proceeds arose pre- or post-petition.

FACTUAL BACKGROUND

Sprint, a wireless telecommunications carrier, obtained the approval of the FCC to move its bandwidth spectrum from its designated bandwidth to a much more valuable bandwidth. In connection with the FCC approval of this move, the FCC required Sprint to move, or clear, the incumbents using the new bandwidth. In that order, the FCC also permitted Sprint to recoup its clearing costs from other licensees who would subsequently occupy that bandwidth. TerreStar Networks, a mobile satellite service provider, obtained a license from the FCC to utilize a portion of Sprint's new bandwidth spectrum, after Sprint had cleared this bandwidth.

In 2008, TerreStar obtained $500 million in financing from certain noteholders. The noteholders and TerreStar entered into a Security Agreement, in which the debt was secured by "All FCC License Rights … including all FCC Licenses, including, without limitation, the <u>right to receive monies, proceeds or other consideration in connection with the sale, assignment, transfer, or other disposition of FCC Licenses, the proceeds from the sale of any FCC Licenses or any goodwill or other intangible rights or benefits associated therewith</u> . . ." (emphasis in opinion). The Security Agreement and offering documents explicitly excluded the FCC License itself. The Security Agreement also pledged as collateral all "General Intangibles," as defined in the New York Uniform Commercial Code.

TerreStar and its affiliates filed for chapter 11 bankruptcy protection. Sprint filed proofs of claim on the grounds that TerreStar owed Sprint on account of its clearing costs. Sprint, which was unsecured, commenced this adversary proceeding against the noteholders' collateral agent seeking to either prime or invalidate the noteholders' security interests as to any and all future proceeds from the FCC Licenses.

COURT ANALYSIS

The court began by stating that, since 1992, case law and FCC rulings are clear that, although a lien cannot attach directly to an FCC license, liens can attach to the proceeds of such a license. The rationale for the distinction was a practical one: although the FCC did not want its licenses involuntarily transferred without its approval, it was not concerned about secured creditors seizing the proceeds of such licenses. "If a security interest holder were to foreclose on the collateral license, by operation of law, the license could transfer hands without the prior approval of the Commission. In contrast, giving a security interest in the proceeds of a sale of a license does not raise the same concerns."

This distinction was important in the *Spectrum Scan LLC v. Valley Bank & Trust Co. (In re Tracy Broadcasting, Corp.)*, 438 B.R. 323 (Bankr. D. Colo. 2010), decision, in which the court invalidated a lien on the proceeds of an FCC license arising from a post-petition sale. The *Tracy* court reasoned that a lien could not be perfected against the FCC license itself, and any liens against the proceeds of the sale of such license could not arise until the sale took place pursuant to UCC section 9-203. Where the sale occurred post-petition, as in *Tracy*, the court held that the lien only arose post-petition and was, thus, barred pursuant to section 552 of the Bankruptcy Code. It was on this decision that Sprint relied.

The *TerreStar* court heavily criticized the *Tracy* decision as badly reasoned and out of step with the rulings in other circuits. The court noted that the *Tracy* decision relied on outdated and FCC-rejected authority. The court held that the FCC's clear motive in invalidating liens on FCC licenses was exclusively to prevent involuntary transfers of the licenses themselves. The court also criticized *Tracy's* interpretation of the UCC because *Tracy* overlooked the fact that pre-petition liens on general intangibles (including unrealized proceeds from an FCC license) would attach to the proceeds of such intangibles, whether the property was sold pre- or post-petition. The *TerreStar* court noted, as a practical matter, that the *Tracy* decision would invalidate every lien on FCC license proceeds except in the limited situation of a pre-petition sale in a pre-packaged bankruptcy. Such requirements would unsettle lenders' expectations, diminishing the value of licenses, and perhaps, making it very difficult for licensees to obtain credit at all.

The court concluded that the noteholders did have a valid security interest in the economic value of the license, and that enforcement of the interest did not violate section 552 of the Bankruptcy Code. The court denied Sprint's motion for summary judgment, and granted the noteholders' and collateral agent's motions for summary judgment.

PRACTICAL CONSIDERATIONS

This court forcefully affirms that, although there are restrictions on liens of FCC licenses, liens on the proceeds of such licenses will be respected post-bankruptcy. Lenders must, of course, spell out in their agreements the collateral and their rights thereto; make all necessary state UCC and federal filings; and be aware that, for now, the *Tracy* decision is still law in the District of Colorado.

For further insight into the *Tracy* decision, please see the June 2011 *Commercial Restructuring & Bankruptcy Alert.*

Christopher Rivas

FDIC TREATMENT OF CREDITOR CLAIMS UNDER ORDERLY LIQUIDATION PROCESS

When a traditional nonbanking company files a case under the Bankruptcy Code, a judge is appointed to be the neutral arbiter of disputes that arise between the debtor and its creditors. Under the new insolvency regime created by Title II of the Dodd-Frank Wall Street and Consumer Protection Act (the "Act"), the Federal Deposit Insurance Corporation (the "FDIC"), who, until now, was only the receiver for banks, also may be appointed as receiver of the nonbank financial company if the Secretary of Treasury, in consultation with the president, determines that the company is in default or in danger of default, and the failure of the company would have serious adverse effects on the nation's financial stability.

Although it is likely that such a nonbank financial company will have been previously designated by the Financial Stability Oversight Council as a "systemically important financial institution" under Title I of the Act, the express language of Title II permits the Secretary of Treasury to pull any financial company into the orderly liquidation process regardless of its Title I designation. Once the FDIC is appointed as receiver under Title II, it is required to liquidate the failing company, without assistance or oversight from a judge, in a manner that imposes all losses on the company's creditors and shareholders (rather than on taxpayers). If the proceeds from the disposition of the failing financial company are insufficient to cover the costs of receivership, the remaining obligations incurred by the FDIC may be the responsibility of the financial sector, through assessments.

The orderly liquidation process established by Title II is an extraordinary remedy that should, and likely will, be used sparingly. Certain of these financial institutions may utilize their "living wills," which are required by the Act, to convince regulators that they could reorganize or liquidate under the Bankruptcy Code without posing a systemic risk. Nevertheless, creditors of these financial institutions, who likely are familiar with proceedings under the Bankruptcy Code, should be prepared to adapt to a different claims procedure under Title II that places significant discretion in the hands of the FDIC. This article highlights those aspects of Title II's claims procedures where the FDIC, as receiver, has been provided with significantly more discretion than that given to a debtor or trustee under the Bankruptcy Code.

Upon its appointment as receiver, the FDIC will initiate an administrative process for the resolution of claims against the failing financial company. Unlike the Bankruptcy Code, where the court serves as arbiter of claims disputes, Title II empowers the FDIC, as receiver, to allow or disallow all or any portion of a claim in its sole discretion. If the FDIC fails to make a determination to allow or disallow a claim within 180 days after the claim is filed and no agreement is reached to extend this deadline, the claim is deemed disallowed. In effect, inaction by the FDIC equals disallowance of claims.

Under Title II, claimants of disallowed claims are not without recourse and have 60 days after notification of disallowance to seek a judicial determination of their claims in the district court for the district in which the financial company is located. The district court must conduct a *de novo* review of the merits of the claim, not a review of the FDIC's determination. This standard of review favors creditors because the court will make an independent determination without deference to the FDIC's decision. If the claimant fails to seek judicial review within the requisite 60-day period, the claimant will have no further rights or remedies with respect to its claim.

FDIC Powers Over Liquidation Priority Scheme

The priority scheme established by Title II is based upon the fundamental principle that an orderly liquidation should fairly treat similarly situated creditors. Nevertheless, the priority scheme may be altered by the FDIC. First, the FDIC, as receiver, has discretion to determine which expenses are necessary and appropriate to facilitate a smooth and orderly liquidation. Such expenses will be paid as a first priority administrative claim. Second, there are limited circumstances in which the FDIC is permitted to pay some creditors more than other similarly situated creditors. Additional payments are permitted when they are necessary to: (1) maximize the value of the assets; (2) initiate and continue operations essential to implementation of the receivership and any bridge financial company; (3) maximize the present value return from the sale or other disposition of the assets; (4) minimize the amount of any loss on sale or other disposition; and, the catch-all, (5) minimize the losses from the orderly liquidation of the financial company. Accordingly, the FDIC has substantial leeway to make additional payments to certain creditors when they are deemed necessary.

Other than a lack of immediate judicial oversight, the FDIC's final rule regarding the treatment of secured claims under Title II is nearly identical to the Bankruptcy Code. This is by design, as Title II directed the FDIC to draft regulations relating to secured claims that would harmonize with relevant provisions of the Bankruptcy Code. The FDIC notes in the final rule, however, that complete harmonization of Title II with the Bankruptcy Code is impossible because of the differences in judicial review. In a bankruptcy case, the debtor's or trustee's actions are subject to prior court approval. In contrast, the FDIC's receivership under Title II is an administrative process, and court jurisdiction is limited.

When reviewing a secured claim under Title II, the FDIC has discretion to determine the amount of the claim, the relative priority of the security interest, whether the security interest is legally enforceable and perfected, and the fair market value of the collateral. To the extent that the claim exceeds the value of the collateral, the claim will be bifurcated into secured and unsecured components. To the extent that the value of the collateral exceeds the amount of the secured claim, the secured creditor will be allowed interest and any reasonable fees, costs, or charges provided for in the agreement or state statute under which the claim arose. Any excess value remains with the financial company.

The FDIC also has discretion in the disposition of collateral. The FDIC may: (1) surrender the collateral upon written request by the secured creditor; (2) sell, use, or lease the collateral and provide adequate protection to the creditor; and (3) redeem the property from a lien by paying the creditor the fair market value of the property up to the value of its lien. Although the first option is similar to seeking relief from the automatic stay under the Bankruptcy Code, it is the FDIC, rather than a judge, that determines whether the collateral will be surrendered.

The FDIC's discretion, however, is limited in at least one respect. Upon a secured creditor's written request for the surrender of collateral, which must state the

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THIRD CIRCUIT CONSIDERING IF THE ‘POLICE POWER’ EXCEPTION TO THE AUTOMATIC STAY EXTENDS TO THE UK PENSIONS REGULATOR

One exception to the otherwise far-reaching scope of the automatic stay is the “police power” exception, which permits a governmental unit to commence or continue an action or proceeding that is in furtherance of its police and regulatory powers (section 362(b)(4) of the Bankruptcy Code). In the past, bankruptcy courts have held that the “police power” exception extends to actions taken by the Pension Benefit Guaranty Corporation, the agency charged with protecting pension benefits in private-sector defined pension plans.

In *In re Nortel Networks,* 426 B.R. 84 (Bankr. D. Del. 2010), the Bankruptcy Court for the District of Delaware examined whether the police power exception extended to proceedings initiated by the UK Pensions Regulator, the UK equivalent to the PBGC. Although another Delaware bankruptcy court had approved a settlement stemming from regulatory actions taken post-petition by the Pensions Regulator in the case of *In re Sea Containers*, 2008 WL 4296562 (Bankr. D. Del. Sept. 19, 2008), the *Nortel* Bankruptcy Court found that the police power exception did not extend to actions taken by the Pensions Regulator. The District Court affirmed the Bankruptcy Court’s decision and an appeal has been taken to the Third Circuit Court of Appeals. The Third Circuit heard oral arguments in September 2011 and its decision is pending.

The Pension Protection Fund and the UK Pensions Regulator

The UK Pensions Act of 2004 established the Pension Protection Fund (the “PPF”), a statutory body that maintains a fund for members of eligible pension plans financed through levies on pension plans, similar to private insurance premiums, to compensate beneficiaries if their pension plan is inadequately funded. The Pensions Regulator is responsible for protecting each member’s plan benefits and reducing the risk that the PPF will need to compensate plan beneficiaries for underfunded plans.

Among its powers, the Pensions Regulator may issue a Warning Notice if it believes that an employer funding a pension plan is, among other things, insufficiently resourced. Further, if it deems it necessary, the Pensions Regulator may issue a Financial Support Direction (an “FSD”) directing either the employer (the “Employer”) or a party connected or associated with the Employer (the “Non-Employer”) to secure financial support for a particular pension plan. The FSD specifies a time by which financial support must be put in place and requires that the support continue for so long as the pension plan is in place. Under applicable law, the Pensions Regulator may only issue an FSD to a Non-Employer if it is “reasonable to do so.” “Reasonableness” is determined by looking at (1) the relationship between the Employer and the Non-Employer, including whether the Non-Employer controlled the Employer; (2) the value of the benefits received, both directly and indirectly, by the Non-Employer from the Employer; and (3) the financial circumstances of the Non-Employer.

If an FSD is not complied with, the Pensions Regulator may issue a Contribution Notice (a “CN”), which imposes on the party to whom it is issued an obligation to pay the trustee of the pension plan a specified sum. If a party disputes an FSD or CN, it may appeal to the Pension Regulator Tribunal within 28 days of issuance. The Pension Regulator Tribunal may either revoke, confirm or vary the FSD or CN. Following a decision by the Tribunal, a party may, with permission of the Tribunal or the UK Court of Appeal, appeal to the Court of Appeal.

Nortel Networks U.K. Limited maintained a pension plan for its employees under the Nortel Networks U.K. Pension Plan, which is a defined benefit occupational final salary pension scheme and subject to the U.K. Pensions Act.

Procedural Background

On January 14, 2009, Nortel Networks, Inc. (“NNI”) and certain of its affiliates (collectively, the “U.S. Debtors”) filed for chapter 11 bankruptcy relief. Also on the Petition Date, the Debtors’ ultimate parent, Nortel Networks Corporation (“NNC”), and NNI’s direct corporate parent, Nortel Networks Limited (“NNL,” and together with NNC, “Nortel”) and certain of their Canadian affiliates (the “Canadian Debtors”) filed an application with the Ontario Superior Court of Justice under the Companies Creditors Arrangement Act (Canada) seeking relief from their creditors. The High Court of Justice in England also placed 19 of Nortel’s European affiliates (the “EMEA Debtors”), including NNUK, into administration on the Petition Date. On June 26, 2009, and in response to a petition filed by NNUK, the Bankruptcy Court recognized the England insolvency proceeding as a foreign main proceeding under chapter 15 of the Bankruptcy Code.

On June 9, 2009, the U.S. Debtors, the EMEA Debtors and the Canadian Debtors entered into an Interim Funding and Settlement Agreement (the “IFSA”), by which the parties agreed to hold the net proceeds of any material asset sales in escrow pending resolution of certain cross-affiliate claims. The IFSA provided that escrow would be maintained until the parties reached a consensual allocation or, if agreement could not be reached, the appropriate allocation would be determined in a single cross-jurisdictional forum. The IFSA was approved by the Bankruptcy Court June 29, 2009. On September 30, 2009, NNUK, on behalf of itself and the other EMEA Debtors, filed a proof of claim against the Debtors for any “unknown, unliquidated or unmatured claims” (the “NNUK Proof of Claim”).

The UK Pension Claim against Nortel

The commencement of the UK Proceedings triggered the NNUK Pension Plan entering into a PPF “assessment period.” During the assessment period. the PPF worked with the Trustee under the Nortel Networks UK Pension Trust Limited to determine the NNUK Pension Plan’s funding position. On September 30, 2009 and January 25, 2010, the Trustee and the PPF jointly filed proofs of claim against the Debtors, (1) alleging that the NNUK Pension Plan is underfunded by an estimated amount alternatively stated to be £2.1 billion or £3.1 billion, and (2) providing notice that the Pensions Regulator may seek to require certain of the U.S. Debtors, along with certain other non-U.S. Nortel entities, to provide support for the NNUK Pension Plan (the “UK Pension Claim”). As set forth in the UK Pension Claim, the Pensions Regulators had determined that NNUK was insufficiently resourced as of June 30, 2008, and that there were sufficient grounds to issue Warning Notices and seek an

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Third Circuit Considering if the 'Police Power' Exception to the Automatic Stay Extends to the UK Pensions Regulator —continued from page 11

FSD against certain members of the Nortel Group, including NNI and NN CALA, as companies "connected with or associates of NNUK."

By letters dated January 13, 2010, the Pensions Regulator issued a Warning Notice, initiating an administrative proceeding, to NNI, NN CALA, and certain other non-U.S. Nortel entities (the "Targets"). The Warning Notice alleged that there was a shortfall in the NNUK Pension Plan as of June 30, 2008, and stated that the Pensions Regulators believed it was reasonable to issue an FSD against the Targets because of certain benefits conveyed among the affiliates. The Warning Notice put a deadline of March 1, 2010 for the Targets to respond to the Warning Notice. Following receipt of the Warning Notice, the U.S. Debtors filed a motion with the Bankruptcy Court seeking an order enforcing the automatic stay against the Trustee and the PPF with respect to the UK Proceedings.

The Bankruptcy Court's Decision

The Bankruptcy Court began its analysis by noting that the stay imposed by section 362 of the Bankruptcy Code is very broad, and any acts to "assess" a claim that arose prior to the Petition Date are prohibited. Although noting that the exercise of a governmental unit's police or regulatory power is exempt from the automatic stay under section 362(b)(4), the Bankruptcy Court found that this exception did not apply to the current case because neither the Trustee nor the PPF is a "governmental unit." The Bankruptcy Court held that the Trustee is a private party and, although the PPF is defined as a statutory body, it exercises the rights and powers of the Trustee during an assessment period, and therefore stands in the shoes of a private party in such circumstances. Under applicable precedent, which narrowly construes the police power exception, the Bankruptcy Court held that the actions of the PPF and the Trustee are barred by the automatic stay.

Generally speaking, bankruptcy courts apply one of two objective tests when determining if an action falls within the police power exception - the "pecuniary purpose" test or the "public policy" test. Under the pecuniary purpose test, the question is whether the governmental action or proceeding relates primarily to the protection of the government's pecuniary or financial interest in the debtor's property, or to matters of public safety or welfare. The Bankruptcy Court noted that the purpose of the UK Proceedings was to address alleged shortfalls in private pension plans. As this purpose did not address matters of public safety or welfare, the UK Proceedings did not satisfy the pecuniary purpose test.

Similarly, the Bankruptcy Court found that the UK Proceedings failed the public policy test. The public policy test examines if the governmental action at issue is taken in furtherance of a matter of public policy, or if it is intended to adjudicate private rights. The Bankruptcy Court noted that the Pensions Regulator is not seeking to protect the safety or welfare of the public, but instead is seeking to obtain financial support for the benefit of private parties. Any amounts received through the UK Proceedings would not generally benefit the public, but instead would reduce the debt owing by NNUK to the Trustee. As such, the Bankruptcy Court found that the UK Proceedings did not satisfy the public policy test.

The Bankruptcy Court distinguished the case before it from *Sea Containers* based on the procedural posture of the cases and the "entirely different facts." In September 2008, the bankruptcy court in *In re Sea Containers*, approved a settlement under Bankruptcy Rule 9019 involving claims made by the Pensions Regulator against a U.S. debtor for obligations owing under an affiliate's UK pension plan. In *Sea Containers,* an FSD was issued post-petition against a single U.S. debtor. The debtor did not file a motion to invoke or to lift the automatic stay, and one of the two U.S. creditor's committees appointed in the case encouraged that an FSD be issued so that the pension plan trustee could rely on it when pursuing claims in the case. Following the issuance of the FSD, a settlement was reached that granted the pensions trustee an allowed claim in the bankruptcy case. The settlement agreement was filed with the bankruptcy court for approval pursuant to Bankruptcy Rule 9019. The bankruptcy court approved the settlement agreement over the objection of certain parties, including the second creditor's committee who argued that the FSD proceeding violated the automatic stay. The bankruptcy court ruled that the FSD "'should not be ignored as invalid' because it 'provided guidance as to the…pertinent considerations in valuing'" the claims. Further, the bankruptcy court also considered the fact that the UK Determinations Panel did not view itself as being subject to the automatic stay, and no party sought an order from the bankruptcy court enforcing the automatic stay.

Notwithstanding the outcome in *Sea Containers*, the Bankruptcy Court in *Nortel* found the case before it distinguishable. Specifically, the Bankruptcy Court found persuasive that *Sea Containers* only involved an FSD proceeding, while in the instant matter, the Pensions Regulator was trying to secure financial support through an enforceable debt. Further, the Trustee had submitted to the jurisdiction of the Bankruptcy Court by filing proofs of claim for the very same financial support the Pensions Regulator sought to obtain through the UK Proceedings.

Finally, the Bankruptcy Court noted that an overriding issue in the bankruptcy case was the allocation of billions of dollars of proceeds from post-petition asset sales. The U.S. Debtors, the Canadian Debtors and the EMEA Debtors entered into the IFSA pursuant to which they agreed that the proceeds of any sales would be held in escrow and the parties would negotiate in good faith to determine how to properly allocate the proceeds. The Bankruptcy Court noted that the parties had, in fact, engaged in extensive negotiations and, absent a consensual resolution, the issues should be determined in a single-cross jurisdictional forum. Allowing the UK Proceedings to continue would result in the Pensions Regulator, an administrative body with a single constituency, deciding various issues that overlap with the matters being negotiated by the parties under the IFSA. The Bankruptcy Court noted that this was unfair to the U.S. Debtors and the Canadian Debtors, and was contrary to the negotiations among the parties and the spirit of the IFSA.

Elizabeth McGovern

THE SELLER OF LOAN PARTICIPATION INTERESTS PROTECTED FROM PREFERENCE RECOVERY UNDER THE 'CONDUIT THEORY'

Northern Capital, Inc. v. The Stockton National Bank, et al. (In re Brooke Corporation), 2011 WL 4543484 (Bankr. D. Kan. Sept. 28, 2011)

CASE SNAPSHOT

In this case of first impression, the court determined whether the status of the lead bank in a loan participation was that of an "initial transferee" or a mere conduit for the purposes of establishing preference liability. At stake was more than $460,000 in loan payments made by the debtor to the lead bank, which were then disbursed to the loan participants. The court analyzed the roles of the lead bank and participants set forth in the participation agreements, as well as case law, and found that the lead bank was a mere conduit. This decision paved the way for the trustee to recover the payments from the loan participants.

FACTUAL BACKGROUND

The Brooke Corporation solicited several banks to participate in a loan package, through which Brooke borrowed $4.5 million. Brooke executed a promissory note and security agreement in favor of Stockton National Bank. On that same day, Stockton entered into eight identical Participation Certificates and Agreements with the loan participants. The participants' aggregate ownership of the note and security was 94.44 percent; Stockton's ownership was 5.56 percent.

Each Participation Agreement identified Stockton as the "Originating Lender (Seller)," and each participant as a "Participating Lender (Purchaser)." Each Agreement provided that in "consideration of the sum of $ (Purchaser's Investment) Seller hereby sells and certifies to Purchaser an undivided … percent interest (Share), without recourse to Seller, in the Principal and Interest hereby accruing from the Loan." Each Agreement also provided that the Purchaser would be considered, for all purposes, the legal and equitable owner of its share in the loan, documents, and security. Each Agreement provided that the Seller retained the duties of loan administrator, and the Seller was required to collect from Brooke all payments, which would be "held for the benefit of Seller and Purchaser until the payments are actually paid to and received by Purchaser." Stockton was also required to remit payments to each Purchaser no later than 10 days after receipt, subject to a penalty if the funds were not remitted within that time.

At issue are three payments, totaling $480,000, that Stockton received from Brooke in the 90 days prior to Brooke's bankruptcy filing. Stockton distributed more than $460,000 of these payments to the participants, retaining $28,000 for its 5.56 percent share of the participation, and fees it earned as the loan administrator. Stockton maintained a correspondent relationship with another bank where payments were deposited until disbursed. The bankruptcy trustee initiated an adversary proceeding to recover the total of nearly $480,000 in payments Brooke made to Stockton, alleging the payments were preferential transfers. Stockton countered that it was a mere conduit with respect to the $460,000 paid to the other loan participants, and that the trustee could not recover that amount from Stockton. The other participants intervened, arguing that Stockton was the "initial transferee" of the $460,000, so that the trustee could recover that amount only from Stockton under section 550(a)(1) of the Bankruptcy Code.

COURT ANALYSIS

Section 550(a)(1) provides that a trustee may recover preferential transfers from an "initial transferee," but the term "initial transferee" is not defined in the Code. In analyzing the legal claims, the court considered *Bonded Fin. Serv., Inc. v. European Amer. Bank,* 838 F.2d 890 (7th Cir. 1988), which had previously been cited favorably by the Tenth Circuit. In *Bonded*, the court held that "[t]he minimum requirement of status as a 'transferee' is dominion over the money or other asset, the right to put the money to one's own purposes." This "conduit theory" recognizes that a party that merely acts as a financial agent or conduit, is not an "initial transferee." If a transferee receives no benefit from the transferred funds, follows instructions as to the disposition of the transferred funds, or would be liable to the transferor for using the funds for the transferee's own purposes, then the transferee is not an "initial transferee."

Applying the conduit theory to the facts before it, the court found that the Agreements unambiguously established that Stockton sold interests in the loan to each participant without recourse to Stockton. Each Agreement identified Stockton as the Seller, and the participant as the Purchaser, and each Purchaser was "considered for all purposes the legal and equitable owner" of its share of the loan, documents, and property securing the loan. Stockton's role was that of a loan servicing agent, payment collector and disbursement agent. Furthermore, the court found that Stockton's actions always comported with its duties set forth in the Agreements. As such, the court concluded that Stockton (other than with respect to its 5.56 percent share) did not exercise legal dominion or control over the payments, and that that Stockton was a mere conduit.

The court flatly rejected the participants' arguments that, because Stockton retained some discretion as to how to administer the loan payments, it had dominion and control over the funds. The court reasoned that administrative discretion is not equivalent to payment discretion, and was therefore not legal dominion. The court likewise rejected the argument that Stockton's relationship as a creditor of the debtor made Stockton an initial transferee. Stockton was only a creditor with respect to its share of the loan participation; its relationship to the 94.44 percent was that of an administrative agent. Moreover, Stockton's commingling of payments with unrelated funds in its correspondent bank account did not convert Stockton to an initial transferee. That account was used only for administrative convenience, and there was no language in the participation agreements requiring Stockton to segregate payments. There was no trustee relationship between Stockton and the participants, and so, legal title of the $460,000 in payments resided with the participants. Finally, the fact that Stockton filed a proof of claim for the entire amount of the balance due on the Note did not evidence dominion over the funds. The court found that Stockton was only fulfilling its contractual duty to administer the loan "as though it were the sole owner and holder thereof."

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The Seller of Loan Participation Interests Protected from Preference Recovery Under the 'Conduit Theory'—continued from page 13

The Bankruptcy Court held that Stockton was not an "initial transferee," and that, to the extent the transfers were preferential, the trustee could recover from Stockton only the $28,000 it retained as its share of the loan participation. Stockton was a mere conduit with respect to the $460,000.

PRACTICAL CONSIDERATIONS

As stated by this court, the purpose of section 550(a)(1) is to recover preferential transfers from the "real recipients" of the transfers. An overly literal application of the Code section could easily lead to an inequitable recovery from a bona fide middleman that has no dominion or legal control over the funds or property. Because the Code does not define "initial transferee," courts have created the conduit theory, to differentiate between transferees that actually take ownership and have dominion and control of transfers, and those that serve merely as conduits. This case makes it clear that documentation, as well as conduct, must clearly define the roles of the parties.

Ann Pille

FDIC Treatment of Creditor Claims Under Orderly Liquidation Process—continued from page 10

amount of the claim, a description of the property, the value of the property, and the proposed disposition, the FDIC is required to surrender the collateral if it decides not to use, sell, or lease the property. If the FDIC does not act on such request for a period of 30 days, consent to surrender will be deemed to have been granted. In the event that the FDIC decides to sell, use, or lease the collateral, it must provide the secured creditor with adequate protection to the extent that the sale, use, or lease of the property results in a decrease in the value of the creditor's security interest. Adequate protection may consist of making a cash payment or periodic cash payments to the secured creditor, or providing the secured creditor an additional or replacement lien to the extent of the lost value, or providing any other relief that results in the realization of the "indubitable equivalent" of the creditor's security interest. When the value of the collateral is not depreciating or is sufficiently greater than the amount of the secured claim, adequate protection will be presumed. The concept of adequate protection was a late addition in the FDIC's rulemaking process. It was added to the Final Rule to ensure that secured creditors are able to realize the full value of their collateral in the liquidation process.

The lack of judicial oversight is perhaps the biggest difference between Title II and the Bankruptcy Code. Bankruptcy judges are responsible for balancing the competing interests between a debtor and its creditors. Conversely, the FDIC is responsible for ensuring that the creditors and shareholders bear the losses of the financial company so that no taxpayer funds are utilized. To accomplish this goal, the FDIC has been provided broad discretion with respect to the determination and treatment of creditors' claims.

Robert P. Simons and Luke A. Sizemore

SECURED CREDITORS NEED NOT FILE A PROOF OF CLAIM TO LIFT THE AUTOMATIC STAY TO PROCEED WITH A FORECLOSURE ACTION

In the Matter of Richard Louis Alexander (7th Cir., 2011) U.S. App. LEXIS 17110, (August 16, 2011)

CASE SNAPSHOT

An individual debtor appealed the Bankruptcy Court's orders lifting the automatic stay to permit two creditors to proceed with foreclosure proceedings on real property. The debtor argued that relief from the automatic stay was improper because neither creditor filed a proof of claim. The Seventh Circuit affirmed the relief from stay order, holding that a secured creditor need not file a proof of claim to exercise its secured real property interests, and that such *in rem* rights "pass through" the bankruptcy case unaffected.

FACTUAL BACKGROUND

Kondaur Capital and Prime Asset Fund II were assignees of a promissory note and mortgage executed by Richard Alexander. Alexander defaulted, and these two secured creditors initiated foreclosure proceedings in state court. Alexander filed bankruptcy, and the creditors moved to lift the automatic stay so that they could proceed with the foreclosure. The creditors provided sufficient proof that the debtor failed to make monthly payments and that the debtor lacked any equity interests in the property. The debtor objected to the motions, arguing that neither creditor had filed a proof of claim. The Bankruptcy Court held that the secured creditors did not have to file proofs of claim, and that they could pursue their claims in state court. The District Court affirmed.

COURT ANALYSIS

In reviewing the findings of the lower courts, the Seventh Circuit Court of Appeals found no clear error in the factual conclusions, and it was evident that the creditors' interests were not adequately protected and the debtor had no equity in the properties.

The court considered the debtor's arguments that creditors could not seek to lift the automatic stay unless they filed proofs of claim. The Seventh Circuit summarily disposed of the argument, holding that a "secured creditor can bypass his debtor's bankruptcy proceeding and enforce his lien in the usual way, which would normally be by bringing a foreclosure action in a state court. This is the principle that liens pass through the bankruptcy unaffected."

The court therefore denied the debtor's objections, finding that no proofs of claim were required, and that there was cause to lift the automatic stay.

PRACTICAL CONSIDERATIONS

This decision bolsters black letter bankruptcy law that a secured creditor's real property rights against collateral "pass through" the bankruptcy case unaffected, and that a secured creditor may "opt out" of the distribution-of-assets scheme provided for by the Bankruptcy Code. Nevertheless, it is usually advisable to timely file a proof of claim, and a secured creditor should seek the advice of bankruptcy counsel before choosing to not file a proof of claim for strategic reasons.

Christopher Rivas

STRICT COMPLIANCE WITH SECTION 524(C) REQUIRED TO UPHOLD REAFFIRMATION CONTRACT

Sandburg Financial Corp. v. American Rice, Inc. (In the Matter of American Rice, Inc.), No. 11-40301 (5th Cir., Sept. 22, 2011)

CASE SNAPSHOT

In April 1998, Sandburg Financial, as successor in interest to a purchaser in a real estate transaction, obtained a judgment in an action arising from that transaction against a related entity of American Rice, Inc. In connection with the real estate transaction, the purchaser had obtained indemnities and guarantees from, *inter alia,* American Rice, as a related entity of the seller. In August 1998, American Rice filed a chapter 11 petition, and its reorganization plan was confirmed in July 1999. Four months after confirmation, Sandburg and American Rice entered into two contracts to "reaffirm" American Rice's debts, whereby Sandburg agreed not to execute and enforce the judgment against American Rice prior to June 30, 2008 in exchange for American Rice reaffirming the indemnity and guaranty of any obligations of American Rice and/or its related entities. Ten years later, Sandburg filed suit in Texas state court, seeking more than $19 million from American Rice for amounts due under the 1998 judgment. American Rice filed a motion to reopen its bankruptcy case and sought sanctions against Sandburg for violating the terms of the discharge injunction and confirmation order. After surveying decisions from other circuits and district courts and finding that a majority of courts reject the "new and independent consideration" exception to section 524(c), the Fifth Circuit Court of Appeals held that Sandburg had failed to satisfy the strict requirements of section 524(c) of the Bankruptcy Code, and that Sandburg had violated the discharge injunction.

FACTUAL BACKGROUND

In 1988, Sandburg Financial Corp.'s predecessor-in-interest sought to purchase real property and lease the property back to the seller, ERLY Industries, Inc. The purchaser and its lender required ERLY and several of its affiliates (including American Rice, Inc.) to provide indemnities and guarantees to the purchaser for any damages or judgments arising out of the real estate transactions. Ten years after the close of the transactions, Sandburg obtained a judgment based upon the transactions against ERLY and entities related to American Rice. Four months

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Strict Compliance with Section 524(c) Required to Uphold Reaffirmation Contract—continued from page 15

after that judgment, American Rice filed its chapter 11 petition, and its plan of reorganization was confirmed in July 1999.

In August 1999, one month after the plan confirmation, Sandburg and American Rice entered into a covenant not-to-sue contract, in which American Rice stated that the contract was a new contract to pay any new claims that Sandburg may have against American Rice. In exchange, Sandburg agreed not to sue or assert any new claims against American Rice prior to June 30, 2008. In November 1999, these parties entered into an indemnity and release contract, in which American Rice "reaffirmed" its guaranty to pay all of its obligations and the obligations of its related entities. In exchange, Sandburg again agreed not to bring any action against American Rice prior to June 30, 2008.

In October 2009, Sandburg filed suit in state court against American Rice seeking $19 million allegedly due to Sandburg from affiliates of American Rice under both pre-petition contracts and the 1998 judgment. American Rice filed a motion to reopen its bankruptcy case and sought sanctions against Sandburg for violating the discharge injunction and confirmation order. The Bankruptcy Court found for American Rice, holding that the two post-confirmation contracts violated section 524(c) of the Bankruptcy Code. The District Court affirmed, and Sandburg appealed to the Fifth Circuit Court of Appeals.

COURT ANALYSIS

Section 524(c) addresses the enforcement of a contract between a creditor and a debtor involving dischargeable debt, also known as a "reaffirmation contract." The Code sets forth a number of requirements that must be satisfied in order for a debtor to enter into a reaffirmation contract. These requirements are: (1) the agreement must be made before the granting of a discharge of the debt; (2) the debtor receive certain disclosures before or at the time of executing the agreement; (3) the agreement must be filed with the court, accompanied by an affidavit of the debtor's attorney setting forth prescribed declarations; and (4) the agreement must not be rescinded by the debtor prior to the granting of discharge or within 60 days of the agreement being filed with the court, whichever occurs later. This section is intended to protect debtors from entering into unwise contracts to repay dischargeable debt. Reaffirmation contracts are not favored under the Code, and strict compliance with this section is required to enforce such contracts.

The lower courts here found that the contracts had not been made prior to the discharge, the contracts did not contain the required disclosures, and the contracts had not been filed with the court; therefore, the contracts were not enforceable.

Sandburg argued that American Rice's obligations were not discharged by the discharge injunction and confirmation order because the contracts were new contracts supported by new and independent consideration, rather than dischargeable debt, and, thus, were valid and enforceable.

Sandburg's argument was based upon a line of cases that support a "new and independent consideration exception" to section 524(c). In consideration of this argument, the court surveyed jurisprudence from the circuits and district courts and found that the "new and independent consideration exception" has been called into doubt and/or rejected by a majority of courts. As explained by another court, "Section 524(c) is not concerned with the consideration that the debtor received; instead, *it invalidates non-complying contracts where any part of the consideration given by the debtor involves his promise to pay a discharged debt.* Every reaffirmation contract involves some new element of consideration. Otherwise, the debtor would not agree to pay the discharged debt. If new consideration saved a non-complying reaffirmation contract, little would remain of the protection afforded by section 524(c)." (Emphasis in opinion.) Additionally, the only Texas court to have considered the cases Sandburg cited declined to follow those cases, and instead held that 524(c) was purposefully rigorous so as to protect debtors from their own "improvident actions."

In rejecting Sandburg's argument, the court held that if the consideration for a reaffirmation contract is based, in whole or in part, on debt that is dischargeable in a bankruptcy case, then such a contract may be enforced only if it meets all of the requirements of section 524(c). Because the post-confirmation contracts were based in part upon the dischargeable pre-petition debts of American Rice, the court found the contracts were reaffirmation contracts. As the contracts did not strictly comply with the requirements of section 524(c), the court affirmed the District Court's decision.

PRACTICAL CONSIDERATIONS

This decision rejects the "new and independent consideration exception" to section 524(c), which had been recognized by courts in the Second, Seventh and Ninth Circuits. Thus, the opinion casts serious doubt on a creditor's ability to successfully argue that a reaffirmation contract is supported by new and independent consideration. Accordingly, creditors who accept dischargeable debt as consideration, in part or in whole, in an agreement with a debtor should strictly comply with the requirements of section 524(c).

Joseph Filloy

SECURED LENDER TOOK SUFFICIENT AFFIRMATIVE ACTION TO EFFECT THE ASSIGNMENT OF RENTS

Soho 25 Retail, LLC v. Bank of America, N.A. (In re Soho 25 Retail, LLC), Case No. 10-15114 (SHL), (Bankr. S.D.N.Y., March 31, 2011)

CASE SNAPSHOT

The debtor executed a mortgage and assignment of rents in favor of the lender. The assignment stated it was a present, absolute and unconditional assignment of rents; identified the rents as the lender's property without need for any affirmative action by lender; and gave the debtor a revocable license to use the rents, provided there was no default under its loan with the lender. Following the debtor's default, the lender took several steps to protect its interests, including notifying tenants to pay rent directly to the lender, and filing a foreclosure action (which requested appointment of a receiver). A default judgment was entered against the debtor and a sale scheduled to auction the property. Prior to the auction, the debtor filed a chapter 11 petition. The lender filed a lift stay motion, seeking to continue the foreclosure proceedings. The debtor responded to the lift stay motion and, separately, filed an adversary action against the lender, contending that the rents were property of the debtor's estate and demanding the lender turn over the rents it had collected. The Bankruptcy Court held in favor of the lender, finding that the rents were not property of the estate, but belonged to the lender.

FACTUAL BACKGROUND

Soho 25 Retail, LLC owned commercial property. Soho executed a promissory note, securing the note with a mortgage and Assignment of Rents and Leases in favor of the lender. The Assignment granted expansive rights to the lender, and contained language indicating that it was an absolute assignment – "As part of the consideration for the Debt, [the Debtor] does hereby absolutely and unconditionally assign to [the Lender] all right, title and interest of [the Debtor] in and to all present and future Leases and Rents, and this Assignment constitutes a present and absolute assignment and is intended to be unconditional and not as an assignment for additional security only. It is further intended that it not be necessary for [the Lender] to institute legal proceedings, absent any requirements of law or regulation to the contrary, to enforce the provisions hereof." (Emphasis in opinion.) The Assignment also provided that the debtor, prior to any default, had a "revocable license" to enjoy "the rights of the lessor" under its leases. In the event of a default by Soho, however, the Assignment further provided that "[the Debtor] does hereby irrevocably appoint [the Lender] as its attorney-in-fact with full power … to demand, receive, collect … any and all of the Rents…." (Emphasis in opinion.)

Soho failed to make the mortgage payments, triggering the default provisions. The lender then took several steps to protect its interests in the rent. First, it sent Soho a notice of default, informing Soho that the revocable license to use rents was terminated and that the lender was entitled to all future rents.

Second, the lender sent letters to tenants notifying them that all future rent payments were to be made directly to the lender.

Third, the lender initiated a state foreclosure action against the debtor's property in which it requested the appointment of a receiver. The lender obtained a default judgment in the foreclosure action and proceeded to schedule a public auction of the property. The foreclosure auction, however, was stayed by the filing of Soho's chapter 11 bankruptcy petition.

In response to the bankruptcy filing, the lender filed a motion requesting relief from the automatic stay, seeking to continue with the foreclosure sale. The debtor filed a response to the stay motion as well as an adversary action. In both pleadings, the debtor contended that the rents were property of the estate, and that the lender had improperly collected rents and should be compelled to turn over the rents.

COURT ANALYSIS

The threshold issue before the court was whether the rents were property of the lender or property of the estate. The debtor was a single asset real estate case, and the answer to the threshold question determined resolution of the lift stay motion, the adversary action, and the viability of the debtor's reorganization.

Starting with the well-established premises that the Bankruptcy Code determines what property belongs to the debtor's estate while state law governs the nature of the debtor's interest in property, the court concluded, and the parties agreed, that New York law governed the critical threshold issue of who owned the rents.

The debtor argued that, under New York law, an assignment of rents was not self-executing, and that an assignment would not become effective until the lender affirmatively asserted rights to the rents. The debtor argued that the lender had not taken affirmative steps to assert those rights. The debtor also argued that the Assignment contained contradictory language on this question, pointing to several provisions that stated the Assignment was intended to provide additional security to the lender. The lender argued that the Assignment, by its terms, was self-executing and absolute, and that no additional steps were required of it. Alternatively, the lender argued that it had taken sufficient affirmative action to effect the assignment. Both parties pointed to language in the Assignment to support their arguments that the document was, or was not, self-executing.

The court found a split of authority as to whether a self-executing, absolute assignment of rents was permitted under New York law, concluding that the majority of cases did not permit a self-executing absolute assignment of rents, regardless of language in the document. The court stated, however, that it did not have to "resolve this murky legal question because the Lender here took sufficient affirmative steps to make the Assignment effective under New York law."

The court found four alternative actions recognized under New York law as conveying title to assigned rents to a lender. These actions include: (1) requesting the appointment of a receiver to collect rents; (2) demanding or taking possession or the rents; (3) foreclosing on the property; or (4) sequestering the rents. The court ruled that *completing* any one of the four actions was not a prerequisite to perfection. It is enough that the lender *initiates* the action. The court reasoned that New York law rewards parties who diligently act to protect their interests.

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COURT UPHOLDS *IPSO FACTO* CLAUSE AND DEFAULT INTEREST RATE

In re General Growth Props., Inc., Case No. 09-11977 (ALG), 2011 BL 189724 (Bankr. S.D.N.Y. July 20, 2011)

CASE SNAPSHOT

The court addressed the enforceability of an *ipso facto* acceleration clause in a credit agreement triggered by a bankruptcy filing, and whether a lender group was entitled to post-petition interest at the default rate by a solvent debtor. The debtor argued that the failure by the lender group to accelerate the defaulted loan obligations pre-petition rendered the automatic acceleration clause contained in the credit agreement ineffective upon the filing of the debtor's bankruptcy case. The court rejected the debtor's argument. In ruling that the loan was accelerated automatically on the petition date and the lender group was entitled to receive post-petition default interest, the court relied on the sound policy for encouraging pre-petition out-of-court workouts by lenders rather than creating an incentive for lenders to immediately accelerate a loan upon any default, and send borrowers into free-fall bankruptcy filings.

FACTUAL BACKGROUND

General Growth Properties, Inc. entered into a credit agreement with a group of lenders, pursuant to which several secured loans were made. The lenders' administrative agent was Eurohypo AG, New York Branch. General Growth defaulted under the credit agreement by failing to make several scheduled interest payments. Upon the occurrence of an event of default, the credit agreement authorized Eurohypo to accelerate the obligations due and to impose a default rate of interest that was two percentage points higher than the interest rate then in effect. Eurohypo elected to impose the default rate of interest, but did not accelerate the loan obligations. Eurohypo's decision not to accelerate the loan avoided triggering cross-default provisions contained in the loan agreements with General Growth's other creditors. The parties then entered into a forbearance and waiver agreement, whereby Eurohypo agreed to not accelerate payments for the duration of the forbearance period. After the forbearance period expired, but before Eurohypo sent a formal notice of default and acceleration to General Growth, General Growth filed a chapter 11 bankruptcy petition.

It was undisputed that General Growth was solvent. General Growth proposed a chapter 11 plan pursuant to which all creditors were paid in full with post-petition interest. On the effective date of the debtor's plan of reorganization, the debtor paid more than $2.5 billion in principal payments to the lenders, as well as various fees and expenses, and interest. According to General Growth, the Eurohypo lenders were to be unimpaired under the chapter 11 plan, with post-petition interest payable at the nondefault contract rate. Eurohypo objected, arguing it was entitled to post-petition interest at the default rate.

At the center of the dispute was the enforceability of section 8(f) of the credit agreement. Section 8(f) provided that the voluntary bankruptcy filing by General Growth constituted an event of default, which *automatically* accelerated payments and triggered the default interest rate. Eurohypo relied upon this provision to demand that post-petition interest at the default rate must be paid to it under the debtor's chapter 11 plan. General Growth argued, however, that Eurohypo's election not to accelerate the loan pre-petition rendered the *ipso facto* clause contained in section 8(f) ineffective. General Growth argued that Eurohypo was therefore required to take some affirmative action post-petition in order to accelerate the loan obligations and to institute the default rate of interest, which action was barred by the automatic stay. As a consequence, General Growth maintained that its chapter 11 plan could be confirmed by paying the Eurohypo lenders post-petition interest at the nondefault contract rate.

The difference between post-petition interest at the default rate versus the nondefault rate totaled between $85 million and $87 million.

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Secured Lender Took Sufficient Affirmative Action to Effect the Assignment of Rents—continued from page 17

Consequently, a creditor that initiates and shows diligent prosecution of these actions, including filing a lift stay motion to complete a forestalled action, affirmatively perfects its interests in the assigned rents.

Here, the lender commenced three of the four actions – making demand for the rents, initiating a foreclosure proceeding, and requesting the appointment of a receiver. The lender also moved for relief from stay to proceed with the foreclosure once the debtor filed its bankruptcy case. These actions, taken together, showed the lender's diligent pursuit of its interests in the assigned rents sufficient to convey title to the rents from the debtor to the lender.

Based upon its conclusion that, under New York law, the lender owned the rents, the court concluded that the rents were not property of the bankruptcy estate under federal bankruptcy law. The court recognized that the revocable license to the debtor constituted an equitable interest in the rents. The court determined, however, that the license was revoked pre-petition, and that the extent of the estate's interests in the rents was contingent on satisfaction of the note and mortgage. Since the note and mortgage had not been satisfied, the rents were not property of the estate.

PRACTICAL CONSIDERATIONS

Whether an assignment of rents conveys absolute title to rents to a lender, or merely a lien securing repayment of the debtor's obligation, is not clear, no matter what the language in the assignment documents may state. In this case, however, the court was able to point to pre-petition action taken by the lender that perfected its title in the rents under state law, allowing the court to make the difficult decision that rents were not property of the estate, even though that signaled the end of the debtor's reorganization efforts. Accordingly, a lender should not rely on self-executing language in its assignments of rents, but should diligently pursue actions recognized under applicable state law as divesting the debtor of its title to rents.

Jeanne Lofgren

SUBSTANTIVE CONSOLIDATION ORDER NOT AUTOMATICALLY RETROACTIVE ABSENT LANGUAGE TO THE CONTRARY

Giuliano v. Shorenstein Company, LLC (In re Sunset Aviation, Inc.), Adv. No. 11-50965, Bankr. No. 09-10778, 2011 WL 4002429 (Bankr. D. Del. Sept. 7, 2011)

CASE SNAPSHOT

The issue decided in this case is whether an order granting substantive consolidation of several debtors in bankruptcy is retroactively effective, even when it does not expressly provide that it is, because of the nature of substantive consolidation. Disagreeing with authority from the Sixth Circuit and relying on authority from the District of Delaware, the United States Bankruptcy Court for the District of Delaware held that substantive consolidation orders are not automatically retroactive and, absent language in the order to the contrary, the order will not be given retroactive effect.

FACTUAL BACKGROUND

On February 25, 2009, Regal Jets, LLC filed a chapter 11 bankruptcy petition. On March 6, 2009, Sunset Aviation, LLC filed a chapter 7 bankruptcy petition. On May 1, 2009, JetDirect Aviation, LLC filed a chapter 7 bankruptcy petition. Shortly thereafter, Regal Jets converted its bankruptcy case to a chapter 7 case, and a Trustee was appointed. The three companies were affiliated companies. For that reason, among others, the Trustee moved for and received an order substantively consolidating the bankruptcy cases.

The Trustee then filed a complaint to avoid and recover, as a preferential transfer, $440,000 paid to Shorenstein Company, LLC by JetDirect December 2, 2008. For purposes of calculating the 90-day preference period, the Trustee contended that the three debtors shared the earliest petition date of February 25, 2009 because, by its very nature, the substantive consolidation order was *nunc pro tunc,* i.e., retroactive. Thus, JetDirect's transfer to Shorenstein was within the 90 days before the petition date.

Shorenstein moved to dismiss the Trustee's complaint. Shorenstein argued that neither the Trustee's motion seeking substantive consolidation nor the order granting that motion made any mention of a retroactive application of the consolidation. Further, Shorenstein argued that consolidation orders are not, by

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Court Upholds *Ipso Facto* Clause and Default Interest Rate—continued from page 18

COURT ANALYSIS

The court analyzed whether the Eurohypo lenders were entitled to post-petition default interest in two parts. First, the court had to determine whether the *ipso facto* acceleration clause was enforceable and effective. Second, the court had to determine if the Eurohypo lenders were otherwise entitled to receive post-petition interest at the default rate.

The court noted that the Bankruptcy Code precludes enforcement of *ipso facto* clauses in limited circumstances involving executory contracts and unexpired leases. Since the credit agreement was not an executory contract or unexpired lease, the *ipso facto* acceleration clause was not per se unenforceable. The court went on to reject the debtor's argument that the *ipso facto* clause was ineffective because Eurohypo elected not to accelerate the loan pre-petition following the debtor's interest payment default. The debtor's argument, the court reasoned, created an incentive for lenders immediately to accelerate loans and to refuse to consensually work with debtors in out-of-court restructurings, resulting in the unfortunate free-fall into bankruptcy that might otherwise have been avoided. To the court, the better practice and policy was to adhere to the terms of the loan documents negotiated and agreed upon by the parties, and to enforce their plain terms. As such, the *ipso facto* acceleration clause was enforceable and the loan obligations became automatically due and payable in full upon the filing of General Growth's bankruptcy petition.

Having decided the issue of acceleration, the court turned to the question of whether the Eurohypo lenders were entitled to post-petition interest at the default rate. Examining prior case law in the Second Circuit and a companion case recently decided by the court, the court held that General Growth had to provide the Eurohypo lenders with post-petition interest at the default rate.

The court first noted that the Eurohypo lenders presumptively were entitled to the default rate of interest for four reasons. First, the right to default interest was provided for in the credit agreement. Second, the rate of default interest (only 2 percent over the interest rate then in effect) was both reasonable and did not constitute a penalty. Third, the Eurohypo lenders were oversecured. Finally, the debtor was solvent.

The court then examined whether General Growth could rebut the presumption of entitlement, and found that it could not. The Eurohypo lenders had not acted inequitably. Further, payment of post-petition interest at the default rate did not impair General Growth's fresh start following its chapter 11 case and did not deprive General Growth of the benefits of its chapter 11 filing, nor did it harm the unsecured creditor class.

Based upon the foregoing, the court held that "unimpaired" treatment of the Eurohypo lenders required General Growth to pay the loan in full with post-petition interest at the default rate.

PRACTICAL CONSIDERATIONS

In the Second Circuit, a debtor's bankruptcy filing can trigger acceleration of the entire indebtedness and imposition of the default rate of interest, provided that the applicable loan documents provide for automatic application of these credit terms, the default rate of interest is reasonable, the debtor is sufficiently solvent, and the oversecured creditor has acted equitably. Consequently, a creditor satisfying these terms should feel some comfort in negotiating an out-of-court arrangement with its borrower without worrying that a sudden bankruptcy filing by the borrower will negate these critical rights and remedies under the applicable loan documents.

Jeanne Lofgren

COURT FINDS DEFENDANTS KNOWINGLY WAIVED RIGHT TO JURY TRIAL, AFFIRMS SUCH WAIVERS MUST BE CLEAR

Lehman Brothers Holdings, Inc. v. Bethany Holdings Group, LLC, et al., 2011 WL 3427013, (S.D.N.Y. Aug. 5, 2011)

CASE SNAPSHOT

Defendant Bethany Holdings Group, LLC borrowed more than $200 million from Lehman, securing the loans with mortgages on real properties. Defendants, The Terry and Rose Knutson 2000 Family Trust, and Terry Knutson, executed guaranties in connection with the loans, which, among other things, waived the guarantors' right to a jury trial. After the borrower defaulted, Lehman sued the guarantors, demanding payment on the guaranties. The guarantors demanded a jury trial but Lehman opposed the request because the guaranties contained a clause waiving the right to a jury trial. The court, noting that the right to a jury trial should be stoutly protected, held that the guarantors had waived their right to a jury trial because: (1) the waiver of a jury trial in the guaranty was clear and prominent; (2) the parties had conducted other negotiations that indicated there was not an overwhelming disparity of negotiating power; and (3) the course of conduct with respect to prior loans and guaranties, as well as the authority and conduct of the defendants' attorney, showed that the defendants knowingly waived their right to a jury trial.

FACTUAL BACKGROUND

Bethany Holdings, LLC was the owner/operator of apartment complexes across the United States. Mr. Terry Knutson, individually, the Knutson family trust, and others, invested in a series of five apartment complex acquisitions in transactions organized by Bethany. In these transactions, the Knutson defendants provided equity funding, which Bethany leveraged with debt financing obtained largely from Lehman.

The instant action concerns the third of those transactions, the PK I portfolio of properties. Lehman provided three loans for this transaction, in the amount of approximately $240 million. Knutson, acting individually and as trustee of the family trust, executed five guaranties in connection with the PK I loans. Each of the guaranty documents contained a provision that waived the guarantors' right to a jury trial; the waiver was in the same style and size of typeface as the remaining terms of the guaranty documents.

Bethany defaulted on the loans and Lehman demanded payment of $33 million from the guarantors. The guarantors failed to respond to Lehman's payment demand and Lehman sued. The Knutson defendants alleged that they were fraudulently induced into guaranteeing the loans because: (1) Bethany was essentially insolvent at the time it incurred the debt; (2) Bethany hid its insolvency from the guarantors; and (3)

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Substantive Consolidation Order Not Automatically Retroactive Absent Language to the Contrary—continued from page 19

their nature, retroactive. Thus, for purposes of calculating the 90-day preference period for this transaction, the proper petition date was May 1, 2009, i.e., the date of JetDirect's bankruptcy filing. JetDirect's transfer to Shorenstein was, therefore, outside of the 90 days before the petition date.

COURT ANALYSIS

The Bankruptcy Court began by analyzing the Trustee's position that, by its very nature, the substantive consolidation order was automatically retroactive. The Trustee cited cases from the Sixth Circuit to support his argument. The court noted that, while the United States Court of Appeals for the Third Circuit had not ruled on this issue, the District of Delaware had already rejected the argument that substantive consolidation orders are automatically retroactive. Thus, the Bankruptcy Court declined the Trustee's invitation to adopt the approach of the Sixth Circuit cases.

The Bankruptcy Court found that the District of Delaware cases also made it clear that the language of the order was controlling. "[W]here there is no language suggesting that the order should be applied retroactively, the order will not be given that effect." After reviewing the substantive consolidation order, the court determined that it only contained prospective language, e.g., "Further ordered, that <u>from the date of this order forward….</u>" (emphasis in opinion), and made no mention of retroactive effect. "In my view, the critical fact in this case is that neither the Trustee's motion nor the Order itself contain any language to suggest a *nunc pro tunc* application."

Thus, the Bankruptcy Court held that the substantive consolidation order did not have a retroactive effect and JetDirect's transfer to Shorenstein was, therefore, outside of the 90 days before the petition date. The Bankruptcy Court, therefore, granted Shorenstein's motion to dismiss.

PRACTICAL CONSIDERATIONS

From a Trustee's perspective, a primary purpose of a chapter 7 bankruptcy is to bring as much property into the debtor's bankruptcy estate as lawfully possible to provide as large a recovery as possible for creditors. This is one reason why the Bankruptcy Code allows a Trustee to recover transfers deemed to be preferential. Here, the Trustee arguably served that purpose by obtaining the substantive consolidation order. This case, however, makes it clear that, if a Trustee's intent is for a substantive consolidation order to have retroactive effect, the Trustee should include in the order language that the order is effective *nunc pro tunc.*

Brian Schenker

ACTUAL CONFLICT OF INTEREST REQUIRED TO DISQUALIFY LEGAL COUNSEL UNDER SECTION 327

In re The Colonial BancGroup, Inc., 2011 WL 2792477 (Bankr. M.D. Ala. July 15, 2011)

CASE SNAPSHOT

The lender, a creditor, objected to the plan trustee's post-confirmation appointment of a special litigation and conflicts counsel, on the grounds that the law firm did not meet the "disinterested" requirement set forth in section 327 of the Bankruptcy Code. The law firm represented at least seven other creditors during the bankruptcy case, and three of those prior represented creditors were current members of the Plan Committee. The lender alleged that the law firm would influence the plan trustee to act in the best interest of its former clients and not in the best interest of the entire creditor body. The court overruled the objection on the grounds that the law firm did not have an actual conflict because (1) the law firm no longer represented the creditors now serving on the Plan Committee, (2) the plan trustee, not the law firm, determines what causes of action to pursue, and (3) the law firm is beholden to the plan trustee, no one else.

FACTUAL BACKGROUND

The debtor originally proposed a plan that created a Plan Committee. Under this plan, the Committee was given the authority to pursue causes of action on which the trustee passed. The Plan Committee would then be compensated from the estate. The lender objected to the plan and argued that the creation of the Plan Committee would do nothing more than drain estate resources, as the trustee was already tasked with pursuing causes of action on behalf of the debtor. The court denied confirmation of the original plan. The debtor amended its plan to revise the role of the Plan Committee. Under the amended plan, the Plan Committee would serve in a purely advisory capacity and would not be compensated from the estate. The amended plan was confirmed.

The plan trustee filed a post-confirmation notice to retain the law firm as special litigation and conflicts counsel. The lender objected to this appointment. During the bankruptcy case, the law firm represented seven hedge fund creditors, three of whom ultimately were appointed to the Plan Committee. These hedge fund creditors held millions of dollars of the debtor's indebtedness. The lender argued that the appointment of the law firm was a backdoor way for the hedge fund creditors to influence the course of estate litigation to the primary benefit of the hedge fund creditors, rather than to the benefit of the entire creditor body. The debtor argued that the law firm no longer represented any of the hedge fund creditors, and the law firm would represent only the interests of the debtor/trustee. Quite simply, the debtor stated that the law firm was not conflicted. Furthermore, the trustee pointed to the law firm's extensive, relevant experience in similar cases.

COURT ANALYSIS

Pursuant to section 327 of the Bankruptcy Code, the trustee may, with the court's approval, employ professionals that do not hold or represent an interest adverse to the estate and that are "disinterested." A professional is not disqualified solely based on that professional's representation of a creditor; an actual conflict of interest must exist to warrant disqualification.

The confirmed plan contained a mechanism by which the trustee could retain professionals without court approval: if no party objected to the proposed retention over a 15-day period, the retention was approved. If, however, a party in interest filed an objection and the parties could not reach an agreement on the professional retention, the court would conduct a hearing. The court therefore concluded that the plan tacitly intended that professional retention disputes were to be decided in accordance with section 327.

The court first concluded that the law firm did not have an actual conflict because the firm no longer represented any creditors in the case. Specifically, while some of the law firm's former clients did serve on the Plan Committee, the law firm was not representing the creditors or the Plan Committee. Quite simply, the law firm was beholden only to the plan trustee. Second, the plan trustee controlled the litigation, and the plan trustee had a fiduciary duty to the estate and therefore had to exercise independent judgment as to whether or not to pursue litigation. The court noted that no creditor, including the lender, ever objected to the appointment of the plan trustee. There was no reason to believe he was not impartial or unable to meet his fiduciary obligations. Accordingly, the court overruled the lender's objection to the trustee's employment of the law firm.

PRACTICAL CONSIDERATIONS

The trustee's employment of the law firm, a law firm intimately familiar with the bankruptcy case after having represented multiple creditors, was not an actual conflict under section 327. Accordingly, when professionals are retained for post-confirmation matters, a perceived conflict should not disqualify their application. Practically speaking, this allows the trustee, or other party handling post-confirmation matters, to retain counsel that previously worked on the bankruptcy case, which should streamline the post-confirmation process and help eliminate duplicative work and unnecessary expenses. This case also buttresses the trustee's independent exercise of his authority.

Jarod Roach

COURT RECHARACTERIZES CLAIM, DECLINES TO ADOPT A *PER SE* RULE THAT RECHARACTERIZATION ONLY APPLIES TO INSIDERS

Grossman v. Lothian Oil Incorporated, 650 F.3d 539 (5th Cir., 2011)

CASE SNAPSHOT

In a case of first impression in the Fifth Circuit, the court recharacterized a claim of a non-insider, declining to create a *per se* rule that recharacterization could only apply to insiders.

FACTUAL BACKGROUND

Mr. Israel Grossman executed two "loans" with the corporate Secretary of Lothian Oil Incorporated, pursuant to which Grossman loaned Lothian $350,000 in exchange for, *inter alia,* a specified percentage of royalties related to Lothian's share of gross production of oil and gas from properties in New Mexico. The loans included no specified interest rate, repayment terms or maturity date. Two years later, Lothian Oil filed its chapter 11 petition. Grossman filed proofs of claim based on the two "loan" documents. In evaluating those claims, the Bankruptcy Court held that Grossman's interests were common equity interests, and that, at best, insufficient evidence of the value of those interests had been presented. The District Court affirmed in part and reversed in part. Notably, the District Court reversed the lower court's recharacterization of Grossman's interests as equity, and "declin[ed] to extend the concept of debt recharacterization to a non-insider creditor." The debtor appealed to the Fifth Circuit Court of Appeals.

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Court Finds Defendants Knowingly Waived Right to Jury Trial, Affirms Such Waivers Must Be Clear—continued from page 20

Lehman knew of Bethany's insolvency and hid this knowledge from the guarantors in order to generate fees and improve the quality of the PK I loans for resale. The Knutson defendants demanded a jury trial to decide this matter. After discovery, Lehman filed a motion to strike the jury trial demand.

COURT ANALYSIS

The court began its discussion by stating that the constitutional right to a jury trial is "fundamental, and there is a presumption against its waiver. Contract provisions waiving the right are narrowly construed, and the requirement of knowing, voluntary, intentional waiver is strictly applied." Jury waivers, common in loan and guaranty documents, are regularly enforced. In order to determine if a waiver was knowingly and voluntarily granted, a court must consider the following factors: (1) the negotiability of contract terms and negotiations between the parties concerning the waiver; (2) the conspicuousness of the waiver provision in the contract; (3) the relative bargaining power between the parties; and (4) the business acumen of the party opposing the waiver. When these criteria are met, the waiver is enforceable.

The court also pointed out that an allegation that the *guaranty* was fraudulently induced is not sufficient to invalidate a *jury waiver* contained in the guaranty. The party must allege that the jury waiver itself was induced by fraud. Here, the Knutson defendants did not allege that the waiver was fraudulently induced, so the only question before the court was whether the waivers were entered into knowingly and voluntarily by the Knutson defendants.

The Knutson defendants argued that they had not personally had the opportunity to review the guaranties prior to the loan closings. Lehman countered that the Knutson attorney had reviewed the guaranties on behalf of the Knutson defendants prior to authorizing the use of the signature pages, rendering Knutson's personal knowledge of the waivers inconsequential. The court agreed with Lehman and explained that it is well-established that a lawyer can bind his client to a contract where the client has authorized the lawyer to do so. Here, the evidence showed that Knutson's personal lawyer had such authority.

The court then addressed the other factors, and concluded that they weighed decidedly in favor of enforcing the jury waiver. While there was no evidence that the jury waiver language had been negotiated, the court found that there was the *opportunity* to negotiate the language, and that opportunity was sufficient to satisfy this factor. Next, the court was "not concerned" that the Knutson defendants lacked sufficient bargaining power. This was not a case where "one party's dire financial condition gave his counterparty undue leverage." Moreover, the Knutson defendants could have sought financing elsewhere, as they had done in other Bethany acquisitions. The court also "easily" concluded that the Knutson defendants had sufficient business acumen.

The court finally concluded that the waiver language itself was sufficiently conspicuous to warrant enforcement. "To be sure, the jury waivers here could have been more prominent. In general, it is advisable that they be so…. Capital letters, clear headings, and placement near a signature line help ensure that a party's jury waiver is knowing and voluntary. But that does not mean that all cases require such features to demonstrate a knowing and voluntary waiver." The waivers in the five guaranties executed by the Knutson defendants all appeared in the same font and size as the rest of the documents, were clear in their terms, and were similar to waivers enforced in previous cases. The court rejected "the notion that a clearly legible and plainly stated provision that appeared repeatedly in documents counsel had the opportunity to review is somehow too inconspicuous to be enforced."

The court held that Lehman had met its burden of proving that the Knutson defendants knowingly and voluntarily waived their right to a jury trial, and granted Lehman's motion to strike the defendants' jury demand.

PRACTICAL CONSIDERATIONS

The right to a jury trial is a fundamental, Constitutional right. Any waiver of this right will be closely scrutinized by courts. Parties seeking to obtain a jury waiver must take care to ensure that the factors discussed in this opinion are satisfied, in language as well as in conduct.

Kathleen Murphy

'INDUBITABLE EQUIVALENCE' NOT PROVEN IN PROPOSAL TO EFFECT PARTIAL CONVEYANCE OF PROPERTY IN FULL SATISFACTION OF CLAIM

In re SUD Properties, Inc., Case No. 11-03833-8-RDD (Bankr. E.D.N.C. Aug. 23, 2011)

CASE SNAPSHOT

The debtor, a real estate developer, proposed a plan of reorganization that focused on surrendering 35 of 70 undeveloped lots to its secured lender in full satisfaction of the lender's claims. The lender objected and argued that the partial conveyance would not constitute the "indubitable equivalence" of its claim as required by section 1129(b)(2)(A)(iii) of the Bankruptcy Code. The lender produced testimony from two experts to bolster its claim that the lots were worth only about one half of the value the debtor assigned to them. The court sought to determine whether the value of the lots constituted the indubitable equivalent of the lender's secured claim by using a clear and convincing standard. The court held that the proposed partial conveyance was not the indubitable equivalent and therefore the debtor's plan could not be confirmed as proposed.

FACTUAL BACKGROUND

SUD Properties, Inc. was a North Carolina corporation engaged in the business of owning and developing real estate. In 2005, SUD purchased a tract of land, for which First Bank had made two loans secured by a first and second deed of trust in the land. In 2006, SUD subdivided the tract into 88 lots and built the infrastructure to support future residential development, which was to include a clubhouse and pool. SUD sold 18 lots to homebuyers, but the real estate decline left SUD with 70 unsold lots. SUD defaulted on its loan obligations to First Bank and after First Bank initiated foreclosure proceedings, SUD filed its first voluntary chapter 11 petition. As part of the first plan of reorganization, SUD was to sell the remaining 70 lots by January 31, 2014. SUD failed to sell the lots pursuant to the first plan. The first bankruptcy was therefore dismissed.

First Bank subsequently initiated a second foreclosure proceeding, and on the eve of the sale, SUD filed a second voluntary chapter 11 petition. In its second plan of reorganization, the debtor proposed to convey one-half of the vacant lots to First Bank in full satisfaction of the bank's claim, appraising each of these lots at approximately $43,000, for a total of $1.5 million (First Bank's claim was approximately $1.45 million, which amount included attorneys' fees, appraisers' fees and interest). First Bank obtained two appraisals. One appraisal estimated that the value of each lot was $20,000, and the other appraisal estimated that the value of each lot was $23,000. Accordingly, using the lender's appraisals, the 35 lots were not worth more than $805,000.

First Bank objected on several grounds to the debtor's plan. The court, however, only addressed one of these objections – that the plan failed to provide First Bank with the indubitable equivalent of its claim as required under section 1129(b)(2)(A)(iii) of the Bankruptcy Code.

COURT ANALYSIS

Section 1129(b) outlines the requirements of approving a so-called cram-down plan, wherein an objecting creditor is forced to accept the debtor's plan. In order to cram down an objecting creditor's claim, section 1129(b)(2) requires that the plan must not discriminate unfairly, and that it must be "fair and equitable." In order to be considered fair and equitable, a plan must provide an objecting creditor with the "indubitable equivalent" of its secured claim.

Given the statutory framework, the central issue for the court was whether the 35 lots that the debtor proposed to surrender in full satisfaction of First Bank's claim were the indubitable equivalent of the bank's claim. The court looked to the *Merriam-Webster Dictionary*, which defines "indubitable" as "too evident to be doubted; unquestionable." The Bankruptcy Court undertook a two-part analysis regarding the appropriate burden of proof, looking both at the burden of proving

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Court Recharacterizes Claim, Declines to Adopt a *Per Se* Rule that Recharacterization Only Applies to Insiders—continued from page 22

COURT ANALYSIS

The Court of Appeals, in this case of first impression in the Fifth Circuit, rejected the District Court's contention that there is a *per se* rule prohibiting the recharacterization of non-insider claims. Instead, the Court of Appeals held that recharacterization may apply to non-insiders as well as insiders.

The court determined that the correct framework for evaluating the claim is to look to the applicable state law. Specifically, the court held that, although section 502(b) of the Bankruptcy Code permits a bankruptcy court to recharacterize claims, it must rely on state law to determine if a claim characterized as debt is, in fact, debt, or if it is equity. The court applied Texas state law to the Grossman documents, and concluded that Grossman's interests were equity interests. In particular, the court noted that there was no specified interest rate, repayment term or maturity date, and that Grossman would be repaid from royalties (which depended on Lothian's success) rather than interest and principal payments. "Because Texas law would not have recognized Grossman's claims as asserting a debt interest, the bankruptcy court correctly disallowed them as debt, and recharacterized the claims as equity interests. Moreover, because insiders and non-insiders alike can mischaracterize their claims in contravention of state law, we decline to limit recharacterization to insider claims."

PRACTICAL CONSIDERATIONS

Bankruptcy courts look to state law to define property and the nature of property interests. As a result, *per se* rules prohibiting the recharacterization of non-insider claims will not be adopted by the bankruptcy court unless they are supported by the applicable state law.

Ann Pille

UPDATES ON BANKRUPTCY RULES WITH RESPECT TO PROOF OF CLAIMS: SANCTIONS AUTHORIZED IF NOT FOLLOWED

Effective December 1, 2011, a number of the Federal Rules of Bankruptcy Procedure were amended. Two of the amendments specifically address the information required on Proof of Claim forms.

The amendment to Rule 3001 (Proof of Claim) is expanded to require that additional supporting information be filed with proofs of claim in individual debtor cases. The amendment authorizes a ***court to impose sanctions against a creditor*** that fails to provide the required information.

New Rule 3002.1 (Notice Relating to Claims Secured by Security Interest in the Debtor's Principal Residence) implements section 1322(b)(5) of the Code, which allows a chapter 13 debtor to cure defaults and maintain home mortgage payments over the course of the debtor's plan. The new rule requires notice of any changes to post-petition mortgage payments for the debtor's principal residence and of the assessment of any post-petition fees, expenses, or charges. Under the new rule, ***a court may impose sanctions for failure to provide the required notice***. The new rule also provides a procedure for determining at the end of the case whether the pre-petition default has been fully cured and whether the debtor is current.

Amy Tonti

'Indubitable Equivalence' Not Proven in Proposal to Effect Partial Conveyance of Property in Full Satisfaction of Claim

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the value of the property, as well as the burden of providing indubitable equivalent value to the lender.

When valuing collateral in a dirt-for-debt plan, the court determined the best course of action was to take a conservative approach to value, especially during uncertain financial conditions surrounding the real estate market. The debtor's valuation expert valued the 70 lots at approximately $3.3 million. First Bank's valuation experts, however, valued the lots at $1.4 million and $1.6 million respectively. The court emphasized the lackluster regional real estate market and the fact that the debtor had not sold a lot in two years, holding that the debtor's appraisal was unjustifiably high and the realistic value of each lot was $25,000.

Turning to the question of indubitable equivalent value, the court evaluated whether the property provided the secured creditor with an equivalent that was "too evident to be doubted." The court first concluded that when the creditor receives the entirety of its collateral, it is receiving indubitably equivalent value because "common sense tells us that property is the indubitable equivalent of itself." Conversely, cases involving plans that propose to transfer only a part of the secured property are "much more controversial and more difficult to confirm."

The court, using the $25,000 per lot valuation, held that the transfer of 35 lots to First Bank did not provide the bank with sufficient value. Furthermore, the court added that the debtor would not be able to provide the lender with indubitable equivalent value by transferring anything less than all 70 lots because of the lack of lot sales for the previous two years and the declining real estate values in the local area. Indeed, the court admitted that its assigned value, $25,000 per lot, may have been too optimistic. The court denied confirmation of the proposed plan.

PRACTICAL CONSIDERATIONS

Determining the value of real estate is a difficult and constantly changing practice, but one that is particularly relevant during the downtrodden real estate market. Courts are likely to hold debtors to a high standard of proof when determining the value of real estate, and especially vacant land. Furthermore, when the debtor, as was true in the case at bar, is seeking to confirm a plan over a secured lender's objection, the court will be very conservative when estimating the value of the collateral, so as to insure that the creditor is receiving indubitable equivalent value.

Jarod Roach

COURT DENIES LENDER'S MOTION TO DISMISS SECTION 547 PREFERENCE ACTION SEEKING TO AVOID VALID FORECLOSURE SALE

Whittle Development, Inc. v. Branch Banking & Trust Co. et al. (In re Whittle Development Inc.) 2011 WL 3268398 (Bankr. N.D. Tex., July 27, 2011)

CASE SNAPSHOT

The lender foreclosed on the borrower's property after the borrower defaulted on its loan obligations. At the foreclosure sale, the property was sold to a subsidiary of the lender for less than the outstanding loan balance. Within one month following the foreclosure sale, the borrower filed for chapter 11 bankruptcy, and the lender filed a deficiency claim for the difference between the loan balance due and the amount of the credit bid at the foreclosure sale. Despite the fact that the foreclosure sale was operated in accordance with state law, the borrower argued that the value of the property exceeded the pre-foreclosure loan balance, and that the foreclosure sale was avoidable as a preferential transfer. The lender filed a motion to dismiss the preference claim, and the Bankruptcy Court denied the motion.

FACTUAL BACKGROUND

Whittle Development, Inc. was a real estate developer in Dallas, Texas. Whittle and the lender entered into a loan agreement secured by real property. After Whittle defaulted on its obligations, the lender notified Whittle of its intent to foreclose upon the property securing the note. A sale was held in conformity with all relevant state requirements, and the property was sold to a subsidiary of the lender for $1.2 million. Within a month, Whittle filed for bankruptcy, and the lender filed a deficiency claim for the roughly $1 million that remained due and owing following the foreclosure sale.

The debtor argued that there was no deficiency claim, contending that the property was worth $3.3 million. As such, the debtor contended that the lender received more than it would have under a chapter 7 liquidation, rendering the foreclosure avoidable as a preferential transfer under section 547 of the Bankruptcy Code. The debtor filed an adversary action, and the lender filed a motion to dismiss.

COURT ANALYSIS

Under section 547 of the Bankruptcy Code, a transfer can only be avoided if the creditor received more than it would receive in a chapter 7 case. The lender argued that this requirement could not be met as a matter of law, because the Supreme Court's decision in *BFP v. Resolution Trust Corp.* 511 U.S. 531 (1994), held that a non-collusive foreclosure sale conducted in accordance with state law was not avoidable because, as a matter of law, it provided "reasonably equivalent value" for the property transferred. The debtor countered that, if it could prove the property's fair market value was $3.3 million, the lender did indeed receive more through foreclosure than it would have in a chapter 7 liquidation (i.e., *both* the property and a $1 million deficiency claim on a $2.2 million debt). Further, the debtor argued that *BFP* did not control the outcome of this case, because *BFP* dealt with a constructively fraudulent transfer under section 548, and that section's requirement of "reasonably equivalent value" is distinguishable from section 547, which requires only that the creditor receive more than it would have under chapter 7 without regard to equivalent value. The debtor's position was that the amounts bid at a foreclosure are not *per se* equal to the fair market value of the property. As such, it is possible that a creditor might receive more through a pre-petition foreclosure sale than it might have obtained in hypothetical chapter 7 liquidation. If true, the prong of section 547 at issue would be satisfied, and the transfer would be avoidable.

In declining to dismiss the preference claim, the court held that applying the *BFP* reasoning to a case involving section 547 was "misplaced." In *BFP*, the Supreme Court analyzed what, as a matter of law, was meant by "reasonably equivalent value" under section 548. Section 547, however, does not require that value be reasonably equivalent; it requires only that a creditor receive an amount in excess of a hypothetical recovery. The court concluded that *BFP* was not controlling, and that the debtor's complaint was sufficient to state a claim against the lender.

PRACTICAL CONSIDERATIONS

Mere compliance with state law is insufficient to shield a foreclosure sale, and the benefits received therefrom, from a preference action. Secured lenders that wish to credit bid at a foreclosure sale need to be cognizant that a low-ball offer may subject them to liability if their borrower files for bankruptcy protection within 90 days after the foreclosure sale.

Ann Pille

ARE YOU WAIVING YOUR RIGHT TO A DEFICIENCY CLAIM IF YOU LIST YOUR CLAIM AS FULLY SECURED ON THE PROOF OF CLAIM?

In a very recent decision by the Court of Appeals for the Eleventh Circuit, *In re J.H. Investment Services, Inc.,* the court held that a creditor must take an affirmative step to pursue an unsecured claim, and that section 506(a)(1) of the Bankruptcy Code does not automatically provide for a deficiency claim.

"In this case, it is undisputed that the IRS submitted Claim #6-4 [which listed its claim as secured] and that the IRS claim was undersecured. But the parties dispute whether Claim #6-4 properly raised or preserved the IRS's unsecured claim. The IRS contends that section 506(a)(1) automatically bifurcated Claim #6-4 into a secured and an unsecured claim and that the unsecured claim was allowed under section 502. Section 506(a)(1) also put Oscher and the other creditors on notice that the IRS would pursue its deficiency claim. Thus, the IRS argues, the district court's concerns about due process are misplaced. Additionally, the IRS contends that even if it had to note its unsecured claim on Claim #6-4, its mistake in failing to do so should be excused as harmless. It claims that Oscher and the other creditors learned it would pursue a deficiency claim when the IRS objected to the Plan. Because no one objected to the validity of the IRS's unsecured claim at that time, the claim should be allowed."

In rejecting the arguments of the IRS, the court cited to section 506(a)(1), which provides: "An allowed claim of a creditor secured by a lien on property in which the estate has an interest, . . . is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property, . . . and is an unsecured claim to the extent that the value of such creditor's interest . . . is less than the amount of such allowed claim." The court based is reasoning on the fact that an undersecured creditor is not required to pursue a deficiency claim. Further, it found that the Rules and Official Bankruptcy Forms suggest that when an undersecured creditor does not note an unsecured claim on its proof of claim, it has decided not to pursue that claim. Finally, the court held that if a creditor fills out the proof of claim form in a manner that indicates the creditor believes that it is fully secured, it has waived any unsecured claim.

The November 22, 2011 Opinion is marked "Do Not Publish," which may mean that it may not serve as controlling precedential authority.

Amy Tonti

COUNSEL'S CORNER: NEWS FROM REED SMITH

Presentations

Jeanne Lofgren, Bob Simons, Greg Taddonio and **Amy Tonti** were all on separate panels at the Pennsylvania Bar Institute's 16th Annual Bankruptcy Institute Oct. 6 in Pittsburgh. Jeanne spoke about the top commercial cases of 2011, including the U.S. Supreme Court's landmark decision on bankruptcy court jurisdiction rendered in *Stern v. Marshall.* Bob's topic was "Retention and Compensation Professionals." Greg held an ethics presentation, "How to Earn a Living as Bankruptcy Counsel Without Getting Into Trouble." Amy addressed "Hot Topics in Commercial Foreclosures and Bankruptcy."

Also at the Oct. 6 PBI session, **Kurt Gwynne** was a panelist for "Bankruptcy Litigation – What You Need to Know About Preparing Witnesses to Testify – Introducing Expert Testimony and Following Rules of Evidence." Kurt made a second presentation in Philadelphia Oct. 27.

Mark Silverschotz and **Michael Venditto** did presentations at the bankruptcy conference of the National Association of Attorneys General Oct. 27 in Austin, Texas. Mark's topic was "Regulatory Enforcement in the Context of a Going Out of Business Sale," and Michael's was "Consumer Privacy Protection in a Section 363 Sale."

On Oct. 31 in Chicago, **Cynthia Jared** was a member of a panel presentation on real estate finance for Practising Law Institute.

Andy Rahl was both co-chair at the Distressed Investing 2011 Conference and a panel member. The Conference was held at The Helmsley Park Lane Hotel in New York Nov. 28, and Andy led the panel on "Distressed Derivatives."

Amy Tonti is the program planner for a PBI session to be held in Pittsburgh and Philadelphia in March 2012 addressing "Hot Topics in Commercial Foreclosures and Bankruptcy."

Jennifer P. Knox was a panelist at the Eastern District of Pennsylvania Bankruptcy Conference Fall Program in November. The topic was "Class Gifting and the Absolute Priority Rule," and included an analysis of the Second Circuit's recent decision in In re DBSD North America, Inc., 634 F.3d 79 (2d Cir. 2011).

Awards

Reed Smith is pleased to have six of its lawyers listed in the 2012 edition of *Best Lawyers in America* in the category "Bankruptcy and Creditor Debtor Rights/Insolvency and Reorganization Law." They include **Peter Clark** and **Claudia Springer** (Philadelphia); **Andrew Rahl** (New York); and **Eric Schaffer, Bob Simons** and **Paul Singer** (Pittsburgh).

Articles

Georgia Quenby, Vince Gordon, Ed Estrada and **Henry Burkitt** shared in the "authoring" of an article entitled, "Europe, Middle East: Recent Developments in Restructuring, Insolvency," for *The Journal of Corporate Renewal,* September 2011

Bob Simons and **Luke Sizemore** were co-authors of "FDIC Treatment of Creditor Claims Under Orderly Liquidation Process," published in the Oct. 25 issue of *BNA's Banking Report.*

Bob Simons and **Jeanne Lofgren** were co-authors of an article entitled, "What Anna Nicole Smith's Bankruptcy Case May Mean to Credit Managers Everywhere," published in the Oct. 31 issue of *Creditier Newsletter,* a newsletter of the Pennsylvania Association of Credit Management.

Amy Tonti, Luke Sizemore and **Joseph Filloy** authored a chapter for *Collier* on bankruptcy dealing with the appointment duties of chapter 11 trustees.

Amy Tonti and **Luke Sizemore** also authored an article for *The Bankruptcy Strategist* that addressed successor liability issues under section 363 "free and clear" sales.

News

Kurt Gwynne was recently invited to become a Fellow of the American College of Bankruptcy.

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