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CR&B Alert

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MAKE–WHOLE CLAIM IN THE AMOUNT OF 37% OF LOAN BALANCE IS ENFORCED BY DELAWARE BANKRUPTCY COURT

Peter S. Clark, II
Firmwide Practice
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Good news for lenders. Judge Carey of the Bankruptcy Court for the District of Delaware enforced a make-whole premium equal to 37 percent of the outstanding principal balance on a loan. He determined that, under New York state law, the calculation was not "plainly disproportionate" to the lender's possible loss and was negotiated at arm's length between sophisticated parties. In addition, Judge Carey held that a make-whole claim was not equivalent to "unmatured interest," which is unauthorized under Section 502 of the Bankruptcy Code, but instead was a claim for liquidated damages. This is an important and favorable decision for lenders, especially in the current low interest rate environment. The case is *In re School Specialty, Inc.*, No. 13-10152 (Bankr. D. Del. April 22, 2013).

This month, Reed Smith's Commercial Restructuring and Bankruptcy group was named the Best Corporate Law Firm Practice group for 2013 by Pennsylvania's largest law journal, *The Legal Intelligencer. The Legal* based its decision not just on bankruptcy work done in Pennsylvania, but also on national work performed primarily by Pennsylvania lawyers. The criteria for selection included the level of representation "that makes clients turn to" the firm. We are very proud to be selected to *The Legal's* inaugural list of Best Corporate Law Firm Practice – Bankruptcy/Reorganization.

SEVENTH CIRCUIT REQUIRES COMPETITION FOR INSIDER'S NEW-VALUE PLAN OF REORGANIZATION

Stephen Bobo
Partner, Chicago

In re Castleton Plaza, LP,___F.3d__, 2013 WL 537269 (7th Cir. Feb. 14, 2013)

CASE SNAPSHOT

The United States Court of Appeals for the Seventh Circuit recently extended the "competition rule" to a new-value reorganization plan that proposed that an insider would end up as the owner of the reorganized debtor. The debtor's equity holder had arranged for his wife to contribute the new value under the plan in order to become the equity holder of the reorganized debtor. In the first case to reach the Court of Appeals level on this issue, the Seventh Circuit ruled that a competitive process is necessary whenever a plan distributes an equity interest in the reorganized debtor to an insider while leaving an objecting creditor unpaid. *In re Castleton Plaza, LP*, __F.3d __, 2013 WL 537269 (7th Cir. Feb. 14, 2013).

The decision is largely based on the "competition rule" created by the U.S. Supreme Court in *Bank of America National Trust & Savings Assn. v. 203 N. LaSalle Partnership*, 526 U.S. 434 (1999), which involved the debtor's use of its exclusive rights to confirm a plan over the objections of its mortgage lender, and without exposing the terms of the plan to any competitive process. The Supreme Court overturned the plan, emphasizing that the insiders' use of the debtor's exclusive rights to become the equity holder of the reorganized debtor without any market testing of the plan through an opportunity for either competing bids or competing plans "renders the partners' right a property interest extended 'on account of' the old equity position and therefore subject to an unpaid senior creditor class's objections." Id. at 456.

In its *Castleton* decision, the Seventh Circuit expanded upon *203 N. LaSalle* in two respects. It applied the competition requirement to insiders of the debtor and not just the debtor's equity holders. It also required competition whether or not the debtor proposed its plan during the period in which it had the exclusive right to file a plan and regardless of who proposes the plan.

FACTUAL BACKGROUND

Castleton Plaza was a limited partnership whose sole asset was a shopping center in Indiana. The equity owner owned 98 percent of the equity interest in Castleton directly and held the remaining 2 percent indirectly. Castleton had financed its shopping center through a mortgage loan of $9.5 million, which matured before it filed for chapter 11 in 2011.

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FOLLOWING *CASTLETON PLAZA*, COMPETITIVE BIDDING REQUIRED WHERE INSIDER ASSERTS 'NEW VALUE' EXCEPTION TO ABSOLUTE PRIORITY RULE

Ann Pille
Associate, Chicago

In re GAC Storage Lansing, LLC, No. 11-40944 (Bankr. N.D. Ill., Feb. 27, 2013)

CASE SNAPSHOT

The court denied confirmation of the debtor's plan, finding that: (i) the debtor failed to demonstrate that it would be able to obtain financing to pay off the balloon payment; (ii) the proposed transfer of new equity to an individual with indirect ownership interest violated the absolute priority rule; and (iii) the plan's injunction barring actions by the secured creditor against the guarantors was overly broad.

FACTUAL BACKGROUND

GAC Storage Lansing, LLC was the owner/operator of a self-storage facility. GAC executed a note and granted a security interest to the bank to refinance the original construction loan. GAC defaulted and filed for chapter 11 bankruptcy. The debtor continued to operate the business as a debtor in possession. The bank filed a proof of claim in the amount of $12.4 million; the property was valued at $8.1 million.

The debtor's plan proposed to treat the secured portion of the bank's claim as follows: the claim would be amortized over a 30-year period at 4.9 percent interest, monthly payments of principal and interest would be made, and a balloon payment of the unpaid balance would be made on the maturity date of the loan. The plan also proposed a Master Lease Agreement, under which GAC Storage El Monte, LLC (a 50 percent owner of the debtor), as landlord, would lease the storage facility to the tenant, SE El Monte Leasehold, LLC, which would operate the storage facility. This tenant would pay to the debtor the monthly rental payments equal to the net operating income set forth in the debtor's cash flow projections. Rent from the storage facility tenants would effectively flow through El Monte to the debtor to fund the debtor's payments to the bank. The plan also called for a $146,000 new equity contribution from Mr. Schwartz, the sole member of Newco (the reorganized debtor), and a contribution of $100,000 from the original loan guarantors. Both of these contributions were contingent upon court approval of the Guarantors Injunction (prohibiting suits against the guarantors).

The debtor sought plan confirmation under the cramdown provisions of section 1129(b) of the Bankruptcy Code.

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FOURTH CIRCUIT IS THE FIRST TO HOLD ABSOLUTE PRIORITY RULE APPLICABLE TO INDIVIDUAL CHAPTER 11 DEBTORS

Alison Toepp
Associate, Richmond

In re Maharaj, 681 F.3d 558 (4th Cir. 2012)

CASE SNAPSHOT

The Court of Appeals for the Fourth Circuit is the first court of appeals to determine whether the absolute priority rule continues to apply to individual chapter 11 debtors. Taking the "narrow view" adopted by certain courts, the Fourth Circuit held that the rule was not abrogated by the amendments of the Bankruptcy Abuse Prevention and Consumer Protection Act, and therefore affirmed the bankruptcy court's order denying confirmation of the proposed plan.

FACTUAL BACKGROUND

The individual debtors owned and operated an auto body repair shop. As the victims of fraud, the debtors were saddled with considerable debts that exceeded the statutory limits for a chapter 13 filing. Accordingly, the debtors filed a chapter 11 petition and continued to operate their business as debtors in possession. The proposed plan of reorganization involved four creditor classes, only one of which—consisting of most general unsecured claims (Class III)—would be impaired. The plan provided that the debtors would continue to operate the business and use income from the business to pay the Class III creditors. The holder of Class I and IV claims—a bank with secured (Class I) and unsecured (Class IV) claims—voted to approve the plan. A secured auto lender (the lone Class II creditor) did not vote. Only one Class III creditor returned a ballot—and voted against the plan under which it would receive 1.7 cents on the dollar over a period of five years.

The debtors sought to have the bankruptcy court cram down and approve the plan. If the absolute priority rule were to apply, the Class III dissenting creditor must be paid in full in order for the plan to be crammed down because the debtors retained property under their proposed plan. Debtors argued that the absolute priority rule did not apply to individual chapter 11 debtors, and that if the rule did apply, the debtors would be forced to liquidate their business, would lack a source of income, and would be unable to make payments to creditors. The bankruptcy court held that the absolute priority rule continues to apply to individual chapter 11 debtors, and denied plan confirmation. The debtors appealed, and the bankruptcy court, on its own motion, certified its order for direct appeal to the Court of Appeals, because the judgment involved a question of law as to which there was no controlling decision; a panel of the Fourth Circuit Court of Appeals authorized the direct appeal.

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TENTH CIRCUIT JOINS FOURTH CIRCUIT IN HOLDING THAT ABSOLUTE PRIORITY RULE APPLIES TO INDIVIDUAL CHAPTER 11 CASES

Alison Toepp
Associate, Richmond

Dill Oil Company, LLC v. Stephens, No. 11-6309 (10th Cir., Jan. 15, 2013)

CASE SNAPSHOT

The Court of Appeals for the Tenth Circuit, in a case of first impression before the court, joined the Fourth Circuit in holding that the absolute priority rule remains applicable in individual chapter 11 cases.

FACTUAL BACKGROUND

The individual debtors were the owners/operators of convenience stores and owed their supplier $1.8 million for gasoline purchases. The debtors executed mortgages on various real properties in favor of the supplier, which mortgages were subordinate to existing mortgages on the properties. The debtors subsequently filed a chapter 11 petition and later filed a proposed plan of reorganization. Under the plan, the gasoline supplier would be paid approximately $15,000 as a secured creditor, but its remaining claim would be considered unsecured. The debtors would retain possession and control of their property. The supplier filed an objection to the proposed plan, arguing that the plan violated the absolute priority rule. Additionally, the supplier voted to reject the plan, under which it would receive approximately 1 percent of their unsecured claim over five years. Because the supplier's vote constituted 96 percent of one class of claims, the supplier's rejection precluded approval of the plan. The bankruptcy court entered an order approving the plan under the cramdown provisions of section 1129(b). The supplier appealed to the Bankruptcy Appellate Panel, which certified the question for immediate appeal to the Court of Appeals.

COURT ANALYSIS

The question on appeal was "whether the 2005 amendments to the Bankruptcy Code exempt individual Chapter 11 debtors from the absolute priority rule." That rule "bars junior claimants, including debtors, from retaining any interest in property when a dissenting class of senior creditors has not been paid in full." The court began its analysis by focusing on the language of section 1129(b)(2)(B)(ii), which provides that the holder of any claim that is junior to the claim of any objecting class shall not receive or retain any property, *except that in a case in which the debtor is an individual, the debtor may retain property included in the estate under section 1115*…." (Emphasis in opinion.) Section 1115, which was added by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), states, "*In a case in which the debtor is an individual, property of the estate includes, in addition to the property specified in section 541*…." (Emphasis in opinion.)

"Although a number of courts have held this language to be ambiguous, they have reached starkly different conclusions regarding the 'plain' meaning." The court cited a Florida case that held that the plain meaning is that section 1115 includes section 541 property; however, the *Dill* court also cited a Georgia case where the court held that nothing in section 1115's language suggests that it subsumes section 541. The *Dill* court said, "The very existence of this dichotomy seems indicative of the text's ambiguity." The court then noted that the Ninth Circuit B.A.P. and five bankruptcy courts (one of which was affirmed by a district court) adopted a "broad view" – that the BAPCPA amendments eliminated the absolute priority rule as applied to the individual's entire estate. In contrast, the Fourth Circuit and numerous bankruptcy courts reached the opposite conclusion – the amendments only exempt from the absolute priority rule property acquired by the individual post-petition, what is known as the "narrow view."

The *Dill* court found that either interpretation of section 1115 was plausible, and thus the language was ambiguous. Because of the statutory ambiguity, the court next examined Congressional intent. "Nowhere in BAPCPA's sparse legislative history is there an explanation of what changes result from section 1115." The court determined that both the text and Congressional intent were ambiguous, and so the court "heed[ed] the presumption against implied repeal" of established creditor protections. The court adopted the narrow view, reasoning that Congress certainly knew how to clearly express repeal, and if it had intended to limit application of the absolute priority rule to individual chapter 11 debtors, it could have expressed such intent in the legislative history and/or statutory language. Therefore, the court reversed the bankruptcy court's order confirming the plan, and remanded for further proceedings.

PRACTICAL CONSIDERATIONS

This is the second Court of Appeals to adopt the so-called narrow view that the absolute priority rule continues to apply to individual chapter 11 debtors. (The Fourth Circuit first adopted the narrow view in *In re Maharaj*, also discussed in this newsletter.) Creditors are gaining some advantage on this question, thanks to these two Court of Appeals decisions.

COURT AFFIRMS SEPARATE CLASSIFICATION, HOLDS ARTIFICIAL IMPAIRMENT NOT *PER SE* IMPERMISSIBLE

Ann Pille
Associate, Chicago

In the Matter of: Village at Camp Bowie I, L.P., No. 12-10271 (5th Cir., Feb. 26, 2013)

CASE SNAPSHOT

In a matter of first impression in the Fifth Circuit, the court affirmed the bankruptcy court's confirmation of a chapter 11 cramdown plan, holding that the creation of an artificially impaired class of creditors was not *per se* impermissible. Instead, the Court of Appeals concluded that the creation of an artificially impaired class for purposes of satisfying section 1129(a)(10) was more appropriately considered under the fact-specific good faith inquiry set forth in section 1129(a)(3). Here, the court found no clear error in the lower court's finding that the debtor had not acted in bad faith in creating the artificially impaired class for strategic reasons, and not out of any economic necessity.

FACTUAL BACKGROUND

The debtor, Village at Camp Bowie I, L.P., owned commercial property in Texas. This property secured first and second notes in favor of secured lenders, the combined outstanding balances of which were approximately $32 million as of the petition date. After the debtor defaulted on the loans, but prior to filing the bankruptcy petition, the institutional lender auctioned off the notes. Western Real Estate Equities, LLC purchased the notes at a discount with the intention of displacing Village as owner. Immediately after acquiring the notes, Western posted the property for foreclosure. The day prior to the foreclosure sale, Village filed for chapter 11 protection. Its schedules identified the existence of more than $32 million in secured claims owed to Western and unsecured trade debt of less than $60,000.

The debtor's proposed reorganization plan designated two voting-impaired creditor classes – (i) a secured class consisting of Western's claims; and (ii) an unsecured class consisting of the trade debt. The plan proposed to pay the unsecured creditor class in full within three months of the effective date, without interest. Western would be paid in full over five years at 5.83 percent interest. Western voted against the plan, and the unsecured creditors voted in favor of the plan. At the plan confirmation hearing, Western argued that: (i) the debtor had artificially impaired the unsecured creditors in order to satisfy the cramdown requirement that at least one impaired class approve the plan; and (ii) the debtor's plan was not proposed in good faith.

The bankruptcy court agreed that the debtor had artificially impaired its trade creditors, but rejected Western's argument that the acceptance of the plan by the artificially impaired class could not satisfy section 1129(a)(10). In addition, the bankruptcy court rejected Western's argument that artificial impairment violated the good faith requirement of section 1129(a)(3). Western appealed.

COURT ANALYSIS

The Fifth Circuit began its analysis by considering the artificial impairment of the unsecured class, and whether the accepting vote of that class could satisfy the requirements of section 1129(a)(10). The court recognized the split between the Eighth and Ninth Circuits as to whether section 1129(a)(10) distinguishes between artificial and economically driven impairment. The Eighth Circuit (in *Matter of Windsor on the River Associates, Ltd.*) holds that section 1129(a)(10) recognizes impairment only to the extent it is driven by economic "need," while the Ninth Circuit holds that the statutory language requires no particular degree of impairment and permits no inquiry into a debtor's motivation for creating an impaired class. The court then examined its own precedents, noting that it had yet to stake out a clear position on the question.

The court expressly rejected the Eighth Circuit, and "join[ed] the Ninth Circuit in holding that section 1129(a)(10) does not distinguish between discretionary and economically driven impairment." The court disagreed with the Eighth Circuit's reasoning, saying, "[b]y shoehorning a motive inquiry and materiality requirement in section 1129(a)(10), *Windsor* warps the text of the Code, requiring a court to 'deem' a claim unimpaired for purposes of section 1129(a)(10) even though it plainly qualifies as impaired under section 1124." It further noted that "*Windsor's* motive inquiry is inconsistent with section 1123(b)(1), which provides that a plan proponent '*may* impair or leave unimpaired any class of claims,' and does not contain any indication that impairment must be driven by economic motives." (Emphasis in opinion.) The court concluded that the statutory provisions "must" be read literally, and doing so here, the court held that an artificially impaired class should be treated no differently from a class impaired as a result of economic necessity.

The court then moved to the question of the debtor's motives, stating that "a plan proponent's motives and methods for achieving compliance with the voting requirement of section 1129(a)(10) must be scrutinized, if at all, under the rubric of section 1129(a)(3), which imposes on a plan proponent a duty to propose its plan in good faith." Good faith should be evaluated in light of the totality of the circumstances, bearing in mind the underlying purposes of the Bankruptcy Code. Generally, where a plan is proposed with the legitimate and honest purpose to reorganize and has a reasonable hope of success, the good faith requirement is satisfied.

The court, reviewing the bankruptcy court analysis only for clear error, could not conclude that the court clearly erred. The court affirmed that a single-asset debtor's desire to protect its equity can be a legitimate chapter 11 objective. The court emphasized, however, that its decision did not circumscribe the factors bankruptcy courts may consider in evaluating good faith questions, and that artificial impairment does not "enjoy a free pass from scrutiny under section 1129(a)(3). Ultimately, the section 1129(a)(3) inquiry is fact-specific, fully empowering the bankruptcy courts to deal with chicanery."

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DEBTOR HAD LEGITIMATE BUSINESS REASON TO SEPARATELY CLASSIFY UNSECURED CLAIMS

Alison Toepp
Associate, Richmond

In re Burcam Capital II, LLC, Case No. 12-04729-8-JRL (Bankr. E.D.N.C., Feb. 15, 2013)

CASE SNAPSHOT

Following the vote on the chapter 11 debtor's reorganization plan and before the confirmation hearing, the debtor modified its plan. The modified plan proposed to reclassify unsecured claims purchased by the lone secured creditor separately from unsecured trade creditor claims. Over the objection of the secured creditor, the court upheld the reclassification, holding that the debtor demonstrated a legitimate business reason for reclassifying the claims, that re-solicitation of the vote was not necessary because it is required only when the treatment of an accepting claim is materially changed, and that, as modified, the plan was fair and equitable.

FACTUAL BACKGROUND

CWCapital was the debtor's only secured creditor, holding deeds of trust on the debtor's real property (an office/retail building). The original reorganization plan separated unsecured creditors into two classes: Class 5 comprised of allowed general unsecured claims (to be paid in quarterly installments of $5,000), and Class 6 comprised of allowed small unsecured claims (to be paid in full 120 days after the plan's effective date). The plan provided that all creditors would be paid in full.

Prior to voting, CWCapital purchased 16 unsecured claims in order to block plan confirmation. CWCapital filed a total of 18 ballots rejecting the plan – one for each of its secured claims (Class 3 and Class 4) and one for each of the 16 unsecured claims it had purchased or had otherwise been assigned. There were only two votes for plan approval, one each from Class 5 and 6. The remaining 15 creditors did not vote.

Subsequent to voting and prior to confirmation, the debtor modified the plan. Like the original plan, the modified plan proposed to pay all creditors in full; however, it created a separate class of allowed unsecured claims – Class 4A – into which CWCapital's purchased claims were placed. The Class 4A claims were treated differently than Class 5 and 6, amortizing the 4A claims over 10 years, and securing these claims with a new deed of trust. The accompanying amended disclosure statement explained that CWCapital's purchase of unsecured claims put the secured creditor at odds with the interests of the other unsecured creditors, and that part of the justification for the separate classification was the debtor's desire to pay first the trade creditors with whom it would continue to have a business relationship.

CWCapital objected to the modified plan and moved to dismiss the chapter 11 case. The debtor's objection to CWCapital's claims based on CWCapital's inclusion of more than $1 million in pre-payment penalties was not before the court.

COURT ANALYSIS

Section 1127(a) of the Bankruptcy Code permits the modification of a plan at any time before confirmation (so long as certain requirements are met), and that the "plan as modified becomes the plan." Section 1127(d) provides that any claim holder that has accepted or rejected a plan is deemed to have accepted or rejected the modified plan, unless the claim holder changes its previous vote. Federal Rule of Bankruptcy Procedure 3019(a) provides that a modification will be deemed to be accepted by claim holders who have not accepted the modification, so long as there is no adverse change to the treatment of such claim holders.

The Bankruptcy Court for the Eastern District of North Carolina stated that "the inquiry of whether a modification has materially and adversely affected the treatment of creditors is important when a creditor accepted the original plan and now is receiving different treatment." If material adverse treatment is found, then re-balloting of the plan is required. Here, the court found that an inquiry into re-balloting was inapposite because that analysis contemplates accepting ballots receiving adverse treatment, and because CWCapital had voted to reject the plan, re-balloting would not produce a different result. Further, the treatment of Classes 5 and 6 did not change, so they were deemed to have accepted the modified plan.

The court then turned to the question of whether the plan was confirmable under the cramdown provisions. First, the court examined whether the reclassification of claims was proper. Section 1122(a) provides that a claim may be placed in a class only if such claim is substantially similar to the other claims of the class, but does not require that all similar claims be included within a single class. Citing Fourth Circuit case law, the court set forth the test: separate classification requires a legitimate business justification as well as different treatment for separate classes. The court looked to *Deep River Warehouse* (a bankruptcy case from the Middle District of North Carolina), which noted that reasons may exist to separately classify deficiency claims and trade creditor claims. Quoting *Deep River Warehouse*, the *Burcam* court said, "If the two classes received different treatment under the Plan, for legitimate reasons, then the separate classification might be viewed in a different light."

The court concluded that debtor had articulated a legitimate business justification for its modification separating the unsecured claims purchased or acquired by CWCapital, an institutional creditor, from the debtor's trade creditors; specifically, that separate classification would allow the debtor to maintain positive relationships with and continue conducting business with its trade creditors. Additionally, the Class 4A claims received different treatment from Classes 5 and 6, satisfying the second prong of Fourth Circuit precedent. "As such, the classification set forth in the [modified] plan will stand," the court held. The court further considered whether the debtor's proposed treatment of the Class 4A claims was fair and equitable to CWCapital, and increased the interest rate at which the Class 4A claims would be paid.

PRACTICAL CONSIDERATIONS

The court appears to have considered not only the statutory framework and case law on plan modification after a creditor vote, but also the facts that CWCapital purchased claims to block the plan, that CWCapital was fully secured, and that all creditors would be fully paid under both the original and modified plans.

Seventh Circuit Requires Competition for Insider's New-Value Plan of Reorganization—continued from page 2

Castleton proposed a plan of reorganization that would pay the lender $300,000 and reduce the balance of the secured debt down to $8.2 million, with the approximately $1 million difference treated as unsecured debt. The secured debt would be extended for 30 years at a reduced interest rate and virtually no principal repayment for eight years. The loan terms would also be modified to eliminate certain lender protections, such as lockbox arrangements and approval rights. The plan proposed that the owner's wife would make a new investment of $75,000 and become the owner of the new equity in Castleton. Unsecured creditors would receive a 15 percent distribution on their claims.

After the lender objected to the plan, the plan was amended to raise the amount of the new investment to $375,000. The lender requested that this proposed new investment be subject to competitive bidding, but the bankruptcy court ruled that this was not necessary because the wife was not an equity holder in Castleton, and section 1129 (b)(2)(B)(ii) of the Bankruptcy Code deals only with the holder of any claim or interest that is junior to the impaired creditor's claim. The plan was confirmed, but the bankruptcy court certified a direct appeal of the issue to the Seventh Circuit.

COURT ANALYSIS

In reversing the decision of the bankruptcy court, the Seventh Circuit relied on a broad reading of the *203 North LaSalle* decision. It acknowledged that the Supreme Court's decision did not interpret section 1129(b)(2)(B)(ii), which does not deal with new-value plans, but the competition rule was intended to curtail evasion of the absolute priority rule. As Chief Judge Easterbrook explained:

"A new-value plan bestowing equity on an investor's spouse can be just as effective at evading the absolute-priority rule as a new-value plan bestowing equity on the original investor. For many purposes in bankruptcy law . . . an insider is treated the same as an equity investor. Family members of corporate managers are insiders under § 101(31)(B)(vi). In *203 North LaSalle* the Court remarked on the danger that diverting assets to insiders can pose to the absolute priority rule. . . . It follows that plans giving insiders preferential access to investment opportunities in the reorganized debtor should be subject to the same opportunity for competition as plans in which existing claim-holders put up the new money."

Id. at 5 (internal citations omitted).

The Seventh Circuit pointed out the ways in which the existing equity holder would benefit from the new equity to be acquired by his wife, including his continued $500,000 per year salary, as well as the increase in the family's wealth from acquiring the new equity interest in reorganized Castleton at below market value. Accordingly, Chief Judge Easterbrook concluded that the "absolute-priority rule therefore applies despite the fact that [the wife] had not invested directly in Castleton. This reinforces our conclusion that competition is essential." Id. at 6-7.

The opinion proceeded to state the court's view that application of the competition rule was required regardless of whether Castleton had proposed the plan during its exclusivity period and regardless of who proposed the plan. "Competition helps prevent the funneling of value from lenders to insiders, no matter who proposes the plan or when. An impaired lender who objects to any plan that leaves insiders holding equity is entitled to the benefit of competition. If, as Castleton and [the insiders] insist, their plan offers creditors the best deal, then they will prevail in the auction. But if, as [the lender] believes, the bankruptcy judge has underestimated the value of Castleton's real estate, wiped out too much of the secured claim, and set the remaining loan's terms at below market rates, then someone will pay more than $375,000 (perhaps a lot more) for the equity in the reorganized firm." Id. at 7.

PRACTICAL CONSIDERATIONS

At least in the Seventh Circuit, a court cannot confirm a plan through which insiders gain new equity interests in the reorganized debtor over creditor objection without subjecting the proposed capital contribution to a competitive process. The *Castleton* decision expands the requirement of competition beyond a plan utilizing the debtor's exclusivity rights to any plan in which insiders acquire a new equity interest. Unclear in the decision is why the lender did not file its own competing plan, and whether filing a creditor's competing plan would satisfy the Seventh Circuit's requirement of competition. It remains to be seen whether this opinion could be subject to further expansion by requiring auctions or other forms of competition for all new-value plans, even for plans that do not grant any new equity interests to insiders.

Court Affirms Separate Classification, Holds Artificial Impairment Not *Per Se* Impermissible—continued from page 5

PRACTICAL CONSIDERATIONS

This court removed the question of a debtor's class impairment motivation from section 1129(a)(10), and placed it squarely in the good faith requirement of 1129(a)(3). Determining good faith is a fact-specific analysis, requiring a court to examine all relevant circumstances. The court noted that "it bears mentioning that Western here concedes that the trade creditors are independent third parties who extended pre-petition credit to the Village in the ordinary course of business. An inference of bad faith might be stronger where a debtor creates an impaired accepting class out of whole cloth by incurring a debt with a related party," especially if there is evidence of a sham. In this case, the court disregarded the fact that the accepting class was owed only $60,000 and was artificially impaired by receiving their payments over a three-month period (where the debtor could have paid these creditors in full at the effective date), while Western was owed more than $30 million. Courts in the Fifth Circuit will still analyze artificial impairment cases closely, but this decision makes clear that courts may be able to analyze facts in a light more favorable to debtors.

VENUE CREATED BY SUBSIDIARY INCORPORATION 'BOOTSTRAPS' VENUE SELECTION

Claudia Springer
Partner, Philadelphia

In re Patriot Coal Corporation, et al., 492 B.R. 718 (2012)

CASE SNAPSHOT

A case that has made the news over the past several months is the decision from the United States Bankruptcy Court for the Southern District of New York regarding venue selection in the *Patriot Coal Corporation* chapter 11 case. The statute controlling venue selection of a bankruptcy case is 28 U.S.C. § 1408. It permits a debtor to file a bankruptcy case in either (i) the district where its principal assets are located; (ii) the district where its corporate headquarters are located; (iii) the district where it is incorporated, or (iv) any district where an affiliate, partner or general partner has a pending bankruptcy case. It has become commonplace for many of the larger chapter 11 corporate debtors to file in either the Southern District of New York or Delaware. Many corporations have the option to file a bankruptcy case in one of these two locations because they are the jurisdictions where many corporate entities are incorporated for reasons unrelated to bankruptcy. These jurisdictions are also widely regarded as "debtor friendly" forums and are experienced in handling large chapter 11 cases. Consequently, many corporate debtors that meet the criteria of 28 U.S.C. § 1408, usually with the blessing of their lenders or largest creditors, have selected one of these locations to file their chapter 11 cases. Over the years, the venue statute has been the subject of some criticism by persons who, for a variety of reasons, would prefer to see corporate bankruptcies filed in jurisdictions where the principal place of the debtor's business or a substantial amount of its assets are located rather than where it is incorporated.

FACTUAL BACKGROUND

Patriot Coal Corporation and its 98 subsidiaries or affiliates filed their bankruptcy cases in the Southern District of New York July 9, 2012. Patriot Coal and its affiliates are companies that mine and prepare metallurgical coal and thermal coal. The debtors' assets include coal reserves, surface property and other real estate interests located in a variety of states, including West Virginia, Kentucky, Illinois, Indiana, Missouri, Ohio and Pennsylvania. None of these assets or any of Patriot's operations is located in New York. Most of Patriot's workforce are subject to collective bargaining agreements and are located in West Virginia or Kentucky, as are the companies' operations. The main headquarters are located in St. Louis, Missouri.

Up until five weeks prior to the petition date, none of Patriot's subsidiaries or affiliates had any relationship to New York. However, several weeks before the petition date, two subsidiaries were formed – PCX Enterprises, Inc. and Patriot Beaver Dam Holdings, LLC (the "New Entities") – neither of which had any employees or substantial operations. Both entities were incorporated in New York and the largest asset held by either was a checking account in the name of PCX holding approximately $100,000. Based upon the state of incorporation of the New Entities, Patriot Coal and its subsidiaries and affiliates filed their chapter 11 cases in New York, and the cases were assigned to Judge Shelley C. Chapman of the United States Bankruptcy Court for the Southern District of New York.

The venue of the bankruptcy cases was challenged very soon after the petition date. The statute controlling the transfer of venue in a bankruptcy case, 28 U.S.C. § 1412, provides that venue may be transferred (i) in the interest of justice, or (ii) for the convenience of the parties. Motions seeking to change venue were filed by the United Mine Workers of America, certain insurance companies as sureties of the debtors, certain utility providers and the West Virginia Attorney General. These motions were based upon both the convenience of the parties and the interest of justice, and requested that the cases be sent to the bankruptcy court in West Virginia. The United States Trustee also requested that venue be changed, arguing that the debtors' actions in forming new subsidiaries for no legitimate business purpose other than venue selection violated the interest of justice standard and was an abuse of the venue statute. The United States Trustee's motion, however, did not propose to transfer the cases to any specific venue.

There were numerous arguments opposing a venue change – first and foremost by the debtors, but also the Creditors Committee, the two secured lender groups (which included the DIP lenders), and large numbers of unsecured creditors holding substantial claims in the cases. These parties argued that the debtors' actions in forming the New Entities for the purpose of being able to file the cases in New York was not forbidden by applicable law, and that New York was a convenient forum for the vast majority of the debtors' creditors, representing a substantial amount of the claims in the case as well as for the debtors' professionals, virtually all of whom were resident in New York City.

COURT ANALYSIS

In a thoughtful and well-reasoned opinion, Judge Chapman ultimately decided to transfer venue, but not to a location suggested by the unions or many of the other moving parties. The judge agreed with the United States Trustee that justice would be served by moving the cases, and decided to transfer the cases to the Eastern District of Missouri, a location where the debtors' headquarters, executive offices and management team were located.

The facts of this case were largely determinative of the outcome. The judge noted that there is little guidance in the scant cases dealing with the venue issue, although she did rely in part on Judge Drain's decision in the *Winn-Dixie* case, which she found had facts most similar to the ones at issue in this case. The formation of the New Entities a short period prior to the bankruptcy filing and for the sole purpose of complying with the venue statute – a fact admitted by the debtors – was a determinative factor in the court's decision. Even though this strategy, while carefully orchestrated by the debtors, was found not to be in bad faith, the fact that it was done so close to the bankruptcy filing amounted to what the judge in the *Winn-Dixie* bankruptcy case found to be problematic: that it was formulating facts to fit the statute rather than applying the statute to fit the facts. This action, Judge Chapman held, was "an affront to the purpose of the bankruptcy venue statute and the integrity of the bankruptcy system." In relying upon *Winn Dixie*, Judge Chapman held that the manner in which the debtors chose to comply with the venue statute must be taken into account when performing an analysis under the interest-of-justice test. To ignore the manner in which the debtors obtained venue in New York "would be to condone the Debtors' strategy and elevate form over substance in a manner that courts have found impermissible; it would run afoul of any reasonable application of the

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SEVENTH CIRCUIT OVERTURNS VEIL-PIERCING

Stephen Bobo
Partner, Chicago

On Command Video Corp. v. Roti, Nos. 12-1351 and 12-1430 (7th Cir., Jan. 14, 2013)

CASE SNAPSHOT

The United States Court of Appeals for the Seventh Circuit recently overturned a District Court ruling that had permitted the claimant to pierce the corporate veil to collect on a judgment from the sole member of the judgment debtor. The case, *On Command Video Corp. v. Roti*, Nos. 12 1351 and 12-1430 (7th Cir., Jan. 14, 2013), arose under Illinois law, and is the latest in a line of decisions from the Seventh Circuit limiting the use of veil-piercing to situations where it is required to remedy harm resulting from fraud or inequitable conduct.

FACTUAL BACKGROUND

The plaintiff, On Command Video (OCV), supplied equipment and licensed software to hotels, motels and resorts permitting guests to watch movies and play video games from their rooms. In 2002, Markwell Hillside, a limited liability company owned by Samuel Roti, bought a Holiday Inn in a Chicago suburb. This Holiday Inn had already been a customer of OCV, and this relationship continued under Markwell Hillside's ownership. Several years later, OCV requested that a new contract be signed in order to cover some new equipment to be installed. After Markwell Hillside identified itself as the contract counterparty, OCV inadvertently conducted a search of state corporate records for the former owner of the Holiday Inn instead.

After OCV failed to find a current listing for the previous owner, OCV informed the hotel's manager that there was an unidentified "problem." The hotel manager mistakenly assumed that OCV meant that it had concerns about Markwell Hillside's credit and therefore substituted Markwell Properties, another Roti-owned limited liability company, as the party to the new contract. The contract identified Markwell Properties as the owner of the hotel, even though the hotel was actually owned by Markwell Hillside. Thereafter, OCV did not conduct a credit check on Markwell Properties or seek information from Roti about Markwell Properties' financial condition.

OCV continued to send its invoices to the hotel, although the invoices were not in the name of either Markwell entity, and Markwell Hillside continued to pay those invoices. A few days after the new contract was signed, Markwell Hillside declared bankruptcy. OCV was on notice of the bankruptcy and continued doing business with the hotel. It continued to accept payments from Markwell Hillside and later from its bankruptcy trustee, but it never filed a claim in the bankruptcy case. The trustee eventually sold the hotel, and the buyer continued paying OCV until it had a falling out with OCV and refused to assume its contract.

Collection Efforts

OCV sued Markwell Properties, the party named in its contract, in Colorado for breach of contract. This resulted in a default judgment against Markwell Properties that could not be satisfied because the entity had been dissolved with no remaining assets. OCV then filed a complaint against Roti in the Northern District of Illinois seeking to enforce its judgment personally against him through piercing the corporate veil.

OCV contended that Roti had shielded Markwell Hillside's assets from creditors by substituting the assetless Markwell Properties on the contract. OCV also claimed that Roti had personally benefitted from this arrangement through receiving his salary as sole manager of Markwell Hillside. The District Court entered summary judgment in favor of OCV on its veil-piercing claim, and Roti appealed.

COURT ANALYSIS

Illinois Standards for Piercing the Corporate Veil

Veil-piercing claims are governed by the law of the state of organization of the entity whose veil is sought to be pierced. In this case, both Markwell entities were Illinois limited liability companies, and Illinois law therefore applied.

Illinois law, like that of a number of other states, requires that two conditions must be satisfied in order to pierce the corporate veil of a limited liability entity:

(i) The owner failed to operate it as a separate entity, neglecting such requisites of the corporate form as adequate capitalization, election of directors and officers, and separation of corporate from personal funds; and

(ii) Refusing to pierce the veil would "sanction a fraud or promote injustice."

Judge Richard Posner, writing for the panel, noted that the first condition had been unquestionably satisfied, leaving only the second condition at issue. The opinion notes that whether adhering to the fiction of the corporate separateness of Markwell Properties would "promote injustice" is a "vague test . . . [that] is best understood as asking whether there has been an abuse of limited liability, as when owner of a party to a contract strips the party of assets so that if it breaks the contract the other party will have no remedy."

The Veil Had Been Pierced in the Wrong Direction

The District Court had permitted the piercing of Markwell Properties' veil because Roti had used it "to avoid contractual responsibilities . . . ." But Judge Posner pointed out that the responsibilities that had been avoided were not Roti's but those of Markwell Hillside. "[B]y substituting assetless Markwell Properties for Markwell Hillside on the contract, Roti did not shield his personal assets from OCV or other creditors; he shielded Markwell Hillside's assets."

The Seventh Circuit's opinion explained that OCV's attempt to pierce the veil was a non-starter because Roti was "not holding assets that OCV expected to be available to pay the hotel's debt to it." Roti had received a salary from Markwell Hillside, but there was no evidence that the salary was excessive for the work he performed. In the absence of proof that Roti had personally benefitted from using Markwell Properties to shield Markwell Hillside, there was no authority to hold him personally liable for the debts of the Markwell entities.

Judge Posner acknowledged that OCV would have had a compelling argument for a "sideways piercing" between the two Markwell companies on the theory that they were really a single business enterprise, with one entity holding all the assets and the other holding the liabilities. OCV could have filed a proof of claim

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Venue Created by Subsidiary Incorporation 'Bootstraps' Venue Selection—continued from page 8

intent of the venue statute." Interestingly, the judge did keep open the possibility of retaining venue in New York, even under a similar fact pattern, if so doing would promote fairness and would be in the best interests of the estates. The argument put forth by the debtors and others for retaining venue in New York was that most of the "key professionals" in the case were located in New York. This simply did not justify "condoning a 'bootstrap' venue selection" and thus was rejected by the court as a basis for allowing venue of the cases to remain in New York.

In a case that teaches us to "be careful what you wish for," Judge Chapman also rejected many of the movants' requests to transfer venue to the bankruptcy court in West Virginia because in her view, "fairness and not geography…. has been and should continue to be the key factor in determining the appropriateness of venue," and section 1412 of chapter 28 of the United States Code requires the court to look at the interests and convenience of all parties, including, in this case, parties who supported the venue decision of the debtors. The court transferred the cases to the U.S. Bankruptcy Court for the Eastern District of Missouri, a district that met both the "convenience of the parties" and "interest of justice" tests contained in 28 U.S.C. § 1412.

PRACTICAL CONSIDERATIONS

While Section 1408 of the Bankruptcy Code allows a wide degree of latitude in venue selection, this case shows that there are limits. Section 1412 of the Bankruptcy Code permits venue to be transferred when the court evaluates two subjective factors - when transfer will serve the interests of justice, or when transfer will serve the convenience of the parties. It follows, therefore, that venue transfer requests will require fact-specific analysis. The *Patriot Coal* opinion provides insight into the type of analysis undertaken by the court, and demonstrates that efforts to create venue can run afoul of the "purpose of the bankruptcy venue statute and the integrity of the bankruptcy system."

Seventh Circuit Overturns Veil-Piercing—continued from page 9

against Markwell Hillside on that basis and participated in its bankruptcy as an unsecured judgment creditor, for whatever that may have been worth.

Lack of Reliance

The opinion also focuses on whether OCV was justified in relying on Markwell Properties having assets. "There is no fraud or injustice, hence no basis for piercing a corporate veil, with reliance by the would-be piercer." Particularly in the case of a contract creditor such as OCV, "[a] creditor will not be heard to complain about having extended credit to an assetless corporation if he knows or should have known it was assetless." During the contract negotiations, OCV could have taken various actions to protect itself, such as running a credit check on Markwell Properties, requiring submission of the company's balance sheet certified by a reputable accountant, insisting that Markwell Hillside or Roti guarantee Markwell Properties' obligations to it, but OCV did none of these things. Even after OCV learned of Markwell Hillside's bankruptcy, it did nothing to protect its rights.

Markwell Properties had made no representations regarding its solvency one way or the other. The court acknowledged that in some instances, a party may not be in a position to determine whether it is dealing with a solvent entity. "But a person who signs a contract after months of negotiation is in a position to determine whether his counterparty is solvent, and if he makes no effort to do so, though not deflected from doing so by representations by the party he's negotiating with, he's on weak ground complaining if the other party turns out to be insolvent."

PRACTICAL CONSIDERATIONS

In overturning the District Court's judgment, the Seventh Circuit clarified that veil-piercing should be permitted only with careful application of the pertinent legal standards. The decision emphasizes that a creditor has responsibility for its own credit decisions and that reliance is a critical element of veil-piercing. An extension of credit to a limited liability entity needs to be based on the understanding that there may be only limited recovery in the event of a default, in the absence of fraud or inequitable conduct that induced the creditor to justifiably rely on repayment from other sources. Accordingly, this decision reinforces the need for creditors to protect themselves by making reasonable efforts to confirm a counterparty's financial condition and ability to pay its debts, and seeking security or guaranties where appropriate.

Following *Castleton Plaza*, Competitive Bidding Required Where Insider Asserts 'New Value' Exception to Absolute Priority Rule—continued from page 3

COURT ANALYSIS

The court began by citing the plan feasibility requirements set forth in section 1129(a)(11) of the Bankruptcy Code. The bank argued that the plan failed to meet the feasibility standard because the debtor could not prove that, with respect to the balloon payment of $8.1 million, it could either execute a refinance or complete a full payment sale by the maturity date. The court said that "the key issue concerns the reliability of the prospective value figure which the Debtor proffers to be $9,600,000 in year 2019 and whether the Debtor has the ability to pay off the Bank's claim after the balloon payment comes due through a refinancing or sale." The court concluded that the debtor's appraisal methodology was not reliable, and that the debtor had not satisfied its burden of proof. Accordingly, the court held that the feasibility standard of section 1129(a)(11) had not been met. The bank also argued, and the court agreed, that the debtor's financial projections were unrealistic, and for this reason also, the plan was not feasible.

The court then turned to the cramdown requirements of section 1129(b), which provide that a plan may be confirmed over objections if the plan does not discriminate unfairly between impaired classes, and is fair and equitable to the classes of creditors that have rejected the plan. The bank objected on this basis, arguing that the proffered interest rate of 4.9 percent did not adequately reflect the risk of non-payment, submitting that the appropriate rate of interest was at least 8.6 percent. Applying Supreme Court guidance set forth in *Till* to the testimony provided by the debtor's expert and the bank's expert, the court agreed with the bank that the debtor's proposed rate failed to capture the security and default risks of the plan, and that 8.6 percent was the appropriate rate of interest.

The bank next objected that the plan violated the absolute priority rule. The "rule," set forth in section 1129(b)(1)(B), provides that claims of any objecting impaired class must be paid in full before a junior class of claims is allowed to retain any interest. Citing *In re Castleton Plaza, LP*, the court said that the rule "prohibits insiders of the debtor and current holders of equity from retaining any interests or property on account of their equity interests unless senior classes are paid in full." The bank argued that the "insider nature" of the plan warranted application of the rule, and that Schwartz formulated the plan primarily for his own benefit and the benefit of other insiders. The debtor countered that the plan did not involve the transfer of "old equity," so that the rule did not apply.

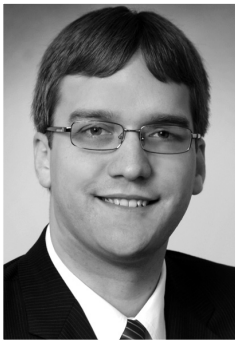
The court cited the U.S. Supreme Court decision, *Bank of America Nat. Trust and Sav. Ass'n. v. 203 North LaSalle St. P'ship*, in which the Court held that vesting equity in the reorganized business in the debtor's partners without extending an opportunity to anyone else either to compete for that equity or to propose a competing plan was a violation of the rule. In *Castleton*, the Seventh Circuit applied *LaSalle*, holding that plans giving insiders preferential treatment in the reorganized debtor should be subject to the same opportunity for competition as plans in which existing claim-holders put up new money. The *GAC* court found that Schwartz was an "insider" as defined in the Bankruptcy Code, and that because the plan contemplated issuance of 100 percent of the equity in the reorganized debtor to Schwartz before paying senior claims in full, the plan "is therefore subject to competitive bidding, as the holding in *Castleton* instructs."

The court found that the debtor "failed to prove the reasonable possibility of a successful reorganization within a reasonable period of time," and that there was no equity in the property. The court therefore denied confirmation of the plan and granted the bank's lift stay motion.

PRACTICAL CONSIDERATIONS

Equity holders of the debtor often run into the restrictions of the absolute priority rule, and have endeavored to create ways around it. Some courts have allowed equity holders to contribute so-called "new value" as consideration for their "new" equity interests, but courts are increasingly expanding the reach of the absolute priority rule to a broad class of insiders, even if those persons are not direct owners or investors. When there appears to be preferential access to investment opportunities motivated by insiders, courts are becoming increasingly willing to require that any pre-bankruptcy equity investor seeking to retain an ownership interest in the reorganized debtor submit to a competitive bidding process.

SUBTENANT RETAINS POSSESSORY RIGHTS UNDER SECTION 365(h) DESPITE EXPLICIT FREE AND CLEAR SECTION 363(f) SALE



Brian Schenker
Associate, Philadelphia

In re Zota Petroleums, LLC, 482 B.R. 154 (Bankr. E.D. Va. 2012)

CASE SNAPSHOT

At a "free and clear" asset sale, a buyer obtained a lease of real property that the bankruptcy court held was not free and clear of interests after all. The chapter 11 debtor was both the tenant under the lease and the sub-landlord under a related sublease. The debtor simultaneously assumed and assigned the lease and rejected the sublease. The subtenant, however, opted under section 365(h) of the Bankruptcy Code to retain its rights under the sublease and remain a subtenant. The bankruptcy court held that the free and clear sale under section 363(f) did not extinguish the rights of the subtenant under section 365(h) to continue to pay rent and remain in the property. Thus, the "free and clear" buyer took the lease subject to the rights of the subtenant.

FACTUAL BACKGROUND

Zota Petroleums, LLC, the chapter 11 debtor in this case, was the tenant under a lease with Kelmont, LLC for real property. Zota subleased this property to D&MRE, LLC. Zota sold substantially all of its assets, pursuant to section 363(f), and, in connection with the sale, assumed and assigned leases, including the lease between Zota and Kelmont, pursuant to section 365. Zota also rejected the sublease with D&MRE. At the sale, LAP Petroleum, LLC was the successful bidder and purchased Zota's assets "free and clear of any and all liens, encumbrances, and any and all 'claims' as defined in section 101(5) of the Bankruptcy Code…." After the sale, LAP notified D&MRE of its intention to take possession of the property. D&MRE responded that section 365(h)(1)(A)(ii) gave it the ability to retain its rights under the rejected sublease and remain in the property as a subtenant, notwithstanding the "free and clear" sale.

COURT ANALYSIS

The bankruptcy court summarized the issue as "whether the assignment of the assumed Kelmont lease extinguished the section 365(h) rights of D&MRE, debtor's sublessee, when that assignment was made as part of a transaction including both the sale of assets free and clear pursuant to the provisions of section 363 of the Bankruptcy Code and the assumption and assignment of various leases and executory contracts pursuant to section 365 of the Bankruptcy Code."

The bankruptcy court noted that lower courts were divided on the issue, some finding that a free and clear sale under section 363(f) extinguishes a tenant's rights under 365(h) and others finding that it does not. The bankruptcy court further noted that only the Court of Appeals for the Seventh Circuit had previously addressed the interplay of 365(h) and 363(f).

Section 365(h)(1)(A)(ii) generally provides that a tenant may opt to retain its rights under a lease, notwithstanding the rejection of the lease by the debtor. Section 363(f), on the other hand, provides that the debtor may sell property, including a lease, "free and clear of any interest in such property of an entity other than the estate."

In *Precision Industries, Inc. v. Qualitech Steel SBQ, LLC*, the Seventh Circuit Court of Appeals held that if a lease were sold as part of a 363(f) sale, such sale was free and clear of a tenant's rights under 365(h), noting that the tenant may request adequate protection of such rights in connection with such sale under section 363(e). It and other courts holding that a tenant's rights under 365(h) may be extinguished by a 363 sale generally rely on two canons of statutory construction. The first is that courts should apply the plain meaning of statutory language. Using this rule, courts reason that nothing in 365(h) prohibits a 363 sale free and clear of the rights granted to tenants by 365(h), and that if Congress had intended such a prohibition, it could have expressly done so. The second canon is that courts should interpret statutes so as to avoid conflicts between them where possible and reasonable. Using this rule, courts reason that both 363 and 365(h) can be given full effect without conflict because, under section 363(e), a tenant can request adequate protection of its rights under 365(h) in connection with any sale free and clear of such rights and, thus, such rights are ultimately protected.

Other courts, however, have not been persuaded by the adequate protection argument, holding "that a lease may not be sold in a section 363(f) sale in an attempt to evade a tenant's section 365(h) rights." These courts reason that allowing the tenant's specific rights under section 365(h) to be extinguished (or replaced and/or cashed out) in a section 363(f) sale would eviscerate section 365(h) and permit the debtor to do indirectly what it could not do directly, i.e., remove a tenant from possession of the property, when it does not desire to leave the property. Courts upholding the tenant's 365(h) rights typically do so based, in part, on the principle that the more specific statutory provision should prevail over the general. Under this rule, courts reason that, because section 365(h) is clear and specific in providing rights to tenants and 363(f) is general, 363(f) sales cannot extinguish tenants' rights under 365(h). These courts also view this holding as consistent with Congress' intent in enacting 365(h) to protect the rights of tenants.

Here, the bankruptcy court agreed with the latter cases, holding that D&MRE's rights under the sublease survived the 363 sale of the underlying lease and, therefore, LAP purchased such lease subject to such rights. Thus, D&MRE was entitled to continue to pay rent and remain in possession of the property, notwithstanding the sale of the lease to LAP. The bankruptcy court noted that "to hold to the contrary would give open license to debtors to dispossess tenants by utilizing the section 363 sale mechanism" and be inconsistent with Congress' intent to preserve the possessory rights of tenants to rejected leases.

PRACTICAL CONSIDERATIONS

The *Zota* decision appears to add the Eastern District of Virginia to the jurisdictions holding that a free and clear sale under section 363(f) does not

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ASSET PURCHASER IS SUBJECT TO SUCCESSOR LIABILITY FOR FLSA JUDGMENT, DESPITE SPECIFIC DISCLAIMER OF LIABILITY

Christopher Rivas
Associate, Los Angeles

Teed v. Thomas & Betts Power Solutions, LLC, (7th Cir., No. 12-2440, Mar. 26, 2013)

CASE SNAPSHOT

The purchaser of a going concern (a company in default of its loan and in receivership) specifically disclaimed liability for the $500,000 settlement reached in the Federal Labor Standards Act overtime suit between the purchased company and its prior employees. While the Court of Appeals for the Seventh Circuit agreed that under Wisconsin law, the purchaser would have successfully disclaimed successor liability, the court held that broader federal common law applied to liabilities under laws such as the FLSA, and that, after the application of federal factors, the purchaser of the going concern was liable as successor to the purchased company's FLSA liabilities (as it would have been had the liabilities been under Title VII).

FACTUAL BACKGROUND

The employees of Packard brought a collective action under the Federal Labor Standards Act against their employer, alleging overtime violations. Later that same year, Packard's parent company defaulted on a $60 million loan obligation, which was guaranteed by Packard. As a result, the parent was placed in receivership, and Packard's assets were sold at auction to Thomas & Betts, with the sales proceeds going to the bank. The asset transfer agreement contained a general condition that the sale was free and clear of all liabilities, as well as a specific condition that Thomas would not assume any liabilities from the FLSA suit.

Prior to its purchase by Thomas, Packard entered into a settlement agreement pursuant to which the employees agreed to accept $500,000 in damages, subject to the results of the appeal. The employees later substituted successor Thomas as the defendant, to which Thomas objected. The district court rejected Thomas' objection and found it was liable as successor, and Thomas appealed.

COURT ANALYSIS

Judge Posner, writing for the panel, stated that the question was "whether Thomas & Betts is, as the district court held, liable by virtue of the doctrine of successor liability for whatever damages may be owed the plaintiffs as a result of Packard's alleged violations." The court noted that, under Wisconsin law, in a typical asset sale (as opposed to a stock sale), the buyer acquires assets only, and does not assume liabilities, except any liabilities expressly or implicitly assumed. "But when liability is based on a violation of a federal statute relating to labor relations or employment, a federal common law standard of successor liability is applied that is more favorable to plaintiffs than most state-law standards to which the court might otherwise look."

Because the purchase agreement specifically stated that Thomas was not assuming liability for the FLSA settlement, Thomas would not be liable if Wisconsin law controlled. The court found, however, that "successor liability is appropriate in suits to enforce federal labor or employment laws – even when the successor disclaimed liability when it acquired the assets in question – unless there are good reasons to withhold such liability." As an over-arching principle, the court noted that the imposition of a distinct federal standard applicable to federal labor and employment laws "is that these statutes are intended either to foster labor peace … or to protect workers' rights … and that in either type of case the imposition of successor liability will often be necessary to achieve the statutory goals because the workers will often be unable to head off a corporate sale by their employer aimed at extinguishing the employer's liability to them. This logic extends to suits to enforce the Fair Labor Standards Act." Absent extending successor liability to FLSA cases, a violator of the statute could escape liability simply by selling its assets and dissolving.

Thomas argued that federal standards should not be extended to the FLSA, but the court could see no basis to exclude the FLSA from federal standards in light of the application of federal standards to so many other federal labor and employment laws. The court therefore concluded that the federal standard applied in this case.

The court then turned to the question of whether the federal standard was properly applied. Among other factors, the court considered whether the fact that Thomas continued operating Packard as a going concern (it did), and whether it was aware of the suit when it acquired the liabilities (it was). Both factors favored successor liability. The court also considered whether plaintiffs would have received any recovery had the company not been acquired by Thomas (they would not), which factor favored no successor liability. On balance, the court determined that successor liability applied to Thomas and its failure to lower the price of its acquisition based on the FLSA liabilities it was purchasing were, essentially, its own fault.

The court acknowledged that the result would reduce the price of assets both in an out of bankruptcy or receivership, but did not find such concerns sufficient to override the federal policy of protecting employee interests. The court held that trustees or receivers were more than capable of determining whether to sell a company piecemeal (in which there would be no successor liability, even for federal claims), or to sell a company as a going concern (in which case there might be successor liability for federal claims). The court brushed away concerns that such considerations would harm creditors in bankruptcy or receivership, since the majority of companies were more valuable as going concerns, even in the face of potential successor liability for federal claims.

PRACTICAL CONSIDERATIONS

Asset purchasers should look beyond state law when purchasing a going concern, and should not rely on express exclusions of successor liability when determining the price at which to purchase a going concern. This is particularly true in the context of receiverships. Asset sales in bankruptcy cases may provide more protection for purchasers pursuant to section 363(f), which has been held by some courts to override even federal labor policies, but purchasers should seek out the advice of experienced bankruptcy counsel to help determine the risks of such a purchase in light of Judge Posner's decision, which does not acknowledge or refer to the protections of section 363(f) in such a scenario.

COMITY OUTWEIGHED BY SIGNIFICANT DIFFERENCES IN LAW IN CHAPTER 15 CASE

Jeanne Lofgren
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Ad Hoc Group of Vitro Noteholders v. Vitro S.A.B. de C.V., 701 F.3d 1031 (5th Cir. 2012)

CASE SNAPSHOT

This case demonstrates the applicability of chapter 15 proceedings, the interaction between the emphasis on comity and the core established protections of the Bankruptcy Code. The Court of Appeals for the Fifth Circuit held that the debtor's restructuring plan (approved in Mexico in accordance with Mexican bankruptcy law) was not entitled to enforcement in the United States because the plan failed to satisfy essential tenets of U.S. bankruptcy law. The plan failed in several respects: affected creditors did not approve the plan and were outweighed by insider votes; equity retained substantial value; non-debtor subsidiaries were granted third-party releases; and non-consenting creditors were cut out from any recovery.

FACTUAL BACKGROUND

Vitro S.A.B. de C.V. is Mexico's largest glass manufacturer. From 2003 to 2007, Vitro borrowed $1.2 billion predominantly from U.S. investors; these notes, which were unsecured, were guaranteed by non-debtor Vitro subsidiaries. The guarantees provided that they would not be released in any bankruptcy proceeding, and that New York law would apply. In 2009, Vitro restructured subsidiary debt owed to Vitro, which resulted in Vitro subsidiaries becoming creditors of Vitro in the amount of $1.5 billion. A year later (after the expiration of Mexico's "suspicion period" in which the debt restructuring could be voided), Vitro commenced bankruptcy proceedings in Mexico, under Mexican bankruptcy law.

Generally, Vitro's restructuring plan called for the $1.2 billion notes to be extinguished, as well as the obligations of the non-debtor guarantors, and existing equity holders would retain their ownership position. Under Mexican law, creditors vote together as a single group. Nearly 75 percent of creditors approved the plan, but more than 50 percent of all voting claims were held by Vitro subsidiaries. In other words, the plan would have failed but for the approval of Vitro insiders.

The Mexican court approved Vitro's plan. Vitro's foreign representatives, appointed by Vitro's Board of Directors, commenced a proceeding under chapter 15 of the Bankruptcy Code, seeking recognition and enforcement of the Mexican proceeding in the United States. The bankruptcy court granted recognition of the Mexican proceeding and plan, but denied the enforcement motion because the plan granted injunctive relief in favor of non-debtor parties without paying creditors substantially what they were owed. The decision was certified for direct appeal to the Fifth Circuit.

COURT ANALYSIS

Chapter 15 was enacted to implement the Model Law on Cross-Border Insolvency, and provides courts with broad, flexible rules to effectuate comity in cross-border bankruptcy matters. The court pointed out that "whether any relief under Chapter 15 will be granted is a separate question from whether a foreign proceeding will be recognized by a United States bankruptcy court."

The first issue addressed was whether Vitro's foreign representatives were properly recognized. The objecting creditors argued that the representatives could only validly be appointed by a court, and since the representatives were appointed by the Vitro Board of Directors, they should not be recognized in the chapter 15 proceeding. The Court of Appeals upheld the bankruptcy determination that "it was unnecessary for a foreign representative to be appointed by a court," based on 11 U.S.C. § 101(24)'s definition of a "foreign representative," and the commentary to the enactment of the Model Rules that expressly rejected such a narrow rule.

The court then engaged in a thorough consideration of Vitro's enforcement motion, in which Vitro sought broad relief under sections 1507 and 1521. Vitro sought an order giving full force and effect in the United States to the Mexican court's order approving the plan, and further sought a permanent injunction prohibiting certain action in the United States against itself and its non-debtor subsidiaries, including any enforcement or collection process under the guaranties. The court addressed the question of whether the bankruptcy court erred in refusing to enforce the Mexican court's approval order "solely because the plan novated guarantee obligations of non-debtor parties and replaced them with new obligations of substantially the same parties."

The court first stated that "a central tenet of Chapter 15 is the importance of comity in cross-border insolvency proceedings. Given Chapter 15's heavy emphasis on comity, it is not necessary, nor to be expected, that the relief requested by a foreign representative be identical to, or available under, United States law. Nevertheless, Chapter 15 does impose certain requirements and considerations that act as a brake or limitation on comity, and preclude granting the relief requested." The court also stated that, "while comity should be an important factor, … we are compelled … to determine whether a foreign representative may independently seek relief under either section 1521 or section 1507, and whether a court may itself determine under which of Chapter 15's provisions such relief would fall. Both appear to be questions of first impression."

The court concluded that it should first consider the specific relief set forth in section 1521(a) and (b), and if the relief is not explicitly provided for there, a court should then consider whether the relief falls more generally under section 1521's grant of any "appropriate relief," which the court construed as the relief available under chapter 15's predecessor, section 304 of chapter 11. "Only" if the requested relief was not available under section 304 should a court turn to section 1507 to decide if the relief is available as "additional assistance."

The court acknowledged that the relationship between sections 1507 and 1521 is not clear. Section 1521(a) empowers a court to "grant any appropriate relief" when necessary to "effectuate the purpose of [Chapter 15], and to protect the debtor's assets or the creditors' interests." This subsection also lists a series of forms of relief, including staying actions and executions against assets of the debtor's, and suspending the right to transfer, encumber or otherwise dispose of any debtor assets. Section 1521(b) provides that the court may "entrust the distribution" of debtor assets located in the United States, "provided that the court is satisfied that the interests of creditors in the United States are sufficiently protected."

CONTINUED ON PAGE 16

Fourth Circuit is the First to Hold Absolute Priority Rule Applicable to Individual Chapter 11 Debtors—continued from page 3

COURT ANALYSIS

The court's opinion began with a review of the judicial and statutory application of the absolute priority rule, noting that in the Bankruptcy Reform Act of 1978, Congress specifically incorporated the rule into section 1129(b)(2)(B)(ii) (this subsection allows the cram down of a plan that is "fair and equitable"). In 2005, Congress enacted the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA), amending section 1129(b)(2)(B)(ii) to read: "the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest in any property, *except that in a case in which the debtor is an individual, the debtor may retain property included in the estate under section 1115, subject to the requirements of subsection (a)(14) of this section*." (Emphasis added.) Section 1115, which was added by BAPCPA, provides: "(a) In a case in which the debtor is an individual, property of the estate includes, in addition to the property specified in section 541 – (1) all property of the kind specified in section 541 that the debtor acquires after the commencement of the case but before the case is closed…."

A "significant split of authorities has developed nationally among the bankruptcy courts regarding the effect of the BAPCPA amendments on the absolute priority rule when the chapter 11 debtor is an individual." As this court described it, some courts—including the bankruptcy courts for the Middle District of Florida, the Northern District of Indiana, the District of Kansas, the District of Nebraska, the District of Nevada, and the Bankruptcy Appellate Panel for the Ninth Circuit—have adopted the "broad view" that the BAPCPA effectively abrogated the absolute priority rule when the chapter 11 debtor is an individual. Some of the "broad view" courts rest their decision on the "plain" language of section 1129(b)(2)(B)(ii), holding that by including in that section a cross-reference to section 1115, which in turn references section 541 (the provision that defines the property of a bankruptcy estate), "Congress intended to include the entirety of the bankruptcy estate as property that the individual debtor may retain, thus effectively abrogating the absolute priority rule in chapter 11 for individual debtors." Other "broad view" courts determined that "reading the amendments to section 1129(b)(2)(B)(ii) as eliminating the absolute priority rule for individual debtor would be consistent with the perceived Congressional intent to harmonize the treatment of the individual debtor under Chapter 11 with those under Chapter 13, which has no absolute priority rule."

Still other courts—including the bankruptcy courts for the Central and Northern Districts of California, the Middle District of Florida, the Southern District of Georgia, the District of Idaho, the Northern District of Illinois, the District of Massachusetts, the District of Oregon, the Eastern District of Tennessee, the Southern District of Texas, and the Eastern and Western Districts of Virginia—however, have adopted a "narrow view," holding that the BAPCPA amendments "merely have the effect of allowing individual chapter 11 debtors to retain property and earnings acquired after the commencement of the case that would otherwise be excluded under section 541(a)(6) & (7)."

The Fourth Circuit noted that some courts reached their conclusions based on what they viewed was unambiguous statutory language (both broad and narrow views), while other courts determined that the language was ambiguous, and after examining Congressional intent, concluded that Congress did intend to abrogate the rule (broad view courts), or Congress did not intend to abrogate the rule (narrow view courts).

The *Maharaj* court determined that the statutory language was "ambiguous because it is susceptible to more than one reasonable interpretation." The court then looked "to the specific and broader context within which Congress enacted the BAPCPA, as well as a familiar canon of statutory construction, the presumption against implied repeal," and concluded that Congress did not intend to abrogate the absolute priority rule. "We arrive at the conclusion that Congress did not intend to alter longstanding bankruptcy practice by effecting an implied repeal of the absolute priority rule for individual debtors proceeding under Chapter 11."

The court was persuaded to adopt the narrow view primarily because: (i) if Congress had intended to abrogate the long-standing application of the absolute priority rule to chapter 11 individual debtors, it would have done so in a straightforward manner, such as by adding the words "except with respect to individuals" at the beginning of section 1129(b)(2)(B)(ii), or by simply increasing the debt limits for chapter 13 filings; (ii) there is no evidence that Congress intended to harmonize the treatment of chapter 11 individual debtors with the treatment of chapter 13 debtors; and, (iii) Congress intended that the BAPCPA amendments would improve bankruptcy law and practice by restoring personal responsibility in the system and ensuring that the system is fair for both debtors and creditors.

The court therefore affirmed the bankruptcy court's denial of plan confirmation.

PRACTICAL CONSIDERATIONS

As the first Court of Appeals to decide this issue, one can expect the *Maharaj* opinion to carry great weight, particularly in "narrow view" jurisdictions. This court took substantial care to examine both sides of the issue, as well as the history of the absolute priority rule. The court certainly charted a clear roadmap for other courts to use—or disagree with—in future cases.

Subtenant Retains Possessory Rights Under Section 365(h) Despite Explicit Free and Clear Section 363(f) Sale—continued from page 12

extinguish the rights of tenants to rejected leases to opt under section 365(h) to continue to pay rent and remain in the property. The bankruptcy court, however, did make it a point to note that D&MRE had not been offered any adequate protection of its 365(h) rights in connection with the sale process, and specifically limited its decision to the facts of the case. Thus, buyers of leases at 363 sales are cautioned to not only perform due diligence and not simply rely on the "free and clear" order, but to also obtain certainty, explore possible replacement rights and/or cash out payments that might serve as "adequate protection" to tenants and allow the sales to proceed. In either case, it appears that purchases of assets of debtor-landlords may have gotten more expensive.

Comity Outweighed by Significant Differences in Law in Chapter 15 Case—continued from page 14

Unlike section 1521, section 1507 gives courts the power to provide "additional assistance." Section 1507 was added "because Congress recognized that Chapter 15 may not anticipate all of the types of relief that a foreign representative may require." Section 1507 requires a court to consider if whether such additional assistance "will reasonably assure" just treatment of holders of claims or interests in the debtor's property, protection of claim holders in the United States against prejudice, and prevention of preferential or fraudulent disposition of debtor property.

"We are thus faced with two statutory provisions that each provide expansive relief, but under different standards." The court thus adopted a framework for analyzing requests for relief. Because section 1521 lists specific forms of relief, the court held that a court should initially consider whether the relief requested falls under one of the explicit provisions of this section. If the relief requested cannot be found in sections 1521(a)(1)-(7) or 1521(b), a court should decide whether the relief requested can be considered "appropriate relief" under section 1521(a), which would require consideration of whether such relief was previously provided under section 304. Then, "only if the requested relief appears to go beyond the relief previously available under section 304 or currently provided for under United States law, should a court consider section 1507." While section 1507's broad grant of assistance might be viewed as a catch-all, "it cannot be used to circumvent restrictions present in other parts of Chapter 15, nor to provide relief otherwise available under other provisions." Thus, section 1507 relief would be "in nature more extraordinary than that provided under section 1521, [and] the test for granting that relief is more rigorous."

The court then applied this new analytic framework to the relief requested by the debtor, and concluded that the bankruptcy court did not err in denying the debtor's enforcement motion. "Sections 1521(a)(1)-(7) and (b) do not provide for discharging obligations held by non-debtor guarantors. Section 1521(a)'s general grant of 'any appropriate relief' also does not provide the necessary relief because our precedent has interpreted the Bankruptcy Code to foreclose such a release…. Even if the relief sought were theoretically available under section 1521, the facts of this case run afoul of the limitation in section 1522. Finally, although we believe the relief requested may theoretically be available under section 1507 generally, Vitro has not demonstrated circumstances comparable to those that would make possible such a release in the United States…." Those circumstances include demonstrating that extraordinary circumstances exist to justify such release.

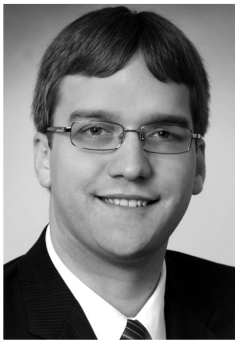
The court then measured its determination against its obligation to extend comity to the Mexican court's order, and held that "many of the factors that might sway us in favor of granting comity … are absent here." Vitro had not shown the "truly unusual circumstances necessitating" the non-consensual release of the non-debtor guarantors. Moreover, the creditors did not obtain a distribution "close to what they were originally owed," while equity retained "substantial value" and dissenting creditors "were grouped together into a class with insider voters who only existed by virtue of Vitro reshuffling its financial obligations between it and its subsidiaries," just outside the "suspicion period" under Mexican law.

Accordingly, the court held that the bankruptcy court's decision to deny the debtor's enforcement motion was reasonable.

PRACTICAL CONSIDERATIONS

The Fifth Circuit laid out a clear roadmap to consider relief requested in chapter 15 proceedings. Given the increasing number of companies operating across borders in today's global economy, this decision may serve as a template for courts required to balance the considerations and expectations of debtors and creditors under the Bankruptcy Code, against chapter 15's statutory requirement of comity. It also provides further assurance that bankruptcy proceedings are proceedings in equity, and that the strong preference to provide comity to foreign proceedings will not outweigh fundamental protections embedded into the U.S. Bankruptcy Code.

SEVENTH CIRCUIT RULES REJECTION OF EXECUTORY TRADEMARK LICENSE DOES NOT TERMINATE THE LICENSE, CREATES A SPLIT OF AUTHORITY



Brian Schenker
Associate, Philadelphia

Sunbeam Products, Inc. v. Chicago American Manufacturing, LLC, 686 F.3d 372 (7th Cir. 2012)

CASE SNAPSHOT

In a matter of first impression in the Seventh Circuit, the court held that a chapter 7 trustee's rejection of an executory contract did not terminate the trademark license contained therein.

FACTUAL BACKGROUND

Lakewood Engineering & Manufacturing Co. made and sold a variety of consumer products, including box fans, which were covered by its patents and trademarks. In 2008, losing money on every fan it made, Lakewood contracted their manufacture to Chicago American Manufacturing. The contract authorized CAM to use Lakewood's patents and put its trademarks on fans while producing fans for the 2009 season. Lakewood would then take orders from retailers, and CAM would ship directly to those customers. Because Lakewood was in financial difficulty, it provided assurances to CAM by authorizing CAM to sell the 2009 run of fans (projected to be 1.2 million fans) for its own account if Lakewood failed to purchase them.

Three months into the contract, Lakewood's creditors filed an involuntary bankruptcy petition against it, a trustee was appointed, and the trustee decided to sell Lakewood's business. Sunbeam Products, Inc. bought the assets, including patents and trademarks, but Sunbeam did not want the Lakewood-branded fans that CAM had in inventory, nor did it want CAM to sell those fans in competition with its fans. Thus, the trustee rejected the executory portion of the CAM contract. CAM, however, continued to make and sell Lakewood-branded fans, and Sunbeam filed an adversary action, alleging patent and trademark infringement.

COURT ANALYSIS

The Court of Appeals first noted that section 365(n) of the Bankruptcy Code allows a licensee to continue to use licensed intellectual property after rejection of the license, provided certain conditions are met. "Intellectual property," as defined in section 101(35A), includes patents, copyrights, and trade secrets, but does not mention trademarks. While some courts have inferred that the omission of trademarks from these statutory provisions means that Congress intended to exclude trademark licenses from section 365(n), other courts, including the court here, concluded that Congress intended to leave the question open in order to study the issue further.

The court then examined the statutory provision dealing with rejection of executory contracts, section 365(g). The court examined specifically "the opening proposition: that rejection 'constitutes a breach of contract.'" The court noted that outside of bankruptcy, a licensor's breach does not terminate a licensee's right to use intellectual property. Such a breach would entitle the non-breaching party either to terminate its own performance, or complete performance and seek damages from the breaching party.

Here, CAM had bargained for the security of being able to sell Lakewood-branded fans for its own account if Lakewood defaulted. "Outside of bankruptcy, Lakewood could not have ended CAM's right to sell the box fans by failing to perform its own duties, any more than a borrower could end the lender's right to collect just by declaring that the debt will not be paid. What section 365(g) does by classifying rejection as breach is establish that in bankruptcy, as outside of it, the other party's rights remain in place. [N]othing about this process implies that any rights of the other contracting party have been vaporized." The court noted that the trustee had never contended that Lakewood's contract was subject to rescission and that rejection is not the functional equivalent of a rescission. Rejection "merely frees the estate from the obligation to perform" and has no effect upon the continued existence of the contract. Thus, the court held that rejection of the contract did not terminate the trademark license contained therein.

PRACTICAL CONSIDERATIONS

The court completed the work begun by Congress in section 365(n) and, in doing so, rejected what was left of the holding in *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*, a 1985 Fourth Circuit case. Even after Congress enacted section 365(n), *Lubrizol* still stood for the proposition that trademark licensees lose their rights upon the rejection of the trademark license. In reaching the opposite conclusion, the Seventh Circuit has created a split of authority on the issue, though it appears to have the more persuasive argument.

POST-PETITION LOCK-DOWN AGREEMENT DOES NOT EQUATE TO IMPERMISSIBLE VOTE SOLICITATION

Lauren Zabel
Associate, Philadelphia

In re Indianapolis Downs, LLC, et al., 486 B.R. 286 (Bankr. D. Del. 2013)

CASE SNAPSHOT

After filing its chapter 11 petition, the debtor entered into a Reorganization Support Agreement with certain creditors, which required those creditors to vote in favor of the debtor's plan. Once executed, the debtor filed the RSA with the bankruptcy court, together with the debtor's plan of reorganization and disclosure statement. Certain other creditors, equity holders and the U.S. trustee objected to plan confirmation, and sought designation of the RSA creditor votes, arguing that the RSA constituted a vote solicitation violative of Bankruptcy Code sections 1125 and 1126. The objecting parties also asserted that third-party releases in the plan were overly broad. The court held that: (i) the RSA did not impermissibly solicit votes; (ii) the RSA creditors, in negotiating the RSA, were afforded adequate information upon which to base participation in the RSA; (iii) the RSA parties had not acted in bad faith, and thus designation was not warranted; and, (iv) the ballot provisions regarding how to opt out of (or be deemed to be bound by) the releases provided sufficient information so a voting party would know whether it had consented to the releases or not. The court therefore confirmed the plan.

FACTUAL BACKGROUND

Indianapolis Downs operated a racetrack and casino in Indiana. Unable to service its debt obligations, and unable to reach a restructuring agreement with certain creditors and equity holders, it filed a chapter 11 bankruptcy petition. Following months of negotiations, the debtor, and certain creditors, including Fortress (a third tier creditor) and the debtor's Ad Hoc Second Lien Committee, executed a Restructuring Support Agreement, which provided that the debtor would seek sufficiently high bids in the market to sell assets under section 363, and, if sufficiently high bids were not obtained, the debtor would proceed with a recapitalization. The RSA contained explicit financial terms of, and creditor treatment under, a potential sale or recapitalization, timeframes, restrictions, and a requirement that the RSA parties vote to accept a plan that complied with the terms of the RSA. The RSA was filed with the court immediately after its execution, and the proposed disclosure statement and plan were filed that same day.

The court approved the disclosure statement and conducted a confirmation hearing. Certain other creditors, equity holders, and the United States Trustee objected to plan confirmation, asserting that the RSA constituted a wrongful post-petition solicitation of votes on a plan prior to court approval of the disclosure statement, and sought designation of the RSA parties' ballots. If the RSA votes were designated, the debtors would not have sufficient votes to confirm their plan. There were also objections to confirmation on the grounds that the third-party releases were overly broad and non-consensual.

The court denied the objections and confirmed the plan.

COURT ANALYSIS

Vote Designation – The structure for the chapter 11 process is well known: a debtor has a period of exclusivity in which to formulate a plan of reorganization, and when that plan is filed with the court, an accompanying disclosure statement is filed, which is intended to provide stakeholders with adequate information upon which they can make an informed decision to vote for or against the plan. Sections 1125 and 1126 of the Bankruptcy Code set forth the vote solicitation requirements. Section 1125(b) states that votes may not be solicited until after a court-approved disclosure plan is conveyed to the stakeholders being solicited. Section 1126(e) provides that the court may designate any entity whose acceptance or rejection of the plan was not in good faith, or was not solicited or procured in good faith or in accordance with the provisions of chapter 11.

The court examined case law regarding solicitation and the sanction of designation. The "seminal" case in the Third Circuit, *In re Century Glove*, held that solicitation must be read narrowly because a broad reading of section 1125 could seriously inhibit creditor negotiations, and that there is no requirement that only court-approved statements could be communicated to creditors. The court found the reasoning and analysis of this seminal case to be dispositive. "Congress intended that creditors have the opportunity to negotiate with debtors and amongst each other; to the extent that those negotiations bear fruit, a narrow construction of 'solicitation' affords these parties the opportunity to memorialize their agreements in a way that allows a Chapter 11 case to move forward." The court also noted that designation of votes in this case would be inconsistent with the bedrock principle of creditor suffrage, especially where there is no bad faith, and the overwhelming majority of creditors voted to accept that plan.

Even "more to the point," "the interests that section 1125 and the disclosure requirements are intended to protect are not at material risk in this case." The RSA parties were sophisticated financial parties, well represented by counsel, and had engaged in months of negotiations. "It would grossly elevate form over substance to contend that section 1125(b) requires designation of their votes because they should have been afforded the chance to review a court-approved disclosure statement prior to making or supporting a deal with the Debtor."

The objecting parties placed special emphasis on the RSA requirements that the RSA parties vote to accept the plan. The court likewise rejected this argument because the parties were sophisticated, the agreement had been heavily negotiated, and in this "large, complex" case, the parties were entitled to "demand and rely upon assurances that accepting votes would be cast by the parties thereto," so long as the plan conformed to the terms set forth in the RSA. Therefore, the court held that "the filing of a chapter 11 petition is an invitation to negotiate…. When a deal is negotiated in good faith between a debtor and sophisticated parties, and that arrangement is memorialized a [*sic*] written commitment and promptly disclosed, section 1126 will not automatically require designation of the votes of the participants."

Release Objections – The objecting parties argued that the third-party releases were impermissible because they applied to those who (i) voted on the plan but did not opt out of the releases; (ii) had unimpaired claims and were deemed to accept the plan; and (iii) did not submit a ballot or otherwise opt out of the releases. The objecting parties urged that the releases could only be enforceable with the creditors' affirmative consent.

CONTINUED ON PAGE 20

DEFRAUDED INITIAL LIEN HOLDER MAINTAINS PRIORITY OVER SUBSEQUENT INNOCENT LENDERS

Joe Filloy
Associate, Pittsburgh

In re RAG East, LP – Case no. 12-04545-CMB (Bankr. W.D. Pa. March 4, 2013)

CASE SNAPSHOT

The court granted summary judgment in favor of a defrauded lender in a lien priority dispute with subsequent third-party lenders. The court determined that the lien of a purchase money mortgage that was allegedly released pursuant to a fraudulent satisfaction piece nonetheless had priority over the liens held by innocent third parties who provided loans to the debtor without notice of the fraud.

FACTUAL BACKGROUND

The debtor, RAG East, LP, was a single-purpose entity formed to purchase a commercial building on Market Street in Philadelphia. Plaintiff in the adversary proceeding loaned the purchase money to the debtor, which loan was secured by a first priority mortgage on the property. Prior to securing additional financing from two additional lenders and unbeknownst to plaintiff, a forged satisfaction piece was recorded that purported to release plaintiff's mortgage. Thereafter, the subsequent lenders recorded mortgages against the property to secure the additional financing to the debtor. Once the fraud was discovered, plaintiff initiated an adversary proceeding against the debtor, the subsequent lenders, and any other party that may have had an interest in the property to reinstate its mortgage and determine lien priority. Because the value of the property was significantly less than the sum of all of the liens, plaintiff risked a complete loss if it did not prevail on the lien priority issue.

COURT ANALYSIS

Relying on precedents that were more than 75 years old, the court found that under Pennsylvania law, the satisfaction piece had no force or effect because it was procured by fraud. For this reason, the mortgages of third-party lenders would be subject to plaintiff's lien, even if these parties had no notice of the fraud. The court acknowledged "the importance of being able to rely upon the public records and recognize[d] the policy of protecting bona fide purchasers and mortgages for value," but nevertheless found "it is clear even a bona fide purchaser or mortgagee for value will not always prevail despite reliance on the public records." Accordingly, the court held that the plaintiff's mortgage was entitled to priority status, "even to the detriment" of the subsequent lenders.

PRACTICAL CONSIDERATIONS

The court's decision highlights the importance of lender diligence in providing secured loans. Lenders should ensure they are operating with a complete understanding of any prior financing before making such a loan. Simply relying on a title search may not suffice. In this case it was clear that a significant loan had been given and secured by the property, and the subsequent lenders made no inquiry as to how such a loan had been repaid in a short amount of time. Further investigation would have likely revealed the fraud and prevented significant pecuniary losses. By obtaining title insurance, the lenders also could hedge against the risk of a fraudulent documentation in the chain of title.

MORTGAGE FORECLOSURE IS 'DEBT COLLECTION' UNDER FAIR DEBT COLLECTION PRACTICES ACT

Lauren Zabel
Associate, Philadelphia

Glazer v. Chase Home Finance LLC, et al., 2013 WL 141699 (6th Cir., Jan. 14, 2013)

CASE SNAPSHOT

The plaintiff sued the mortgage servicing company and the law firm it hired to foreclose on the plaintiff's property, alleging violations of the Fair Debt Collection Practices Act. The Court of Appeals for the Sixth Circuit rejected the law firm's argument that it was simply enforcing a lien and thus not a "debt collector" under the Act. The court held that the only purpose of enforcing a lien is to obtain payment, i.e., to collect a debt, and therefore "mortgage foreclosure is debt collection under the Act."

FACTUAL BACKGROUND

The property at issue was the subject of a mortgage and note executed by the preceding property owner. The original lender assigned the note and mortgage to FNMA, but continued to service the loan. Servicing rights were ultimately assigned to Chase Home Finance and, at the time of the assignment, the loan was current. Three months later, the property owner died, and within four months thereafter the loan was in default. Chase hired a law firm to foreclose on the property. A foreclosure action was filed in state court on Chase's behalf, in which the law firm represented that Chase owned the note. By this time, the plaintiff, Glazer, inherited the property, and asserted defenses against the foreclosure action, including that FNMA, not Chase, owned the note.

After the foreclosure action was voluntarily dismissed by Chase, Glazer filed suit against Chase and the law firm in federal court, alleging that the defendants violated the Act and Ohio law by falsely stating that Chase owned the note and mortgage, improperly scheduling a foreclosure sale and refusing to verify the debt upon request. The district court granted the defendants' motion to dismiss, and Glazer appealed.

COURT ANALYSIS

The provisions of the Act at issue in this case apply only to "debt collectors," and, therefore, the central issue in this case was whether Chase and/or the law firm are "debt collectors" pursuant to the Act.

CONTINUED ON PAGE 20

Mortgage Foreclosure is 'Debt Collection' Under Fair Debt Collection Practices Act—continued from page 19

Although the Act defines the term "debt collector," the definition is subject to several exceptions. Pertinent to Chase, the term "debt collector" does not include any person attempting to collect any debt owed or due another to the extent that the debt was not in default at the time it was obtained by such person. Because the debt was not in default when Chase obtained servicing rights, the court held that Chase is not a "debt collector" within the meaning of the Act. In so holding, the court rejected the two arguments made by the plaintiff: (i) that the exception applies only to mortgage servicers who own the debt they service and (ii) that the exception does not apply to sub-servicers like Chase. In rejecting these arguments, the court relied on the language of the exception, which plainly excludes an entity that collects a debt "owed or due another" from the definition of a debt collector, and does not differentiate between servicers and sub-servicers. Fundamentally, the court believed Chase to be collecting a "debt owed another" that was current at the time Chase began servicing the debt. Thus, the court held that Chase fit squarely into the exception of the definition of "debt collector."

The court affirmed the dismissal with respect to Chase, but reached a different conclusion with respect to the law firm.

Because the loan was in default when the law firm became involved, the law firm does not fit within the exception to the definition of "debt collector." Therefore, the court was presented with the issue of whether a mortgage foreclosure action constitutes debt collection under the Act. Unhelpfully, the Act "speaks in terms of debt collection," but does not actually define "debt collection." As this was an issue of first impression within the Sixth Circuit, the court began noting that the majority view adopted in other jurisdictions holds that mortgage foreclosure is not debt collection. The majority view is premised upon the notion that "enforcement of a security interest, which is precisely what mortgage foreclosure is, is not debt collection."

The court began its analysis with the statutory language. "Debt" is defined in the Act to include "any obligation or alleged obligation of a consumer to pay money arising out of a transaction in which the money, property, insurance, or services which are the subject of the transaction are primarily for personal, family, or household purposes." This definition, the court noted, focuses on the underlying transaction, which "indicates that whether an obligation is a 'debt' depends not on whether the obligation is secured, but rather upon the purpose for which it was incurred." Accordingly, the court concluded that "a home loan is a 'debt' even if it is secured."

Next, the court analyzed the scope of the Act, and emphasized that the Act's use of "broad words," such as "communication," "conduct," and "means" (in addressing how debt collection is performed) is an indication that the statutory language creates a "broad view of what the Act considers collection."

Furthering its analysis of the statutory text, the court noted that the Act does not specifically "exclude from its reach foreclosure or the enforcement of security interests generally." Instead, section 1692i of the Act specifically references actions "to enforce an interest in real property securing the consumer's obligation," and addresses the proper venue of such actions. Because section 1692i applies only to "debt collectors" as defined in a section that does speak in terms of debt collection, the court reasoned that "filing *any* type of mortgage foreclosure action, even one not seeking a money judgment on the unpaid debt, is debt collection under the Act." (Emphasis in opinion.)

The court found that its conclusion that mortgage foreclosure actions constitute debt collection pursuant to the Act is supported by decisions from the Third and Fourth Circuits. Finding the reasoning of the Third and Fourth Circuit opinions to be persuasive, the court rejected the rationale of contrary outcomes.

The court therefore held by instituting a foreclosure action, the law firm was engaged in debt collection, and was therefore subject to the provisions of the Act. Accordingly, the court reversed and remanded to the district court.

PRACTICAL CONSIDERATIONS

Entities engaging in mortgage foreclosure activities must be aware that, depending on the location of the property, the foreclosure may be subject to the provisions of the Act. If the property is located within the bounds of the Third, Fourth and Sixth Circuits (Delaware, Kentucky, Michigan, New Jersey, North Carolina, Ohio, Pennsylvania, South Carolina, Tennessee, West Virginia, and Virginia), entities engaging in mortgage foreclosure activities should comply with the provisions of the Act.

Post-Petition Lock-Down Agreement Does Not Equate to Impermissible Vote Solicitation—continued from page 18

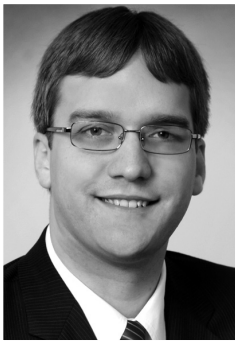
The objecting parties cited *In re Washington Mut. Inc.*, a Delaware bankruptcy case, in support of the proposition that affirmative consent was required for the third-party releases to be enforceable. The court distinguished *Washington Mutual*, because the release contained in the plan in *Washington Mutual* was deemed by the debtor to be essential to its reorganization, so creditors were not able to effectively opt out of the release. In this case, however, the court found the plan provisions to be clear and sufficient in informing a creditor the circumstances under which it would be bound by the releases. The court held that affirmative consent was not required to enforce the releases, and that "case law teaches that no such hard and fast rule applies." The court adopted "a more flexible approach in evaluating whether a third party release [is] consensual."

The court overruled all objections, and confirmed the debtor's plan.

PRACTICAL CONSIDERATIONS

The court emphasized that encouraging a free rein in negotiations among the debtor and stakeholders is a vital aspect of the bankruptcy process, and that memorializing negotiations in a post-petition, pre-disclosure statement approval agreement is not a *per se* violation of section 1125. Thus, imposing the sanction of vote designation is a harsh remedy that should sparingly be used. There had been no allegation of bad faith in this case, and the court found no evidence of bad faith. The court made clear, though, that the exercise of bad faith could result in vote designation, so parties executing lock-up agreements must deal in good faith. Additionally, this court made clear that affirmative consent to third-party releases is not a requirement, and that courts will take a "flexible approach" in assessing these issues. Creditors (especially in the important jurisdiction of Delaware) must evaluate carefully the release provisions in proposed plans in order to protect their rights, and in order to avoid releasing any parties from liability that should not be released.

EXIT LENDERS LIABLE FOR CONVERSION WHERE DISTRIBUTIONS CONTRAVENE CREDIT AGREEMENT



Brian Schenker
Associate, Philadelphia

Prudential Insurance Company of America v. WestLB AG, 961 N.Y.S. 2d 360 (2012)

CASE SNAPSHOT

A group of lenders participated in a syndicated loan. When the borrowers filed for bankruptcy, the lenders were forced to buy certain of the collateral by way of a credit bid. Some of the lenders agreed to provide exit financing in exchange for enhanced rights to the proceeds of the collateral granted by the administrative and collateral agent with the consent of a majority of the lenders. Upon the sale of the collateral, however, the minority of lenders, who did not participate in the grant of the enhanced rights to the exit lenders, complained that the enhanced rights were in contravention of the credit agreement that provided for pro rata distributions to all lenders. The court agreed and, on summary judgment, held the exit lenders liable for conversion of the minority lender's pro rata share and, but for an exculpation clause creating a triable issue, would have also held the administrative and collateral agent liable for breach of contract.

FACTUAL BACKGROUND

Prudential Insurance Company of America, Natixis, New York Branch, and Metropolitan Life Insurance Company, the plaintiffs here, were part of a group of 16 lenders that extended loans totaling $262 million to certain borrowers, secured by three ethanol plants. Under the Credit Agreement, WestLB AG was appointed administrative and collateral agent and is the defendant here along with certain other lenders. The Credit Agreement provides for pro rata distribution to the lenders of all payments received with respect to the loan, including repayments consisting of proceeds of collateral sales.

Following the borrowers' bankruptcy filing, certain lenders and WestLB formed a steering committee to develop a strategy to sell the collateral, i.e., the three ethanol plants. First, certain lenders and WestLB extended DIP financing to the borrowers to fund their working capital needs pending the sale. Second, certain lenders and WestLB committed to extend exit financing to fund working capital needs in the event not all of the plants sold to a third party and the lenders were forced to obtain the collateral through use of a credit bid. While WestLB afforded all of the lenders the opportunity to commit to the exit facility in exchange for enhanced post-sale rights, none of the plaintiffs agreed to participate in the facility. Finally, WestLB, with the consent and guidance of certain lenders, directed the section 363 sale of the ethanol plants.

Only one plant sold to a third party at the auction, for $55 million, and the lenders became the owners of the remaining plants pursuant to a credit bid. The proceeds of the sold plant repaid the DIP financing and then were distributed pro rata to the lenders pursuant to the Credit Agreement. After the sale, the plaintiffs sought to participate in the exit facility but were turned down by the lenders who had agreed to participate pre-sale.

The lenders' ownership of the two remaining plants was to be governed by an operating agreement drafted by WestLB that sought to create a management and ownership structure that rewarded the exit lenders through "participation enhancements" at the expense of the non-participating lenders (including the plaintiffs). The operating agreement generally excluded the non-exit lenders from voting and management, reduced their pro rata distributions by providing the exit lenders with priority in distributions and liquidation preferences, and diluted their pro rata distributions by providing for an increased distribution to the exit lenders beyond what they would have received under the Credit Agreement.

When the remaining two plants were eventually sold for $200 million and the proceeds were going to be distributed to the lenders pursuant to the operating agreement, rather than pro rata pursuant to the Credit Agreement, the plaintiffs sued WestLB and the other exit lenders for breach of contract, conversion, and declaratory judgment, and obtained a temporary restraining order.

The plaintiffs argued that the Credit Agreement mandated pro rata distribution of the sale proceeds to the lenders. Thus, any distribution of proceeds on a non-ratable basis pursuant to the operating agreement constituted a breach of the Credit Agreement.

WestLB and the exit lenders did not deny that the distribution of sale proceeds pursuant to the operating agreement resulted in the exit lenders obtaining more than they would have had the proceeds been distributed pro rata pursuant to the Credit Agreement. They argued, however, that, but for the participation enhancements, there would have been no exit facility to fund working capital prior to the sale, and, as a result, the plants would have been sold for much less and all of the lenders would have received less.

WestLB further argued that it was authorized under the Credit Agreement to pursue the strategy it chose, as "necessary and desirable" to "protect or realize upon" the lenders' interest in the collateral. In other words, WestLB argued that the plaintiffs had consented in the Credit Agreement to be dragged along by the majority of the lenders during exactly this kind of process.

COURT ANALYSIS

The court began with the Credit Agreement, noting that it provided "in no uncertain terms" that all collateral proceeds must be distributed to the lenders on a pro rata basis. The court rejected WestLB's contention that it was permitted to pursue the conveyance of the collateral to the lenders under the terms of the operating agreement because "Required Lenders" (a majority of the lenders) approved the participation enhancements granted to the exit lenders. The court found that the Credit Agreement did not grant unfettered discretion to WestLB and specifically required the unanimous consent of all lenders to modify their contractual rights in connection with the sale of all or substantially all of the collateral. Thus, the court held that there was no legal justification for the differential treatment of lenders vis-à-vis their rights in the collateral without their consent.

The court granted summary judgment against the exit lenders for conversion by reason of their accepting sale proceeds in complete disregard of the pro rata distribution rights of the lenders and, but for an exculpation clause in the Credit Agreement that created a triable issue, would have granted summary judgment against WestLB for breach of contract.

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Exit Lenders Liable for Conversion Where Distributions Contravene Credit Agreement—continued from page 21

PRACTICAL CONSIDERATIONS

The court's decision certainly dis-incentivizes pre-bankruptcy lenders from making exit loan facilities that, under the circumstances, may be critically needed and not obtainable from any other source. The court appears to be asking such lenders to take all the risk but not receive any awards, ignoring the new role they're playing and focusing only on their pre-bankruptcy status. Furthermore, the court's decision puts administrative and collateral agents in an untenable position where, to avoid any liability, they may need to both (i) act swiftly to preserve collateral value and (ii) obtain the unanimous consent of all lenders. On the other hand, the court is clearly attempting to ensure that a majority of lenders aren't permitted to run roughshod over a minority of lenders in contravention of or in a manner inconsistent with their rights. In any event, the decision highlights the importance of carefully considering intercreditor issues at the outset of a loan.

BEWARE THE CREDIT OVERBID

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In re Miller, 2013 WL 425342 (6th Cir. Feb. 5, 2013)

CASE SNAPSHOT

The Sixth Circuit Court of Appeals held that the secured lender's credit bid, which equaled the total debt owed on two properties but exceeded the value of the only foreclosed property involved in the sheriff's sale, extinguished the entire debt. The court affirmed the order to lift the automatic stay only to require the lender to dismiss the second foreclosure action, release the promissory note and mortgage, and turn over the second property to the borrower free and clear.

FACTUAL BACKGROUND

The borrower, Miller, owned a total of five parcels of real property – one in Wisconsin and four in Michigan. Miller signed a promissory note to the State Bank of Florence, and executed a mortgage on his residence in Wisconsin to secure the note. A few months later, Miller signed a second note with the Bank, pledging as collateral a second residence in Michigan and three parcels of land in Michigan. Miller fell behind in his payments, and the Bank decided to foreclose against Miller's properties. In accordance with the foreclosure laws of Wisconsin and Michigan, the Bank commenced a judicial foreclosure proceeding in Wisconsin, and commenced a non-judicial foreclosure by advertisement in Michigan. Miller did not object or participate in either proceeding, but he did file a chapter 13 petition in Wisconsin bankruptcy court staying the foreclosure sales in each foreclosure proceeding. Shortly thereafter, Miller dismissed his bankruptcy petition, sold his Michigan residence, and paid the proceeds to the Bank to reduce his debt.

The Bank obtained a foreclosure judgment in Wisconsin on the Wisconsin mortgage in the amount of $408,000 plus interest, fees and costs. Wisconsin law provides a one-year redemption period applied to foreclosure judgments, so the Bank was precluded from scheduling a foreclosure sale for one year. The Bank also published a new notice of foreclosure by advertisement in Michigan, and scheduled a sheriff's sale of the remaining three parcels of land in Michigan. Miller owed the Bank a total of $413,560.27 on the Wisconsin and Michigan notes, and the Bank credit bid that total amount in the Michigan sheriff's sale of the three Michigan parcels. Michigan law also provides a one-year redemption period.

Miller did not redeem the Wisconsin property within the year, so the Bank scheduled a Wisconsin foreclosure sale. This sale did not proceed, however, because Miller filed a second chapter 13 petition, staying the sale. Miller's bankruptcy filing also extended the Michigan redemption period by 60 days. At the end of the extended period, the Bank cancelled Miller's Michigan note and made an entry on its books that the Bank owned the three parcels.

The Bank claimed that, pre-petition, Miller owed more than $256,000 on the Wisconsin note and more than $185,000 on the Michigan note, for a total of $441,176.37. The Bank claimed that the value of the Wisconsin property had declined, leaving it undersecured, and moved to lift the automatic stay on that basis. The bankruptcy court determined that Miller did not owe the Bank any amount of money because the Bank's credit bid for the total amount of debt at the Michigan sheriff's sale satisfied his entire debt. The bankruptcy court lifted the stay only to allow the Bank to dismiss its Wisconsin foreclosure judgment with prejudice, release that note and mortgage, and turn over the Wisconsin property to Miller free and clear of any debt. The Bank appealed, the Bankruptcy Appellate Panel affirmed, and the Bank appealed to the Sixth Circuit.

COURT ANALYSIS

The promissory notes each provided that Wisconsin law was the applicable law, and the Bank contended that the bankruptcy court erred in applying Michigan law to its analysis. The Court of Appeals found that the case law relied upon by the Bank actually supported the contention that the state in which the real property is located (Michigan) applies when determining issues relating to the mortgage and foreclosure thereof. Notwithstanding, the court determined that it need not decide the choice-of-law issue, and instead agreed with the bankruptcy court that, under either Michigan or Wisconsin law, "the Bank's overbid of the full amount of debt at the Michigan sheriff's sale extinguished the entire debt." The court then reviewed decisions from both states.

Michigan cases, in which mortgagees submitted bids in the full amount of debt owed and subsequently discovered that the property was worth less than the sale price, established that such mortgagees must live with their errors. As one Michigan court observed, "[i]t would defy logic to allow [the mortgagees] to bid an inflated price on a piece of property to ensure that they would not be overbid

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Beware the Credit Overbid—continued from page 22

and to defeat the equity of redemption and to then claim that the 'true value' was less than half the value of the bid." Another Michigan court held that the debt is satisfied where a property purchased at foreclosure for the full amount of the debt owed.

"The governing legal rule is no different in Wisconsin." Citing a Wisconsin Supreme Court case, the court said that a purchaser who complains that his foreclosure sale overbid was the result of his unilateral mistake, "will be bound by his bid." Only where the overbid results from deceit, undue influence or other fraudulent inducement, will the court intervene.

Accordingly, the Court of Appeals held that "the bankruptcy court did not err in concluding under both Michigan and Wisconsin law that the effect of the Bank's credit bid at the Michigan sheriff's sale was to extinguish the entire debt Miller owed to the Bank. As a result, the Bank may not execute on the Wisconsin foreclosure judgment to recover a debt that no longer exists."

As an ancillary matter, the Bank raised a procedural argument regarding its proof of claim for the first time on appeal. Pursuant to section 502(a) of the Bankruptcy Code, a proof of claim is deemed to be allowed unless the debtor or a party in interest objects to such proof of claim. In this case, the debtor did not formally object to the Bank's proof of claim, so the Bank argued on appeal that the Bank's claim should be deemed allowed. The Court of Appeals held that "a party may not litigate the merits of an issue and later attempt to defeat an adverse decision by asserting the other party's failure to comply with a claim-processing rule." Therefore, by raising the issue for the first time on appeal, the Bank had waived the issue. Moreover, the court held that although the debtor did not file a formal objection to the Bank's proof of claim, language in the debtor's chapter 13 plan and its brief submitted in support of the plan and in opposition to the Bank's stay relief motion constituted an objection to the Bank's proof of claim.

PRACTICAL CONSIDERATIONS

This case provides guidance with regard to both non-bankruptcy foreclosures and bankruptcy proof-of-claim litigation. Regarding foreclosure sales, great care should be taken by lenders in deciding what to bid at foreclosure sales, especially where multiple properties constitute collateral. Given that a defaulting borrower is probably more likely to file for bankruptcy, a lender may be in a better position to credit bid the value attributed to each specific property, and if bankruptcy ensues, file the appropriate proofs of claim in the bankruptcy case claiming a deficiency. Moreover, once a bankruptcy is filed, a creditor should be sure to advance all arguments – procedural and substantive – in opposition to any proof-of-claim litigation, as procedural arguments might be waived if not timely raised.

BANK LOSES POSSESSORY LIEN FOLLOWING TURNOVER OF FUNDS TO TRUSTEE – SHOULD HAVE SOUGHT ADEQUATE PROTECTION

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In re WEB2B Payment Solutions, Inc., 2013 WL 1188041 (8th Cir. BAP, Mar. 26, 2013)

CASE SNAPSHOT

The bank, which held a possessory lien in the deposit account of the debtor, lost its lien when it turned over the funds in the account to the trustee upon his turnover demand, because the bank failed to seek adequate protection prior to turning over the funds.

FACTUAL BACKGROUND

Debtor WEB2B Payment Solutions was in the business of providing check clearing and payment processing services to third parties. WEB2B entered into an agreement with North American Banking Company under which WEB2B submitted checks for processing by NABC, which would immediately deposit funds into WEB2B's deposit account. Where such checks were subject to chargeback because they were, for example, counterfeit or forged, NABC exercised its possessory lien rights and its contractual security rights in the deposit account by withdrawing funds from this account in the amount of the chargeback.

At the time of the debtor's chapter 11 petition, it had more than $900,000 on deposit with NABC. The case was converted to chapter 7, and the trustee demanded that NABC turnover the deposit account funds to the trustee pursuant to section 542. NABC complied with the turnover demand, but, with the trustee's consent, held back $50,000 in the deposit account to cover the potential future reclamation requests. This amount was based on NABC's review of the debtor's history of reclamation and its prediction regarding future potential chargebacks. Unfortunately, NABC vastly underestimated the amount of chargebacks, which quickly exceeded $500,000.

NABC demanded that the trustee return the full $880,000 that NABC had initially turned over to the trustee. The trustee refused, and NABC filed an adversary proceeding against the trustee, seeking a determination that NABC held a first-priority lien in the turned-over funds. The parties filed cross-motions for summary judgment, and the bankruptcy court granted the trustee's motion and denied NABC's motion. NABC appealed.

COURT ANALYSIS

At the outset of its discussion, the court stated that it was "undisputed" that NABC's lien was perfected by possession of the funds as of the petition date, and that its lien survived the bankruptcy filing itself. The dispute revolved around the "effect of the turnover [of funds] on NABC's possessory lien."

NABC argued that by virtue of the Bankruptcy Code's section 542 turnover requirement and section 362's automatic stay provisions, it was required to turn over the funds, but that under the U.S. Supreme Court's holding in *U.S. v. Whiting Pools, Inc.*, its lien was preserved notwithstanding the turnover. In *Whiting Pools*, the Court held that a secured creditor may be compelled under section 542 to turn over collateral in its possession, but that if the creditor has a properly perfected security interest, the creditor is entitled to adequate protection for its interest. NABC argued that, therefore, it could only seek adequate protection after it turned over the funds. NABC also argued that, under *Whiting Pools*, its right to adequate protection, i.e., a continuing lien in the money turned over, automatically replaced its possessory lien.

The court rejected these arguments. *Whiting Pools* involved a statutory tax lien, not a possessory lien. The court held that whereas tax liens and recorded UCC-1 liens may survive turnover because the creditor does not expressly release its lien interest in those instances, this was not the case for possessory liens. The court held that this is "a critical distinction because, as opposed to a lien perfected by filing or recording – which is released only upon another affirmative act such as the filing of a release – a possessory lien is, by definition, released when possession of the collateral is relinquished. Thus … NABC did voluntarily and affirmatively release its lien by operation of law when it relinquished possession."

The court analogized the case to *Citizens Bank of Maryland v. Strumpf*, a case in which the U.S. Supreme Court addressed the issue of the creditor's rights dependent on a possessory lien. There, the Court, recognizing that a bank's right to setoff is lost when possession of the account is relinquished, held that a creditor does not violate the automatic stay by temporarily freezing the account and seeking court determination of the parties' relative rights to the funds, by filing a motion for relief from stay or for adequate protection.

The court opined that "Taken together, *Whiting Pools* and *Strumpf* provide a roadmap for creditors whose rights in collateral will be relinquished with possession." In such a scenario, a creditor holding a possessory lien but facing a turnover demand is entitled to seek adequate protection from the bankruptcy court (e.g., an order that the creditor's liens survive turnover and that the funds are not subject to distribution by the trustee) prior to turning over possession. The court also wryly noted that had NABC truly believed its lien survived turnover, it would not have held back the $50,000 it estimated would cover future chargebacks.

The court affirmed the bankruptcy court's decision.

PRACTICAL CONSIDERATIONS

Banks holding possessory liens over deposit accounts must be vigilant in protecting their liens. When faced with a turnover demand, a bank should immediately seek adequate protection of the bankruptcy court before doing so. Quick action is the key, since a bank can expect to be threatened with liability by the trustee for waiting too long to comply with a turnover demand. In the face of such threats, a bank should not allow itself to be coerced by the trustee into giving up its secured status, but should instead immediately seek the protection of the bankruptcy court.

CREDITOR DEFEATS PREFERENCE ACTION BASED ON 'NEW VALUE' DEFENSE

Joe Filloy
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In re ESA Environmental Specialists, Inc., 2013 WL 765705 (4th Cir., Mar. 1, 2013)

CASE SNAPSHOT

As a condition to issuing a surety bond, the insurer required the insured to obtain a Letter of Credit in favor of the insurer. To obtain the LOC, the insured was required to purchase a certificate of deposit, which it funded with a loan from its primary lender. Following the issuance of the surety bond, the insured filed for bankruptcy, and the insurer liquidated the LOC. The trustee argued that the transfer to fund the LOC was an avoidable preference under section 547. The Fifth Circuit Court of Appeals overturned the lower court's holding that the earmarking defense applied because the LOC was not made to satisfy an antecedent debt, but nevertheless affirmed summary judgment in favor of the insurer on the basis that the debtor received "new value" in exchange for the LOC funding because the surety bonds allowed the debtor to obtain government contracts worth more than the value of the LOC.

FACTUAL BACKGROUND

ESA Environmental performed construction projects under contracts with the federal government. Under federal law, as a condition precedent to the award of any such contract, ESA was required to obtain a surety bond. The Hanover Insurance Co. had, for a number of years, issued surety bonds on behalf of ESA. ESA asked Hanover to issue additional surety bonds in conjunction with seven new contracts ESA sought to obtain. Hanover was concerned about ESA's financial condition, however, and refused to issue new bonds without additional security. ESA obtained an irrevocable Letter of Credit from SunTrust Bank, in the amount of $1.375 million, with Hanover as the beneficiary. The LOC collateralized the new bonds as well as all of Hanover's existing guarantees and surety obligations on behalf of ESA. SunTrust required ESA to fund a certificate of deposit at SunTrust as security for the LOC, in the amount of $1.375 million. ESA turned to another lender, Prospect Capital, for these funds, which Prospect provided by amending the existing credit agreement it had with ESA. Prospect then transferred the funds to ESA, ESA transferred the funds to SunTrust, SunTrust issued the LOC, and Hanover issued the New Bonds, which ESA delivered to the government agencies.

ESA was awarded the contracts, but during the 90-day preference period, it filed for relief under chapter 11. Hanover then drew $1.375 million on the LOC, which caused SunTrust to liquidate the CD. Bound by the surety bonds to complete the project work, Hanover fulfilled those obligations and paid the subcontractors.

Following conversion to chapter 7 and an appointment of a trustee, the trustee filed an adversarial proceeding against Hanover, alleging that it was an indirect beneficiary of ESA's transfer of the Prospect loan proceeds into the SunTrust CD, and that this transfer was an avoidable, preferential transfer under section 547. Hanover asserted two affirmative defenses – that the transfer was not a preference because the Prospect loan was earmarked specifically for payment to Hanover, and that ESA received new value in exchange for the Prospect loan proceeds.

The bankruptcy court granted summary judgment in favor of Hanover, holding that both of its asserted defenses applied. The trustee appealed.

COURT ANALYSIS

Section 547(b) provides that a trustee may avoid any transfer of an interest of the debtor in property (i) to or for the benefit of a creditor; (ii) for or on account of an antecedent debt owed by the debtor before such transfer was made; (iii) made while the debtor was insolvent; (iv) made on or within 90 days before the petition date; … (v) that enables such creditor to receive more than the creditor would receive if the transfer had not been made.

The court first addressed Hanover's earmarking defense. Earmarking is a judicially created defense that applies when a third person makes a loan to a debtor specifically to enable the debtor to satisfy the claim of a designated creditor. The underlying rationale is that the earmarked loan never becomes part of the debtor's assets, and therefore the transfer from the debtor to the designated creditor does not diminish the debtor's estate. The court cited Fourth Circuit precedent recognizing the earmarking defense, noting that the test of a true earmarked transfer is not what the creditor receives but what the debtor's estate has lost.

The court found that the bankruptcy court had erred in applying the earmarking defense here because the transfer lacked "a critical element of an earmarking defense: the funds at issue were not used to pay an antecedent debt." Because the loan proceeds were used to fund a new obligation, the LOC, there was "no debt by which one creditor is substituted for another. In the case at bar, a new debt was created where none previously existed."

The court then turned to the "new value" defense. Section 547(c)(1) provides that a trustee may not avoid a preferential transfer to the extent that the transfer was (i) intended by the debtor and the creditor to be a contemporaneous exchange for new value given to the debtor, and (ii) in fact a substantially contemporaneous exchange. When evaluating a new value defense, "the key question is whether the alleged preferential transfer diminished the debtor's estate, i.e., whether the debtor in fact acquired a new asset that offset the loss in value to the estate when the debtor transferred existing assets to acquire the new asset at issue."

The trustee first argued that Hanover failed to carry its burden of proof to establish with specificity the exact measure of new value received by ESA, and that the bankruptcy court erred in finding that ESA had in fact received the new contracts.

As evidence of new value, Hanover offered an affidavit of the debtor's former CEO that stated that the New Bonds enabled ESA to win contracts worth $3.9 million in revenues. Accordingly, Hanover asserted that the surety bonds provided ESA with the ability to earn more than the $1.375 million in loan proceeds required to obtain them. The trustee had no evidence contradicting this testimony, but rather argued that this was not precise enough for Hanover to carry its burden. The Court of Appeals held that there was no need for Hanover to prove with specificity any exact figure beyond the amount of the transfer.

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Creditor Defeats Preference Action Based on 'New Value' Defense—continued from page 25

As to the trustee's second argument – that any new value ESA received was not contemporaneously exchanged for the $1.375 million transfer of funds because the new government contracts were not paid upon issuance of the bonds – the court found that "the trustee conflates two very different concepts, the value of the New Contracts, which have value in and of themselves, and the eventual revenues ESA would have received upon performance of the New Contracts." The court concluded that the trustee failed to recognize that the New Contracts had value in and of themselves in excess of $1.375 million, and so held that the bankruptcy court did not err in its conclusion.

The court affirmed the grant of summary judgment in favor of Hanover.

Dissenting Opinion – Chief Judge Traxler believed that Hanover was not entitled to summary judgment on the new value defense, agreeing with the trustee that Hanover failed to prove the extent of new value provided to ESA. Rather than receiving $1.375 million in new value, Judge Traxler concluded that ESA received only a conditional promise for payment at some indefinite future date, which "does not establish the legal conclusion ESA actually received at least $1.375 million in new value…. Hanover successfully obtained $1.375 million from the estate without replacing it with equal value." Judge Traxler rejected the notion that the New Contracts possessed independent value because the government, not ESA, was the bond beneficiary, and he also noted that if Hanover proved any new value, it was limited to the $74,000 premium that ESA paid for the bonds.

PRACTICAL CONSIDERATIONS

The opinion highlights the complicated nature of preference litigation. While demonstrating the limited circumstances upon which lenders and trade creditors may rely on the earmarking defense in preference actions, the opinion also provides support that expected value of some asset, in this case government contracts, may form the basis of a new value defense.

A LONGER STATUTE OF LIMITATIONS PERIOD FOR PURSUING FRAUDULENT TRANSFER ACTIONS MAY EXIST

Amy Tonti
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Section 544(b) of the Bankruptcy Code empowers a bankruptcy trustee to avoid any transfer of an interest of the debtor in property that is voidable under "applicable law" by an unsecured creditor. Under the plain language of section 544(b), before a trustee can maintain an avoidance action, the trustee must demonstrate the existence of a qualified creditor, i.e., one who: (i) has a right to avoid the transfers; and (ii) holds an "allowable" unsecured claim. Importantly, the scope of "applicable law" is undefined.

Most commonly, a trustee seeking to pursue an avoidance action will have the option of using the longer of the two-year statute of limitations found at section 546(a)(1) of the Bankruptcy Code, or the applicable state fraudulent transfer statute of limitations provision (most of which are two-to-four years from the transfer date), in which to commence the action. Transactions that closed more than four or even six years post-transfer, nonetheless may be subject to an avoidance action for recovery of a fraudulent transfer. While this may be good news for debtors' estates looking for additional recoveries, defendants of such avoidance actions unfortunately may be reliving transactions they had long forgotten.

The Extended Statute of Limitations

The extended statute of limitations is often grounded in either the statute of limitations provision found in the Federal Debt Collection Procedures Act (FDCPA), 28 U.S.C. §§ 3001-3308 (six years), or the recovery under the Internal Revenue Code (IRC), 26 U.S.C. §§ 6501, 6502 (10 years). Whether courts will approve the use of these longer statute of limitations as authorized under the guise of "applicable law" under section 544(a) of the Bankruptcy Code does not have a uniform answer.

The FDCPA

The FDCPA was enacted to aid in the recovery of judgment debts owed to the United States, and as part of such recovery, avoid certain transactions. The FDCPA provides the federal government with a procedure to recover on or secure debts, thereby relieving the federal government of the need to rely on the multitude of various state substantive and procedural laws. FDCPA section 3001(a) provides: "This chapter provides the exclusive civil procedures for the United States (1) to recover a judgment on a debt; or (2) to obtain, before judgment on a claim for a debt, a remedy in connection with such claim." U.S.C. § 3001(a). (Emphasis added.) The FDCPA does not contain a private right of action and is only applicable in situations where the United States (or federal agency) is attempting to collect a "debt" as defined under the FDCPA. The FDCPA also contains a six-year statute of limitations for, *inter alia*, pursuing fraudulent transfer claims authorized under the FDCPA. (28 U.S.C. § 3306.)

The FDCPA's specific provisions, especially its express "exclusivity of use by the United States," are relied on by the courts finding that it is not "applicable law" under section 544 of the Bankruptcy Code. In *In re Mirant Corp.*, 675 F.3d 530 (5th Cir. 2012), a special litigation entity on behalf of the debtor's estate (MCAR), sued lenders, seeking to avoid the debtor's payments on a guaranty as fraudulent transfers. The district court denied the lenders' motion to dismiss based on plaintiff's alleged lack of standing, but granted summary judgment for lenders, holding that Georgia law did not permit avoidance of the guaranty. Both sides appealed. MCAR asserted that the FDCPA was applicable law under section 544(b); the Court of Appeals disagreed, and held that both the statutory language and the legislative history of the FDCPA indicate it is not "applicable law" under section 544(b).

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In *In re Bendetti*, 131 F. App'x 224 (11th Cir. 2005), the chapter 7 trustee filed proceedings in the bankruptcy court to avoid and recover alleged fraudulent transfers by the debtor and to deny the debtor's bankruptcy discharge. The alleged fraudulent transfers concerned the debtor's transfer of several pieces of real estate, real estate projects, and bank accounts to various individuals and corporations. The bankruptcy court, in two separate proceedings – an avoidance proceeding and a discharge proceeding – entered judgment for the debtor on all counts, finding the actions barred by the state statute of limitations. The district court affirmed. The trustee argued that he should be able to recover under the six-year statute of limitations provided by section 3306 of the FDCPA, and that the district court erred in not extending the statute of limitations to the trustee as a private party. The Court of Appeals disagreed.

In *Kipperman v. Onex Corp.*, (No. 1:05-CV-1242, slip op. at 71-86) (N.D. Ga. Sept. 29, 2010) (Kipperman) (Dkt. No. 669); see also, *In re Richard M. Kipperman, not individually but solely in his capacity as Trustee for the Magnatrax Litigation Trust, Plaintiff, v. Onex Corporation*, No. 105CV01242 (D. Ga.) (Order dated Aug 13, 2009, at 35), a chapter 7 trustee sought to use the FDCPA to recover fraudulent transfers. In addressing the standing of the trustee to bring the fraudulent transfer actions under the FDCPA, the court stated that the "difficulty in the trustee's FDCPA claim does not derive from the fact that it is the trustee – and not the federal government – pursuing the claim. But this does not end the matter. Plaintiff must still demonstrate that the claims it pursues come within the purview of the FDCPA." In *Kipperman*, the court noted that the "government would not be even a partial beneficiary and the government, unlike in *FTC v. National Business Consultants, Inc.*, 376 F.3d 317 (5th Cir. 2004) rehearing denied, certiorari denied 125 S.Ct. 1590, 544 U.S. 904, 161 L.Ed.2d 277 (2005), is not the entity pursuing the claim." In accord, *MC Asset Recovery, LLC. v. Commerzbank AG*, 441 B.R. 791 (N.D. Tex. 2010). Taking a slightly different approach, in *FDIC v. Todd & Hughes*, 2006 WL 2128667 (N.D. Tex. July 27, 2006), a'ffd 509 F.3d 216 (5th Cir. 2007) (in which the assignee of an FDIC judgment was not entitled to FDCPA protection), the court held that the United States is the only party that may invoke the benefits of FDCPA, even where the debt was originally owed to the United States.

Applicable Law

While the above cases find that the FDCPA is not applicable law under section 544(b), several courts conclude the opposite and permit the debtor's estate to use the FDCPA as "applicable law." The opinions that permit the debtor's estate to do so, discussed below, lack the rigor and exhaustive approach taken by the courts above.

In *In re Pfister*, 2012 WL 1144540 (Bankr. D.S.C. Apr. 4, 2012), the chapter 7 trustee sought to avoid a transfer of property made by the debtor. The trustee asserted that the transfer was fraudulent and avoidable, and that he was entitled to judgment in his favor pursuant to all or alternatively, sections 548(a)(1)(A) and (B), and sections 544(b) and 550(a) of the Bankruptcy Code, state fraudulent transfer law, and the FDCPA. The bankruptcy court held, with little discussion, "because the debtor was indebted to the IRS at the time of the transfer, the court finds that the transfer is also constructively fraudulent and avoidable pursuant to §544 and 28 U.S.C. §3304(a)(1)." Further, even though the amount of the IRS claims were, in the aggregate, less than $20,000, the court determined that the amount of the recovery sought in connection with the fraudulent transfer action was not limited to the aggregate amount of the IRS claims.

Similarly, in *In re Porter*, 2009 WL 902662 (Bankr. D.S.D. Mar. 13, 2009), the trustee asked the bankruptcy court to consider whether the transfer of certain property from the debtor to his spouse was avoidable as either a fraudulent or preferential transfer under section 544(b) and the FDCPA; the debtor had scheduled the SBA as an under-secured creditor.

"The fact that the SBA did not timely file a proof of claim in this case does not appear to preclude the trustee's reliance on the FDCPA," the court stated. "Section 544(b)(1) requires the trustee to show there is at least one unsecured creditor holding an allowable claim under section 502 who, at the time the subject transfer occurred, could have utilized the cited federal law to avoid the transfer." Id. at *21.

In finding that the SBA's claim met both requirements, the court concluded that the trustee could therefore step into the SBA's shoes under section 544(b)(1).

In *In re Walter*, 462 B.R. 698, 703-04 (Bankr. N.D. Iowa 2011), the court did not require that a debt be owed to the United States at the time of the alleged fraudulent transfer in finding the FDCPA to be "applicable law." The defendant agreed that the trustee represented an existing unsecured creditor with an allowable unsecured claim under section 544(b), but did not otherwise challenge the trustee's standing to assert a claim under the FDCPA. Instead, the defendant challenged the factual merits of the claim, asserting that the trustee was not entitled to rely on the FDCPA solely because the trustee pled no facts to satisfy the part of section 3304(a)(1) that requires the debt to be owing at the time of the allegedly fraudulent transfers.

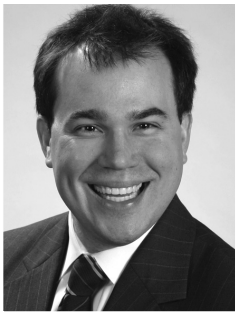
Further, the defendant argued that even if the trustee could successfully avoid the alleged transfers, the trustee could not recover the full amount of the transfers, and that recovery must be limited to the value of the claim owed to the United States – based upon its interpretation that under the FDCPA, the United States may only obtain "avoidance of the transfer or obligation to the extent necessary to satisfy the debt to the United States. 28 U.S.C. §§ 3306(a) (1), 3307(b)." In denying the motion to dismiss, the court found sufficient support for the trustee's argument that the full amount of the transfer was voidable and recoverable as property of the debtor's estate, and not limited by the amount of the debt owed to the United States.

There appears to be more uniformity in permitting the 10-year reach-back period found in the IRC as long as the IRS was a creditor at the time the bankruptcy petition was filed. In *In re Polichuk*, 2010 WL 4878789 (Bankr. E.D. Pa. Nov. 23, 2010) leave to appeal denied, 2011 WL 2274176 (E.D. Pa. June 8, 2011), the trustee's complaint sought to avoid a fraudulent transfer under the Pennsylvania Fraudulent Transfer Statute, which had a four-year statute of limitations. The trustee alleged that the United States – specifically the IRS – was an actual creditor of the debtor at the time the transfers at issue occurred. The court held that, under section 544(b), the trustee may use the statute of limitations available to any actual creditor of the debtor as of the commencement of the case. "Finding that the IRS has at least a ten-year lookback period, and because the Trustee may step into the shoes of the IRS, she may seek to avoid transfers that occurred as far back as January 31, 1998." *In re Polichuk*, footnote 9. In accord, *In re Republic Windows & Doors, LLC*, 2011 WL 5975256 (Bankr. N.D. Ill. Oct. 17, 2011); *In re Greater Se. Cmty. Hosp. Corp. I*, 365 B.R. 293, 297-315 (Bankr. D.D.C. 2006), and *In re Greater Se. Cmty. Hosp. Corp. I*, 2007 WL 80812 (Bankr. D.D.C. Jan. 2, 2007).

Conclusion

Parties may not be "assured" by the mere passage of two, four or even six years post-transfer, that an avoidance action for recovery of a fraudulent transfer is forever barred.

TRUSTEE FAILS TO CARRY BURDEN, COURT AFFIRMS PRE-PETITION TRANSFERS TO COVER CHECK-KITING LOSSES NOT AVOIDABLE PREFERENCE



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The Unsecured Creditors Comm. v. Community Bank (*In re Stinson Petroleum Co., Inc.*), Case No. 12-60234 (5th Cir., Jan. 7, 2013)

CASE SNAPSHOT

Pre-petition, the debtor engaged in a check-kiting scheme using accounts held at two banks. As a result of the scheme, one of the banks incurred substantial losses, and prior to filing its petition, the debtor made wire transfers to this bank to cover those losses. Following the petition filing, the Unsecured Creditors Committee moved to avoid the transfer as an avoidable preference under section 547(b) of the Bankruptcy Code. The Court of Appeals for the Fifth Circuit affirmed the lower courts' decisions, and held that the chapter 7 trustee failed to carry his burden to show that the bank received a greater distribution from the pre-petition transfers than it would have under a chapter 7 liquidation.

FACTUAL BACKGROUND

The debtor, Stinson Petroleum Company, Inc., engaged in a check-kiting scheme involving accounts held at Community Bank and Evergreen Bank. Evergreen discovered the scheme first and froze Stinson's account prior to losing any money. Community, however, did not discover the scheme until it had incurred losses approaching $7 million. Community agreed to accept two wire transfers totaling $3.5 million from Stinson. Stinson subsequently filed for bankruptcy under chapter 11. The Unsecured Creditors Committee commenced an adversary proceeding against Community in an attempt to avoid the two wire transfers as preferential transfers under section 547(b) of the Bankruptcy Code. The case was converted to chapter 7 liquidation, and the bankruptcy trustee was substituted as the plaintiff in the adversary proceeding. The bankruptcy court determined that, under state law, Community held a perfected, first priority security interest in the amount of the dishonored checks that were part of the check-kiting scheme, and that the trustee failed to prove that Community received a greater return than it would have received in a liquidation. The district court affirmed, and the trustee appealed to the Fifth Circuit.

COURT ANALYSIS

Under section 547(b) of the Bankruptcy Code, a trustee may avoid certain transfers that meet the requirements of section 547(b)(1)-(5). Section 547(b)(5) provides that the trustee must prove that the transfer at issue enabled a creditor "to receive more than such creditor would receive if – (A) the case were a case under chapter 7 of this title; (B) the transfer had not been made; and (C) such creditor received payment of such debt to the extent provided by the provisions of this title." The trustee had the burden of proving each element of section 547(b).

Community argued that the trustee failed to meet its burden under section 547(b)(5). Under Mississippi state law, a bank extending provisional credit on a deposited check prior to actually collecting funds on that check automatically obtains a perfected security interest in the check and proceeds. Accordingly, as a matter of law, a fully secured creditor who receives a pre-petition payment does not receive a greater percentage than he would receive in a liquidation proceeding. Undeterred, the trustee argued that Community could not guarantee when and whether it would have received any payment from the debtor under liquidation.

The Court of Appeals rejected the trustee's argument and held that the relevant inquiry was whether Community improved its position because of the pre-petition wire transfers relative to a distribution under a hypothetical chapter 7 liquidation. The court affirmed the judgment of the district court because the district court did not clearly err in concluding that the trustee failed to prove that Community would not have received at least $3.5 million in a chapter 7 liquidation.

PRACTICAL CONSIDERATIONS

This case gives some comfort for financial institutions that are the victims of a debtor's check-kiting scheme. If applicable state law provides that a bank providing provisional credit is a secured creditor, the bank should take comfort in the fact that (i) the bank should have strong defenses to an avoidance action brought to recover any pre-petition repayments made on account of the fraudulent checks, and (ii) the bank will be a secured creditor in the debtor's bankruptcy case (up to the amount of the fraudulent checks).

NINTH CIRCUIT JOINS MAJORITY, HOLDS UNSTAYED JUDGMENTS NOT 'BONA FIDE DISPUTE'

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In re Georges Marciano, No. 11-60070 (9th Cir., Feb. 27, 2013)

CASE SNAPSHOT

Judgment creditors of Georges Marciano filed an involuntary chapter 11 petition against Marciano, who appealed the state judgments before the petition was filed. The Ninth Circuit ruled, in a case of first impression, that unstayed state court judgments on appeal were not "the subject of a bona fide dispute," and thus the Bankruptcy Court did not err when it entered an order for relief under chapter 11 against Marciano, notwithstanding the pending appeals.

FACTUAL BACKGROUND

Guess Jeans founder, Georges Marciano, sued multiple former employees in California Superior Court, alleging theft, and some of these employees cross-complained against Marciano for defamation and intentional infliction of emotional distress. The California court entered separate judgments against Marciano in favor of the employees in amounts as high as $55 million. Three of the former employees and judgment holders filed an involuntary chapter 11 petition against Marciano, while the judgments were being appealed by Marciano to the California Court of Appeal. Marciano did not post a bond to stay the judgments.

Marciano filed a motion to dismiss the involuntary petition based on lack of service, and sought discovery against his petitioning creditors to determine whether the involuntary petition was filed in bad faith. The petitioning creditors filed a motion for summary judgment seeking an order for relief under Bankruptcy Code section 303, and Marciano opposed summary judgment on the grounds that the involuntary petition should not have been filed because the three petitioning creditors' claims were on appeal and, thus, subject to a bona fide dispute or contingent as to liability pursuant to Bankruptcy Code section 303(b)(1). Marciano's motion to dismiss was denied, his discovery was quashed, and the Bankruptcy Court entered an order for relief under chapter 11 against Marciano.

Upon granting the order for relief, the Bankruptcy Court ruled that an unstayed non-default state judgment was not a bona fide dispute under Bankruptcy Code section 303(b)(1), and on appeal, the Bankruptcy Appellate Panel affirmed. Marciano appealed to the Ninth Circuit.

COURT ANALYSIS

The Ninth Circuit began its discussion by addressing the fact that Bankruptcy Code section 303(b)(1) does not define "bona fide" dispute for purposes of the propriety of involuntary bankruptcy petitions. Bankruptcy courts have split in their interpretation of the code section. The majority "Drexler Rule" provides that unstayed non-default judgments on appeal are not the subject of a bona fide dispute under section 303(b)(1) – and thus may *per se* form the basis for an involuntary petition. The minority "Byrd Rule" provides that although such unstayed non-default judgments are normally not the subject of a bona fide dispute under section 303(b)(1), the petitioning creditor must make a prima facie case under section 303(b)(1), and after considering the debtor's dispute, a bankruptcy court must make the determination of whether a "bona fide dispute" exists.

The Ninth Circuit reasoned that the majority Drexler Rule was the better-reasoned rule, and that it was "difficult to imagine a more 'objective' measure of the validity of a claim than an unstayed judgment entered by a court of competent jurisdiction." The Ninth Circuit determined that the Byrd Rule turned the bankruptcy court into an "odds maker on appellate decision-making," and that the more bright-line Drexler Rule better served the purposes of the Bankruptcy Code of promoting an orderly distribution of a debtor's assets to creditors.

DISSENT

In a dissenting opinion, Circuit Judge Ikuta argued that the Fourth Circuit Byrd Rule was better-reasoned because "the filing of an involuntary petition should not be lightly undertaken," and that a bankruptcy court should be "at least bound to consider whether there were legitimate questions" regarding a state judgment on appeal. The dissent argued that the majority Drexler Rule was a "shortcut solution that skips over the safeguard of scrutinizing claims carefully before placing a debtor in involuntary bankruptcy."

PRACTICAL CONSIDERATIONS

The Ninth Circuit has established a bright-line *per se* rule that unstayed state court judgments may form the basis for an involuntary bankruptcy petition. Other circuits, most notably the Fourth Circuit, subject such claims to further analysis by the bankruptcy court. The Ninth Circuit has not yet spoken on the issue of unstayed default judgments, although some bankruptcy courts applying the *per se* rule have indicated that closer scrutiny may be given to such default judgments.

COUNSEL'S CORNER: NEWS FROM REED SMITH

Presentations

Peter Clark – was recently ranked one of the "Nation's Top 10 Bankruptcy Lawyers" in the 2013 edition of United States Lawyer Rankings.

Richard A. Robinson – presented "The Do's and Don'ts of Discovery" on a panel at the 31st Annual Spring Meeting of the American Bankruptcy Institute on April 19.

Robert Simons – contributed a chapter entitled "Liquidating Assets Through a Chapter 11 Sale and Plan of Liquidation Rather Than a Chapter 7 Liquidation" for a book entitled "Inside the Minds: Chapter 7 Commercial Bankruptcy Strategies," 2013 ed. (Aspatore Books).

Robert Simons – Presented "Warning Signs of Ponzi and Check Kiting Schemes "to the PNC Legal Department Asset Recovery Team on April 12.

Gregory Taddonio and **Robert Simons** presented "Bankruptcy Litigation" to the PNC Legal Department on April 25.

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