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CR&B Alert

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In This Issue:

CONSEQUENCES OF THE FAILURE OF A SECURED CREDITOR TO FILE A TIMELY PROOF OF CLAIM

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Most of us are familiar with the concept that liens generally pass through a bankruptcy. But what happens to the secured creditor's claim if the creditor fails to file a proof of claim on or before the bar date? Two recent cases give us some guidance. In *In re Shelton,* No. 12-3555 (8th Cir. Nov. 4, 2013), the Eighth Circuit held that a late claim can be disallowed without extinguishing the underlying lien. So, an action *in personam* is extinguished but an action *in rem* remains. But what does that mean from a plan confirmation standpoint? According to the court in *In re Batista-Sanechez*, No. 12-48247 (Bankr. N.D. Ill. Oct. 25, 2013), that means that the secured creditor loses the right to vote on the debtor's plan and to a distribution. Of course, since the lien claim survives that creates complications for the debtor in getting a plan confirmed. The court said that the lien claim will have to be separately classified since the secured creditor will be deemed to reject the plan because it cannot vote. Consequently, the debtor must satisfy the cramdown provisions to confirm the plan. Hopefully, we will get more clarity on this puzzling issue soon.

PRIVATE EQUITY FUNDS POTENTIALLY LIABLE FOR PORTFOLIO COMPANY'S UNFUNDED PENSION LIABILITY

Joe Filloy
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Sun Capital Partners, et al. v. New England Teamsters & Trucking Industry Pension Fund, et al., No. 12-2312 (1st Cir., July 24, 2013)

CASE SNAPSHOT

In a matter of first impression, the First Circuit Court of Appeals held that certain private equity funds were potentially liable for their portfolio company's unfunded pension liability. Following the acquisition of a company by the private equity funds, the company went bankrupt and stopped making contributions to its pension fund. The pension fund sought to hold the funds liable; the funds argued that they were merely investors, and not engaged in a trade or business. Because of contractual terms and actions taken by the funds following the acquisition, the court held that the funds were engaged in a trade or business, and could be liable for unfunded pension obligations if common control existed among the funds and the debtor company.

FACTUAL BACKGROUND

Two Sun Capital investment funds (the "Sun Funds") had purchased all the stock of Scott Brass, Inc., hoping to turn the business around and resell it for a profit. Two Sun Funds entities acquired a controlling interest in the privately held Scott Brass, Inc. The Sun Funds then entered into management agreements with other Sun Capital entities, which were ultimately controlled by Sun Capital's two principals. In the end, Scott Brass, Inc. fell victim to the 2008 recession, and one month prior to filing for bankruptcy, it stopped making funding contributions to its pension plan. Thereafter, the pension fund sought recovery from the Sun Funds, asserting withdrawal liability under 29 U.S.C. section 1301(b). The Sun Funds filed a declaratory judgment action seeking a declaration that they were not liable for withdrawal liability. The Sun Funds asserted they were merely passive investors, not "trades or businesses" under ERISA, and not part of a joint venture or partnership and, therefore, did not meet the common control requirement.

The district court found for the Sun Funds, holding that the funds were not "trades or businesses." Accordingly, the district court did not address the common control element. The Court of Appeals overturned the district court's order granting summary judgment in favor of the Sun Funds, holding that the Sun Funds constituted a trade or business and, therefore could be liable for the unfunded amounts if common control existed among the Sun Funds and Scott Brass, Inc.

COURT ANALYSIS

The Court of Appeals started with the basic proposition that "To impose withdrawal liability on an organization other than the one obligated to the [pension] Fund, two conditions must be satisfied: (1) the organization must be under 'common control' with the obligated organization, and (2) the organization must be a trade or business." The court found that "trade or business" was not defined in the statute, and that no regulations had been issued regarding its usage by the Pension Benefit Guaranty Corporation. The court, giving deference to a PBGC appeal letter, applied the "investments plus" test to determine whether the private equity firms were in a trade or business. The investments-plus approach is a fact-specific test that examines a number of factors, none of which is dispositive, to determine whether the equity funds' involvement in the debtor company exceeded just a pure investment. Here, the court held the Sun Funds were engaged in a "trade or business" because of the extent to which the funds exercised management and operational control over Scott Brass. As private equity funds, the Sun Funds' objective was to take over management and operations to help undervalued businesses increase revenues and net profits, in order to benefit the funds' investors. The Sun Funds were empowered to make management decisions and employment decisions, and to control Scott Brass's assets.

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MAKE-WHOLE PAYMENT NOT 'UNMATURED INTEREST'

Jeanne Lofgren
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In re School Specialty, Inc., Case No. 13-10125 (KJC), (Bankr. D. Del., April 22, 2013)

CASE SNAPSHOT

The bankruptcy court held that a make-whole payment (which was roughly one-third of the principal amount due) was not an unenforceable penalty, was not plainly disproportionate to the potential loss, and was not "unmatured interest," and thus was not prohibited by section 502(b)(2).

FACTUAL BACKGROUND

Under the terms of a note agreement, the borrower/debtor was required to pay the lender an early payment fee (i.e., a make-whole payment) in the event of acceleration or prepayment of the loan prior to the maturity date. The principal amount of the note was $70 million; the make-whole payment was based on discounting the future stream of interest payments between the date on which the principal is prepaid or accelerated, and the latest possible maturity date as defined in the note agreement. After default, the lender accelerated the balances due – the principal amount was $67 million, unpaid interest was $1.6 million, and the make-whole payment was $23.7 million.

The Unsecured Creditors' Committee filed a motion to disallow that payment, arguing that it was plainly disproportionate to the lender's possible loss.

COURT ANALYSIS

Bankruptcy courts look to state law to determine whether a prepayment provision is enforceable, and under New York law (applicable here), prepayment provisions and early termination fees are analyzed under the standards applicable to liquidated damages. New York courts enforce prepayment premiums when (1) actual damages are difficult to determine, and (2) the sum stipulated is not "plainly disproportionate" to the possible loss.

The court upheld the make-whole payment, despite the fact that it was 37 percent of the term loan. The court found that the prepayment fee was calculated so that the lender would receive its bargained-for yield, and that the fee was the result of an arms'-length transaction. The court held that the applicable standard was whether the prepayment fee was plainly disproportionate to the possible loss, not whether the payment is disproportionate to the principal amount of the loan. The court noted that the amount of the make-whole payment diminished over time and was calculated using a discount rate tied to Treasury note performance. The fact that the lender used the latest possible maturity date for the loan was justified because the lender had to adjust its lending activity to ensure adequate funding was available for all of its outstanding credits in the event the loan was extended through the outside maturity date.

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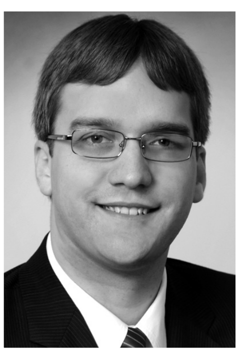
TAX STATUS OF Q-SUB DEBTOR NOT ESTATE PROPERTY; DEBTOR HAS NO STANDING TO CHALLENGE PARENT'S SUB-S REVOCATION



Brian Schenker
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In re The Majestic Star Casino, LLC, 716 F.3d 736 (3d Cir. 2013)

CASE SNAPSHOT

The U.S. Court of Appeals for the Third Circuit was recently the first Court of Appeals to decide whether the Bankruptcy Code prevented a non-debtor indirect parent company, and its non-debtor shareholder, from revoking the parent company's tax status as an "S" corporation (S-Corp) because such revocation would automatically result in the termination of a subsidiary's debtor-in-possession's tax status as a qualified subchapter S subsidiary (Qsub). The Third Circuit held that the non-debtor parent company and its non-debtor shareholder were not prevented by the Bankruptcy Code from making such a revocation because (1) the debtor's tax status as a Qsub was not property within the meaning of the Bankruptcy Code; (2) even if it was, it was not property of the debtor's bankruptcy estate; and (3) for both of those reasons, the debtor lacked standing to challenge such a revocation.

The net effect of the Third Circuit's ruling is to permit tax burdens related to the income of the debtor to be shifted from the non-debtor parent company – and ultimately its non-debtor shareholder – to the debtor, its bankruptcy estate, and eventually its creditors.

FACTUAL BACKGROUND

In simplest terms, as a Qsub, the debtor was not treated as an entity separate from its non-debtor indirect parent for tax purposes, meaning that the non-debtor parent company received the tax benefits and burdens related to the debtor's income and losses. As an S-Corp, the non-debtor parent company was treated as a "disregarded entity" for tax purposes, meaning that the non-debtor shareholder received the tax benefits and burdens related to the non-debtor parent company's income and losses. Thus, the non-debtor shareholder ultimately received the tax benefits and burdens related to the debtor's income and losses.

By consenting to, and causing, the non-debtor parent company to revoke its tax status as an S-Corp, the non-debtor shareholder sought to shift the tax burdens related to the non-debtor parent company's income to the non-debtor parent company. By operation of tax law, such revocation also automatically caused the debtor to no longer qualify as a Qsub, resulting in the tax burdens related to the debtor's income shifting from the non-debtor parent company to the debtor. Thus,

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DON'T LET EXCESS INSURERS AVOID COVERAGE BASED ON SETTLEMENTS OR BANKRUPTCY

Luke Debevec
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Ali v. Federal Insurance Co., 719 F.3d 83 (2d Cir. 2013)

CASE SNAPSHOT

Businesses have liability insurance for a number of risks. General liability insurance generally covers liability for property damage, bodily injury, advertising injury, and violations of the intangible rights of others, like the right of privacy. Directors and Officers liability insurance typically covers the directors and officers of a company, and indeed the company itself, for liability for wrongful acts that cause injury to others. Corporations often have a tower of insurance beginning with primary insurance of, say, $1 million, followed by layers of excess insurance that can reach into the tens or hundreds of millions of dollars.

Excess insurance companies have long argued that they have no obligation to pay until the underlying insurance (the insurance beneath them in this "tower" of insurance) has fully paid its limits of liability. This creates problems when the underlying insurance company is insolvent, denies coverage and refuses to pay, or when the liability of the underlying insurance company under its insurance policy is settled for payment of less than the full applicable indemnity limit.

In *Ali v. Federal Insurance Co.,* 719 F.3d 83 (2d Cir. 2013), the Second Circuit considered whether an excess liability insurance company's obligations would be triggered once the total amount of hypothetical future liability obligations exceed the limits of the underlying policies, regardless of whether such amounts had actually been paid. The Second Circuit applied the plain meaning of the insurance policy language, which required "payment of losses," and held that language was not satisfied by the mere accrual of liability that had not been paid. The court was not asked to consider coverage for a specific loss or liability already incurred.

FACTUAL BACKGROUND

Ali involved insurance coverage for directors and officers of the bankrupt Commodore International Limited, a pioneer in the computer industry. Commodore had a tower of directors and officers liability coverage. The primary insurance of $10 million was exhausted by the payment of defense costs. The next level of insurance was with Reliance Insurance Company, which was placed into liquidation in 2001. Unfortunately, Reliance was not the only insolvent insurance company in the tower. The Home Insurance Company entered liquidation in 2003.

Commodore ceased operations and filed for bankruptcy protection in 1994. The Receivers of Commodore sued the directors and officers (the "Directors") for more than $100 million in damages relating to their alleged wrongful acts that were alleged to have caused Commodore's bankruptcy. Federal Insurance Company and Travelers Casualty and Surety Company of America were solvent and provided, between them, three layers of coverage: $5 million excess of $15 million; $5 million excess of $30 million; and $10 million excess of $40 million. According to the district court's decision, the Directors had incurred approximately $14 million in losses as a result of the various lawsuits that followed Commodore's filing for bankruptcy protection. During the pendency of appeal, there was a large settlement, but the Second Circuit decided that the settlement would not influence its interpretation of the relevant insurance policies.

Federal initiated a declaratory relief action against the Directors seeking a declaratory judgment that it had no obligation to "drop down" to cover liability that would otherwise have been covered by Reliance and Home. The Directors responded by seeking a declaratory judgment against both Federal and Travelers that their coverage obligations are triggered once the total amount of defense and/or indemnity obligations exceeds the limits of any insurance policies underlying their respective policies, regardless of whether such amounts had actually been paid by those underlying insurance companies.

The district court granted summary judgment and decided that the excess insurance companies would not be required to "drop down" to pay loss in the lower layers of insolvent insurance companies. The district court denied summary judgment sought by the Directors concerning whether future liability "obligations" would generally suffice to trigger the excess insurers' obligations to pay, without a prior payment by the lower-level carriers, the Directors, or anyone else. Once that trial court decision was received, the Directors agreed to a stipulated dismissal of the remainder of the case so that they could seek an immediate appeal.

COURT ANALYSIS

On appeal, the Second Circuit first confirmed its own appellate jurisdiction based on the unusual posture of the case, arising as it did from a stipulated dismissal. The court did not address the "drop down" question because it was not appealed. Accordingly, the only issue before the court was, under the particular policy language at issue, whether liability in excess of the underlying limits was sufficient to trigger the excess insurance policies, or whether the "payment of losses" was required.

On the merits, the court ruled against the Directors. The court held that "[t]he plain language of the relevant excess insurance policies requires the 'payment of losses' – not merely the accrual of liability – in order to reach the relevant attachment points and trigger the excess coverage." The Federal policies attached "only after all . . . 'Underlying Insurance' has been exhausted by payment of claim(s)," and stated that exhaustion occurs "solely as a result of payment of losses thereunder." The Travelers policy stated that its coverage "shall attach only after all such Underlying Insurance has been exhausted," and that such exhaustion occurs "solely as a result of payment of losses thereunder."

The court considered several arguments on appeal. The Second Circuit noted that most of the arguments were "inapposite because they are based on a misunderstanding of the District Court's order." For example, the Directors argued that implicit in the lower court's order was that exhaustion of the underlying policies must occur as a result of actual payment by the underlying insurance companies, rather than by the Directors. The Second Circuit ruled that the district court never held that the underlying insurance companies must make the payments, but instead echoed the language of the policies that stated that there needed to be "payment" of losses, without any specification about who needed to make the payments.

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FAILURE TO EXECUTE PLAN-REQUIRED DOCUMENTS VERY COSTLY FOR SUBSEQUENT PURCHASER

In re L.L. Murphrey Company, Case No. 12-03837-8-JRL (Bankr. E.D.N.C., June 6, 2013)

Alison Toepp
Associate, Richmond

CASE SNAPSHOT

The debtor in this chapter 7 proceeding previously obtained confirmation of a chapter 11 plan of reorganization. The plan provided that claims of a secured lender would be divided into two promissory notes, A and B, which would remain secured by the debtor's real and personal property following confirmation. The plan also provided that the Notes would become effective upon the execution of documents embodying the terms of the Notes. No such documents were ever executed. The lender's claims were acquired by a property company, DAN, which objected to the chapter 7 trustee's motion to sell all assets free and clear of all liens under section 363(f). The court held that because Note A and Note B documents were not executed, the terms did not become effective and the trustee could effect the sale. Further, the court prohibited the claim purchaser from credit bidding on the assets.

FACTUAL BACKGROUND

The secured lender asserted claims in the debtor's prior chapter 11 bankruptcy case involving five separate promissory notes, which were secured by properly recorded deeds of trust on debtor's real property, assignments of rent, security agreements and financing statements. The confirmed chapter 11 plan divided the secured lender's claims into two promissory notes, Note A and Note B. The terms of the plan included provisions stating that the debtor and the secured lender "will enter into amended and restated Loan Documents," and further provided that the debtor "shall execute and deliver such agreements, instruments and documents as reasonably may be requested by" the secured lender. The plan also set an implementation date, but imposed as a condition precedent that the restated loan documents "shall have been executed and delivered." Additionally, the plan provided that all liens remaining in favor of any creditor in the chapter 11 case would be deemed released upon confirmation of the plan.

After the plan was confirmed, the secured lender's security instruments were acquired by a joint venture, which subsequently assigned the instruments to DAN. DAN filed notices of assignment, amendments and continuation statements with the county register and the secretary of state. Thereafter, the debtor filed its voluntary chapter 7 petition and DAN filed a proof of claim.

The chapter 7 trustee filed motions requesting court approval to conduct a public sale of the debtor's real and personal property free and clear of liens. DAN, which asserted liens on the majority of the real property and personal property items, filed an objection to the trustee's motion, arguing that the trustee had not established the existence of any of the grounds under section 363(f). The trustee responded that the security agreements DAN relied upon were avoidable under section 544(a)(2), that the security instruments were invalid because they were released upon confirmation of the chapter 11 plan, and that the security instruments failed to accurately describe the underlying obligations created in that plan. DAN countered that the trustee improperly was attempting through its arguments to "manufacture a 'bona fide dispute'" under section 363(f)(4), and that the plan language requiring execution of amended loan documents was not mandatory because of the provision stating that the debtor "shall execute and deliver such agreements, instruments and documents as reasonably may be requested by" the secured lender.

COURT ANALYSIS

The court began its analysis with a discussion of section 363(f)(4), which provides that "[t]rustee may sell property…free and clear of any interest in such property of an entity other than the estate, only if…such interest is in bona fide dispute." The court noted that the phrase "bona fide dispute" is not defined in the Bankruptcy Code, but that courts defined the phrase as requiring a "meritorious, existing conflict" or at least an "objective basis" for a factual or legal dispute as to the validity of the debt. The court also cited authority for the proposition that the court need not resolve the underlying dispute in order to find that a bona fide dispute existed, nor was a pending adversary proceeding a prerequisite to finding that a bona fide dispute existed.

In evaluating whether DAN's liens were subject to a "bona fide dispute," the court looked at the language of the debtor's prior chapter 11 plan. The court held that the unambiguous language of the plan imposed on the debtor and the secured lender "an obligation…to execute amended and restated agreements, instruments and other loan documents consistent with the treatment provided therein. In addition to being explicitly required, the execution and delivery of the amended and restated loan documents was a condition precedent for setting the implementation date for Note A and Note B." The court rejected DAN's arguments that the plan provisions regarding Note A and Note B were self-executing and not mandatory. The court found that in the absence of the amended and restated loan documents required by the plan, the documents DAN relied on to support its claims were insufficient and did not constitute negotiable instruments. Accordingly, the court found the trustee "demonstrated an objective basis" for avoiding DAN's liens under section 544(a)(3), and as such, granted the trustee's motion to sell the property free and clear in accordance with section 363(f)(4).

The court also discussed section 363(k), which allows a court in its discretion to abrogate a creditor's right to credit bid "for cause." The trustee argued that the dispute regarding the extent and validity of DAN's liens supplied the "cause" required for the court to deny DAN the ability to credit bid at the public sale of the debtor's property. Adopting the view of other courts across the nation that "cause" exists when the lien at issue is in question or disputed, the court, exercising the discretion afforded under section 363(k), entered an order prohibiting DAN from credit bidding at the trustee's sale.

PRACTICAL CONSIDERATIONS

Confirmation plans often include requirements that parties execute new documentation in order to effect the revisions included in the plan. This case demonstrates that failure to execute such documents carries a heavy price, especially for a subsequent purchaser of claims that was not involved in the confirmation plan. Purchasers of such property must examine the confirmation plan to determine documentation requirements, and must make sure that those requirements have been fulfilled prior to completing their purchase.

CREDITOR HAS TWO SEPARATE SECURITY INTERESTS IN PROPERTY AND RENTS

Alison Toepp
Associate, Richmond

Putnal v. Suntrust Bank, 489 B.R. 285 (M.D. Ga., 2013)

CASE SNAPSHOT

The debtor secured a note with a deed of trust, granting the lender a security interest in a rental property. The debtor also granted the lender an assignment of rents and a security interest in those rents. After filing a chapter 11 petition, the debtor moved to use almost half of the post-petition rents for bankruptcy costs and other general expenses. The lender objected, arguing that it did not have adequate protection in this cash collateral. The debtor argued that the interest in the cash collateral was subsumed in the security interest in the real property, so that the lender was adequately protected because the value of the rental property was not impaired.

The court affirmed the bankruptcy court, holding that the lender had two separate security interests—one in the rental property and the other in the rental income therefrom. Thus, the lender was entitled to adequate protection in the rents and the property, while the debtor was entitled to use only the portion of the cash collateral that was directly related to the maintenance of the property.

The court noted that while the 11th Circuit had not addressed the issue, the weight of authority held that a creditor's interest in rents is separate from its interest in real property, and that this interest corresponds to the amount of rents that accrue. The court relied on section 552(b)(2) of the Bankruptcy Code, which provides that a pre-petition security interest in cash collateral such as rents extends to rents collected post-petition to the extent provided in the security agreement, concluding that "such security interest extends to such rents."

FACTUAL BACKGROUND

The debtor was the owner and manager of several rent-producing properties. The debtor granted a deed of trust—including a security interest in the rental property, an assignment of rents, and a security interest in the rents—to the lender on one such property that the debtor leased to a pharmacy. The deed of trust granted the lender a security interest in "any and all leases…affecting the [property] both presently existing and hereafter arising, and all rents, income, or profits which are not due or may hereafter become due…; all of which are hereby assigned to [the lender] as further security for the repayment of the indebtedness." The agreement further provided that, upon the debtor's default, the "rents shall be treated as cash collateral."

The parties agreed that the lender had a secured claim of $470,000 (the value of the rental property) and an unsecured claim of more than $500,000. The parties also agreed that the lender had a post-petition interest in the rents produced by the rental property pursuant to section 552(b)(2), and that the rents were "cash collateral" as defined in section 363(a). Because the rents were cash collateral, pursuant to section 363(c)(2) of the Bankruptcy Code, the debtor was required to obtain the lender's consent or court authorization in order to use the rents. The debtor moved the court for authorization to use a portion of the cash collateral—about $3,000 each month—to pay the costs of the bankruptcy and other general expenses, including expenses the debtor incurred appraising the rental property and renegotiating the lease with a tenant.

In his motion, the debtor argued that the lender's interest in the rental property and the rents were unified, and that the lender's interest was adequately protected because the value of the rental property was not impaired. The lender objected, arguing that its cash collateral was entitled to separate adequate protection, and that the debtor's proposed use of a portion of rents deprived the lender of adequate protection in the cash collateral because each dollar the debtor spent would decrease the value of the lender's cash collateral.

The bankruptcy court found that the lender had two distinct security interests: one in the rental property and one in the rents the property produced. It granted the debtor's motion, but only to the extent that the cash collateral was used directly for the rental property. Specifically, the bankruptcy court limited debtor's use of the rents to (1) the cost of appraising the rental property, (2) the expenses incurred in renegotiating the lease with the tenant, and (3) an amount to pay unreimbursed maintenance expenses on the property at issue.

The debtor appealed to the district court and both sides asked the court to amend the bankruptcy court's order.

COURT ANALYSIS

Looking to the language of the deed of trust, the court held that, under section 552(b)(2), the lender's security interest extended to the rents produced by the rental property. The parties conceded that the rents were cash collateral. The court noted that section 363(e) requires that any authorization of the debtor's use of the cash collateral "must sufficiently prohibit or condition the use to provide 'adequate protection'" for the lender's interest. Under section 361, "[a]dequate protection may be achieved in several ways, such as by (1) requiring the [d]ebtor to make cash payments to [the lender] to the extent his use of the rents decreases the value of [the lender's] interest in the property; (2) providing [the lender] an additional or replacement lien to this same extent; or (3) granting other relief that will provide [the lender] the 'indubitable equivalent' of its interest in the property." The debtor had the burden to prove the lender's interest was adequately protected.

The debtor raised several arguments in support of his contention that the bankruptcy court erred in placing conditions on his use of the rents, which the district court boiled down into a single overarching issue: "[w]hether [the lender's] security interest in rents, which admittedly is cash collateral, is separate cash collateral entitled to its own adequate protection." The court found that, although only a few courts had addressed the issue—including the Sixth Circuit and the bankruptcy courts for the Western District of Texas, the Northern District of New York, the Eastern District of Michigan, and the Eastern District of North Carolina—"the weight of authority holds that a creditor's interest in rents is separate from its interest in the land and corresponds to the amount of rents that accrue."

The court found that "[t]he [d]ebtor's arguments in this case rest on the idea that [the lender's] interest in rents is subsumed by its interest in the real property, and that so long as the real property's value is not declining, all that must be protected is a lien in rents." That argument, the court held, "ignore[d] the nature of the interest actually assigned to [the lender]" because the lender took more

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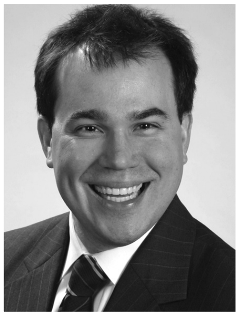
FIFTH CIRCUIT NOW HOLDS ABSOLUTE PRIORITY RULE APPLICABLE TO INDIVIDUAL CHAPTER 11 DEBTORS

In re Lively, No. 12-20277, (5th Cir. May 29, 2013)



Jared S. Roach
Associate, Pittsburgh

CASE SNAPSHOT

The Fifth Circuit joins the Tenth and Fourth Circuits in holding that the absolute priority rule applies to individual chapter 11 debtors.

FACTUAL BACKGROUND

This case involved interpretation of two sections added under the Bankruptcy Abuse Prevention & Consumer Protection Act of 2005 (BAPCPA). Section 1129(b)(2)(B)(ii) provides that a chapter 11 reorganization plan is "fair and equitable" with respect to a dissenting class of unsecured claims, if the debtor does not receive or retain certain 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 in original.) Section 1115 provides that in a case when the debtor is an individual, in addition to property of the estate as set forth in section 541, property includes the debtor's post-petition earnings and property acquired post-petition.

COURT ANALYSIS

The court reasoned that Congress adopted the BAPCPA provisions "in order to coordinate individual debtor reorganization cases to some extent with chapter 13 cases," where debt limits require debtors (including the appellant here) to file under chapter 11. The court stated that, had chapter 11 remained unaltered under BAPCPA, the debtor could have reorganized under terms more favorable than those available to chapter 13 debtors. Pre-BAPCPA, the property of the estate did not include an individual chapter 11 debtor's post-petition earnings, whereas a chapter 13 debtor's earnings were included and used in calculating the debtor's payments to creditors. "When the debtor's post-petition property and earnings were added to chapter 11, however, Congress also had to modify the absolute priority rule so that a debtor would not be saddled with committing all post-petition property to satisfy creditors' claims."

PRACTICAL CONSIDERATIONS

The court joins two other circuits by holding, and setting forth statutory reasoning why, the absolute priority rule applies to individual chapter 11 debtors. The court rejected findings from other courts that found statutory ambiguity in section 1129(b)(2)(B). The court also stated that Congress would have clearly effected an intention to exempt chapter 11 debtors from the absolute priority rule, if that had been Congress' intent.

Private Equity Funds Potentially Liable for Portfolio Company's Unfunded Pension Liability—continued from page 2

The Court of Appeals rejected arguments made by the Sun Funds that their management and partnership structure, which ceded all management decisions to a different Sun Capital entity, rendered Sun Funds a merely passive investor. The court remanded the case, instructing that the district court determine whether the funds and Scott were under "common control," which would then impose withdrawal liability for the pension on Sun.

PRACTICAL CONSIDERATIONS

This decision creates potentially significant risk for private equity funds, given that many funds take an active management role in their portfolio companies without the expectation that they may also be taking on pension liabilities. Such funds should be cautious to evaluate all potential risks prior to investing in distressed companies.

Make-Whole Payment Not 'Unmatured Interest'—continued from page 3

The court also rejected the Committee's argument that the make-whole payment was "unmatured interest" prohibited by section 502(b)(2) of the Bankruptcy Code. Taking the majority view on this issue, the court reasoned that the make-whole premium, while compensating for future unpaid interest, was nonetheless fully matured as of the petition date.

PRACTICAL CONSIDERATIONS

Careful drafting of prepayment fee terms is required to ensure a make-whole provision is treated as liquidated damages and not an unenforceable penalty, and careful thought must be given to the choice-of-law provisions as well.

THIRD CIRCUIT PREDICTS PENNSYLVANIA SUPREME COURT WOULD PERMIT PUNITIVE DAMAGES UNDER FRAUDULENT TRANSFER ACT

Klein v. Weidner, No. 10-3218 (3d Cir., Sept. 3, 2013)

Lauren Zabel
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CASE SNAPSHOT

The Court of Appeals for the Third Circuit upheld the district court's determination that the Pennsylvania Supreme Court would likely find that punitive damages are permitted to be assessed under the Pennsylvania Uniform Fraudulent Transfer Act. The Third Circuit also upheld the award of punitive damages under PUFTA, where the defendant transferred individually owned property into the names of himself and his new wife in order to avoid payment of spousal support and child support obligations owed to his former wife.

FACTUAL BACKGROUND

Mr. Weidner owed his former wife more than $500,000 in unpaid spousal and child support. After remarrying, Mr. Weidner transferred the title on many of his assets from his own name to his name and that of his new wife. Mr. Weidner's former spouse sued him, alleging that his property transfers violated the Pennsylvania Uniform Fraudulent Transfer Act (PUFTA). The district court entered judgment in favor of the former wife, finding that the defendant had committed actual and constructive fraudulent transfers. In addition to requiring the transfer of the affected property back into Mr. Weidner's name individually, the district court determined that punitive damages may be assessed under PUFTA, and assessed punitive damages against Mr. Weidner in the amount of unpaid spousal and child support. Mr. Weidner appealed the decision and the assessment of punitive damages. After the district court entered judgment in the PUFTA action and during the pendency of the appeal thereof, Mr. Weidner filed a chapter 11 petition wherein his discharge was ultimately denied.

COURT ANALYSIS

The Third Circuit first affirmed the district court's determination that the transfer at issue constituted a fraudulent transfer pursuant to PUFTA. The court then analyzed the availability and assessment of punitive damages under PUFTA. Although PUFTA does not make an explicit provision for punitive damages, and the Pennsylvania Supreme Court had never ruled on the issue, the Third Circuit predicted that the Pennsylvania Supreme Court would find that punitive damages may be assessed under PUFTA. In so holding, the Court of Appeals analyzed the nature and purpose of the relevant provisions of the statute, and analogous statutes in Pennsylvania and other states. The court reasoned that the statute's catch-all remedy provision, the remedial nature of the statute, and the egregious nature of the debtor's conduct, all supported its conclusion. Having determined that punitive damages may be assessed under PUFTA, the Third Circuit went on to affirm the assessment of punitive damages made by the district court.

PRACTICAL CONSIDERATIONS

Although not a binding statement of Pennsylvania law, this case opens the door for the assessment of punitive damages in cases under PUFTA, and potentially the Pennsylvania Uniform Fraudulent Conveyance Act, where conduct is egregious enough to warrant punitive damages. Parties should be mindful of this potential when bringing and defending actions under PUFTA and PUFCA.

Don't Let Excess Insurers Avoid Coverage Based on Settlements or Bankruptcy—continued from page 4

The Second Circuit also found unpersuasive the Directors' reliance on the Second Circuit's seminal decision in *Zeig v. Massachusetts Bonding & Insurance Company,* which had been authored 85 years earlier by the accomplished jurist Augustus Hand. The insurance policy in *Zeig* required that the primary policy be "exhausted in the payment of claims to the full amount of the expressed limits." The Second Circuit noted that *Zeig* was a property insurance case, while the case at issue was liability insurance. The Second Circuit also noted that *Zeig* addressed situations in which a policy was deemed exhausted as a result of a below-limit settlement of indemnity claims with an underlying insurance company, whereas that was not at issue in *Ali*.

The Second Circuit's decision that mere liability was not enough was animated by the prospect of "inflated settlements" that insureds might be "tempted to structure" with their adversaries "that would have the same effect as requiring the Excess Insurers to drop down and assume coverage in place of the insolvent carriers." The court was of the view that the excess insurance companies would have good reason to require "actual payment up to the attachment points of the relevant policies" in order to "deter" the possibility of "settlement manipulation," so as to ensure that the losses presented to excess insurers would be actual "losses" and not "mere accrual of losses in the form of liability."

SCOPE OF THE DECISION

The ruling in *Ali* is not as broad as it might initially appear.

First, the ruling is limited by the policy language at issue that required "payment of losses," rather than liability in excess of the underlying limits.

Second, the court cited with favor the majority view that a policyholder or insured can "make up" the difference between a settlement for less than the limits of an underlying insurance policy and the attachment point of the excess insurance coverage. Because the *Ali* decision characterized itself as being consistent with the majority view laid out in *Zeig* on this point, it should be understood as such. In *Zeig*, Judge Hand rejected an excess insurance company's position that its insured had forfeited coverage merely because a settlement was reached by the policyholder with the primary insurer for less than the primary policy's full limits. The *Zeig* court stated: "[t]o require an absolute collection of the primary

CONTINUED ON PAGE 21

COURT CLARIFIES BURDENS OF PROOF IN ADEQUATE PROTECTION AND LIFT-STAY MOTIONS

In re AMR Corp. 490 B.R. 470 (S.D.N.Y. 2013)

Jeanne Lofgren
Associate, Pittsburgh

CASE SNAPSHOT

Following the chapter 11 filing of the debtor, the Indenture Trustee and the Collateral Trustee for $1 billion in senior secured notes moved for adequate protection, or in the alternative, relief from the automatic stay. The district court affirmed the bankruptcy court's denial of the motion (despite harmless error by the lower court regarding burden of proof). The district court held that the statute mandates that the burden of proof rests with the debtor in section 363(e) adequate protection matters.

FACTUAL BACKGROUND

The Trustees argued that the value of the collateral was at risk of diminution if the debtors, American Airlines companies, failed to comply with applicable regulations or failed to utilize the collateral adequately, or if global macroeconomic conditions deteriorated. The Trustees pointed to a 35 percent decline in value the collateral had experienced in the nine months preceding the bankruptcy filing. The Trustees sought adequate protection under section 363(e), or a lifting of the stay under 362(d).

The bankruptcy court denied the Trustees' motion, finding that, with respect to both adequate protection and lifting the stay, the Trustees bore a prima facie burden to demonstrate that the value of the collateral was declining or likely to decline during the pendency of the cases, and that the Trustees had failed to meet that burden.

COURT ANALYSIS

The district court upheld the decision, although it found that the bankruptcy court erroneously assigned the burden of proof on the 363(e) claim to the Trustees. The district court concluded that it was harmless error, however. The court made clear that the statute mandates that "the [debtor] has the burden of proof on the issue of adequate protection; and the entity asserting an interest in property has the burden of proof on the issue of validity, priority, or extent of such interest," citing section 363(p). Thus, the court stated, "when a secured creditor moves for adequate protection pursuant to section 363(e), it need only establish the validity of its interest in the collateral, while 'the Debtor bears the initial burden of proof as to the issue of 'adequate protection.' The movant on a section 363(e) motion therefore bears a much lighter burden than the movant on a section 362(d) motion."

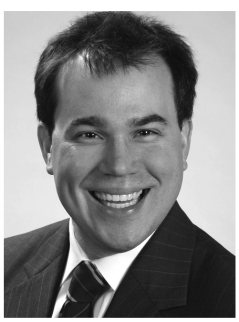
The district court found that the error was harmless because the debtors established that the Trustees were adequately protected under the existing conditions (including, the parties agreed, an equity cushion of at least 20 percent), so there was no need to impose the conditions sought by the Trustees. Additionally, the Trustees' failure to affirmatively request an evidentiary hearing on the post-petition value of the collateral allowed the bankruptcy court to deny the motion without further hearing.

PRACTICAL CONSIDERATIONS

This case makes clear the differing burdens of proof when a creditor seeks adequate protection under 363(e) or seeks to lift the automatic stay under 362(d). The 363(e) movant merely needs to show the validity of its interest in the collateral; the burden then shifts to the debtor to show that the creditor is adequately protected. The lift-stay movant bears a heavier burden, and must show that the value of the collateral was in decline or that there is a real threat of decline.

TAX REFUND OF BANK HOLDING COMPANY SUB BELONGS TO FDIC

FDIC v. Zucker (In re NetBank, Inc.) Case No. 12-13955 (11th Cir., Sept. 10, 2013)



Jared S. Roach
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CASE SNAPSHOT

The Court of Appeals held that the tax refund of a bank holding company's subsidiary (which was in receivership) belonged to the FDIC, and not to the parent company/debtor's estate.

FACTUAL BACKGROUND

The bank holding company (NetBank, Inc.) and its subsidiary (NetBank) entered into a tax sharing agreement whereby NetBank, Inc. filed consolidated tax returns on behalf of its subsidiaries, including NetBank. The Office of Thrift Supervision closed NetBank and appointed the FDIC as receiver. NetBank, Inc. filed for bankruptcy protection the same day the FDIC took control of NetBank. NetBank, Inc. claimed its estate was entitled to the tax refund owed on account of NetBank's net operating losses. The FDIC claimed that the tax refund belonged to it and was not part of the debtor's estate.

COURT ANALYSIS

The 11th Circuit Court of Appeals reversed the lower courts and held that the Tax Sharing Agreement (TSA) between NetBank, Inc. and NetBank was ambiguous regarding the allocation of tax refunds. Because the contract language was ambiguous, the court determined it was necessary to look outside the four corners of the TSA. The court reviewed the Interagency Policy Statement on Income Tax Allocation in a Holding Company Structure (which was referenced in the TSA) and expressly stated that a parent receives refunds from a taxing authority as agent on behalf of the group members. Accordingly, the court ruled that NetBank, Inc. was to file the consolidated tax returns and hold any tax refund that was received on account of a subsidiary's net operating losses solely for the benefit of the specific subsidiary. The court vacated the district court's decision and remanded for the purpose of allowing the district court to enter an order awarding the full amount of the tax refund to the FDIC.

PRACTICAL CONSIDERATIONS

In bankruptcy cases involving bank holding companies (such as NetBank, Inc.), the primary asset of the estate was the tax refund. This opinion makes clear that the tax refund belongs to the FDIC and not the debtor's estate. Creditors will be left without a meaningful recovery because the bank holding companies enter bankruptcy without meaningful assets. The court's holding significantly reduces the likelihood that the creditors will receive a distribution.

OIL AND GAS LEASE IS EXECUTORY WHEN NO EXTRACTION MADE PRE-PETITION

Powell v. Anadarko E & P Company, L.P., et al., 482 B.R. 873 (Bankr. M.D. Pa., 2012)

Joe Filloy
Associate, Pittsburgh

CASE SNAPSHOT

The chapter 12 debtor moved to reject the oil and gas lease related to property owned by the debtor, and the lessees objected. The court held that, under Pennsylvania law, the oil and gas lease under which no oil or gas had been extracted prior to the bankruptcy filing was an unexpired lease for purposes of section 365 of the Bankruptcy Code, which governs the assumption or rejection of executory contracts and unexpired leases. Nonetheless, the court denied the debtor's motion because debtor failed to produce sufficient evidence that rejection was warranted.

FACTUAL BACKGROUND

Prior to the filing of the chapter 12 case, the debtor-farmer executed a five-year initial term oil and gas lease that permitted the lessees and their assigns to explore, extract, and transport oil from the debtor's property. Prior to filing the bankruptcy petition, no oil or gas had been produced under the lease. After the case commenced, the lessees tendered payment to the debtor to exercise their option to extend the term of the lease. Presumably, the lessees exercised this right because oil was found on a neighboring property that was the subject of a pooling agreement with the debtor's property. Thereafter, the debtor moved to reject to the lease, arguing that it was unexpired, and that rejection would be beneficial to the estate because the debtor could negotiate for increased royalty payments.

COURT ANALYSIS

The court surveyed state oil and gas law to determine whether the lease was a true lease under state law and, therefore, subject to section 365. Under Pennsylvania law, once oil or gas is produced from the leased property, an oil and gas lessee is vested with either a fee simple or fee determinable estate in the minerals, depending on the terms of the instrument. Until such time, however, the oil and gas lease is a true lease. Accordingly, the bankruptcy court held that the question of whether the lease is subject to section 365 turns on whether oil or gas had been produced at the time of the bankruptcy filing. Once production occurs, the lessee has a fee in the oil or gas and the instrument, i.e., the lease, no longer qualifies as a lease.

Additionally, the bankruptcy court held that vesting would terminate the executory nature of the instrument. Because no oil or gas had been produced on the debtor's property prior to or at the time of the bankruptcy filing, vesting did not occur, and the lease was found to be subject to section 365 rejection. Recognizing that "rejection would not appear to oust the Lessees from their rights to occupy the premises," and the debtor's failure to produce evidence to support an increase in royalty payments if the lease was rejected, the court denied the debtor's motion.

PRACTICAL CONSIDERATIONS

In a state where the interplay between oil and gas law and bankruptcy law is ever increasing, the bankruptcy court promulgated a bright line test to determine when an oil and gas lease is a true lease and, therefore, subject to assumption or rejection under section 365. This test turns on the timing of production vis-à-vis the filing of a bankruptcy petition, and should protect the rights of oil and gas producers who have successfully extracted resources prior to the filing of bankruptcy. Additionally, the court noted that certain actions taken by the lessees, such as the recording of a pooling agreement and payment of the option to extend the lease term, constituted violations of the automatic stay for which relief from stay should have been sought. Participants in the burgeoning Pennsylvania oil and gas industry are cautioned to consult with a bankruptcy attorney when dealing with bankrupt lessors to avoid the potential for sanctions and penalties.

UNDERSECURED CREDITOR ELECTING 1111(B) TREATMENT ALLOWED POST-PETITION ATTORNEY FEES, BUT NOT INTEREST

In re Castillo, 488 B.R. 441 (Bankr. C.D. Cal., 2013)

Christopher Rivas
Associate, Los Angeles

CASE SNAPSHOT

An undersecured creditor making an election under section 1111(b) to have its entire claim treated as fully secured is entitled to claim its post-petition attorney fees in the value of its secured claim, but not post-petition accrued interest.

FACTUAL BACKGROUND

The creditor was owed in excess of $1 million on a property valued at only $500,000. The undersecured creditor opted not to have its claim bifurcated, and instead elected under section 1111(b) to have its entire claim treated as fully secured. The creditor also sought to include post-petition interest and post-petition attorney fees in its claim. The chapter 11 debtor objected, arguing that section 506(b) allows only fully secured or oversecured creditors to make a claim for post-petition interest and attorney fees. The bankruptcy court disagreed, in part, and held that the undersecured creditor was entitled to post-petition attorney fees, but not post-petition interest.

COURT ANALYSIS

An undersecured creditor's claim is typically bifurcated under section 506(a) into a secured portion in the amount of the value of the collateral, with the remainder being deemed unsecured. However, section 1111(b) permits an undersecured creditor to elect to have its entire claim treated as secured "notwithstanding section 506(a) of this title . . . to the extent that such claim is allowed." Section 506(b) permits a secured creditor to claim post-petition fees and interest if the property is fully secured or oversecured.

The debtor objected to the creditor's claim, arguing that section 506(b) prohibited an undersecured creditor from claiming a security interest in post-petition fees or post-petition interest. The bankruptcy court overruled the objection, finding that the extent of an 1111(b) claim was its allowance under section 502(b), which governs the allowance of claims generally, not section 506(b), which merely governs the extent to which a claim is a secured claim. Section 502(b) allows claims for post-petition fees, and such fees are, therefore, allowed and secured pursuant to section 1111(b). On the other hand, section 502(b)(2) disallows claims for post-petition interest, and, therefore, such interest is not allowed or secured pursuant to section 1111(b).

The bankruptcy court observed that its allowance of post-petition fees in an 1111(b) secured claim was consistent with a similar decision in the 11th Circuit, but was contrary to the holdings made in a "majority of cases" in other circuits.

PRACTICAL CONSIDERATIONS

An undersecured creditor seeking to maximize its leverage and its recovery in the face of a chapter 11 plan is faced with a difficult and complicated calculus when determining whether or not to make an 1111(b) election. This decision further highlights the difficulty in making this decision, since whether a creditor will be permitted to assert the value of its post-petition fees in the amount of its secured claim will vary from court to court, and circuit to circuit. An undersecured creditor faced with the decision of whether to make an 1111(b) election should seek the advice of legal counsel before making such an election.

Creditor Has Two Separate Security Interests in Property and Rents—continued from page 6

than just "the security necessary to maintain the [rental] property"—the lender "also took an interest in the cash generated by the property." Therefore, to accept the debtor's argument, the court would have to adopt a "replacement lien" theory.

The court noted a few courts once followed the "replacement lien" theory, but determined that the theory generally had been discredited—including by the Sixth Circuit—because the theory does not provide creditors possessing security interests in rents with adequate protection "for the very real interest the creditor has in accruing rents." The court found that pre-petition security interests in rents are "a special kind of collateral that, pursuant to [section] 552(b), continues in full force and effect after the petition is filed." The court held that, because the lender's interest in the rents was continually increasing, potentially in perpetuity, and the interest—which was distinct from the lender's interest in the rental property—existed pre-petition, "the interest in rents must be protected dollar for dollar."

The court held that the lender's interest in each dollar of rental income was entitled to adequate protection and that the debtor's proposed use of the rents to administer his bankruptcy or for other general purposes would deprive the lender of adequate protection. Thus, the debtor's use of the cash collateral was limited to those expenses "'directly related to the operation, maintenance, or preservation of the'…property, or that 'are reasonable and necessary to preserving or disposing such property and are incurred primarily for the benefit of the secured creditor.'" Over the lender's objections, the court found that the limited uses of the rents authorized by the bankruptcy court were permissible because they were necessary either to maintain the property or to preserve its value for the lender's benefit.

PRACTICAL CONSIDERATIONS

Assessing case law, the court noted that other courts rejected debtors' proposals to protect their creditors' interests by granting a replacement lien in the rents. Accepting the "replacement lien" argument would ignore the nature of the interest actually assigned to the lender: the lender took more than security necessary to maintain the value of the property; the lender also took an interest in the cash generated by the property. Lenders can take comfort from this decision and its reasoning, so long as lenders are careful to describe their security interests.

NORTH CAROLINA BANKRUPTCY COURT FINDS PROPOSED PLAN NOT FEASIBLE

In re Renegade Tobacco Co., et al., WL (M.D.N.C., May 29, 2013)

Alexander Terras
Partner, Chicago

Bankruptcy Judge William Stocks rejected a plan of reorganization filed by the chapter 11 trustee of an operating company that manufactured cigarettes. Confirmation of the proposed plan was opposed by 45 of the 46 states that are parties to the 1998 Master Settlement Agreement between the states and the tobacco industry, represented by the National Association of Attorneys' General, and by General Electric Capital Corporation, a party in interest because it held substantial claims in a related case, represented by Reed Smith.

Although the court noted that the proposed plan had been objected to on many grounds, it determined that it need not reach other issues unless it found the proposed plan to be feasible. The court found that section 1129(a)(11) of the Bankruptcy Code requires that a "plan proponent provide concrete evidence of a sufficient cash flow to fund and maintain both the business operations of the debtor and the obligations under the plan." While success need not be guaranteed, the plan must offer a reasonable assurance of success.

The court found that a glaring discrepancy between the debtor's past financial performance and its projected future financial performance could not be overcome by evidence that the debtor's mere exit from chapter 11 would restore customer confidence sufficiently to produce a 48 percent increase in sales in the first year of the proposed plan, especially when that evidence was not detailed or supported by any firm customer commitments.

The court then addressed the trustee's contention that the proposed plan was feasible because it provided for liquidation on default. In rejecting this argument, the court noted that the only case endorsing an "automatic liquidation" provision in lieu of proof of feasibility involved circumstances where the liquidation value of the debtor's assets substantially exceeded liabilities. In circumstances where the liquidation value would fall short of paying creditors in full "providing for the liquidation of the Debtors' assets upon a plan default does not satisfy Section 1129(a)(11). To conclude otherwise would effectively read feasibility and the requirement for likelihood of success out of Section 1129(a)(11)." This would be, the court concluded, a result "Congress could not have intended."

Finally, the proposed plan called for substantial payments to creditors to be funded out of the future sale of equity in the reorganized debtor. The court found that "merely providing in a plan that an asset will be sold in the future" without adequate evidence of the value or marketability of that asset is speculative and will not support a finding of feasibility.

The opinion in *Renegade Tobacco Co.* is a good primer for creditors who oppose a plan on feasibility grounds, and offers some sensible straight talk on the economic reality that bankruptcy courts and counsel must consider.

PARTICIPATION IN BANKRUPTCY CASE AND ADVERSARY PROCEEDING CONSTITUTES WAIVER OF CONTRACTUAL ARBITRATION RIGHT

In re Brooke Corporation, Case No. 08-22786 (Bankr. D. Kansas, June 24, 2013)

Brian Schenker
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CASE SNAPSHOT

A franchise agreement between a franchisor (and eventual chapter 7 debtor) and franchisee contained a provision that required the parties to submit all disputes between them to binding arbitration. Following the franchisor's bankruptcy filing, the chapter 7 trustee brought an adversary complaint against the franchisee alleging predominately state law claims. The franchisee moved to dismiss the adversary complaint in favor of binding arbitration. The bankruptcy court denied the motion, holding that the franchisee had waived its right to enforce the mandatory arbitration clause, a result of actions it had taken within the bankruptcy case.

FACTUAL BACKGROUND

The franchisee took primarily two actions within the bankruptcy case that resulted in the bankruptcy court finding that it had waived its right to compel mandatory arbitration. First, the franchisee filed proofs of claim in the bankruptcy case without seeking relief of stay to pursue the claims in arbitration or to otherwise preserve the right to compel arbitration of the claims. Second, the franchisee participated in pleadings, motions, discovery, and mediation related to the adversary complaint over the course of two years without ever raising the issue of the mandatory arbitration clause.

COURT ANALYSIS

The bankruptcy court began its analysis by noting that section 3 of the Federal Arbitration Act provides that federal courts should enforce contractual rights to compel arbitration and stay actions pending before them in favor of arbitration. The bankruptcy court further noted that a chapter 7 trustee steps into the shoes of a debtor when asserting pre-petition state law claims of the debtor and, therefore, is subject to any agreements made by the debtor to submit such claims to arbitration. The bankruptcy court finally noted that, like any other contractual right, the right to compel mandatory arbitration is waivable, which occurs most often "when a party initiates litigation or participates in a lawsuit in violation of the arbitration agreement."

In determining whether such a waiver occurred here, the bankruptcy court considered the following factors: (1) whether the franchisee's actions were inconsistent with the right to arbitrate; (2) whether the litigation machinery had been substantially invoked and the parties were well into preparation of a lawsuit before the franchisee notified the chapter 7 trustee of an intent to arbitrate; (3) whether the franchisee either requested arbitration enforcement close to the trial date or delayed for a long period before seeking a stay; (4) whether the franchisee filed a counterclaim without asking for a stay of the proceedings pending arbitration; (5) whether important intervening steps had taken place (e.g., the taking advantage of judicial discovery procedures not available in arbitration); and (6) whether the franchisee's delay in enforcing its arbitration rights affected, misled, or prejudiced the chapter 7 trustee.

The bankruptcy court reasoned that the franchisee's election to invoke the jurisdiction of the bankruptcy court by filing proofs of claim without any attempt to preserve its right to arbitrate such claims supported answering the questions raised by factors (1) and (4) in the affirmative. The bankruptcy court further reasoned that the franchisee's participation in the lawsuit for two years, including availing itself of judicial discovery procedures, before seeking to enforce the arbitration right supported answering the questions raised by factors (2), (3), and (5) in the affirmative. Thus, the bankruptcy court concluded that the franchisee had both (i) acted inconsistently with its right to demand arbitration and, as a result, had intentionally waived such right; and (ii) raised its right to arbitrate only when it had become an attractive defensive litigation tactic and, thus, was attempting to manipulate the judicial process. For both of those reasons, the bankruptcy court denied the franchisee's motion to dismiss the adversary complaint in favor of arbitration.

PRACTICAL CONSIDERATIONS

This case illustrates conduct within a bankruptcy case that can constitute a waiver of a contractual right to compel mandatory arbitration, overcoming the presumption in favor of enforcing such a right. While waiver of such a right can typically be avoided through careful planning, the enforcement of a contractual arbitration right in a bankruptcy case is not necessarily a straightforward matter. As the bankruptcy court in this case noted, "there is an inherent conflict between the policy of decentralization of litigation promoted by the Federal Arbitration Act and the goal of centralizing resolution of a debtor's affairs as reflected in the Bankruptcy Code." The bankruptcy court further noted that "core bankruptcy claims or causes of action arising under federal bankruptcy rights … will, absent extraordinary circumstances, be adjudicated by the bankruptcy court." For both of those reasons, when an adversary complaint asserts both state law claims and core bankruptcy claims premised on the same underlying operative facts, obtaining a complete dismissal of the complaint in favor of arbitration is not necessarily a straightforward matter, and instead involves consideration of additional factors.

The author of this article was recently involved in successful enforcement of mandatory arbitration provisions under circumstances similar to those in adversary proceedings related to the chapter 11 bankruptcy case of *MicroBilt Corporation,* pending before the United States Bankruptcy Court for the District of New Jersey (Bankr. Case No. 11-18143-MBK; Adv. No. 12-1167-MBK; and Adv. No. 12-1177-MBK; see opinion reported as *MicroBilt Corp. v. Fidelity Nat'l Info. Servs., Inc. (In re MicroBilt),* 484 B.R. 56 (Bankr. D.N.J. 2012)).

LEASE AMENDMENTS MAY BE SEVERABLE, AND THUS SUBJECT TO ASSUMPTION AND REJECTION

In re Contract Research Solutions, Inc., 2013 WL 1910286 (Bankr. D. Del., May 1, 2013)

Joe Filloy
Associate, Pittsburgh

CASE SNAPSHOT

The chapter 11 debtor sought to sever and reject the Third Amendment of its office lease. The Third Amendment related to unattached, adjacent premises in the same complex as the debtor's existing office space. The debtor had not utilized the new space as of the bankruptcy filing, but was current on rent as of the filing. Although assumption or rejection of an unexpired lease must be done in its entirety, courts may analyze a single contract to determine whether it includes multiple, severable agreements, thereby permitting assumption of part of the contract and rejection of other, severable parts. Based on the integration of the Third Amendment to the original lease and the interrelation between the new and old leased premises as expressed in the Third Amendment, the court held that it was not severable.

FACTUAL BACKGROUND

The debtor leased multiple spaces in an office complex prior to the bankruptcy petition; however, one of the spaces, which was added to the lease pursuant to the Third Amendment, was unused by the debtor and the debtor determined that the lease was not necessary to its reorganization. The terms of the Third Amendment provided that it was integrated into to the original lease, and many of the amendments referred to the leased space in the aggregate. For example, the Third Amendment extended the lease term for all leased space; it provided for rent abatement for all leased space if the new space was not delivered by a certain date; the identical rental rate applied to all leased space; and there was an increase in the debtor's share of common area maintenance charges expressed in the aggregate and covering all leased space. In addition to the leased space under the original lease as amended, the debtor and lessor had a separate lease for separate office space in the same complex.

COURT ANALYSIS

The court looked to Florida law to determine whether the Third Amendment was severable. Under Florida law, whether a contract is severable turns on the parties' intent. The court used standard rules of contract interpretation to determine the intent of the parties, starting within the four corners of the lease. In addition to the provisions that referred to the leased space in the aggregate, the contract expressly ratified the original lease, and provided that such terms remained in effect except as modified by the Third Amendment. The court found this ratification provision "plainly suggests a direct connection between the [original lease] and the Third Amendment." The court rejected out of hand the debtor's argument that a standard severability clause, pursuant to which unenforceable terms would be severed, evidenced any intent of the parties as to the severability question at issue. Additionally, the court found persuasive the existence of an additional lease between the parties related to office space within the same complex that was not connected to the original lease or any of its amendments. Had the parties intended separate leases, "they were perfectly capable of making – and did make – a truly separate agreement."

Because the obligations in the original lease and all amendments involved the same parties and the same subject matter, the court held that the Third Amendment was not severable, and thus could not be rejected.

PRACTICAL CONSIDERATIONS

Landlords should be aware that lease amendments may be treated as severable agreements, giving debtor/tenants the ability to assume part of the lease while rejecting another part. The determination of whether an agreement is severable is a question of state law, and in this case, the determination was based on the intent of the parties, which was determined by the terms of the agreements. Thus, careful consideration must be given to the level of interdependence of obligations the parties seek when drafting lease amendments.

the debtor, and not the non-debtor shareholder, would ultimately be responsible for the tax burdens related to its income.

Such a shifting of the debtor's tax burdens would have dramatic effects. In particular, the debtor (and not the non-debtor shareholder) would be responsible for paying more than $2 million in income taxes. Furthermore, the debtor (and not the non-debtor shareholder) would be responsible for $170 million of "cancellation of debt" income resulting from the debtor's confirmed plan of reorganization, under which the secured creditors became the equity owners of the debtor on account of their secured claims.

Seeking to avoid such tax burdens, the debtor filed an adversary complaint asserting that the revocation of its indirect parent company's tax status as an S-Corp was void or avoidable as a post-petition transfer of property of the bankruptcy estate, i.e., the debtor's tax status as a Qsub, under either sections 362, 549, or 550 of the Bankruptcy Code. The bankruptcy court agreed with the debtor and entered an order that voided the revocation of the indirect parent company's tax status as an S-Corp and reinstated the debtor's tax status as a Qsub.

COURT ANALYSIS

The Third Circuit began its analysis by noting that each of the debtor's theories for relief turned on whether its tax status as a Qsub was both property within the meaning of the Bankruptcy Code and property of the debtor's bankruptcy estate. The Third Circuit further noted that if either inquiry was answered in the negative, then the debtor lacked standing to challenge the revocation of the indirect parent company's tax status as an S-Corp.

In determining whether the debtor's tax status as a Qsub was property within the meaning of the Bankruptcy Code, the Third Circuit addressed two sets of cases: (1) those holding that a debtor's tax status as an S-Corp is property within the meaning of the Bankruptcy Code; and (2) those holding that tax benefits related to a debtor's net operating losses (NOLs) are property within the meaning of the Bankruptcy Code.

The Third Circuit concluded that the first set of cases was wrongly decided. The Third Circuit reasoned that a debtor's tax status as an S-Corp or Qsub is not property within the meaning of the Bankruptcy Code because such a tax status is "entirely contingent on the will of the shareholders" of the parent company. Furthermore, the Third Circuit found that such cases were premised on the incorrect notion that anything that adds value to a debtor's bankruptcy estate is by default property within the meaning of the Bankruptcy Code. The Third Circuit explained that: "It goes without saying that the 'right' of a debtor to place its tax liabilities on a non-debtor may turn out to have some value, but that does not mean that such a right, if it exists, is property. Capacious as the definition of 'property' may be in the bankruptcy context, we are convinced that it does not extend so far as to override rights statutorily granted to shareholders to control the tax status of the entity they own."

The Third Circuit distinguished the second set of cases regarding tax benefits related to a debtor's NOLs. The Third Circuit reasoned that such tax benefits are different because their amount is fixed at the commencement of a bankruptcy case, their value is readily determinable, they can be easily and immediately monetized for the benefit of the debtor's bankruptcy estate either by way of tax refund or sale, and they are not subject to revocation. A debtor's S-Corp or Qsub tax status, however, is not controlled by the debtor, has no inherent realizable value, can't necessarily be used to compensate creditors, and can't be transferred to generate funds for creditors.

The Third Circuit further explained that treating a debtor's S-Corp or Qsub tax status as property within the meaning of the Bankruptcy Code would result in an inequitable outcome where all of the debtor's income during the pendency of its bankruptcy case would remain in the debtor's estate for the further benefit of its creditors but the non-debtor parent corporation, and ultimately the non-debtor shareholder, would be required to pay the income tax on such income. Thus, the Third Circuit found the analogy of a debtor's tax status as an S-Corp or Qsub to the tax benefits of a debtor's NOLs of "limited validity."

The Third Circuit further held that, even if a debtor's tax status as an S-Corp or Qsub was property within the meaning of the Bankruptcy Code, it would not be property of the debtor's bankruptcy estate. Instead, it would be the property of the shareholder of the parent company that solely controlled the designation of debtor's tax status. The Third Circuit reiterated that the opposite conclusion would put remarkable restrictions on the shareholder's rights under tax laws, in effect divesting the shareholder of its statutorily granted control.

In summary, the Third Circuit found that the debtor had no right or ability to control its S-Corp or Qsub tax status outside of bankruptcy, and the Bankruptcy Code did not provide the debtor with such a right. Therefore, the Third Circuit further concluded that the debtor lacked standing to challenge the revocation of the indirect parent company's tax status as an S-Corp. The Third Circuit then remanded the matter to the bankruptcy court with instructions to dismiss the adversary complaint.

PRACTICAL CONSIDERATIONS

This seminal decision by the Third Circuit has obvious importance to bankruptcy planning with respect to a company with S-Corp or Qsub tax status. Having said that, it is yet to be seen to what extent courts outside of the Third Circuit will concur with its analysis.

FAILURE TO PRECISELY PUNCTUATE DEBTOR'S NAME IN UCC FILING COSTS CREDITOR ITS LIENS

In re C. W. Mining Company, 488 B.R. 715 (Bankr. D. Utah, 2013)

Christopher Rivas
Associate, Los Angeles

CASE SNAPSHOT

A Utah Bankruptcy Court avoided the liens of a secured creditor that failed to accurately reflect the punctuation in the name of the borrower. The secured creditor's omissions of two periods and a space in its UCC financing statements rendered its liens invalid.

FACTUAL BACKGROUND

Most of the business conducted between a coal producer (CWM) and a coal broker (Standard) had been conducted under a verbal agreement, but two written contracts had been executed by the parties. The written agreements provided that Standard would advance money to CWM, in exchange for which CWM would immediately assign to Standard all legal and equitable title to all of its mined coal and assets deriving from such coal. Alternatively, in an abundance of caution, the agreements granted Standard a security interest in substantially all of CWM's assets. Standard recorded UCC financing statements in an effort to perfect its liens.

Following an involuntary chapter 11 filing against the mining company (and conversion to chapter 7), the trustee sought to avoid any liens by Standard to certain cash assets (traceable from the subject coal) upon which Standard claimed either legal and equitable title, or, alternatively, a security interest.

At summary judgment, it was revealed that the debtor's registered name was "C. W. Mining Company" but the financing statements listed the name as "CW Mining Company" (omitting the punctuation and spacing in "C. W.") The director of the Utah Division of Corporations and Commercial Code, which maintained UCC filing statements, testified that the database's search engine would only retrieve exact matches, and that the lack of the periods and space between the C and W resulted in an empty search result. The bankruptcy court held that the punctuation inaccuracy rendered the lien materially misleading and invalid.

COURT ANALYSIS

The bankruptcy court found that the agreements unambiguously granted a security interest (not legal or equitable title), but found that the UCC financing statements were ineffective because the punctuation discrepancy between the financing statements and the debtor's registered name, under Utah law, rendered the financing statements "seriously misleading." Standard argued that the financing statements qualified for the "escape hatch" provisions of the UCC, whereby a reasonably diligent search would turn up the financing statements. The bankruptcy court rejected the argument because the escape hatch was only available if a search query using the debtor's registered name nevertheless revealed liens that were recorded against a misnamed entity. Because Utah's search logic required exact punctuation, a search for "C. W. Mining Company" failed to reveal any liens recorded against "CW Mining Company." Standard's punctuation error was therefore fatal to its liens.

The district court upheld the bankruptcy court's finding that the UCC financing statements did not perfect the security interest, but ordered the bankruptcy court to consider extrinsic evidence to determine whether the contracts granted legal and equitable title instead of a security interest.

PRACTICAL CONSIDERATIONS

This decision highlights the importance of properly completing UCC financing statements, and, most importantly, conducting a UCC search of the registered entity (using its registered name, exactly as it appears in a state's records) to confirm proper recordation. Notwithstanding that the UCC is intended to be "uniform," UCC search logic differs from state to state, and the simple matter of punctuation and spacing may invalidate a secured creditor's liens. Secured creditors should seek the advice of legal counsel familiar with the UCC standards and practices of a particular state when seeking to record their security interests.

REOPENING A BANKRUPTCY CASE TO ENFORCE ANTI-ASSIGNMENT CLAUSE MAY BE WITHIN SUBJECT MATTER JURISDICTION

In re Lazy Days RV Center, Inc. No. 12-4047, (3d Cir., July 30, 2013)

Lauren Zabel
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CASE SNAPSHOT

The debtor sought to reopen its bankruptcy case in order to enforce a prohibition on an anti-assignment clause in an unexpired lease pursuant to section 365(f). The Third Circuit held that reopening a case in order to enforce section 365(f) is within the bankruptcy court's subject matter jurisdiction. The court also rejected the argument of the landlord that an agreement between the parties waived the protections of section 365(f), finding that section 365(f) is a default rule applied to the contract where the agreement does not expressly provide otherwise.

FACTUAL BACKGROUND

The debtor leased certain land pursuant to a lease that afforded the debtor an option to purchase the property. Pursuant to the terms of the lease, the debtor could not assign the lease without the landlord's prior written consent, unless the lease was assigned to an affiliated entity. The debtor informed the landlord of its intention to file for bankruptcy, assume the lease, and assign it to an affiliate, which would also file for bankruptcy. These debtors entered into a "settlement agreement" with the landlord, under which the landlord consented to the assignment, and the tenant debtor agreed not to argue about the interpretation of the lease before the bankruptcy court, "except to the extent necessary in connection with the assumption and assignment of the lease." The settlement agreement also provided that all terms and conditions of the lease would remain in full force and effect; there was no mention of the purchase option, however.

The debtor filed a chapter 11 petition, and confirmed a plan of reorganization that incorporated the settlement agreement. After the closing of the bankruptcy case, the assignee debtor attempted to exercise the purchase option. The landlord refused to honor the purchase option, and the parties filed suit in state court. The debtors also moved to reopen the bankruptcy case, seeking a ruling that the lease's anti-assignment provision was unenforceable under section 365(f)(3), which renders unenforceable provisions in unexpired leases that act to terminate or modify any rights under the lease on account of such assignment. The bankruptcy court agreed with the debtors, held that the landlord's refusal to honor the purchase option violated the terms of the settlement agreement, and ordered the landlord to honor the purchase option. The district court reversed, finding that the bankruptcy court had rendered an improper advisory opinion directed at the state court litigation.

COURT ANALYSIS

The Court of Appeals first addressed several jurisdictional issues. To begin with, the appellate court reversed the district court, finding that the bankruptcy court's decree declaring the anti-assignment clause invalid impacted the rights of litigants, thus resolving litigation. Accordingly, the Court of Appeals determined that the bankruptcy court's decision was not advisory. The Court of Appeals also determined that the bankruptcy court's ability to reopen a bankruptcy case in order to resolve a dispute regarding an agreement that it had previously confirmed is well within the subject matter jurisdiction of the bankruptcy court. Similarly, the appellate court also concluded that the dispute at issue involved the determination of rights under the Bankruptcy Code and, therefore, rejected the landlord's argument that the bankruptcy court had unconstitutionally asserted subject matter jurisdiction in violation of the Supreme Court's decision in *Stern v. Marshall.*

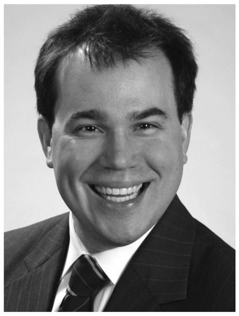
The Court of Appeals also upheld the bankruptcy court on the substantive issues. First, the court determined that the settlement agreement did not impact the purchase option whatsoever. The landlord argued that the settlement agreement acted to waive the protections of section 365(f). The Third Circuit rejected this argument for two reasons: first, because the settlement agreement was intended only to deal with the landlord's consent to assignment; and second, because contracts are supplemented by legal principles that the parties "may not have bothered to incorporate expressly but that operate as default rules," including, presumably, the provisions of section 365(f). Because the settlement agreement plainly provided that all rights and obligations would remain in place following assignment, the court affirmed the bankruptcy court's determination that the purchase option remained enforceable.

PRACTICAL CONSIDERATIONS

This decision sheds light not only on post-bankruptcy jurisdiction, but also upon the rights afforded by section 365(f). The Third Circuit's decision makes clear that the bankruptcy court does have jurisdiction to re-open a bankruptcy case in order to enforce the anti-assignment prohibitions afforded by section 365(f). In addition, and perhaps more interestingly, the Third Circuit's statement that the provisions of section 365(f) are among the "default rules" implied in contracts "to govern in absence of a clear expression of the parties' intent that they not govern," leaves open the possibility that parties could, in fact, expressly waive the protections of section 365(f).

COURT LIFTS STAY, FINDS CREDITOR OBJECTIONS DID NOT CAUSE DEBTOR TO MISS CONFIRMATION DEADLINE

I*n re Five Rivers Petroleum,* No. 11-25202-JAD (Bankr. W.D. Pa., July 9, 2013)



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CASE SNAPSHOT

After the debtor received multiple extensions from the bankruptcy court, the secured creditor moved to lift the automatic stay. The court granted the motion, but stayed relief, imposing last-chance deadlines for plan filings and confirmation. The debtor filed its plan, the secured creditor filed objections to the plan, and the debtor missed the confirmation deadline. The debtor moved to vacate the court's conditional relief and sought to re-impose the automatic stay, arguing that the circumstances regarding its ability to reorganize had materially changed. The court denied the debtor's motions, rejecting the argument that the creditor's objections to the proposed plan caused the confirmation deadline to be missed.

FACTUAL BACKGROUND

The court granted the debtor multiple extensions to file its disclosure statement and proposed plan of reorganization. After the debtor filed its disclosure statement and proposed plan, the primary secured creditor filed a motion for relief from the automatic stay and also objected to the disclosure statement. The court conditionally granted the motion to lift the stay, but stayed relief. Relief was conditioned on the debtor meeting deadlines for filings and plan confirmation. If the debtor failed to meet the deadlines, the order made clear that the automatic stay would be lifted without further action.

The debtor complied in part, but after the creditor objected to the proposed plan as infeasible, the debtor could not meet the required plan confirmation deadline. The debtor then filed a motion to vacate the court's conditional relief from stay order (under Fed. R. Civ. P. 60, as made applicable by Fed. R. Bankr. P. 9024) and filed a complaint to re-impose the automatic stay (under section 105(a) of the Bankruptcy Code), arguing that circumstances regarding its ability to reorganize had materially changed.

COURT ANALYSIS

The court first rejected the debtor's argument that the creditor's objection to the proposed plan caused the debtor to miss the confirmation deadline. The secured creditor merely exercised its right to object to a proposed plan; the proposed plan failed because the debtor filed an infeasible plan. The court also rejected the debtor's request to vacate its order under Fed. R. Civ. P. 60, which allows relief from an order when there has been, among other things, newly discovered evidence that, with reasonable diligence, could not have been previously discovered. The court said that the evidence the debtor claimed was newly discovered was not material and could have been discovered earlier.

PRACTICAL CONSIDERATIONS

The court succinctly stated its rejection of the debtor's arguments – "The Debtor's failure to comply with the Order was not caused by Community Bank's objecting to the Plan, but rather by the Debtor's failure to put forth a feasible Plan. . . . The fact is that the Debtor did not propose its best plan from the outset. . . . Having assumed that risk, the Debtor cannot complain at this hour about the fact that its plan was not confirmed and the consequences of the same." The court will not give the debtor an infinite amount of time to propose a feasible plan, so the debtor must be prepared to work quickly and efficiently to develop and propose a feasible plan of reorganization.

$14 MILLION OVERSECURITY OVERCOMES PLAN RISKS, CRAM-DOWN PLAN APPROVED

In re SCC Kyle Partners, LTD, No. 12-11978 (Bankr. W.D. Texas, June 14, 2013)

Ann Pille
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CASE SNAPSHOT

The chapter 11 single asset real estate debtor sought to cram down its reorganization plan over the objection of its primary secured creditor. The court, finding that the creditor was oversecured by as much as $14 million, utilized the *Till* analysis to set the interest rate and approved the debtor's plan.

FACTUAL BACKGROUND

SCC Kyle Partners owned commercial real estate for development. Unable to profitably develop the property, SCC filed for chapter 11. The secured creditor objected to the proposed plan, and the debtor sought confirmation under the cram-down provisions of section 1129(b)(2). The secured creditor was oversecured by as much as $14 million, and although some aspects of the proposed plan presented high risk (e.g., possible inability to pay property taxes, possible inability to sell parcels at the minimum required prices), the court approved the debtor's plan.

COURT ANALYSIS

The court, after careful consideration of the expert testimony of the debtor and the bank, found that the bank was oversecured by as much as $14 million. The court also found that the debtor's plan, while presenting a high degree of risk to the bank, satisfied the cram-down requirements of section 1129(b)(2). The court employed the *Till* analysis to set the interest rate applicable to the bank's loan at 7 percent in order to offset the risk to the secured creditor, and approved the debtor's plan.

PRACTICAL CONSIDERATIONS

The court, at the outset of its opinion, described its decision as giving both parties what they needed, rather than what they wanted. Although the court found that the debtor's plan presented several risks (including the possibility that the debtor would be unable to pay property taxes and the fact that the debtor had no regular source of income), the court concluded that the extent of the bank's oversecurity outweighed these risks so as to allow confirmation of the plan; these risks were accounted for by the court's imposition of a higher interest rate. This is another case of the prime rate-plus formula of *Till*, a chapter 13 case, applied to a chapter 11 case.

CROSS-BORDER COMPARISONS: PIERCING THE CORPORATE VEIL

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The courts in both England and the United States recognize the concept of a corporation being a legal personality separate from its shareholders. This basic concept is sometimes described as a fiction, but it is also the foundation of company and insolvency law and the basis for the concept that a corporate entity's liabilities are distinct from the liabilities of its shareholders. This "veil" between corporate entity and shareholder is not impenetrable, however, and can be disregarded (commonly referred to as "piercing" or "lifting") in certain limited circumstances. When this occurs, parties can look beyond a corporate entity and seek relief or compensation directly from its shareholders. Notoriously ephemeral and difficult to define, courts in both England and the U.S. have sought to provide greater guidance on when this principle should apply, with mixed success.

In the recent case of *Preset v. Petrodel Resources Ltd.,* the Supreme Court of England and Wales considered piercing the corporate veil in the context of a divorce settlement. The case considered the question of whether properties held by companies, the shares in which were ultimately owned by the husband, could be transferred to a wife in a divorce settlement on the basis that the properties were more properly viewed as being owned by the husband than the companies in question. Following a review of the case law on this issue, the Supreme Court's judgment held that there is a "limited principle" in English law for lifting the corporate veil. This principle "applies when a person under any existing legal obligation or liability or subject to any existing legal restriction which he deliberately evades or whose enforcement he deliberately frustrates by interposing a company under his control". In these circumstances, a "court may … pierce the corporate veil for the purpose of depriving the company or its controller of the advantage that they would otherwise have obtained by the company's separate legal personality". The Court's judgment stressed caution when applying this principle, noting that in almost every case where this test is satisfied the facts will in practice disclose a legal relationship between the company and its controller which would make it unnecessary to pierce the corporate veil. When such circumstances exist, the veil should not be pierced and piercing the corporate veil should be strictly limited to those cases where the abuse of the corporate veil to evade or frustrate the law can only be addressed by disregarding the legally distinct personality of a company from its shareholders.

Courts throughout the U.S. take a similarly cautious approach to piercing the corporate veil and no clear set of guidelines exists on when it should be applied, at either the state or federal level. Although certainly not commonly applied, the doctrine has been evoked and developed to a greater extent in the U.S. than in England. Despite this, no guiding principle can be cited other than that a case-by-case analysis is necessary and courts should consider various factors when determining whether it is appropriate to pierce the corporate veil. No single factor is determinative and the focus lies on the totality of the circumstances. Factors frequently considered by courts include intermingling of corporate and personal funds, staff and property, undercapitalization, fraudulent representation by shareholders or directors, and lack of separate books, amongst others.

This lack of cohesion or guiding principle has drawn criticism from both the courts and academics, with the Delaware Chancery Court noting that the doctrine is "rightly criticized for its ambiguity and randomness" and whose application results "in few predictable results". Academics have noted that piercing happens "freakishly" and is "rare, severe and unprincipled". Despite this recognition, piercing the corporate veil seems one of those areas of U.S. law that is hard to clearly define but is nonetheless generally recognized.

PRACTICAL CONSIDERATIONS

Both the U.S. and England view piercing the corporate veil as a limited, equitable remedy to be used in limited circumstances in the interest of justice. England appears to require a greater degree of purposeful evasion than is required in the U.S., but the ability to pierce the corporate veil is undoubtedly present under English law.

The concept of "piercing the corporate veil" also exists under French law and has evolved over the last few years, due to the development of both case law and statutes in various areas ranging from social, labour to environmental, competition, corporate and bankruptcy.

A LOOK AT VEIL-PIERCING IN FRANCE

The approach taken by French courts differs depending on the issues at stake and the nature of the courts (labour, civil and commercial) hearing the case.

For instance, unlike commercial courts, social courts have recently taken a more lenient approach and decided to pierce the corporate veil on the grounds of a mere interference of the shareholders in the affairs of the corporation and a lack of autonomy of the latter, which led to a triple confusion of interest, activities and management. A recent example is the 2013 Continental ruling in which the *Conseil des prud'hommes de Compiègne*[1] (a first instance labour court in northern France) found that Continental France and its shareholder Continental Aktiengesellschaft[2] were both employers of Continental France's employees and as a result, declared them jointly liable for the unfair dismissal of some of the employees bound by a written working agreement with Continental France.

Commercial courts tend to take a stricter approach and require more than a mere interference. They pierce the corporate veil only where there is either a confusion of assets (*"confusion de patrimoines"*) of the corporation and those of its shareholders or where the corporation is fictitious. The confusion of assets is characterised where courts consider that there are unreasonable financial dealings (*"relations financières anormales"*) between the corporation

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insurance to its full limit would in many, if not most, cases involve delay, promote litigation, and prevent an adjustment of disputes which is both convenient and commendable. A result harmful to the insured, and of no rational advantage to the insurer, ought only to be reached when the terms of the contract demand it.” The *Zeig* court opined that it would not impose such a harsh rule unless the parties had agreed to a policy that expressly required the insured to collect full underlying limits from its insurers as a condition precedent.

Third, the decision does not to apply to excess property insurance, because the court also distinguished *Zeig* on that basis.

Fourth, the decision does not address the interaction of the insurance insolvency system with underlying exhaustion. For example, if the Reliance estate approved a claim in liquidation in a manner that exhausted a Reliance policy, that should constitute “payment of losses” that “exhausts” a policy, regardless of whether the rate of distribution on policyholder claims was 10 percent, 50 percent, or 100 percent.

Fifth, the Second Circuit’s decision is a mere prediction of state law under principles of diversity jurisdiction. Insurance law varies from state to state. Yet, the Second Circuit cites practically no state law.

PRACTICAL CONSIDERATIONS

The *Zeig* principle is important. If policyholders could only access excess insurance layers upon recovering the full limits of insurance from every underlying policy, policyholders would find it far more difficult to settle any insurance coverage involving “layers” of coverage. The *Ali* decision does not undermine, criticize, or limit *Zeig*.

Many courts nationwide follow the *Zeig* position regarding exhaustion of underlying insurance, rejecting excess insurers’ positions. These courts typically hold that exhaustion requirements in insurance policies are ambiguous or unenforceable, and do not require the underlying insurer to pay full policy limits as a condition to payment by the excess insurer, unless the policy language specifically says this requirement must be met. Because courts favor settlements, abhor forfeitures based on technicalities, construe ambiguities against insurers, and recognize the disparity in bargaining power in the insurance relationship, exhaustion clauses are usually strictly construed.

Nevertheless, the *Ali* decision counsels caution in the pursuit of excess insurance in situations where the liability is contingent or unliquidated. In liability insurance cases, claimants and policyholders may demand global settlements with all insurance companies in such situations, rather than face exhaustion arguments from excess layers.

If the insured makes up the gap below the excess attachment point with its own funds, most courts (like the *Ali* court) understand that the excess insurance must then pay its own portion. If the underlying limits have been paid, there is little valid ground for dispute (though insurers may make the effort). The true practical difficulty is presented in cases involving bankrupt companies, and directors and officers who do not have the financial wherewithal to make settlement payments for the full amounts of underlying insurance.

The *Ali* court recognized that in the first-party insurance context, there is little concern for “settlement manipulation,” because the loss at issue is property that can be evaluated directly. In the third-party context, presumably, a loss could be demonstrated directly if the alleged legal liability is proven in amount. Where a liability is proven against an insured and reduced to a judgment in excess of the attachment point, there is arguably no more basis for an excess insurer to object based on failure to exhaust underlying insurance than there would be in the first-party context addressed in *Zeig*. In the bankruptcy context and other circumstances, there may even be a court order approving the settlement.

Judges may also be moved by facts involving the potential for injured parties to go without relief, particularly where the insureds at issue do not have sufficient funds to pay the judgments or settlements at issue. Relatedly, in some cases, it might be possible to undertake a so-called Elat settlement that awards the injured party an assignment of the directors’ and officers’ insurance claim for a good-faith settlement, so that the party who incurred the loss being compensated can demonstrate the settlement’s value and merit directly. A similar possibility that could be explored is a settlement that is paid in the first instance by a third party on behalf of the directors and officers (or other insured facing liability).

Policyholders facing insurance insolvencies should not ignore the potential for recoveries from state insurance guaranty funds and liquidators. Although these sources typically do not permit a full recovery of a loss, they can be important sources for significant insurance recoveries.

Finally, the *Ali* case and similar disputes involving exhaustion and drop down issues illustrate the importance of reviewing policies and negotiating better policy wording where possible. Language that requires actual payment by the underlying insurance company should be avoided. Less restrictive “exhaustion” language is widely available in the marketplace.

COUNSEL'S CORNER: NEWS FROM REED SMITH

Anker Sorenson published the following: 'French Ruling reinforces board members' right to information prior to their revocation', 27 September 2013 (Reed Smith Client Alert);
'Distribution of dividends in kind: a useful way to divest company holdings in favour of shareholders: TCI, EADS, Dassault and Co', 26 September 2013 (Reed Smith Client Alert);
'French Accelerated Financial Safeguard Procedure (AFS): The Nanterre Court Gives Green Light to the First Safeguard Plan Presented under the AFS Regime', (Editorial in International Corporate Rescue, Volume 10, June 2013); and
'Directors in the Twilight Zone IV', Insol International, July 2013

Amy Tonti presented at the 18th Annual Bankruptcy Institute for the Pennsylvania Bar Institute on the topic of 'Top Commercial Cases of the Year.'

Michael Venditto published 'Finding New Value for Single Asset Real Estate Cases' in the September 23, 2013, New York Law Journal.

Cross-Border Comparisons: Piercing the Corporate Veil—continued from page 20

and its shareholder(s). In this respect, courts have taken diverse views as to the characterizing factors.

Civil courts require an undue and faulty interference as well as an interference, as per the *"Chambre Mixte"* of the Court of Cassation in the high-profile "Tapie 2009" case, which "… needs to mislead a third party to reasonably believe that the shareholder (i.e. a bank in this case) was also party to the contract between the corporation and the third party". As such it overturned the ruling of the Paris court of appeal (in favour of various Bernard Tapie's corporations) and referred the case back to the same court of appeal, with a different panel of judges.

As in England and the U.S., the courts in France have not defined a unique criteria or a set of criteria applicable in all cases and courts independently of the nature of the courts (civil, commercial or labour) in charge of the matter in which the piercing of the corporate veil is at stake.

1 The first instance social court in France.

2 A German entity which was the parent corporation of Continental France

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