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# CR&B Alert

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## HOW SAFE ARE THE BANKRUPTCY CODE SAFE HARBORS?

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In *Krol v. Key Bank National Association, et al.* (*In re MCK Millenium Centre Parking, LLC*), Adv. No.14-00392 (N.D. Ill. Apr. 24, 2015), the U.S. Bankruptcy Court, Northern District of Illinois (the "Court") issued a decision of particular importance to lenders and securitization servicers facing complications from the bankruptcy of a borrower involved in a commercial mortgage-backed securitization ("CMBS"). The Court clarified the scope of safe harbor protections for loan payments that are "related to" a securities contract, dismissing a chapter 7 trustee's avoidance claims seeking to claw back over $5 million in pre-petition loan payments made to repay loan obligations owed to a trust. The Court held that the safe harbor under section 546(e) of the Bankruptcy Code protected from avoidance the debtor's payments to the bank on account of a non-debtor affiliate's loan. Because the loan was evidenced by a promissory note which was then transferred to a real estate mortgage conduit trust and managed as a CMBS, the payments on the underlying loan "related to" a securities contract – a type of transaction covered by the Bankruptcy Code safe harbors. Noting a split of authority, the Court held that a financial institution that seeks safe harbor under section 546(e) of the Bankruptcy Code need not acquire a beneficial interest in the transferred funds in order to trigger the safe harbor. Even a conduit financial institution will benefit from the protections from avoidance actions where the transfers are in connection with a securities contract. The Court dismissed the trustee's preference claim and recommended dismissal of the trustee's constructive fraudulent transfer claims.

If you would like more information on Safe Harbors and Securitizations, please contact my colleagues Andrea Pincus and Paul Turner as follows:

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## STOCKTON'S CHAPTER 9 PLAN APPROVAL

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*In re City of Stockton*, 526 B.R. 35 (Bankr. E.D. Cal. 2015)

### CASE SNAPSHOT

The bankruptcy court issued a written published opinion confirming two prior chapter 9 rulings relating to treatment of the city of Stockton's pension plan in its Plan of Adjustment. The opinion concludes that municipal contracts providing for employee retirement benefits are subject to impairment in bankruptcy, just like private party contracts, but nevertheless confirms the city's plan over the objections of an unsecured creditor, even though the plan left the city's pension obligations unimpaired. Based on all the evidence before it, the court ruled that the plan was fair and equitable and was the city's best exit route out of chapter 9.

### FACTUAL BACKGROUND

The primary legal contest in Stockton's chapter 9 bankruptcy case pitted the California Public Employees' Retirement System (CalPERS), which administered Stockton's pension plans, against Franklin Templeton Investments, which was owed approximately $35 million by the city. Of that amount, approximately $4 million was secured and the balance was unsecured.

Before and during the chapter 9 proceedings, the city successfully negotiated claims settlements with all of its creditors except Franklin; negotiated the end of retiree health care subsidies; and raised additional tax revenues through a voter-approved ballot measure. The city's obligations to CalPERS to fund future employee retirement benefits ran into the hundreds of millions of dollars. CalPERS asserted that the pension obligations could neither be rejected under Bankruptcy Code section 365 nor otherwise impaired in a plan both because (i) bankruptcy courts are prohibited under Bankruptcy Code sections 903 and 904 and the 10th Amendment of the U.S. Constitution from interfering with a state's control over its municipalities' political and governmental powers, and (ii) California Government Code section 20487 expressly prohibits a municipality from rejecting its contract for CalPERS benefits. For its part, Stockton determined that impairing its pension obligations would discourage employees from being willing to work for the city, hampering its ability to perform fundamental public services. Accordingly, the city proposed a Plan of Adjustment that left its pension obligations intact, but proposed to pay its general unsecured creditors (including Franklin) pennies on the dollar.

Franklin objected to the plan, arguing (i) as a matter of bankruptcy law, the debtor could reject or otherwise impair its pension obligations, (ii) the pension obligations are unsecured claims that are not entitled to priority over Franklin's

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## DELAWARE CHANCERY COURT CLARIFIES FIDUCIARY DUTIES OF INSOLVENT CORPORATION DIRECTORS IN DERIVATIVE ACTION

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*Quadrant Structured Products Company v. Vertin*, 102 A.3d 155 (Del. Ch. 2014)

### CASE SNAPSHOT

The Delaware Chancery Court clarified the fiduciary duties of the directors of insolvent corporations in a derivative action brought by a creditor. The court held that the business judgment rule barred derivative claims asserted against directors by a creditor who had alleged that the company's high-risk investment strategy was implemented for the purpose of benefitting the corporation's controller at the creditors' expense.

### FACTUAL BACKGROUND

Athilon Capital Corp. was a credit derivative product company that became insolvent during the 2008 financial crisis. EBF & Associates purchased all of Athilon's Junior Subordinated Notes and all of Athilon's equity, thereby assuming control of the company. EBF appointed four directors to the company's five-person board, which also included Athilon's CEO.

After the EBF takeover, Quadrant Structured Products Company, Ltd. acquired senior subordinated notes, thereby becoming an Athilon creditor. Quadrant later brought this action, alleging, among other things, that the EBF-controlled board breached its fiduciary duties by (i) adopting a risky investment strategy where any losses would be borne solely by the creditors, while any upside would benefit EBF as controller; (ii) continuing to pay interest on EBF's junior subordinated notes after Athilon became insolvent; and (iii) paying fees to an EBF subsidiary at above-market rates. In particular, the new investment strategy involved the company purchasing high-risk securities and making highly speculative investments.

The defendants brought a motion seeking to dismiss Quadrant's complaint for failing to state a claim on which relief can be granted.

### COURT ANALYSIS

*Direct Claims versus Derivative Claims*

As a preliminary matter, the court held that creditors of an insolvent corporation cannot assert breach of fiduciary duty claims directly against directors, but can assert them derivatively, on behalf of the company. In so holding, the court undertook a thorough review of Delaware case law on this subject, and ultimately relied on the Delaware Supreme Court's decision in *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*, 930 A.D.2d 92 (Del. 2007), which established that directors owe no fiduciary duty directly to creditors.

The court also held that creditors can assert claims that predate their ownership of the debt. Accordingly, the "contemporaneous ownership requirement," which in Delaware is a statutory prerequisite to derivative claims brought by shareholders, does not apply to claims by creditors. However, the court emphasized that this ruling should not affect other prerequisites to bringing derivative claims, such as demand excusal.

*The Business Judgment Rule Applies to Claims Related to Investment Strategy*

Turning to the substance of Quadrant's claims, the court made a distinction between decisions that would be evaluated under the business judgment rule and decisions that would be evaluated under the entire fairness standard. The court classified Athilon's investment strategy decisions as decisions intended to maximize the enterprise value of the corporation and therefore subject to the business judgment rule; however, the claims regarding payments to EBF and its subsidiary were viewed as transfers of value that would be subject to the entire fairness standard.

Quadrant argued that well-intended fiduciaries would have invested conservatively in order to preserve the value of the corporation for its creditors and prepare for liquidation. The board's decision to instead pursue a riskier strategy, Quadrant claimed, constituted a breach of its fiduciary duties. According to Quadrant, this strategy was implemented:

"[F]or the benefit of EBF and contrary to the interests of [Athilon's] creditors. Because EBF owns [Athilon's] equity and Junior Notes, which are currently underwater, EBF does not bear any of the risk if the investment strategy fails. Only Quadrant and the other more senior creditors bear the downside risk. If the riskier investment strategy succeeds, however, then EBF will capture the benefit."

Quadrant argued that where the corporation's controller was the sole beneficiary of a board decision, and a conflict of interest was present, the entire fairness standard – rather than the business judgment rule – should apply.

The Delaware Chancery Court disagreed. Invoking *Gheewalla*, the court held that directors owe no duty directly to creditors, and thus do not owe conflicting duties to the corporation and to individual creditors. Instead, a director's sole duty remains to maximize the value of a corporation for the residual claimants, which includes shareholders and, upon a corporation's insolvency, creditors. The court thus held that "the fact that the residual claimants of the firm at that time are creditors does not mean that the directors cannot choose to continue the firm's operations in the hope that they can expand the inadequate pie such that the firm's creditors get a greater recovery" (citing *Trenwick Am. Litig. Trust v. Ernst & Young LLP*, 906 A.2d 168, 174 (Del. Ch. 2006)).

Despite holding that the five-director board contained at least three interested directors, the court held that the directors faced no actual conflicts of interests, and therefore applied the business judgment rule to the board's decisions regarding investment strategy. The court held that those decisions impacted the value of the corporation as a whole, and as a result, the court would not assess whether they were intended to benefit some residual claimants more than others.

*The Entire Fairness Standard Applies to Claims Related to Actual Transfers of Value*

The court also held, however, that decisions regarding the transfer of value to the controller will be subject to the entire fairness standard, which places the burden on the directors to prove that the terms of the transaction and the price were entirely fair.

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unsecured claims, and (iii) Franklin's claims were misclassified with hundreds of millions of dollars of retiree claims for rejected health care subsidies, effectively nullifying Franklin's vote against the plan. In all, Franklin contended that the plan could not be confirmed because it was inequitable and unfairly discriminated against Franklin.

### COURT ANALYSIS

The bankruptcy court quickly disposed of the notion that state law could survive the federal Supremacy Clause, finding that the "vested rights" doctrine was trumped by Congress' grant to federal bankruptcy courts of the right to impair all sorts of contracts, including pension contracts. Section 365 permits bankruptcy courts to approve a debtor's rejection of executory contracts, and the Code's plan confirmation provisions permit impairment of other contractual obligations.

The court also found that Stockton's provision of retirement benefits to its employees was a commercial function, not a political or governmental function, and thus sections 903 and 904, and the 10th Amendment, did not require federal deference to states' rights. In fact, the court denied CalPERS' creditor standing entirely, finding that the pension system was merely a collection agent for the city, not a real party in interest with any risk of loss, with the real creditors being the thousands of individual retirees collectively holding hundreds of millions of dollars in unsecured claims. The court further ruled that California state prohibitions imposed on municipalities post-petition (e.g., the prohibition on rejection of the CalPERS' contract under California Government Code sec. 20487, the acceleration of the unfunded liabilities upon bankruptcy filing, the imposition of a statutory lien upon default in pension contributions) were preempted by the avoiding powers of the Bankruptcy Code and the Supremacy Clause of the federal Constitution. In the court's words: "As long as California authorizes its municipalities to be debtors in cases under Chapter 9 of the Bankruptcy Code, municipal contracts may be impaired by way of a confirmed Chapter 9 plan of adjustment of municipal debts."

On the issue of whether or not to confirm Stockton's proposed Plan of Adjustment, however, the court acknowledged that the debtor had not proposed to reject or impair its pension obligations, and the court had no choice but to weigh the only plan before it under the classic confirmation standards of the Bankruptcy Code. Here, the court flatly disagreed with Franklin; the court found that Stockton had proposed a plan that treated all unsecured creditors fairly; that lenders, employees, retirees and taxpayers had all "shared the pain"; and that Franklin's claims were appropriately classified with the unsecured claims of impacted retirees, who outvoted Franklin in the unsecured creditor class by overwhelming numbers and amounts. The court also noted that the pensioners were giving up approximately $550 million in health care benefits in exchange for keeping their pension benefits. On that basis, the court declared that Franklin's losses were "dwarfed" by those of retired employees.

Throughout its 50+ page opinion, the court repeatedly castigated CalPERS for acting as a "bully" in the proceedings, pressing its arguments "with an iron fist" but turning out to have the legal equivalent of "a glass jaw." The court also expressed deep hostility toward California's "heavy-handed" protections of employee rights and benefits. But the court leveled similar criticism at Franklin, chiding it for being the only institutional lender that refused more favorable offers from the city during mediation, or to otherwise reach a cooperative compromise with the debtor.

### PRACTICAL CONSIDERATIONS

After confirming the plan, the court declined Franklin's request that the plan's execution be stayed pending appeal. Franklin then filed its appeal to the Ninth Circuit's Bankruptcy Appellate Panel, where briefing and argument are pending. At this time, then, whether the bankruptcy court's myriad rulings will be upheld or overturned is entirely speculative, as is the potential impact they may have on other municipalities in California and elsewhere. If Franklin prevails on appeal and Stockton's plan confirmation is reversed, however, it may prove to be a hollow victory, since the plan has already been consummated.

Ultimately, this case may be confined to its unique facts. Because Stockton was a "contract agency" with CalPERS, the court did not have to address the more difficult question as to the treatment of pensions promised through a mandatory, statutory pension plan where no contract exists, such as those affecting most state and many county employees.

Finally, the bankruptcy court also recognized two very practical hurdles facing any municipality that might seek to use bankruptcy to reduce its pension liabilities: first, it would have to wrestle with the impact on recruiting and hiring future public employees, who will (rightly) fear their employer could break its promises to them upon retirement; and second, it will face the overwhelming costs incurred in a municipal bankruptcy (which in Stockton exceeded tens of millions of dollars by some estimates – far more than the city would have needed to satisfy all of its objecting creditors). These realities may discourage more prevalent use of bankruptcy by financially strapped municipalities in the future.

## PARTIES TO WHOM DIRECTORS OWE DUTIES DEPEND ON SOLVENCY

*Lauren Zabel*
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*In re Tropicana Entertainment, LLC*, Case No. 08-10856 (KJC), (Bankr. D. Del., Nov. 25, 2014)

### CASE SNAPSHOT

The trustee of a litigation trust filed a complaint against parent companies and the sole controlling shareholder of the parents, alleging, among other things, equitable subordination, breach of fiduciary duties, and aiding and abetting breach of fiduciary duties. Essentially, the trustee alleged that the controlling shareholder purposefully operated one of the parent companies (and its subsidiaries) to the detriment of the other parent company (Wimar) and its subsidiaries, causing Wimar subsidiaries to file bankruptcy. The court dismissed the trustee's breach of fiduciary duty claims, holding that the trustee lacked standing to pursue those claims because it failed to plausibly allege facts supporting an inference that the debtors were insolvent or that the shareholder's misconduct led to insolvency.

### FACTUAL BACKGROUND

The debtors – affiliated hotels and casinos – were wholly owned by the same parent company (Wimar), which was solely owned and controlled by an individual (Yung). The complaint made numerous allegations about operational and financial issues allegedly caused by Wimar and Yung's operation of the debtors. For example, the complaint alleged that in the months after Wimar acquired the Tropicana Atlantic City, it laid off nearly 20 percent of its workforce, allegedly leading to an admonishing report regarding the casino's staffing, cleanliness, operations and audit committee issued by New Jersey's Division of Gaming Enforcement, which ultimately formulated the basis for the denial of the casino's request for a casino gaming license and fines issued in connection therewith. The opinion making these determinations specifically stated that Yung "demonstrated a lack of financial integrity," and recommended his removal as the sole member of Tropicana's board of directors. After unsuccessful appeals and "a series of cascading events," the debtors filed chapter 11 petitions.

As a result of the defendants' actions, the complaint alleged, among other things, that the defendants breached their fiduciary duties, contracts, and covenant of good faith and fair dealing; that the defendants aided and abetted a breach of fiduciary duties; and that the defendants' claims should be equitably subordinated.

### COURT ANALYSIS

The court analyzed each claim and found that certain of the claims failed to meet the requisite pleading standard. In particular, the court found the breach of fiduciary duty and aiding and abetting claims to be deficient. The court noted that the appropriate plaintiff in a breach of fiduciary action changes with the debtors' solvency. Under Delaware law, for a solvent corporation, fiduciary duties may be enforced by shareholders, who have standing to bring derivative actions on behalf of the corporation. For an insolvent corporation, the corporation's creditors take the place of its shareholders and have standing to bring derivative claims. When a corporation is solvent, the directors of the subsidiaries (the debtors) are obligated only to manage the affairs of the subsidiary in the best interest of the parent (Wimar) and its shareholder (Yung). The complaint asserted that Yung "deliberately chose to prefer the financial health of his hotels to the financial harm of his casinos." However, assuming the debtors were solvent, Yung was obligated to manage the debtors in the best interests of Wimar (as the parent corporation) and, ultimately, himself (as sole shareholder of Wimar). Because the complaint failed to adequately allege that the debtors were insolvent or became insolvent as a result of the alleged misconduct, the court found that the trustee (as a representative of the debtors' creditors) lacked standing to bring these claims. As a result, the court dismissed the trustee's breach of fiduciary duty and aiding and abetting claims.

The court determined that the trustee's breach of contract and breach of implied covenant of good faith and fair dealing claims, which were premised upon contracts specifically identified in the complaint, were sufficiently pleaded, but dismissed any claims premised upon contracts that were not specifically identified therein. The court also dismissed the trustee's equitable subordination claim because the trustee failed to identify which particular claims of the defendants it sought to equitably subordinate.

### PRACTICAL CONSIDERATIONS

Directors of a company should know the law of the state of the entity's incorporation regarding when their fiduciary duties shift from the shareholders to the creditors of the company. It is important for directors to keep in mind their shifting duties when the corporation becomes financially troubled. Likewise, from a litigation standpoint, it is always important for a plaintiff to consider standing issues prior to filing a complaint, and be sure to plead facts sufficient to establish standing.

## PUNITIVE DAMAGES OF OFFICERS UPHELD, BUT VACATED AS TO DIRECTORS, IN MISMANAGEMENT CASE

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*In re Lemington Home for the Aged*, No. 13-2707 (3d Cir., Jan. 26, 2015)

### CASE SNAPSHOT

The appellants, two former officers and several former directors of the debtor nonprofit nursing home, had been found liable for mismanagement and ensuing bankruptcy of the facility. The Third Circuit affirmed the jury's liability findings and punitive damages against the former officers (CEO and CFO), but vacated the punitive damages against the former directors. The court found that there was insufficient evidence to show that the directors acted with "malice, vindictiveness and a wholly wanton disregard of the rights of others." The court found that the two officers had "acted outrageously, supporting the jury's imposition of punitive damages against them."

### FACTUAL BACKGROUND

Prior to filing its bankruptcy petition, a nonprofit nursing home faced severe financial difficulties. Although its board convened and voted to close the nursing home in January 2005, the home did not file its chapter 11 petition until April of that year. After the bankruptcy petition was filed, the court approved the closure of the nursing home, in part, based upon the representation that the debtor was unable to find funding or a buyer for the nursing home. Thereafter, it came to light that the debtor delayed filing certain bankruptcy operating reports that would have shown that the nursing home received considerable Nursing Home Assessment Tax payments, which may have increased the chances of finding a buyer.

The creditors' committee filed an adversary proceeding against the debtor's administrator/CEO (Causey), CFO (Shealey) and directors alleging claims for breach of fiduciary duty generally, breach of the duty of loyalty, and deepening insolvency. The district court granted summary judgment in favor of the defendants on all claims. That decision that was vacated in its entirety by the Third Circuit and the case was remanded for trial. During trial, judgment as a matter of law was granted to the director defendants on the breach of duty of loyalty claim, but denied as to all other claims and all other defendants. Following a six-day jury trial, the jury returned a compensatory damages verdict against 15 of 17 defendants, jointly and severally, in the amount of $2.25 million. The jury also awarded punitive damages of $350,000, individually, against five of the director defendants, as well as against Shealey in the amount of $1 million and Causey in the amount of $750,000. After the defendants' motion for judgment as a matter of law, new trial or remittitur was denied, the defendants appealed to the Third Circuit.

### COURT ANALYSIS

The Third Circuit exercised plenary review, applying the same standard as the district court, which required the court to grant judgment notwithstanding the verdict only if the record viewed in the light most favorable to the plaintiff lacked a "minimum quantity of evidence" from which a jury might reasonably afford relief.

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### Delaware Chancery Court Clarifies Fiduciary Duties of Insolvent Corporation Directors in Derivative Action—continued from page 3

With respect to the payment of interest on EBF's junior subordinated notes, the court noted that EBF stood on both sides of the transaction as holder of the Junior Subordinated Notes (and recipient of the interest payments), and as the sole equity shareholder of Athilon. The court also noted that these payments were discretionary, since under the terms of the notes, the board could have deferred payment. Thus, this transaction benefitted the controller at the expense of the senior creditors, who upon insolvency become the company's "residual beneficiaries" (quoting *Gheewalla*, 930 A.2d at 101). Because of the potential for self-dealing, the court determined that the entire fairness standard was appropriate.

The court similarly determined that the entire fairness standard would govern Quadrant's claim related to the payment of fees to an EBF subsidiary at allegedly above-market rates. Because entire fairness governed these claims, the burden of proof fell on the directors, and the motion to dismiss was therefore denied.

With respect to the potential liability of the independent directors, the court held, "entire fairness governs interested transactions between a corporation and its controller, even if a special committee of independent directors *or* a majority-of-the-minority vote is used, because of the risk that when push comes to shove, directors who appear to be independent and disinterested will favor or defer to the interests and desires of the majority stockholder." (Emphasis in original.)

*Other Claims*

In addition to its claims for breach of fiduciary duty, Quadrant brought claims for waste, fraudulent transfer, constructive dividends, and injunctive relief. With the exception of the claim for constructive dividends, which the court held is not a cause of action recognized under Delaware law, the court held that the remainder of these claims survived the motion to dismiss.

### PRACTICAL CONSIDERATIONS

*Quadrant* demonstrates Delaware's strict approach toward insolvent companies that transfer value to favored shareholders – but equally signifies Delaware's hesitation to engage in an evaluative review of strategic decisions regarding the maximization of a corporation's value as a whole. It remains unresolved whether all claims can be so conveniently classified as a maximization decision or as a transfer of value. For instance, it may be possible that an investment strategy may be so skewed to benefitting the controller, that it may essentially be considered a transfer of value.

## EQUITABLE CONVERSION ENABLES LENDER'S SECURITY INTEREST TO RELATE BACK, GIVING LENDER PRIORITY OVER IRS LIEN

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*In re Restivo Auto Body, Inc.*, 772 F.3d 168 (4th Cir. 2014)

### CASE SNAPSHOT

The Fourth Circuit recently reviewed a district court's (D. Md.) decision affirming the bankruptcy court's ruling on a dispute between a secured lender and the IRS regarding liens on debtor's property. The lender's security interest was created by a deed of trust executed by the debtor before – but recorded in the land records after – the IRS filed its tax lien. The lender sought a judgment declaring that its interest had priority over the IRS' tax lien, despite the fact that the lender was not the first to record. The district court ruled that the lender's interest in the debtor's property took priority over the IRS' lien both by statute and under Maryland common law. The Fourth Circuit rejected the district court's holding (based on Maryland statute) that the lender's later recording of the deed of trust related back to the date of execution; however, it affirmed the judgment under Maryland common law, ruling that the lender acquired an equitable security interest on the date the deed of trust was executed, which took priority over the IRS' subsequent unsecured lien.

### FACTUAL BACKGROUND

On January 4, 2005, the debtor executed a deed of trust in favor of the lender to secure a $1 million loan. Six days later, the IRS filed a notice of federal tax lien (for unpaid employment taxes due in 2004) against the debtor. The lender did not record the deed of trust until February 11, 2005, more than a month after the IRS filed its notice of tax lien.

When the debtor filed for chapter 11 bankruptcy protection in 2011, the IRS filed a proof of claim relating to the unpaid employment taxes. The lender then commenced an adversary proceeding to determine priority of the liens. The IRS and the lender both moved for summary judgment, and the bankruptcy court found in favor of the lender. The IRS appealed, arguing that its tax lien was entitled to priority because the IRS recorded before the lender recorded the deed of trust. Both the district court and the Fourth Circuit found that the lender's security interest took priority.

### COURT ANALYSIS

The lender's motion for summary judgment was based on two arguments: first, under Md. Code. Ann., Real Prop. section 3-201, the deed of trust's recordation date related back to the date the deed of trust was executed; and second, the lender had an equitable lien that took priority over the IRS.

Both the bankruptcy court and the district court relied on *WC Homes, LLC v. United States*, Civil Action No. DKC 2009-1239, 2010 WL 3221845 (D. Md. Aug. 13, 2010) in ruling that the lender had already obtained a security interest by statute when the IRS' lien was recorded. The district court explained: "under Maryland law, which is made applicable by 26 U.S.C. § 6323(h)(1)(A), 'a recorded deed of trust is effective against any creditor of the person who granted the deed of trust as of the date the deed of trust was delivered (not the date it was recorded) regardless of whether the creditor did or did not have notice of the deed of trust at any time.'"

As an alternative basis for affirming the bankruptcy court's ruling that the lender's lien took priority, the district court applied Maryland's doctrine of equitable conversion, which "entitles the holder of a deed of trust to the same protections as a bona fide purchaser for value, who takes free and clear of all subsequent liens regardless of recordation."

The Fourth Circuit began its review with a discussion of federal tax liens, the priority of which is governed by federal law. The Fourth Circuit explained that:

"Under federal law, a lien in favor of the IRS attaches to all property owned by a person who 'neglects or refuses' to pay taxes for which he is liable after the IRS demands payment. The lien arises at the time the tax assessment is made, and generally takes priority over a lien created after that date under the common-law principle that 'the first in time is the first in right,' even if the tax lien is unrecorded. But a tax lien is not 'valid as against any … holder of a security interest…until notice thereof … has been filed by the Secretary [of the Treasury].'"

Thus, the question before the Fourth Circuit for de novo review was whether the lender had a security interest on the date the deed of trust was executed, even though the deed of trust was not recorded until more than a month later.

Under Md. Code Ann., Real Prop. section 3-101(a), a deed of trust is not effective unless it is "executed and recorded." Pursuant to section 3-201, when the date of execution is earlier than the date of recordation, the recordation relates back to the deed's effective date, i.e., the latter of the date of the last acknowledgement or the date stated on the deed. The Fourth Circuit found that, based on Maryland case law, the deed was effective on the date it was signed even if the deed was not recorded on that date.

That inquiry, however, did not resolve the issue, "because the question…is not what interest [the lender] had on February 11 [when its deed of trust was recorded], but rather, under 26 U.S.C. § 6323(a), whether [the lender] had a 'security interest' *at the time* the IRS recorded its tax lien on January 10." (Emphasis in original.) According to the Fourth Circuit, the lender did not trigger the relation-back statute on the date the IRS recorded because an essential element of the relation-back statute—i.e., the recording of the deed—had not been met. Unlike the district court, the Fourth Circuit placed a great deal of weight on the present perfect tense used in the federal statute, and found that the district court erred in upholding the bankruptcy court's judgment insofar as it was based on Md. Code Ann., Real Prop., section 3-201. The Fourth Circuit rejected the lender's arguments that the statute was ambiguous, and found support for its ruling on the relation-back issue in other courts' applications of 26 U.S.C. section 6323(h)(1)(a) to bar state law relation-back claims.

The Fourth Circuit then turned its discussion to Maryland's doctrine of equitable conversion, pursuant to which "the holder of an equitable title or interest in property, by virtue of an unrecorded contract of sale, has a claim superior to that

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## DELAWARE JOINS THE 7TH AND 9TH CIRCUITS IN PROTECTING TRADEMARK LICENSE OWNERS FROM NON-CONSENSUAL BANKRUPTCY ASSUMPTIONS AND ASSIGNMENTS

*Christopher Rivas*
*Associate, Los Angeles*

*In re Trump Entertainment Resorts, Inc.*, Case No. 14-12103 (Bankr. D. Del., Feb. 20, 2015)

### CASE SNAPSHOT

The bankruptcy court in Delaware recently joined a number of bankruptcy courts in other jurisdictions protecting trademark owners' rights to prohibit a debtor from either assuming or assigning a trademark without the trademarkowner's consent. (This article was originally published in Reed Smith's Global Restructuring Watch blog.)

### FACTUAL BACKGROUND

The casino operator/debtors were the licensees of Donald and Ivanka Trump's trademarks, which were owned by their company, Trump AC. Trump AC filed a motion for relief from the automatic stay to continue pursuing pre-petition state court litigation that sought to terminate the trademark license agreement on the grounds that the debtors had failed to uphold the quality of the Trump trademarks as required by their trademark license agreement. Trump AC argued that there was cause to lift the stay because the debtors were not permitted to assume or assign the trademark licenses under section 365(c)(1) of the Bankruptcy Code, which prohibits assumption or assignment of executory contracts where "applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor . . . "

### COURT ANALYSIS

The bankruptcy court acknowledged that section 365(f)(1) generally nullifies anti-assignment provisions in contracts, but agreed with the Ninth Circuit that section 365(c)(1) may supersede section 365(f)(1), depending on why the governing non-bankruptcy law restricted assignment. Analyzing federal trademark law, the bankruptcy court determined that the assignment of trademark licenses is generally banned, absent a licensor's consent. The rationale for the ban is to protect trademark licensors' ability to control the quality of their trademarks.

In Trump, because the applicable non-bankruptcy trademark law prohibited assignment without consent, and because the subject trademark agreement likewise prohibited assignment without consent, the bankruptcy court ruled that the debtors could not assume or assign the trademark license without Trump AC's express consent, and, therefore, granted Trump AC's motion for relief from stay.

### PRACTICAL CONSIDERATIONS

With this holding, the Delaware bankruptcy court joined the Ninth Circuit and the Seventh Circuit in protecting the non-assignability provisions of trademark license agreements in bankruptcy court.

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### Equitable Conversion Enables Lender's Security Interest to Relate Back, Giving Lender Priority over IRS Lien—continued from page 7

of a creditor obtaining judgment subsequent to the execution of the contract." Under the doctrine, sellers retain legal title only during the executory period of contracts for the purchase of land, and the buyer holds equitable title to the land superior to any judgment lien subsequently obtained against the seller. While the lender was not a purchaser of debtor's property, "Maryland principles in equity 'treat lenders who secure their interests with a mortgage or deed of trust as entitled to the protections available to bona fide purchasers for value,' so long as those lenders act in good faith." Thus, a lender's equitable interest in secured property is superior to interests of subsequent judgment lienholders even if the lender did not record its lien.

The Fourth Circuit rejected the IRS' arguments that the lender was not entitled to protection because the lender was not a "purchaser," explaining that: "Maryland's doctrine of equitable conversion does not transform lenders into purchasers. Rather, it 'entitle[s] [lenders] to the protection afforded' by Maryland law to bona fide purchasers."

Under federal law, tax liens are subordinate to deeds of trust that are protected from subsequent judgment liens. Under the doctrine of equitable conversion, the lender's equitable interest became protected from subsequent judgment liens January 4, 2005. According to the Fourth Circuit, because the IRS' tax lien was recorded after January 4, 2005, the lender's equitable interest in debtor's property had priority.

The lone dissenter, Judge Wynn, disagreed that the IRS' lien was subordinate to the lender's equitable lien. In Judge Wynn's view, 26 U.S.C. section 6322, which provides that the tax lien at issue "shall arise at the time the assessment is made," controlled the analysis. According to Judge Wynn, the case should have been governed by the principle "first in time is first in right." Finding that the IRS' lien arose in September 2004, Judge Wynn concluded that debtor's title was already encumbered by the tax lien when the deed of trust was signed, and as such the lender's lien was subordinate to the IRS' lien.

### PRACTICAL CONSIDERATIONS

One must be mindful of the tenses used in applicable statutes—at least if the Fourth Circuit will be evaluating priorities under 26 U.S.C. section 6323. It is always best to promptly record deeds of trust to ensure that security interests are perfected. Even where recording is delayed, however, under appropriate circumstances a secured lender may still assert priority over IRS tax liens under the common law of the state where such property is located.

## FRAUDULENT TRANSFERS MAY NOT BE AVOIDED WHERE NO BENEFIT TO THE ESTATE

*Sarah Kam*
*Associate, New York*

*In re New Life Adult Medical Day Care Center, Inc.*, Case Nos. 11-43510 (NLW) and 12-29807 (NLW), (Bankr. D. N.J., Dec. 3, 2014)

### CASE SNAPSHOT

The U.S. Bankruptcy Court, District of New Jersey granted summary judgments to alleged recipients of fraudulent transfers. Because all creditors of the debtor had been paid in full under the debtor's chapter 11 joint liquidating plan and there was no reorganized entity, recovery of the alleged fraudulent transfers would solely benefit the equity holder rather than benefit the estate, as required by section 550(a) of the Bankruptcy Code.

### FACTUAL BACKGROUND

The debtor, an operator of an adult medical day care center, filed a chapter 11 bankruptcy petition. The owner of the real estate on which the debtor conducted its business also filed a chapter 11 bankruptcy petition. Both cases were jointly administered. After operating the business in chapter 11 for almost a year, the debtor determined that it was in its best interest to sell its business and related assets. After the sale, the debtor and the real estate owner confirmed a joint plan of reorganization. The plan provided for payment in full of all claims against the debtor and the real estate owner. The balance of any value in the debtor, including cash, unsold assets, claims and causes of action, was to be distributed to the equity holder of the debtor. After substantial consummation of the plan, the debtor commenced an adversary proceeding seeking to recover alleged fraudulent transfers. The defendants moved for summary judgment.

### COURT ANALYSIS

Like a trustee, a debtor-in-possession has a paramount duty to act on behalf of the bankruptcy estate, for the benefit of creditors. Section 550(a) of the Bankruptcy Code permits the recovery of certain avoidable transfers "for the benefit of the estate." The bankruptcy court noted that courts are divided on whether to construe the "benefit to the estate" requirement broadly or narrowly. Under the broad view, which appears to be the majority view, benefit to the estate includes both direct benefits to the estate (e.g., an increased distribution) and indirect ones (e.g., an increase in the probability of a successful reorganization). On the other hand, under the narrow view, courts require a direct and tangible benefit to creditors.

Applying the broad view, the bankruptcy court concluded that recovery of the alleged fraudulent transfers would provide no conceivable benefit to the estate, either directly or indirectly. The plan provided for full payment of all creditor claims, and the claims had been paid in full with interest under the joint liquidating plan. There was no ongoing reorganized entity and no creditors who would receive a benefit. The only entity that stood to benefit from the avoidance of the alleged fraudulent transfers was the debtor's equity holder. Thus, the bankruptcy court granted the defendants' summary judgment.

### PRACTICAL CONSIDERATIONS

Recovery to equity holders may not constitute a benefit to the estate under section 550(a) of the Bankruptcy Code.

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## COURT REJECTS 'BUSINESS JUSTIFICATION' FOR CLAIM CLASSIFICATIONS, CREDITOR CANNOT BE FORCED TO MAKE SECTION 1111(B) ELECTION

*Christopher Rivas*
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*In re Marlow Manor Downtown, LLC*, BAP No. AK-14-1122-JuKiKu (9th Cir. BAP, Feb. 6, 2015)

### CASE SNAPSHOT

The Ninth Circuit BAP affirmed the bankruptcy court's refusal to confirm the chapter 11 plan based on the debtor's efforts to gerrymander a secured creditor's deficiency claims, the classification of which effectively "forced" an 1111(b) election on the secured creditor.

### FACTUAL BACKGROUND

Debtor Marlow Manor was a housing developer that owned a high-rise building securing two notes held by the Alaska Housing Financing Corporation (AHFC) and serviced by Wells Fargo Bank. The value of the building had diminished such that the building partly secured AHFC's first note, and left the second note fully undersecured. The debtor sought to cram down its second amended chapter 11 plan, by placing the second note in its own impaired class separate from the general unsecured creditors' impaired class. The debtor then purchased a sufficient number of claims in the general unsecured creditors' class to vote in favor of its plan and satisfy the requirement of Bankruptcy Code section 1129(a)(10) that at least one impaired class vote in favor of the plan.

The court rejected the separate classification of the second note, finding that there was no legitimate business purpose for the separate classification, and that the classification was made for gerrymandering purposes. The court rejected the debtor's arguments that separate classification was proper because the second note was guaranteed, finding that the guarantor was insolvent. The court also rejected the debtor's argument that separate classification was proper because the second note's terms only required repayment if the debtor had positive cash flow, and rejected the debtor's arguments that the second noteholder should therefore be treated as though it were an equity holder.

CONTINUED ON PAGE 10

## Punitive Damages of Officers Upheld, but Vacated as to Directors, in Mismanagement Case—continued from page 6

First, the Third Circuit rejected the defendants' arguments that the evidence did not support the jury's liability findings on the breach of fiduciary duty claims. With respect to the claims against the debtor's officers, the Third Circuit determined that evidence presented at trial demonstrated that Causey (i) lacked the experience and qualifications to serve as and fell far short of fulfilling her responsibilities as administrator/CEO, and (ii) remained in her position and collected her full salary as administrator (which is required to be a full-time position) despite the fact that she was working part time. From this evidence, the Third Circuit concluded that the jury had sufficient evidence to conclude that she breached her duties of care and loyalty. Likewise, based upon testimony that Shealey hadn't kept a general ledger for the debtor, or billed for Medicare prior to the bankruptcy filing and attempted to negotiate a pre-petition sale of the debtor that would have personally benefitted Shealey, the Third Circuit concluded that the jury had sufficient evidence to conclude that Shealey breached his duties of care and loyalty as CFO. With respect to the director defendants, the Third Circuit concluded that the evidence supported the finding that they breached their duty of care by failing to remove Causey and Shealey once the results of their mismanagement became apparent.

Next, the Third Circuit rejected the defendants' arguments that the evidence did not support the jury's liability findings on the deepening insolvency claims, finding that the evidence supported a liability finding on that claim based upon the fact that the directors delayed the bankruptcy filing and failed to disclose the receipt of significant tax credits; that the officers mismanaged the debtor; and that both the directors and officers failed to run a proper chapter 11 process.

Finally, the defendants against whom punitive damages were awarded argued that the jury did not have sufficient facts upon which to award punitive damages. Under Pennsylvania law, punitive damages must be premised upon a finding of outrageous conduct. On this subject, the Third Circuit concluded that the jury lacked sufficient evidence to find that the director defendants acted "outrageously," finding that the lack of evidence of self-dealing weighed heavily against imposition of the "extreme" remedy of punitive damages. Therefore, the Third Circuit overturned the sanctions imposed against those defendants. The court found that evidence supported the award against Shealey and Causey.

### PRACTICAL CONSIDERATIONS

Boards of directors of both for-profit and nonprofit organizations must always be cognizant of their fiduciary duties. Among other things, if directors have reason to believe that the officers of the entity are mismanaging the company, the directors should investigate the situation and, if necessary, take appropriate measures to remedy the situation. Once a bankruptcy filing occurs, the directors must be diligent about ensuring the debtor's compliance with the requirements of the Bankruptcy Code and the rules. Failure to abide by fiduciary duties can result in liability and, if the conduct is extremely culpable, punitive damages.

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## Court Rejects 'Business Justification' for Claim Classifications, Creditor Cannot Be Forced to Make Section 1111(b) Election—continued from page 9

The debtor filed a third amended plan that yet again sought to separately classify AHFC's notes from the general unsecured creditors' class. This time, the debtor placed the deficiency claim on the first note in a "secured" and "unimpaired" class that was deemed to accept the plan, and placed the second fully undersecured note in a "secured" and "unimpaired" class that was likewise deemed to accept the plan. The court rejected the plan based on the improper classifications and further attempts at gerrymandering. The debtor appealed to the BAP.

### COURT ANALYSIS

On appeal, the BAP affirmed the rejection of the plan, finding that – as before – there was no business justification for the separate classification of the completely undersecured second note because its guarantor was insolvent, and finding that the note could not be classified as "secured" because Bankruptcy Code section 506(a) requires that the unsecured portion of the note be treated as an unsecured claim. As to the first note, the BAP found that the treatment of the deficiency note as "secured" was an improper attempt by the debtor to "force" AHFC to make the election under Bankruptcy Code section 1111(b) to have its partly undersecured note treated as fully secured. Further, the BAP rejected the debtor's arguments that the claim was not impaired because the debtor was making all payments required under the terms of the note, finding that the debtor failed to make any showing under Bankruptcy Code section 1124(2) that it cured all defaults, reinstated maturity, and other similar "cure" requirements. Lacking any business justification for separately classifying either the first or second notes, the BAP found that the bankruptcy court did not err when it rejected the plan.

### PRACTICAL CONSIDERATIONS

Although the Ninth Circuit BAP permitted separate classification of a deficiency claim in its 2012 holding, *In re Loop 76, LLC* – based, in part, on the fact that the claim was guaranteed – the *Marlow Manor* decision demonstrates that the court will carefully analyze whether the guaranty has any value before automatically permitting separate classification. Moreover, *Marlow Manor* reflects that obvious efforts by a debtor to purchase and gerrymander votes may garner stricter scrutiny from a court regarding the appropriateness of separate classification than it would otherwise receive. The decision also affirms that a secured creditor has the exclusive right to make or not make an election under Bankruptcy Code section 1111(b), and that the election cannot be "forced" on the creditor by a debtor's too-clever plan classifications.

# APPLYING *TILL*, COURT REQUIRES EVIDENCE TO INCREASE INTEREST RATE ABOVE PRIME

*Chrystal Puleo*
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*In re William Arendarczyk, Jr.*, No. 14-40844, (Bankr. S.D. Georgia, Savannah Division, Nov. 21, 2014)

### CASE SNAPSHOT

A secured creditor argued that a cramdown interest rate equal to the prime rate did not satisfy the *Till* requirement to increase the base interest rate to account for other risks, and that rate adjustments of 1 percent to 3 percent are generally approved. The court denied the secured creditor's argument, finding that the creditor failed to meet its *Till* evidentiary burden to support such an increase.

### FACTUAL BACKGROUND

A chapter 13 debtor resided in a manufactured mobile home, which was encumbered by a claim against the real estate in the amount of $10,760.46, and a claim against the manufactured mobile home in favor of Green Tree Servicing LLC in the amount of $69,724.28. The debtor valued his property, inclusive of the mobile home, in his schedules at $14,000. The debtor proposed a chapter 13 plan where he would pay interest on both claims related to the property at a rate of 3.25 percent per annum.

Green Tree, as a secured creditor, filed an objection to confirmation of the debtor's plan. Green Tree objected that: (i) it believed that the mobile home should be valued at a minimum of $19,464.52; and (ii) the proposed prime interest rate of 3.25 percent was not appropriate under applicable precedent as to cramdown interest rates on secured loans under *Till v. SCS Credit Corp.*, 541 U.S. 465 (2004). Green Tree argued that using the prime rate overlooks the additional factors the Supreme Court recognized in its *Till* decision that should be added to the base rate to account for investment risks, such as: (i) the probability of plan failure; (ii) the rate of collateral depreciation; (iii) the liquidity of the collateral market; and (iv) the administrative expenses of enforcement.

### COURT ANALYSIS

The court held an evidentiary hearing on the valuation of the mobile home where the debtor testified that he took into account the NADA book value for homes of the identical make and model as his home, which was in the amount of $18,400, and from that number proposed a valuation of $14,000 based on the condition of the home, which included needed repairs. Green Tree produced an appraisal that was accepted into evidence without objection, together with the testimony of the appraiser, who estimated that the fair market value of the manufactured home and lot of $44,000, with the mobile home itself being worth $19,600. The court asked Green Tree's expert to do a comparable separation of value between land and structure on a listing in the same neighborhood as the debtor's home, and concluded that the suggested appraisal value of $19,600 was well-supported.

The court also considered Green Tree's objection to the proposed 3.25 prime rate interest rate and held that although the *Till* decision provided for adjustments to interest rates of 1 percent to 3 percent, the secured creditor failed to meet its evidentiary burden to support such an increase. The court found that Green Tree offered no specific evidence of what an appropriate rate should be, based on the factors from *Till*, other than to argue that some flat percentage of at least 1 percent should be added to the prime rate.

Green Tree's objection to confirmation was sustained, and confirmation was denied. The debtor was instructed to amend his plan assigning a value to the manufactured mobile home of $19,600 with interest at the rate of 3.25 percent.

### PRACTICAL CONSIDERATIONS

When challenging a cramdown interest rate, secured creditors have the burden of proving that additional interest should be allowed over the prime rate because of the probability of plan failure, the rate of collateral depreciation, the liquidity of the collateral market, and/or the administrative expenses of enforcement of the plan.

## EQUITABLE MARSHALLING DOES NOT REQUIRE SECURED LENDER TO FORECLOSE OR REDUCE THE VALUE OF ITS CLAIM

*Melissa Mickey*
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*In re T & H Construction, Inc.*,
Case No. 3:14-bk-09452-DPC,
(Bankr. D. Ariz., Feb. 3, 2015)

### CASE SNAPSHOT

The bankruptcy court denied a debtor's "dirt for debt" chapter 11 plan where the plan forced the debtor's only secured creditor, a bank, to (i) foreclose on its real property collateral or (ii) accept deeds to the real property collateral or (iii) reduce its claim by the fair value of the real property collateral, whether or not the bank foreclosed its liens or took title to the real property collateral. The court found that the plan was not "fair and equitable" to the bank within the meaning of section 1129(b)(2)(A).

### FACTUAL BACKGROUND

The debtor, a contractor, filed a small business chapter 11 petition under the Bankruptcy Code. New York Community Bank, the debtor's only secured creditor, filed a proof of claim in the amount of approximately $1.09 million, representing the balance of the bank's loan to the debtor and the debtor's principals, who were co-borrowers under the loan. The bank's loan was secured by the debtor's real and personal property. Certain of the bank's personal property collateral was sold and the proceeds paid to the bank. Likewise, the bank foreclosed on two of its four parcels of real property collateral. The bank was unwilling to foreclose its liens on the remaining two parcels because it was concerned about possible environmental conditions on the property. The debtor argued that the court should force the bank to foreclose its liens or accept title to the remaining parcels of real property, or reduce its overall claim by the fair value of the remaining two parcels.

The debtor sought confirmation of its "dirt for debt" chapter 11 plan that called for: (i) liquidation of the debtor's personal property assets; (ii) the bank's (a) acceptance of a deed in lieu of foreclosure on the remaining two parcels, or (b) the bank's foreclosure on the remaining two parcels, or (c) reduction of the bank's claim by the fair value of the remaining two parcels; (iii) determining the value of the remaining two parcels in state court; and (iv) the debtor's payment of any deficiency on the secured claim using funds from the liquidated personal property collateral, in full satisfaction of the bank's claim against the debtor. The debtor's appraisal valued the remaining two parcels at $750,000, while the bank's appraisal valued them at $360,000. The Bankruptcy Court for the District of Arizona considered whether the debtor's plan was "fair and equitable" to the bank within the meaning of Bankruptcy Code section 1129(b)(2)(A).

### COURT ANALYSIS

The bankruptcy court began its analysis by noting that it "doubt[ed] its authority to confirm a cram-down plan that forces a secured creditor to accept its collateral and/or reduce its claim against both the debtor and the third-party obligors in the amount of the yet-to-be-determined value of the [remaining two parcels], all under the guise of providing the secured creditor the section 1129(b)(2)(A) 'indubitable equivalent' of its secured claim." In support of its plan, the debtor cited to a Ninth Circuit case, *Victor Gruen Assocs., Inc.*, 338 F.2d 826 (9th Cir. 1964), where the Court of Appeals held that when a debtor has two creditors, one that can reach two assets and one that can reach only one, equity requires the creditor who can reach both funds – if it can be done without prejudice to him or inequity to third parties – to look first to the fund that cannot be reached by the other creditor. The bankruptcy court noted that this concept is known as "equitable marshalling" or "marshalling of assets."

The debtor argued that the court should confirm the plan so that the debtor could make a meaningful distribution to its unsecured creditors, whose sole source of recovery under the plan is the money available after the bank's collateral is liquidated or after the bank is forced to foreclose or accept the value of the remaining two parcels as a reduction in its overall claim against the debtor and its principals. However, the bankruptcy court held that forcing the bank to reduce its secured claim by the value of the remaining two parcels, regardless of whether the bank wants the remaining two parcels or agrees to reduce its claim by such value, is the definition of inequity under *Victor Gruen*. For this reason, the bankruptcy court found that the plan did not meet the requirements for equitable marshalling.

The debtor further argued that the court should partially disallow or equitably subordinate the bank's secured claim if the bank refused to foreclose. However, the bank argued that it negotiated for the right to decide when or whether to foreclose, the right to first seek payment from the debtor's principals, and that the debtor waived its equitable marshalling defense when it signed the deed of trust for the real property collateral. The court agreed with the bank, and denied the debtor's motion for confirmation of its chapter 11 plan.

### PRACTICAL CONSIDERATIONS

Courts may refuse to confirm a plan that is not "fair and equitable" within the meaning of section 1129(b)(2)(A), where the plan forces a secured lender to forgo its bargained-for contractual rights and remedies.

## TYPO IN SECURITY AGREEMENT CANNOT BE REPAIRED USING PAROL EVIDENCE AFTER BANKRUPTCY FILING

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*In re Duckworth*, Nos. 1561 and 1653, (7th Cir., Nov. 21, 2014)

### CASE SNAPSHOT

The Seventh Circuit reversed the decisions of the bankruptcy court and district court, and found that a security agreement that contained a typographical error in the description of the debt secured could not be reformed with the use of parol evidence after the borrower filed for bankruptcy.

### FACTUAL BACKGROUND

In December 2008, David Duckworth, a bankruptcy debtor later charged with money laundering and bankruptcy fraud, borrowed $1.1 million from the State Bank of Toulon. The loan was evidenced by a promissory note, executed December 15, 2008, and the parties also entered into a security agreement that was intended to secure the loan. The security agreement provided that Duckworth granted the State Bank of Toulon a security interest in certain crops and farm equipment. However, the security agreement prepared by the bank's loan officer contained a critical drafting mistake. The security agreement said that it secured a note "in the principal amount of $_________ dated December 13, 2008." Accordingly, the amount was left blank, and the referenced note was incorrectly dated.

In 2010, Duckworth filed a petition under chapter 7 of the Bankruptcy Code. The bankruptcy trustee challenged the bank's interest in Duckworth's crops and farm equipment using his strong-arm powers under section 544 of the Bankruptcy Code. The bankruptcy court held, on summary judgment, that the bank had a valid security interest based on the intent of the parties. The bank officer who prepared the documents and the borrower both testified, and it was clear from the testimony that the security agreement contained a mistaken date. The trustee appealed, and the district court affirmed. The trustee then appealed to the Seventh Circuit.

### COURT ANALYSIS

On appeal, the Seventh Circuit reversed the lower courts, holding that parol evidence cannot be used against a chapter 7 trustee to correct a mistaken description in a security agreement. The Seventh Circuit admitted that the bank would likely have been able to use parol evidence to obtain reformation, even for an unambiguous agreement, against the original borrower if he had tried to avoid the security agreement based on the mistaken date. However, the Seventh Circuit explained that a bankruptcy trustee is in a different position. A bankruptcy trustee is tasked with maximizing recovery for unsecured creditors. To perform this task, the Bankruptcy Code gives a bankruptcy trustee so-called "strong-arm powers" that enable the trustee to defeat security interests that were not properly perfected before a debtor filed bankruptcy. The Seventh Circuit conceded that the result was harsh, but said that it was necessary to protect the ability of subsequent creditors to rely on unambiguous security agreements. Accordingly, the Court of Appeals held that the security agreement secured indebtedness under a December 13, 2008, promissory note. Because there was no December 13, 2008, promissory note, there was no debt to secure and, therefore, no security interest.

In its decision, the Seventh Circuit cited at length a previous Seventh Circuit decision, *In re Martin Grinding & Machine Works, Inc.*, 793 F.2d 592, 595 (7th Cir. 1986), where the court rejected a similar argument that the security agreement at issue had inadvertently omitted the debtor's inventory and accounts receivable from the collateral description. The Seventh Circuit confirmed that *Martin* is still good law, and that an unambiguous security agreement will be enforced according to its terms, regardless of the parties' intent.

### PRACTICAL CONSIDERATIONS

Secured parties should exercise great care when drafting the terms of security agreements and consider performing loan file reviews on a regular basis to avoid unwelcome surprises after a borrower files for bankruptcy.

# BANKRUPTCY COURT REFUSES TO ALLOW DEBTOR AND COMMITTEE TO RE-NEGOTIATE CARVE-OUT FROM SECTION 363 SALE PROCEEDS

*Sarah Kam*
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*In re Stacy's, Inc.*, 508 B.R. 370 (Bankr. S.C. 2014)

#### CASE SNAPSHOT

The U.S. Bankruptcy Court, District of South Carolina denied the debtor's motion to use sale proceeds included in the lender's cash collateral or, in the alternative, to surcharge the sale proceeds after the debtor underestimated tax and other claims. The debtor did not meet its burden of proving adequate protection for the use of cash collateral; res judicata barred the debtor from asserting a surcharge claim against the lender; the tax liability did not arise from preserving or disposing of the lender's collateral; and the "equities of the case" exception did not apply.

#### FACTUAL BACKGROUND

Immediately after filing a chapter 11 petition, the debtor filed a motion seeking authorization to sell substantially all of its assets free and clear of liens to a stalking horse bidder under section 363 of the Bankruptcy Code. The debtor did not negotiate with its lender who held a security interest on the debtor's assets (including proceeds) regarding a bankruptcy sale. The debtor also did not notify the secured lender of its plan to file bankruptcy.

The lender objected to the sale motion. The parties disputed a carve-out from the sale proceeds for payment of allowed general unsecured claims and allowed administrative expense claims. The debtor amended its schedules to list the lender's claim as disputed in order to obtain approval of the sale over the lender's objection under section 363(f)(4) of the Bankruptcy Code, and filed an adversary proceeding seeking to surcharge the lender's collateral under section 506(c) of the Bankruptcy Code. The committee also filed a motion seeking authorization to proceed with litigation on behalf of the debtor against the lender and others.

The parties ultimately negotiated a consensual sale that included a $450,000 carve-out for allowed general unsecured claims, a $950,000 carve-out for allowed administrative expense claims, dismissal of the debtor's adversary proceeding against the lender, the committee ceasing litigation against the lender, a release of the lender by the debtor and the committee, and an allowed secured claim for the lender.

A few months after the sale closed, the debtor realized it underestimated its expenses and filed a motion to use the sale proceeds included in the lender's cash collateral or, in the alternative, to surcharge the sale proceeds under section 506(c) of the Bankruptcy Code.

#### COURT ANALYSIS

As to the debtor's request for authorization to use cash collateral under section 363(c)(2), a debtor may not use cash collateral unless the secured creditor consents or the debtor provides adequate protection to the secured creditor. The bankruptcy court distinguished an unpublished Fourth Circuit opinion pointed to by the debtor, which suggested that a bankruptcy court did not need to address adequate protection because the creditor consented to use of its cash collateral to pay certain expenses. The bankruptcy court concluded that the debtor did not meet its burden of proving adequate protection for the use of cash collateral.

As to the debtor's request to surcharge the collateral under section 506(c), res judicata barred the re-litigation of the surcharge claim that the debtor agreed to dismiss as part of the consensual sale. The debtor's asserted lack of knowledge regarding the additional expenses did not alter the bankruptcy court's conclusion that res judicata barred the surcharge claim. Moreover, section 506(c) only permits the recovery of the reasonable, necessary costs and expenses of preserving, or disposing of, a secured party's collateral. The debtor did not demonstrate that the additional expenses related to disposing of the lender's collateral, or that the lender received a direct and quantifiable benefit.

Finally, the bankruptcy court noted that the equities of the case exception under section 552(b)(1) did not apply to further reduce the lender's collateral beyond the carve-outs to which it agreed. The equities of the case exception places significant weight on whether the debtor used unencumbered funds at the expense of unsecured creditors to increase the value of the secured creditor's collateral. No evidence established that the debtor used unencumbered assets post-petition to increase the value of the lender's collateral. Rather, the debtor's estate operated through the use of the lender's collateral.

#### PRACTICAL CONSIDERATIONS

It may be difficult to re-negotiate a carve-out from sale proceeds once a sale is approved by the bankruptcy court, even if circumstances change.

## DUTCH COMPANY, NEW YORK LAW – AN ENGLISH SCHEME OF ARRANGEMENT?

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*DTEK Finance B.V., Re* [2015] EWHC 1164 (Ch)

### CASE SNAPSHOT

Following upon the November judgment in *Re APCOA Parking Holdings GmbH*, last week Mrs Justice Rose sanctioned a scheme of arrangement between DTEK Finance B.V. ("DTEK"), a Dutch company, and holders of notes issued by DTEK in 2010 (the "Notes"). Notably, this case reinforces the finding in *APCOA* that a non-English company without substantial connection to England can nevertheless avail itself of an English scheme of arrangement by changing the governing law in its debt documents to English law.

### FACTUAL BACKGROUND

DTEK is part of a group of energy companies generating and selling electricity to customers in Ukraine and elsewhere. DTEK initially issued the Notes in 2010 under New York law, but due to various financial difficulties did not think it would have the resources necessary to repay the Notes when they matured in April 2015. Given the impending maturity date, DTEK put together a proposal for its noteholders whereby DTEK would acquire and cancel the Notes in exchange for giving the noteholders new notes for 80 percent of the par value with a 2018 maturity date, and a cash payout for the remaining 20 percent of the Notes (the "Proposal"). Under the terms of the Indenture, the Proposal could be approved without court sanction if 98 percent of the Noteholders agreed to it.

On 23 March 2015 DTEK launched an exchange offer and consent solicitation requesting consent to the Proposal, and also "invited noteholders to agree to certain changes in the terms of the [Notes], including a change of the governing law [from New York] to English law" to enable DTEK to pursue a scheme of arrangement if sufficient agreement to the Proposal was not obtained (the "Consent Solicitation"). DTEK received agreement from 91.1 percent to the Consent Solicitation, which was not enough to approve the Proposal, but was enough to change the governing law to English law, thus enabling DTEK to avail itself of an English scheme of arrangement and restructure the Notes as set out in the Proposal notwithstanding its inability to receive the 98 percent acceptance to the Proposal as required under the Notes documents.

Permission to convene a meeting of noteholders was granted by Nugee J, and the meeting of the noteholders was held on 23 April 2015. The scheme was approved by over 90 percent of the noteholders at the meeting.

### COURT ANALYSIS

At the sanction hearing on the scheme, Rose J, considered whether the change in governing law of the Notes from New York law to English law was a sufficient connection to England to grant the courts of England jurisdiction and justified an exercise of her discretion to approve the scheme.

Rose J began by affirming that an English governing law clause in a debt instrument was a sufficient connection for the purposes of establishing jurisdiction. She then turned to whether the connection with England was any less sufficient in the present case because English law was not the original governing law, and the change to the governing law was made only a few weeks prior to the sanction hearing and done solely to allow DTEK to use a scheme of arrangement and bypass the consent requirements under the 2015 Notes.

Rose J, applied the judgment set out in *Re APCOA Parking Holdings GmbH*, and found that there was a sufficient connection, noting that the 2015 Notes had always included a provision for a possible change to the governing law and that this formed part of the bargain that commercial noteholders had signed up to. She also noted that the legal experts present agreed that New York law did not prohibit a change in law.

Additionally, Rose J, noted the existence of three other factors which further satisfied her that there was a sufficient connection with England beyond the governing law of the Notes, namely that:

1. Some of the guarantees provided by Ukrainian companies within the group were (and always had been) governed by English law;
2. DTEK had moved its centre of main interests ("COMI") to England (noting the decision in *Re Magyar Telecom* that moving COMI for the purpose of obtaining a court sanctioned scheme of arrangement did not prevent the sufficient connection arising);
3. DTEK had substantial assets in England, namely cash in its London bank account.

Finally, legal opinions confirming the effectiveness of the scheme in the Netherlands, where DTEK was incorporated and in the various jurisdictions of the guarantors further assured the court of the practical effect of the scheme.

As regards to the overall fairness and the exercise of the court's discretion, Rose J was satisfied that (despite some mooted but unsubstantiated opposition) there was no reason not to sanction the scheme. (A copy of the judgment may be found here).

### PRACTICAL CONSIDERATIONS

This case both affirms the principles set out in *APCOA* and sets out some practical steps that a non-English company may want to take to increase the likelihood that a proposed scheme of arrangement will be successfully sanctioned. More importantly, however, it indicates that *APCOA* was not an overreach by English courts, but instead a sign of things to come. This judgment will likely make English schemes of arrangement that much more attractive to companies in need of a quick and affordable means of restructuring their debt outside of a formal insolvency process.

## BANKRUPTCY COURT REJECTS CREDITOR ARGUMENT THAT PLAN NOT FEASIBLE, REFUSES TO VACATE ORDER CONFIRMING CHAPTER 11 PLAN

*Sarah Kam*
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*In re GST, LLC*, Case No. 13-00705 (Bankr. D.C., Dec. 15, 2014)

### CASE SNAPSHOT

The U.S. Bankruptcy Court, District of Columbia denied the secured creditor's motion for reconsideration of the bankruptcy court's order confirming the debtor's second amended chapter 11 plan. The debtor offered legally sufficient evidence of the plan's feasibility; the court appropriately weighed the evidence, taking into account numerous factors relevant to feasibility; and the motion offered no persuasive grounds for the court to vacate its order confirming the debtor's plan.

### FACTUAL BACKGROUND

The secured creditor objected to, among other things, the feasibility of the debtor's plan that proposed to make payments on the secured creditor's $987,117.72 claim based upon a 30-year amortization schedule at a 6.25 percent per annum interest rate, with a balloon coming due 10 years after the effective date of the plan. In its motion for reconsideration, the secured creditor contended that under section 1129(a)(11) of the Bankruptcy Code, the debtor failed to make an adequate non-speculative showing that it could fund the plan.

### COURT ANALYSIS

In order to confirm a plan, the feasibility requirement under section 1129(a)(11) requires a finding that "[c]onfirmation of the plan is not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor or any successor to the debtor under the plan, unless such liquidation or reorganization is proposed in the plan." Applying the factors set forth in *Chelsea State Bank v. Wagner (In re Wagner)*, 259 B.R. 694, 671 (B.A.P. 8th Cir. 2001), which the secured creditor and debtor relied upon, the bankruptcy court concluded that the debtor met its burden to show the feasibility of the proposed plan.

The bankruptcy court rejected the secured creditor's contention that the debtor's failure to produce a lease barred the debtor from offering testimony of the debtor's intent to lease its commercial space as a means of funding the plan. The best-evidence rule under Fed. R. Evid. 1002, which requires the production of the original document in order to prove the contents of a writing, does not apply if a witness' testimony is based on first-hand knowledge of an event as opposed to knowledge of the document. The debtor offered the testimony of the potential lessee demonstrating the mutual intent and likelihood that the lessee would operate a dry cleaning operation on the debtor's premises with a sufficient margin to fund the plan.

The bankruptcy court also rejected the secured creditor's contention that the lessee's projected revenue for its operation constituted mere speculation. Although historic revenues may be preferable, the testimony of the potential lessee was grounded in business experience rather than in "pie in the sky projections." The debtor's projected income also adequately covered plan payments and operating expenses. In addition, although the term of the plan was 10 years, the debtor's one-year projections gave the court a meaningful framework within which to assess whether the debtor's income will generally be in line with its expenses. The debtor further showed a reasonable likelihood of being able to refinance the debtor's property in 10 years by virtue of the increased loan-to-value ratio. Thus, the bankruptcy court denied the secured creditor's motion for reconsideration.

### PRACTICAL CONSIDERATIONS

In determining whether a chapter 11 plan is feasible under section 1129(a)(11), bankruptcy courts do not generally require a guarantee of success. Rather, the feasibility requirement is often met if the debtor can show a reasonable possibility of success.

## COUNSEL'S CORNER: NEWS FROM REED SMITH

**Peter Clark** was named to the *United States Lawyer Rankings* 2015 list of the "Nation's Top 10 Bankruptcy Lawyers." The *United States Lawyer Rankings* can be viewed at www.unitedstateslawyerrankings.com.

**Theresa Davis** conducted a webinar, "Conducting Internal Investigations Amid Heightened Government Scrutiny of Corporate Practices," March 10.

**Robert Simons** and **Amy Tonti** conducted a seminar, "Contingency Planning in the Distressed Energy Market: Legal Considerations Involving a Shutdown, Restructuring, Acquisition or Bankruptcy Filing," March 17 in Pittsburgh.

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