ReedSmith

The business of relationships.℠

CR&B Alert

Commercial Restructuring & Bankruptcy News

OCTOBER 2015, ISSUE 3

In This Issue:

- Third Circuit: Bankruptcy Sale Proceeds Not Subject to Bankruptcy Code Priority Scheme—2
- French Supreme Court Rules out Liability for Undercapitalising Companies—2
- Security Interest Was Perfected Even Though Financing Statements Filed Prior to Debtor's Execution of the Security Agreements—5
- Insider Guarantor Not a 'Creditor' Where Indemnification Rights Are Waived—6
- Court Refuses to Recharacterize Loans from Sole Shareholder Even Though Business Was Undercapitalized—7
- Litigation Funding for Liquidators in Singapore: Re Vanguard Energy Pte Ltd—8
- The Third Circuit's Internal Split on the Viability of Equitable Mootness Continues—10
- Who Owns the Social Media Accounts in a Closely Held Business?—11
- 'Operating Interests,' 'Working Interests,' 'Production Payments' and 'Overriding Royalty Interests' – How Do These Interests Fit Within 'Property of a Debtor's Estate' Under the Bankruptcy Code?—12
- *Landlord's Corner*—15
- What Constitutes 'Value' Under Texas UFTA? Fifth Circuit Vacates Its Decision and Certifies the Question to the Texas Supreme Court—16
- Delaware Bankruptcy Court Holds Section 502(b)(6) 15% Cap Applies to Time, Not Rent—17
- Pre-Petition Sublease Termination Not Avoidable Where Termination Is Valid under State Law—18
- Surety's Entitlement to Subrogation Precludes Debtor from Retaining Funds—18
- Make-Whole Premium Is Not Owed Unless the Indenture Expressly Requires Payment upon Acceleration—19
- Secured Creditor and Purchaser of Mortgage Debt Portfolio Cannot Claim Lack of Privity with Debtor—20
- The Absolute Priority Rule Applies to Chapter 11 Debtors—21
- Applying Section 510(b), Court Subordinates Judgment Claim of Former LLC Member—21
- Bankruptcy Court Upholds Debtor's Right to Offset Vendor Overpayments and Trade Credits Against Section 503(b)(9) Claims—22
- Chapter 7 Trustee Recovers Repayments of 'True Overdrafts' to Depository Bank as Preferential Transfers—23
- Claims Against Separate Debtors Must Be Treated Separately When Cases Are Jointly Administered and Not Consolidated—25
- Counsel's Corner: News From Reed Smith—25

THIRD CIRCUIT: BANKRUPTCY SALE PROCEEDS NOT SUBJECT TO BANKRUPTCY CODE PRIORITY SCHEME

Peter S. Clark, II
Firmwide Practice Group Leader
Philadelphia

The United States Court of Appeals for the Third Circuit recently upheld a bankruptcy asset sale where some of the funds were used to pay unsecured creditors over other priority creditors, in *In re ICL Holding, Inc.* No. 14-2709 (3rd Cir. Sept. 14, 2015). Specifically, the court held that escrows that the secured creditor buyer established to pay wind-down costs, professional fees and settlement payments to unsecured creditors were not property of the estate and therefore were not required to be distributed in accordance with the Bankruptcy Code's priority requirements. The case is another step in the direction of making the Third Circuit the most bankruptcy sale-friendly jurisdiction in the country, following its decision in *In re Jevic Holding Corp.* that a structured dismissal of a chapter 11 case was permissible even if the scheme of distribution to creditors deviated from the Bankruptcy Code requirements. [*Jevic* was discussed in *Global Restructuring Watch*, the blog of Reed Smith's Commercial Restructuring and Bankruptcy group, which aims to keep you informed of the latest developments and emerging trends within global restructuring and bankruptcy law. Click here to subscribe.].

FRENCH SUPREME COURT RULES OUT LIABILITY FOR UNDERCAPITALISING COMPANIES

Anker Sørensen[1]
Partner, Paris

(This article first appeared in *International Corporate Rescue*, Volume 12, Issue 4, 2015)

Minimum share capital requirements have disappeared from French legislation over the past few years, leaving the *société anonyme* as the last and only commercial company with such a requirement, set by the French Commercial code at EUR 37,000,[2] thereby increasing the need in practice to accurately determine the equity and debt financing required when starting operations.

In this regard, two decisions addressing the liability of the main shareholder and the Managing Directors (the 'MDs') of commercial companies in the case of undercapitalisation, were recently rendered by the Commercial chamber of the French Supreme Court (hereafter the 'Supreme Court'). In both matters, although based on different facts, the liability of shareholder and MDs, respectively, was not triggered.

In the first case, the unusual attempt by a subsidiary, not subject to any insolvency proceedings, to target the deep pockets of its parent company was dismissed by the Paris Court of Appeal.

In the second case, the court-appointed liquidator of the company, which had filed for insolvency, obtained a ruling by the Bordeaux Court of Appeal sentencing the two MDs, who were also shareholders of the company, to assume personal responsibility for a part of the company's outstanding debts. The decision by the Court of Appeal was overruled in a short decision, setting a ground-breaking precedent.

I. SA Rhodia v SA Sanofi: the end of the saga[3]

a. Facts

In 1997, Rhône-Poulenc spun off its entire chemical, fibres and polymers division to an existing, fully owned subsidiary named Rhône-Poulenc Fibres and Polymers, later renamed as Rhodia. The spin-off was carried out by way of the sale of the shares of the chemical division by Rhône-Poulenc to Rhodia, funded by a share capital increase in cash by Rhône-Poulenc.

As a consequence, Rhodia acquired not only assets, but also liabilities associated with the transferred division, including pension liabilities and environmental liabilities. In 1998, Rhodia's shares were listed on the Paris and New York stock exchanges. A year later, Rhône-Poulenc, after disposing of the majority of Rhodia's shares, merged with the German group Hoechst to create Aventis, which was later acquired by Sanofi Synthelabo, renamed Sanofi in 2011.

In 2005, Rhodia informed Sanofi of its intention to claim compensation for damages that it claimed had resulted from the transfer by Rhône-Poulenc of liabilities and obligations as part of the spin-off.

In 2007, Rhodia pursued a claim in tort against Sanofi before the Paris Commercial Court, claiming that it could not discharge the pension and environmental liabilities and related expenses due to an undercapitalisation by Rhône-Poulenc during the stage of its creation. Rhodia also claimed that Sanofi should have financially supported its subsidiary, given the lack of resources resulting from the structuring of the spin-off.

b. Decision

The Paris Commercial Court dismissed Rhodia's claim, holding that there was no proof of negligence or recklessness on the part of Rhône-Poulenc during the creation of Rhodia. It was also confirmed that there was no duty owed by Rhône-Poulenc to provide indefinite and unlimited support to a former subsidiary.

The Paris Court of Appeal took an identical stance and dismissed Rhodia's claim on all grounds, and this stance was approved by the Supreme Court 12 May 2015.[4] The Supreme Court insisted and relied on the interpretation of the facts by the Court of Appeal on all grounds, and its decision was based on three main arguments:

CONTINUED ON PAGE 3

- First, the Supreme Court acknowledged that Rhône-Poulenc contributed equity, through several share capital increases in cash and a discharge of debt, up to the amount of EUR 2.17 billion[5], to Rhodia. Hence, it ruled that Rhodia suffered no damages from its level of capitalisation, set by its former shareholder, Rhône-Poulenc.
- Second, it further ruled that the Court of Appeal, based on its findings, rightfully held that Rhône-Poulenc had shown no negligence or recklessness during the creation of Rhodia on the basis that (i) there is no 'good practice' governing the transfer of pension liabilities that Rhône-Poulenc should have complied with, and (ii) the environmental liabilities did not overburden Rhodia, as the financial structure was considered sufficient by several experts and investment banks.
- Last, it held that the difficulties encountered by Rhodia were caused by the challenges faced in the chemical sector and a number of costly transactions (such as the acquisitions of Albright & Wilson and Chirex made by Rhodia in 1999 and 2000, respectively), rather than by the pension liabilities or environmental liabilities.

c. Comments

A distinctive feature of the decision rendered by the Court of Appeal is that, rather than being based on legislation or existing case law, it is very factual, and that Rhodia failed to provide adequate evidence. The meticulous emphasis placed on facts by the Court of Appeal greatly influenced the outcome of the Supreme Court's decision, as French civil procedure rules[6] solely allow the latter to control the adequacy of the decision subject to the appeal with French law. Facts are 'evaluated without appeal' (*'appréciés souverainement'*) by the Court of Appeal and therefore cannot be subject to a new evaluation or interpretation by the Supreme Court. Consequently, the Supreme Court's decision was rather predictable as all the facts pointed toward the conclusion, according to the Court of Appeal, that Rhône-Poulenc did not undercapitalise its former subsidiary. On the contrary, Rhône-Poulenc contributed to its future success through healthy share capital increases and a major discharge of debt, which contributed to Rhodia becoming a major player in the chemical industry market.

Interestingly, the Supreme Court stated twice in its decision that the Court of Appeal had rightfully considered, based on its findings and analysis of the facts, that Rhône-Poulenc had not disregarded Rhodia's interests, nor breached its duty of care and prudence (*'ses obligations de prudence et de diligence'*) when Rhodia was created.[7] This repeated statement in relation to such a duty owed by shareholders at the creation of a company, which was among the arguments developed by Rhodia, seems to set a standard for the control to be exercised by the lower courts when ruling on similar issues.

Although the Court of Appeal and the Supreme Court did not give any indication as to the legal nature of the above-mentioned duty, it is very likely that it is not an absolute obligation (*'obligation de résultat'*), but a so-called *'obligation de moyen'*, which is characterised by the fact that a failure to obtain a result does not in itself equal a breach of the obligation.

This decision also puts an end to a decade of claims and proceedings initiated by Rhodia against its former shareholder in different jurisdictions and countries, thereby ending a litigation saga.[8]

II. No liability for mismanagement by the MDs of a company incorporated with insufficient equity to fund its operations

a. Facts

During the creation process of a limited liability company (*'société à responsabilité limitée'*), the two founders agreed that the share capital of the new company would be contributed in cash for EUR 10,000 by one of the founders and contributed in kind for EUR 190,000 by the other. The company was later placed in liquidation and the court-appointed liquidator claimed in two separate proceedings that the statutory MDs had mismanaged the company and were liable on the grounds of article L. 651-2[9] of the French Commercial code for the company's shortfall of assets (*'insuffisance d'actif social'*).

b. Decision

After a very detailed and fact-based presentation, the Court of Appeal[10] overruled the judgment of the Commercial court[11] and judged that both MDs had contributed insufficient capital to the company at its creation, as an act of mismanagement under article L. 651-2 of the French Commercial code. The court subsequently held that the two MDs were liable to cover, in different proportions, a part of the company's shortfall of assets.

The Supreme Court, in its ruling, which expressly refers to article L. 651-2 of the French Commercial code, overturned the ruling of the Court of Appeal and held, apparently for the first time, that the contribution of sufficient equity to a company during its creation phase is an obligation of the shareholders of that company, and as such cannot be considered as an act of mismanagement by MDs.

c. Comments and conclusion

This decision is ground-breaking as it puts an end to a contrary line of case law[12] in respect of an MD's liability to sufficiently capitalise a company at its constitution.

One question is whether the Supreme Court would have reached a different conclusion in this case, if the claim had been brought against the shareholders rather than against the same persons in their legal capacity as MDs. In such an event, would the shareholders have been deemed to have complied with their duty of care and prudence as required per the *Rhodia v Sanofi* decision?

This question may be of even greater interest considering that a number of companies, heavily leveraged at their creation, are currently subject to severe financial difficulties, which may have been predictable, given the aggressive structuring of their business plans and financing models at the outset.

1 The author would like to thank his trainee, Thomas Allain, for his enthusiastic involvement in the preparation of this article.

2 Article L. 224-2 of the French Commercial code.

3 For this case, the reader can refer to the article published by the same author analysing the decision rendered by the Paris Court of Appeal 17 September 2013: *'SA Rhodia v SA Sanofi:* Maternity Obligations do not Extend to Funding the Offspring in Spin-offs', *International Corporate Rescue*, Volume 11, Issue 2, 2014.

4 Commercial chamber, *Rhodia v Sanofi*, No. 13-27.716

CONTINUED ON PAGE 4

[5] The court has inconsistently and erroneously referred to EUR 2.17 million on page 5 and EUR 2.18 billion on page 8 of its decision, whereas the combined amount of the share capital increases and discharge of debt is in fact EUR 2.78 billion (i.e., two share capital increases of EUR 609 million and EUR 650 million, and a discharge of debt of EUR 1.52 billion).

[6] Article 604 of the French Civil Procedure Code.

[7] Here, the Supreme Court erroneously refers to the '*creation*' of Rhodia. The term '*creation*' is inaccurate, as the company previously existed under the name Rhône-Poulenc Fibres et Polymers and was apparently incorporated almost 10 years prior to the spin-off. Obviously, the Supreme Court may have referred here to the time of the spin-off and the start of the operational existence of Rhodia – for more information on this aspect, please refer to the author's prior article, 'Maternity Obligations do not Extend to Funding the Offspring in Spin-offs', *International Corporate Rescue*, Volume 11, Issue 2, 2014, p. 75.

[8] For more details about the previous proceedings, please refer to the author's article: '*SA Rhodia v SA Sanofi:* Maternity Obligations do not Extend to Funding the Offspring in Spin-offs', *International Corporate Rescue*, Volume 11, Issue 2, 2014.

[9] This article is the French equivalent of section 214 of the UK Insolvency Act 1986 (wrongful trading) and enables French courts to hold statutory and *de facto* directors liable for the shortfall of assets in case of a court-ordered liquidation, when the directors have committed acts of mismanagement that have contributed to such shortfall.

[10] Bordeaux, Second Civil Chamber, 21 November 2011, RG: 10/01945.

[11] Angoulême, 10 December 2009, RG 2008X01139, *Hirou v Ribette & Ollard*.

[12] Commercial Chamber of the Supreme Court, 23 November 1999, No. 97-12834; 27 May 2003, No. 00-14981; Rouen, 20 October 1983.

SECURITY INTEREST WAS PERFECTED EVEN THOUGH FINANCING STATEMENTS FILED PRIOR TO DEBTOR'S EXECUTION OF THE SECURITY AGREEMENTS

Alison Wickizer Toepp
Associate, Richmond

In re The Adoni Group, Inc. No. 14-11841, Adv. No. 14-02382 (Bankr. S.D.N.Y. May 4, 2015)

CASE SNAPSHOT

In a case of first impression, the bankruptcy court dismissed an adversary complaint challenging a creditor's security interest, holding that the creditor's security interest was properly perfected under the Uniform Commercial Code as enacted in New York, even though the financing statement was filed prior to the date on the security agreements at issue.

FACTUAL BACKGROUND

After an involuntary petition was filed against the debtor, the Official Committee of Unsecured Creditors brought an adversary proceeding against a creditor, Capital Business Credit, LLC, challenging Capital's security interests in the debtor's accounts and inventory. For its first claim, the Committee sought to avoid Capital's security interests on the ground the interests were not properly perfected because the debtor had not signed the security agreements at the time the financing statement was filed. Thus, according to the Committee, the financing statement was void. For its second claim, the Committee asserted that the court should disallow and expunge Capital's secured claims on the ground that the financing statement was of no effect.

The parties disputed whether the financing statement was filed before or after the security agreements were actually signed—with Capital asserting that the security agreements were erroneously post-dated. Capital moved to dismiss the Committee's first two claims, arguing that sections 9-502 and 9-509(b) of the Uniform Commercial Code, when read together, established that the debtor's signing of the security agreements conferred authority on Capital regardless of whether the financing statement predated the security agreements.

Even taking the Committee's allegations as true, the court agreed with Capital's interpretation of the statutes and granted its motion to dismiss the Committee's first two claims.

COURT ANALYSIS

Section 9-502(d) of the UCC as enacted in New York provides that "a financing statement may be filed before a security agreement is made or a security agreement otherwise attaches." Section 9-509(a) provides in pertinent part that a person may file a financing statement "only if: (1) the debtor authorized the filing in an authenticated record or pursuant to subsection (b) or (c)," while section 9-509(b) provides in pertinent part that "[b]y authenticating or becoming bound as debtor by a security agreement a debtor or new debtor authorized the filing of an initial financing statement and an amendment."

The Committee argued that section 9-502(d) applies only if the financing statement is "authorized" (under the UCC) at the time the statement was filed, or if the statement is otherwise "ratified" (under common law). The Committee, although conceding that a debtor may later ratify a financing statement, also argued that the wording of section 9-509 required the debtor to provide *advance* authorization to Capital. Capital, however, urged that section 9-509 does not require advance authorization, and that inserting such a requirement into subsection (a) would be inconsistent with the automatic authority contemplated in subsection (b).

The court noted that section 9-510, which provides "[a] record is effective only to the extent that it was filed by a person that may file it under Section 9-509," is "oddly-worded" and "of little use in answering the question raised" by Capital's motion to dismiss. In the absence of reported case law on the issue, the court turned to secondary sources and the Official Comments to the UCC to aid in its interpretation of the statutes. Several of the Official Comments referred to post-filing authorization or ratification of prior financing statements; so, too, did the secondary source the court cited.

The court held that the policy underlying the UCC—i.e., to put potential creditors on notice—supported Capital's position that the financing statement was authorized by the debtor's later-dated security agreements. Granting Capital's motion as to the Committee's first two claims, the court explained: "This goal was met here, as Capital put others on notice of Capital's claimed security interests on May 15. The fact that the Financing Statement was filed one day before the Security Agreements were signed does not violate the 'notice' purposes of such a filing, and is a sequence of events that the statute permits."

PRACTICAL CONSIDERATIONS

Security interests may not be avoided merely because a financing statement is filed before a debtor provides authority to the creditor.

INSIDER GUARANTOR NOT A 'CREDITOR' WHERE INDEMNIFICATION RIGHTS ARE WAIVED

Marsha Houston
Partner,
Los Angeles

Christopher Rivas
Associate,
Los Angeles

Stahl v. Simon (*In re Adamson Apparel, Inc.*), 785 F.3d 1285 (9th Cir. 2015)

CASE SNAPSHOT

The Ninth Circuit affirmed the dismissal of a preference action against the debtor's insider guarantor. An insider guarantor ordinarily faces preference liability if its guaranty obligations are reduced by a payment by the debtor that has the effect of reducing the guarantied debt. But where the guarantor contractually waives any indemnification by the debtor and acts consistently with such a waiver, the insider is not a "creditor" of the bankruptcy estate and, thus, even if the insider received an indirect benefit from the preferential transfer, the insider is not subject to Bankruptcy Code section 547.

FACTUAL BACKGROUND

In 2002, debtor Adamson Apparel, Inc. borrowed more than $8 million from a commercial lender. The loan was personally guarantied by Adamson's president, Arnold Simon, who waived all of his indemnification, subrogation and reimbursement rights (referred to in the decision collectively as "indemnification rights") against Adamson pursuant to the written guaranty. In 2003, Adamson sold a large amount of merchandise to BP Clothing LLC, which was instructed to transfer approximately $5 million of the sale proceeds directly to the lender in repayment of Adamson's debts to the lender. Guarantor Simon paid the remaining $3.5 million debt to the lender from his own personal funds. Nine months later, Adamson filed bankruptcy.

The Committee of Unsecured Creditors sued Simon under a preference liability theory arguing that Simon benefitted from the $5 million transfer to the lender because the transfer reduced his guaranty liability. On summary judgment, the bankruptcy court found that because Simon waived any indemnification rights against Adamson, he was not a creditor of the estate, and, therefore, the Committee could not prove that the transfer was "to or for the benefit of a creditor" as to Simon, as required by section 547(b)(1) to establish preference liability. After an initial appeal by the Committee to the district court that was remanded for further findings, the bankruptcy court found that: the lender required Simon to contractually waive all indemnification rights; the lender and Simon both understood that Simon was waiving such rights; and Simon acted consistently with the waiver, including by not filing any proofs of claim in the bankruptcy case. The bankruptcy court ruled again that Simon was not a creditor and, therefore, could not be liable for alleged preferential transfers. On further appeal, the district court affirmed, and the Committee appealed to the Ninth Circuit.

COURT ANALYSIS

On an issue of first impression at the circuit level, the Ninth Circuit considered whether an indemnification waiver relieved a guarantor from preference liability; an issue about which bankruptcy courts have been split. The split arose out of the Seventh Circuit's opinion in 1989 in *In re Deprizio* and Congress' subsequent response to the *Deprizio* decision. The Seventh Circuit in *Deprizio* ruled not only that the one-year, look-back period for insider preferences applied to payments that benefitted insider guarantors, but that lenders receiving such payments would also be liable. In 1994, Congress addressed concerns that innocent lenders faced extended liability under *Deprizio*, by amending Bankruptcy Code section 550(c) to exclude lenders from the one-year, look-back period.

Bankruptcy court decisions made after *Deprizio* but prior to the 1994 amendment found that guarantors who waived indemnification rights could not be liable for preferential transfers, because the guarantors were not "creditors" as required by Bankruptcy Code section 547(b)(1). However, after the 1994 amendment, bankruptcy courts in Delaware, Illinois and Tennessee departed from the earlier line of cases, holding that such "*Deprizio* waivers" could be "shams" because a guarantor could obtain a claim against the debtor's estate by purchasing the note rather than by paying the lender under the guaranty, and subsequently asserting a claim against the debtor as noteholder rather than as guarantor.

Analyzing the decisions, the Ninth Circuit ruled in a 2-1 decision that the post-1994 decisions improperly created a bright-line rule based on a "fear of what *could* happen," rather than analyzing the facts to determine what actually *did* happen. Where an insider guarantor acted consistent with the indemnity waiver and did not take any actions to undermine the economic benefit to the debtor of the waiver (e.g., by purchasing the note to assert a claim, or otherwise asserting a claim in the bankruptcy case), such waiver was not a "sham waiver" and the insider was therefore not a creditor of the debtor. Applying this standard to the facts before it, the Ninth Circuit ruled that because Simon took no actions to undermine the waivers in his guaranty, he was not a creditor of Adamson's estate with respect to the guaranty, and could therefore not be liable for any preferential payments made by Adamson to the lender.

PRACTICAL CONSIDERATIONS

The *Adamson* decision provides an additional defense for insider guarantors facing potential preference liability, provided that the guarantors waived any indemnity rights against the debtor and that they act consistently with such a waiver, including by not filing a proof of claim or attempting to purchase the note to circumvent the guaranty waivers, or otherwise asserting a claim against the debtor. Insider guarantors who have waived indemnity rights against a debtor should seek the advice of experienced bankruptcy counsel before seeking to enforce any of their rights against a debtor to determine whether the potential benefits of enforcing such rights would be outweighed by potential liability to the guarantor for any preferential transfers.

COURT REFUSES TO RECHARACTERIZE LOANS FROM SOLE SHAREHOLDER EVEN THOUGH BUSINESS WAS UNDERCAPITALIZED

Melissa Mickey
Associate, Chicago

In re Alternate Fuels, Inc., No. 14-3086 (10th Cir. June 12, 2015)

CASE SNAPSHOT

The Tenth Circuit Court of Appeals reversed the bankruptcy court's authority to recharacterize claims as equity contributions. The Tenth Circuit held that loans made by a sole shareholder to his distressed business were legally enforceable even though the business was undercapitalized and unable to obtain loans from third parties.

FACTUAL BACKGROUND

The debtor, Alternate Fuels, Inc. ("AFI"), was a Kansas corporation that engaged in coal mining operations. In December 1999, William Karl Jenkins and his wife purchased from John Warmack, the sole shareholder of AFI: (i) all of the outstanding shares of AFI and 99 percent of the stock in AFI's operating company, (ii) certain equipment owned by AFI's operating company, and (iii) 24 certificates of deposit that were pledged to secure bonds in favor of the State of Missouri to guarantee AFI's reclamation obligations to restore permitted mining sites to their original condition. Jenkins and his wife paid $549,250 directly to Warmack for this transaction. Jenkins entered into the transaction with the express purpose of fulfilling the mining company's obligations to restore the permitted mining sites. In connection with the transaction, AFI executed three promissory notes payable to Green Acres Farms, a fictitious business name Jenkins registered with the state of Missouri. Jenkins was aware that AFI had no present ability to repay the note from its own funds.

In 2002, AFI filed a lawsuit against certain state officers and employees, alleging tortious interference with the completion of AFI's reclamation process. In exchange for Jenkins continuing to fund AFI and as security for his loans, on March 1, 2003, AFI assigned $3 million of its potential recovery to Jenkins. In 2006, a judgment was entered in favor of AFI for actual damages of approximately $5.5 million and punitive damages of $900,000. After learning about the judgment, AFI's creditors began making claims against the judgment proceeds. In January 2009, AFI filed for bankruptcy for assistance in determining the priority of payment.

Jenkins filed a proof of claim in the bankruptcy case in the amount of $4.3 million. The claim included $3.8 million for payment of the three promissory notes, plus interest, secured by AFI's assignment of $3 million of the judgment proceeds. The bankruptcy court found that the transfers evidenced by the promissory notes underlying Jenkins' claim should be recharacterized as equity. The bankruptcy court also held, in the alternative, that Jenkins failed to provide sufficient documentation to prove the amount of his claim. Finally, the bankruptcy court held that Jenkins' secured claim should be equitably subordinated to an unsecured claim. On appeal, the Tenth Circuit Bankruptcy Appellate Panel affirmed the bankruptcy court's decision. Jenkins then appealed to the Tenth Circuit Court of Appeals.

COURT ANALYSIS

In its decision, the Tenth Circuit applied the 13 factors set forth in the *Hedged-Investments* case to determine whether the bankruptcy court should have exercised its authority under section 105(a) to recharacterize debt as camouflaged equity. The Tenth Circuit noted that these factors are not exclusive, and no single factor is dispositive. At the outset, the Tenth Circuit emphasized that Jenkins was engaged in a venture with substantial risk, and the court found nothing inherently improper about purchasing equity in a struggling business and providing advances when the business needed additional financial support.

After considering all of the *Hedged-Investments* factors under the facts of the case, the court found that recharacterization of Jenkins' advances was not warranted. The Tenth Circuit reached this conclusion because, among other things, the instruments were labeled as promissory notes, sufficient consideration was given, and advances serving as consideration for a note do not necessarily need to precede the note's execution. Additionally, the Tenth Circuit found that there was no evidence that Jenkins increased his participation in the management of AFI as a result of his advances.

The Tenth Circuit found no support for many of the bankruptcy court's findings in favor of recharacterization. Specifically, the Tenth Circuit found that there was no reason to assume that all funds transferred to a business owned by a single stockholder must be in the nature of equity. Likewise, the Tenth Circuit disagreed with the bankruptcy court that the notes lacked a fixed maturity date (which might indicate a capital contribution). Each note expressly stated that the "[p]rincipal balance plus accrued interest shall be due and payable five (5) years from the date" of execution. Although the notes provided a contingency, the Tenth Circuit found that a contingency does not render an otherwise definite deadline illusory for purposes of this analysis.

The Tenth Circuit also held that equitable subordination was inappropriate. The Tenth Circuit noted that the bankruptcy trustee did not argue, and the bankruptcy court did not find, that Jenkins engaged in any fraud or illegality when obtaining the three notes or in taking the assignment of the judgment proceeds. Furthermore, the bankruptcy court did not find that Jenkins controlled AFI as an instrumentality or mere alter ego, and the bankruptcy trustee's arguments to the contrary were unpersuasive. The Tenth Circuit declined to hold that a company becomes the alter ego of its majority shareholder simply because that shareholder funds a project that will ultimately benefit him. Finally, the Tenth Circuit found that none of Jenkins' actions were unfair.

For these reasons, the Tenth Circuit reversed the bankruptcy court and BAP, holding that recharacterization and equitable subordination were not appropriate, and Jenkins satisfied his burden of proof as to the validity of the amount of his claim.

PRACTICAL CONSIDERATIONS

This case should serve as a reminder that courts are reluctant to equitably subordinate or recharacterize debt as equity absent some type of egregious conduct.

LITIGATION FUNDING FOR LIQUIDATORS IN SINGAPORE: RE VANGUARD ENERGY PTE LTD

Troy Doyle
Partner,
Singapore

Estelle Victory
Associate,
Singapore

The case of *Re Vanguard Energy Pte Ltd* was heard in Singapore recently, with judgment handed down by the High Court 9 June 2015.

Of significance to liquidators and underlining the importance of this case to the insolvency profession in Singapore, Judicial Commissioner Chua Lee Ming stated that "it is undeniable that litigation funding has an especially useful role to play in insolvency situations."

Key Points

This decision brings clarity to liquidators taking appointments in Singapore on a number of aspects.

- It was held to be valid to assign the rights to the proceeds of claims to the parties who provided litigation funding to conduct them.
- The assignment of proceeds did not fall within, or offend, the doctrine of champerty and maintenance, a concept devised to protect the interests and "purity" of litigation.
- It may be possible for an assignment of proceeds to exceed the level of litigation funding provided.

Background

Vanguard Energy Pte Ltd had filed three actions in the High Court prior to being placed into compulsory liquidation 21 November 2014, and had also identified various other potential claims (the **Claims**).

The liquidators were unwilling to proceed with the Claims without an indemnity or funding from a third party, given that Vanguard, as is typical for insolvent companies, had insufficient assets.

Litigation funding was proposed to allow Vanguard to proceed with the Claims, in the hope of achieving a better result for the liquidation than if the Claims were not pursued because of lack of funds.

The Application

The High Court was requested to consider the application for approval of the terms of a funding agreement. This was later amended to a request to consider an assignment of the proceeds agreement (the **Assignment Agreement**), which the Court approved.

The terms of the Assignment Agreement were similar to those of the funding agreement, save that, rather than comprising a promise by Vanguard to repay the funding provided (as per the funding agreement), the Assignment Agreement provided for the *sale* of the rights to certain proceeds of the Claims, capped at the amount of funding provided by the assignees (**Assigned Property**). Notably, the three assignees were shareholders of Vanguard, one of whom was a director, and the other two were former directors (**Assignees**). Accordingly, the Assignees had an interest in the outcome of the litigation.

The Assignment Agreement

Under the Assignment Agreement:

- Vanguard would meet the upfront funding of 50 percent of the solicitor-and-client costs, and pay security for costs, to a specified maximum (**Co-Funding**).
- The Assignees would:
  - o Fund party-and-party and other legal costs
  - o Provide a banker's guarantee, payable on demand, to be increased for each additional action commenced relating to a potential Claim
  - o Indemnify Vanguard against any shortfall between the proceeds of the Claims and the Co-Funding, and any damages, compensation, costs, security, interest or disbursements which Vanguard may agree to or be ordered to pay in relation to the Claims (apart from the Co-Funding)
- Any amounts received by Vanguard following the settlement, discontinuance or final judgment of the claims (the **Recovery**) would be applied:
  - o To Vanguard, up to the amount of the Co-Funding
  - o To the Assignees, up to the amount of funding they had provided
  - o Any surplus thereafter to be paid to Vanguard.
- The Assigned Property would be sold to the Assignees by way of assignment.
- The liquidators would have full control of the proceedings, save that the Assignees must agree to the choice of solicitors, and any settlement or discontinuance of any Claim.

The Judgment

The liquidators submitted that it was in the best interests of Vanguard to enter into the Assignment Agreement. The Assignment Agreement would allow Claims to be pursued which might otherwise not be, at minimal risk of depleting the estate's assets. It would also offer an opportunity for enhanced recovery if the proceeds of the Claims exceeded the cost of funding.

Key aspects considered in the proceedings were:

Was the assignment a sale of property? The Judicial Commissioner held that the assignment was a sale of Vanguard's property, considering that section 272(2)(c) of the Companies Act (Cap 50, 2006 Rev Ed) (the **Act**) "*permits the sale of a cause of action as well as the proceeds from such actions*".

In making this assessment, the Court considered the approach taken under English and Australian case law. The Court also considered statutory definitions of "property" in those jurisdictions, given this was not defined in the Act.

Under the English Insolvency Act 1986, property includes "*things in action … and every description of interest … whether present or future or vested or contingent, arising out of, or incidental to, property*".

CONTINUED ON PAGE 9

Under the Australian Corporations Act 2001, the definition of property includes "*any legal or equitable estate or interest (whether present or future and whether vested or contingent) … and includes a thing in action*".

The Court considered the definition of "property" under the Singapore Bankruptcy Act (Cap 20, 2009 Rev Ed) and noted that this included "*things in action, land and every description of property wherever situated and also obligations and every description of interest, whether present or future or vested or contingent, arising out of or incidental to, property*". This definition was imported into the interpretation of section 272(2)(c) of the Act to remove any doubt as to the application of the English and Australian law approaches.

Did the doctrine of maintenance and champerty apply and, if so, was this offended by the assignment? The statutory power of sale under section 272(2)(c) of the Act was held to apply and the doctrine of champerty and maintenance (the **Doctrine**) was considered to have no application.

The judgment went on to set out that, in any event, the Assignment Agreement did not offend the Doctrine, giving reasons including:

- The fact that the Assignees had a genuine commercial interest in the litigation (being shareholders and either current or former directors, with one of the three also being a creditor of Vanguard) and therefore fell within a common law exception to the Doctrine.
- The Assignment Agreement did not offend the policy reasons behind the Doctrine (in summary, these are to protect the purity of justice and the interests of vulnerable litigants).

A factor in concluding that the Assignment Agreement did not offend the Doctrine was that the liquidators retained substantial control of the litigation, and the Assignees would not be in a position to influence the outcome of the litigation.

In his judgment, the Judicial Commissioner added that it would not "be fatal even if the Assignees were to be entitled to a share in the Recovery exceeding the amount they funded", indicating that the removal of the cap on recoveries (as in the current case, to the level of funding provided) may not preclude them from being able to enter into litigation funding arrangements.

Would the payments to the Assignees contravene section 328(1) of the Companies Act and could they be approved under section 328(10)? The Judicial Commissioner considered the application of sections 328(1) and 328(10) of the Act, which govern the statutory order of payments out of an insolvent estate. He concluded that these did not apply because, in receiving their portion of the Recovery, the Assignees would be "simply recovering what has already been sold to them". This position would have been different under the funding agreement, which would have contravened the statutory order of payments.

Comment

This judgment brings clarity to liquidators taking appointments in Singapore on the ability to enter into litigation funding arrangements to enable companies in liquidation to access potential recoveries from claims which may otherwise never be commenced due to lack of funding. The comment that it would not "be fatal even if the Assignees were to be entitled to a share in the Recovery exceeding the amount they funded" could pave the way for insolvency litigation funding arrangements which envisage a return in excess of the funding provided in the event of a successful claim.

THE THIRD CIRCUIT'S INTERNAL SPLIT ON THE VIABILITY OF EQUITABLE MOOTNESS CONTINUES

Derek Baker
Partner, Philadelphia
and Princeton

In re One2One Communications LLC,
No. 13-3410, 2015 (3d Cir. July 21, 2015)

In re Tribune Media Co., No. 14-3332
(3d Cir. Aug. 19, 2015)

In two precedential decisions issued in as many months, the United States Court of Appeals for the Third Circuit addressed the doctrine of equitable mootness. In *In re One2One Communications LLC*, No. 13-3410, 2015 (3d Cir. July 21, 2015), a panel of the United States Court of Appeals for the Third Circuit evaluated the appropriateness of dismissal of an appeal on equitable mootness grounds. In 1996, the Third Circuit adopted the doctrine of equitable mootness in a 7-6 en banc decision. *In re Continental Airlines*, 91 F.3d 553 (3d Cir. 1996) (en banc). In *Continental Airlines*, the Third Circuit adopted the doctrine to avoid adjudicating an appeal if the adjudication could have rippling effects on a confirmed plan beyond just those parties before the court. Although each of the other federal circuits has adopted some form of "equitable mootness doctrine," at least three courts of appeals have recently limited use of the doctrine. See, e.g., *Miami Beach Lodging LLC v. Sagamore Partners Ltd.* (*In re Sagamore Partners Ltd.*), Case No. 14-11106, (11th Cir. July 13, 2015); *In re Transwest Resort Properties Inc.*, at *1 (9th Cir. July 1, 2015); *In re Pacific Lumber Co.*, 584 F.3d 229, 240 (5th Cir. 2009).

Over the past several years, the Third Circuit has stressed that equitable mootness should be applied narrowly and sparingly, and only in "complex reorganizations when the appealing party should have acted before the plan became extremely difficult to retract." *In re One2One Communications LLC* at *13 (quotations omitted). The court reiterated the "five prudential factors" that inform equitable mootness rulings from *Continental Airlines*, see 91 F.3d at 568, but essentially collapsed the analysis into "two analytical steps: (1) whether a confirmed plan has been substantially consummated; and (2) if so, whether granting the relief requested in the appeal will (a) fatally scramble the plan and/or (b) significantly harm third parties who have justifiably relied on plan confirmation." See *In re Semcrude LP*, 728 F.3d at 321.

Because the doctrine essentially eliminates appellate review, the court reiterated that the party seeking dismissal on equitable mootness grounds has the burden of proving that the "five prudential factors" fall in favor of avoiding the appeal and should be limited to circumstances involving intricate transactions, often involving publicly traded debt or securities. Here, the panel noted that, while the plan was substantially consummated without a stay, the "garden variety" nature of the reorganization did not warrant the application of equitable mootness. The panel highlighted that there was no finding that intricate transactions under the plan would be unable to be unraveled and/or that specific harms would incur to third parties who had relied upon the plan.

Although agreeing that the district court should have considered the merits of the appeal (and concurring in the reversal), a strongly worded 38-page concurrence raised numerous objections to the "judge-made nature" of the equitable mootness doctrine, and called into question whether an Article III decision to avoid reviewing a bankruptcy court confirmation order was appropriate under the Supreme Court's recent decisions on bankruptcy court authority in *Wellness International Network, LTD v. Sharif*, 575 U.S. (2015) and *Stern v. Marshall*, 564 U.S. 2 (2011).

In the *In re Tribune Media Co.*, No. 14-3332 (3d Cir. Aug. 19, 2015) decision (written by Judge Ambro), the court restated the equitable mootness standards originally promulgated in *In re Continental Airlines*, and again focused on the two-step analysis adopted in *In re Semcrude, LP*. In this appeal, the court was presented with two side-by-side appeals from a confirmed plan of reorganization. The district court initially dismissed both appeals as equitably moot.

The court focused on whether a confirmed plan has been substantially consummated and, if so, whether the relief sought in the appeal would (i) fatally scramble the plan or (ii) present significant harm to third parties who have justifiably relied on plan confirmation. In both appeals, the appellants acknowledged that the plan had been substantially consummated (thereby satisfying the first prong of the *Semcrude* analysis). For purposes of the equitable mootness analysis, the court assumed that the appellant would be successful in its ultimate appeal on the merits. The court then analyzed the relief that was being sought by the appellant to determine whether such relief could be fashioned on appeal. In one appeal, the appellant sought to reverse the confirmation order so as to undo one of the settlements contained in the plan. In the other appeal, the appellant was seeking to reverse the confirmation order so as to enforce a subordination provision that prohibited the payment of funds to a particular class of creditors.

The Court of Appeals first reviewed the appeal seeking to reverse the confirmation order to overturn the settlement contained in the confirmed plan. The court noted that the settlement was the central issue in the formulation of the plan of reorganization; to allow the settlement to be overturned would essentially revert the debtor back to its pre-bankruptcy situation. The court noted that the appellant originally opposed the plan (and had presented its own competing plan), which objection was overruled. Despite the opportunity to obtain a stay pending appeal with the posting of a bond for $1.5 billion, the appellant refused to post the bond and instead attempted to proceed on an expedited appellate basis. When the plan was substantially consummated, funds were invested into the plan (including settlement funds), and those settlement funds were thereupon distributed to various creditors in accordance with the plan's distribution scheme. The court noted that such a wide-ranging reliance was important for the equitable mootness analysis. The court held that third parties have interests that are worthy of protection because it encourages investments-behavior to contribute to a success reorganization. The court also highlighted that this appellant failed to post the bond to stay confirmation so as to prevent the substantial exchange of funds upon which numerous third parties relied. As a result of the failure to take advantage of that action, the court held that equity favored third parties, and that the court should not proceed to review the underlying confirmation order on the merits on equitable mootness grounds.

With respect to the second appeal, the court noted that the appellant was simply seeking relief pursuant to its alleged subordination agreement. There, the appellant was arguing that funds distributed to a lower class of creditors should have been paid to the appellant pursuant to its subordination agreement. There, the court noted that granting the appellants the relief that they seek would have

CONTINUED ON PAGE 11

no detrimental effect on innocent third parties. Rather, the relief sought by the appellant would only seek to redistribute the distributions among two classes of the plan in accordance with an appropriate determination on the merits. Therefore, the court reversed the lower court's prior dismissal and ordered a determination of the merits.

In addition to authoring the majority opinion, Judge Ambro authored a concurring opinion to address the issues raised by the concurring opinion in *One2One Communications, LLC*. First, the Judge Ambro concurrence argues that equitable mootness does not raise any constitutional concerns because equitable mootness is a judge-made doctrine and is not an instance where Congress is seeking to require an Article III issue to be determined by an Article I adjudicator. Therefore, the concerns of *Stern* and *Wellness International* are not implicated.

Further, equitable mootness is merely a further extension of principles of equity to address a situation where an Article III court has determined that it would be inequitable to grant the relief requested. Article III courts utilize equitable principles in various instances to ensure that the relief sought would not adversely affect innocent third parties, and would be in the public interest. Judge Ambro argues that equitable mootness follows that same line of thinking so as to prohibit granting relief that would upset third-parties' legitimate reliance on the finality of that plan.

Finally, Judge Ambro's concurrence highlights that any party seeking an appeal always has the ability to ensure against an equitable mootness determination. The appealing third party can obtain a stay of the decision pending appeal, and has the absolute right to post a bond in order to secure that stay.

The panel's decisions reiterate that courts should endeavor to give parties their full day in court (including appellate review); however, they continue to show an internal split as to how pervasively equitable mootness can insulate a confirmation order. They also emphasize that an appellant's best defense against an equitable mootness attack is to take steps to secure a stay of the confirmation order to protect its appellate rights.

WHO OWNS THE SOCIAL MEDIA ACCOUNTS IN A CLOSELY HELD BUSINESS?

Christopher Rivas
Associate, Los Angeles

In re CTLI, LLC, 528 B.R. 359
(Bankr. S.D. Tex. 2015)

CASE SNAPSHOT

In an issue of first impression, a Texas bankruptcy court holds that a business' social media accounts are property of its bankruptcy estate.

FACTUAL BACKGROUND

Debtor CTLI, LLC operated a gun store and shooting range in Texas. At the time of CTLI's chapter 11 bankruptcy filing, Jeremy Alcede owned a majority of the company, and Steven Wilson, a wealthy investor, owned a minority stake. After disputes arose between the owners and CTLI defaulted on its loans, Wilson sought to place a receiver in charge of CTLI, but Alcede preemptively caused the company to file bankruptcy before the receiver could take control. Alcede remained in control of the debtor during the pending bankruptcy.

Upon the expiration of the exclusivity period, Wilson proposed a plan of reorganization pursuant to which he became 100 percent owner of CTLI. Upon confirmation of the plan, the bankruptcy court ordered Alcede to deliver possession and control of the passwords for CTLI's Facebook and Twitter accounts. Alcede refused to comply, arguing that the social media accounts belonged to him personally and that it would violate his personal privacy if he were required to turn over the accounts. The bankruptcy court ordered the appointment of a neutral party to separate the business content in the social media accounts from Alcede's personal information, to which Alcede initially consented on the record, but later changed his mind and objected. Alcede also began using the Facebook and Twitter pages to denigrate Wilson and to harm CTLI's business. The bankruptcy court then ruled the social media accounts were entirely property of CTLI's estate, and that no neutral party was necessary because none of Alcede's privacy rights was implicated.

COURT ANALYSIS

The Texas bankruptcy court found that social media accounts were clearly estate property under the broad provisions of Bankruptcy Code section 541, which has been defined broadly in case law to include "all kinds of property, including tangible or intangible property." The court examined the limited case law on a bankruptcy estate's ownership of social media accounts, including a 2014 Florida decision finding that a debtor had no interest in the "likes" of a Facebook page, because individuals could "unlike" the debtor's page at any time, and a 2011 New York decision finding to the contrary and analogizing "likes" to a debtor's subscriber list. The Texas bankruptcy court ruled that the social media accounts were property of the estate, and that even though fans of the Facebook page could "unlike" CTLI's page and Twitter followers could "unfollow" CTLI's Twitter page, they were effectively no different from other similar property of a debtor, including email list subscribers and customer lists.

The Texas bankruptcy court disposed of Alcede's constitutional arguments. The court found that although an individual's Facebook or Twitter page comprised the individual's "persona," and that the persona was protected from transfer under the 13th Amendment of the Constitution (which prohibits involuntary servitude), there were no such concerns for a business account. The bankruptcy court ruled that although CTLI's Facebook page may have been started by Alcede for personal reasons, it was clearly used for purposes of marketing and promoting CTLI's business, and even though Alcede closely associated his own identity with his business, the two were legally distinct. Similarly, the bankruptcy court was

CONTINUED ON PAGE 12

not persuaded that Alcede's posts to Twitter (i.e., his "Tweets") were personal merely because Alcede provided his updates regarding his attendance at gun shows or his anti-Obama political views. These Tweets were clearly aimed at drumming up CTLI's gun-selling business and were an integral part of CTLI's professional goodwill, and were similar to marquee banners physically posted at CTLI's building with such messages as "I like my guns like Obama likes his voters / undocumented." The fact that Alcede testified in the bankruptcy that he was a "PR genius" corroborated that his Facebook and Twitter accounts were merely marketing tools used by Alcede to generate business for CTLI, and were, therefore, part of CTLI's bankruptcy estate.

PRACTICAL CONSIDERATIONS

The *CTLI* decision reflects a common-sense analysis of a bankruptcy debtor's ownership of social media accounts. As businesses continue to expand their social media presence, a debtor's social media accounts will likely constitute valuable property of the debtor's estate. Where the debtor is closely held or where its account is managed by the debtor's principal, questions may arise regarding who the accounts belongs to; but the *CTLI* decision reflects a broad view that a principal's unusual or offbeat social media messages, which are still clearly oriented at marketing the principal's business, do not change the ownership nature of the social media accounts from business accounts to personal accounts.

'OPERATING INTERESTS,' 'WORKING INTERESTS,' 'PRODUCTION PAYMENTS' AND 'OVERRIDING ROYALTY INTERESTS' – HOW DO THESE INTERESTS FIT WITHIN 'PROPERTY OF A DEBTOR'S ESTATE' UNDER THE BANKRUPTCY CODE?

Robert Simons
Partner,
Pittsburgh

Amy Tonti
Partner,
Pittsburgh

(This article originally appeared in and is reprinted with permission from the June issue of *The Bankruptcy Strategist* 2015 © ALM Media Properties, LLC. Further duplication without permission is prohibited. All rights reserved).

The recent decline in oil prices and the historically low and stagnant natural gas prices are causing various parties in the oil and gas industries to seek bankruptcy protection. As a result, bankruptcy judges must apply specialized Bankruptcy Code provisions and varying other applicable non-bankruptcy laws to determine the rights of debtor and non-debtor parties to such agreements as those providing Overriding Royalty Interests (ORRI) and Net Operating Interests (NOI).

For guidance, the Bankruptcy Code defines certain terms such as "Farmout" (section 101(21A), "Term Overriding Royalty" (section 101(56A), and "Production Payments" (section 101(42A). However, bankruptcy courts must also resort to the application of non-bankruptcy laws that classify various interests in minerals, oil and gas as "real property," while others deem the interests "personal property," and yet others treat the interests as a third kind of property – distinguished from real and personal property. For a good visual overview of the various mineral rights considerations in bankruptcy, **see http://tinyurl.com/k6eezx6**.

The Bankruptcy Code enumerates exceptions to the otherwise wide breadth of "Property of the Debtor's Estate." Some of the exceptions include: (i) any power that the debtor may exercise solely for the benefit of an entity other than the debtor (§ 541(b)(1)); (ii) any interest of the debtor as a lessee under a lease of nonresidential real property that has terminated at the expiration of the stated term of such lease before the commencement of the bankruptcy case, and ceases to include any interest of the debtor as a lessee under a lease of nonresidential real property that has terminated at the expiration of the stated term of such lease during the case (§ 541(b)(2)); and (iii) any interest of the debtor in liquid or gaseous hydrocarbons to the extent that – (A)(i) the debtor has transferred or has agreed to transfer such interest pursuant to a *farmout agreement* or any written agreement directly related to a farmout agreement; *and* (A)(ii) but for the operation of this paragraph, the estate could include the interest referred to in clause (i) only by virtue of section 365 or 544(a)(3) of this title; *or* (B)(i) the debtor has transferred such interest pursuant to a written conveyance of a *production payment* to an entity that does not participate in the operation of the property from which such production payment is transferred; and (B)(ii) but for the operation of this paragraph, the estate could include the interest referred to in clause (i) only by virtue of section 365 or 542 of this title (emphasis added) (§ 541(b)(4)).

The owner of a mineral interest – usually a landowner – grants a right to explore, drill, and produce to an E&P operator – referred to as an "Operating Interest" or "Working Interest." "Royalty Interests" generally convey the right to share in a contracted portion of production – if production occurs. Often, owners of mineral estates that grant a Working Interest retain a Royalty Interest. "Net Profit Interests" generally are carved out of the Working Interest, but are payable from net production profits over a stated term. ORRIs generally are pared out of the Working Interest, while Royalty Interests are carved from the Mineral Interest.

Several courts have recently considered whether "Production Payments" are always "Overriding Royalty Interests" (see *NGP Capital Resource Co. v. ATP Oil & Gas Corp.* (*In re ATP Oil and Gas*), Case No. 12-36187, Adv. No. 12-03443, Doc No. 145 at 32 (Bankr. S.D. Tex. Jan 6, 2013)). See also, *Tow v. HBK Main Street Investments, L.P.* (*In re ATP Oil and Gas*), Case No. 12-36187, Adv. No. 14-03286, Doc No. 27 (Bankr. S.D. Tex. Mar 10, 2015). Courts have also determined whether the debtor's interest is held solely for the benefit of a third party and hence is not Property of the Estate. (*Dahlberg v. ConocoPhillips Co.* (*In re Reichmann Petroleum Corp.*), 434 B.R. 790, 797-798 (Bankr. S.D. Tex. 2010), addressing whether the debtor's estate held technical title to revenue from interests, while the interests are held solely for the benefit of a third-party, non-working interest owner.)

Other cases dealing with the oil and gas interest addressed whether the non-debtor interest rises to the level of a conveyance of real property, such that

CONTINUED ON PAGE 13

the debtor retains little advantage over the interest-holder. For example, under Pennsylvania property law, oil and gas leases do not vest oil and gas interests until production; hence, they are considered executory prior to production, and the contract is subject to rejection as either an executory contract or an unexpired lease. If production has not occurred prior to the bankruptcy filing of the debtor-lessor, then the lessee’s interest remains “inchoate.” *T.W. Phillips Gas & Oil Co. v. Jedlicka*, 42 A.3d 261, 267 (Pa. 2012). Section 362(a)(3) of the Bankruptcy Code prevents this inchoate interest of the lessee from converting to freehold estate.

The result is that the debtor-lessor’s estate remains the owner of the oil and gas interest. If the agreement is deemed a real property lease (as opposed to a contract) (see, 11 U.S.C. § 365(m)), the lessee would retain rights under the lease even if the lease is rejected, such that the lessee can enforce its rights to exploration. 11 U.S.C. § 365(h)(1)(A)(ii). See *In re Mustafa Tayfur v. Swepi LP, Central Appalachian Petroleum, et al.*, No. 14-3478 (3d Cir. March 18, 2015) (holding because the lessee retains the rights to exploration, the debtor-lessor could not relet for more money, and hence did not meet the test necessary to reject the lease – that rejection would be financially beneficial to the debtor’s estate). If production had occurred prior to the petition date, then the lessee’s interest would be a “fee” ownership, and not property of the debtor’s estate. Id.

A case to watch is *In re Delta Petroleum General Recovery Trust, et al. v. BWAB Limited Liability Company* (Adv. Proc. No. 12-50898), and *In re Delta Petroleum General Recovery Trust, et al. v. Aleron Larson, Jr.* (Adv. Proc. No. 12-50877) (Bankr. D. Del. Apr. 2, 2015) (Dkt. No. 110). In *Delta Petroleum*, the court considered cross motions for summary judgment regarding the parties’ rights under various ORRI and NOI agreements entered into between 1994 and 1999.

Delta Bankruptcy Filing

On Dec. 16, 2011, Delta (and most but not all of its affiliates) filed chapter 11 Bankruptcy Petitions. The debtors’ Bankruptcy Schedules listed an NOI as a real property interest. Neither BWAB nor Larson, counterparties to the ORRIs, filed proofs of claim in the Delta bankruptcy case. Delta obtained approval from the bankruptcy court to continue making payments under the ORRIs, and made such payments until September 2012. Delta confirmed its chapter 11 plan in August 2012. Among other things, the plan transferred all property of Delta’s Estate to the Post-Confirmation Trust – free and clear of all liens, claims and encumbrances.

Post-Confirmation Litigation

A Trustee under a Post-Confirmation Trust filed complaints against BWAB and Larson, the counterparties to the ORRIs, arguing that the rights and claims under the ORRI agreements constitute: (i) contractual rights to payment or claims that have been discharged by the debtors’ confirmed chapter 11 plan of reorganization; or (ii) real property interests that may be avoided and recovered pursuant to Bankruptcy Code sections 544(a)(3) and 550 because of failure to record the interest. Larson and BWAB defended and countersued, asserting that under the ORRI agreements, they hold real property interests that were not part of the debtor’s bankruptcy estate or that passed through the bankruptcy case unaffected.

Relying on California law, the court recited that “[A] land owner may enter into an oil and gas lease which grants to an operating lessee the privilege of entering upon the land for the purpose of producing oil and gas, [and] the interest thus created in the lessee is a profit a prendre, that is, an incorporeal hereditament or interest in real property. [citations omitted]. The term ‘overriding royalty’ is applied generally in the industry to such fractional interests in the production of oil and gas as are created from the lessee’s estate. [citations omitted]. … Both California and Colorado have determined that overriding royalty interest is an interest in real property. [citations omitted].” *In re Delta Petroleum*, Case No. 12-50877, Dkt. No. 110 at page 15-16.

1994 ORRI

The Post-Confirmation Trustee argued that the 1994 ORRI is not a real property interest, but was an interest in “net profits” rather than an interest in oil and gas, and therefore was a contractual interest for the payment of money that was extinguished by the debtors’ plan. The Trustee also argued that the 1999 NOI Agreement transferred Whiting’s interest in the net revenues to Delta; therefore, the net revenues became property of the debtors’ estate. BWAB countered that the 1994 ORRI is a real property interest owned by BWAB, and therefore it never became part of the Debtors’ Bankruptcy Estate and could not be extinguished by the plan.

Examining the language of the 1994 ORRI, “particularly its definition of ‘Net Revenues,’” the court found that the ORRI, “established the parties’ intent to grant BWAB a fractional interest in the revenue received from the hydrocarbons produced by Whiting’s working interest in the Properties, after specific deduction.” Therefore, the court held the 1994 ORRI should be treated in the same manner as a typical overriding royalty interest in real property, as consistent with California law. Further, the real property interest was properly recorded at the time of its grant in 1994. As for the 1999 NOI Agreement, the court noted that agreement provided for the assignment of the net revenues after deduction of the royalties and overriding royalties, and hence it did not alter the rights of BWAB under the 1994 ORRI. Consequently, because the 1994 ORRI is a real property interest of BWAB, that interest was not extinguished, stripped or avoided by confirmation of Delta’s chapter 11 plan.

1999 BWAB ORRI / Assignment and the 1999 Larson ORRI /Assignment

The Post-Confirmation Trustee challenged the 1999 ORRIs on two grounds: (i) the NOI transferred by Whiting to Delta was not a real property interest and hence the 1999 ORRIs cannot be a real property interest; and (ii) if the court holds that the 1999 ORRIs are real property interests, then the interests are avoidable because the interests were not recorded pursuant to the strong-arm provision of section 544(a)(3) of the Bankruptcy Code. BWAB and Larson argue that 1999 ORRIs are real property interests, but the 1999 ORRIs could not be recorded because the NOI was not recorded, hence the chain of title would not be complete.

The crucial determination to the rights of the parties, as with the 1994 ORRI, was whether the 1999 ORRIs conveyed real property interests to Larson and BWAB. The various analytical permutations that were considered by the court are summarized as follows.

CONTINUED ON PAGE 14

‘Operating Interests,’ ‘Working Interests,’ ‘Production Payments’ and ‘Overriding Royalty Interests’ – How Do These Interests Fit Within ‘Property of a Debtor’s Estate’ Under the Bankruptcy Code?—continued from page 13

Real Property or Not

The 1999 Assignments, which embodied the 1999 ORRIs, provided that “Delta conveyed overriding royalty interest in the oil and gas leases and lands,” and hence appear to be ORRIs. However, other language in the 1999 Assignment provided that Delta “conveyed a fractional percentage of the interest that Delta obtained from Whiting in the NOI Agreement.” Because the 1999 Assignment contained conflicting language on its face, the court determined that further evidence was needed to clarify the parties’ intention. Hence, summary judgment was denied. The court further held that just because the Debtor listed the NOI on its Bankruptcy Schedules as a “real property interest,” it would not bind the Post-Confirmation Trustee to such a conclusion as to the nature of the NOI.

Failure to Record the ORRIs if Real Property

Even though summary judgment was denied, the court considered if the 1999 ORRIs were real property interests, whether the failure to record the ORRIs in the public records permits the Post-Confirmation Trustee to avoid the ORRIs pursuant to the strong-arm provision of section 544(a)(3) of the Bankruptcy Code. Relying on California law that requires holders of ORRIs to duly record their interests, the court concluded that if the ORRIs were real property, the failure to record would make the ORRIs avoidable pursuant to the strong-arm provision of section 544(a)(3) of the Bankruptcy Code.

If ORRIs Not Real Property

Neither BWAB nor Larson filed Proofs of Claim, and the 1999 Agreements were not in default until after the debtors’ chapter 11 plan was confirmed and no additional payments were made. The Post-Confirmation Trustee asserted that if the ORRIs are not real property, they are merely claims for the payment of money, which were discharged under the Plan. The court concluded that “although there was no breach prior to the Plan Effective Date, the contractual right to payment is a claim within the definition in Bankruptcy Code § 101(5). Accordingly, to the extent that the 1999 ORRIs are contractual rights to payment [and not real property interests], they are ‘claims: that are subject to the discharge provisions of the Debtors’ confirmed Plan.’”

Recovery of Post-Petition Payment

The Post-Confirmation Trustee also sued to recover post-petition payments made to Larson and BWAB under the 1999 Agreements, because the 1999 Agreements are avoidable under section 544(a)(3). However, if the payments were “*production payments*” or “*term overriding royalty*,” they would be excluded from Property of the Estate pursuant to section 541(b)(4)(B), and hence not recoverable. The court reserved judgment on the Post-Confirmation Trustee’s request for turnover of post-petition payments made on the 1999 Agreements under section 542(a), pending further briefing.

The court denied the Post-Confirmation Trustee’s request for unjust enrichment, and claw-back of post-petition payments, as well as those for recovery under fraudulent transfer laws and other avoidance recoveries.

Conclusion

When dealing with interests, rights and claims involving oil and gas, bankruptcy counsel must carefully consider: (i) the parties’ rights under applicable non-bankruptcy law (local real property, state laws, federal law, etc.) – which may differ significantly depending on the applicable jurisdiction(s); (ii) the effect of the parties’ agreement (beyond the title); and (iii) the unique Bankruptcy Code provisions that apply to these interests, rights and claims (e.g., 11 U.S.C. §§ 541 (b)(4)).

LANDLORD'S CORNER

Derek Baker
Partner, Philadelphia and Princeton

In this edition of the *Landlord's Corner*, we address two recent decisions out of the Third Judicial Circuit concerning the application of section 502(b)(6) of the Bankruptcy Code to the rejection of non residential real property leases.

Section 502(b)(6) of the Bankruptcy Code imposes a cap on the total amount of damages a landlord may assert as a result of the rejection of a lease of real property. The statutory language provides that the landlord may only seek damages equal to the pre-petition arrears owed plus damages resulting from the rejection limited to approximately one year's rent or rent for 15 percent of the remaining term of the lease, not to exceed three years. That statutory cap applies to all damages resulting from the termination of the lease effected as a result of the rejection.

In a decision from the U.S. Bankruptcy Court for the District of Delaware in *In re Filene's Basement, LLC*, the court was tasked with addressing the proper computation of the cap. In particular, the court was addressing whether the statutory language of "15% of the remaining term not to exceed three years" required the court to focus on whether the "cap" applied to the amount of time of the remaining lease term or to gross rent that would be due. In *In re Filene's Basement, LLC,* the court followed what now appears to be the majority view. The cap is based on an analysis of the remaining time under the lease. That was the same analysis undertaken and applied by the *In re Heller Ehman, LLP* in the Northern District of California (and reported in the *Landlord's Corner* from June 2011). In *In re Filene's Basement*, the court also noted that the cap would apply to any and all damages resulting from the termination of the lease, including damages resulting from the cleaning costs the landlord incurred to return the property to "broom clean" condition upon rejection. The *Filene's Basement, LLC* case is important because it represents the first discussion of the computation of the cap out of the District of Delaware, which is a significant jurisdiction for retail cases.

In another matter, the U.S. District Court for the Middle District of Pennsylvania in *High Five Ventures, Inc. v. Sportsman Liquidators.com LLC* addressed whether to apply section 502(b)(6) of the Bankruptcy Code in an equitable receivership context. Although there was no pending bankruptcy case, an equitable receiver was appointed for all of the assets of the defendant. In the context of that action, the receiver terminated certain leasehold interests of the defendant and the landlord asserted damages. The receiver, in an attempt to maximize the receivership estate and to limit the amount of claims that would be asserted by the landlord, sought to apply the statutory cap from the Bankruptcy Code to the equitable receivership proceeding. While the court recognized that it has wide discretion to fashion an appropriate plan of distribution in an equitable receivership, the court refused to apply a singular section of the Bankruptcy Code to that receivership distribution in a manner that would pointedly affect a single group of creditors – i.e., landlords. As a result, the court rejected the receiver's application to apply the statutory cap to the landlord's claim in the equitable receivership context.

This case is an important precedent in light of the proliferation of non bankruptcy restructuring and workout scenarios. While the Bankruptcy Code imposes and creates a very detailed system of distributions and claims allowance, which is often used in certain non-bankruptcy scenarios, the *High Five Venture, Inc.* decision makes clear that parties should not be entitled to "cherry pick" certain provisions of the Bankruptcy Code for application in non-bankruptcy context.

WHAT CONSTITUTES 'VALUE' UNDER TEXAS UFTA? FIFTH CIRCUIT VACATES ITS DECISION AND CERTIFIES THE QUESTION TO THE TEXAS SUPREME COURT

Sarah Kam
Associate, New York

Janvey v. The Golf Channel, Inc., 780 F.3d 641 (5th Cir. 2015), *Opinion Vacated and Superseded on Rehearing by Janvey v. Golf Channel, Inc.*, No. 13-11305, 2015 WL 3972216 (5th Cir. June 30, 2015).

CASE SNAPSHOT

The U.S. Court of Appeals for the Fifth Circuit avoided as a fraudulent transfer under the Texas Uniform Fraudulent Transfer Act (TUFTA) the debtor's payment of $5.9 million to a cable network for marketing services. TUFTA provides an affirmative defense to avoidance of a fraudulent transfer if the transferee proves: (i) that it took the transfer in good faith; and (ii) that, in return for the transfer, it gave the debtor something of "reasonably equivalent value." According to the Fifth Circuit, the cable network failed to introduce evidence that its services preserved the value of the debtor's estate or provided utility from the creditors' viewpoint. In addition, the cable network's services, which encouraged investment in the debtor's Ponzi scheme, did not provide value to the creditors as a matter of law. On a petition for rehearing, the Fifth Circuit vacated its opinion and certified to the Texas Supreme Court the question of what showing of "value" under TUFTA is sufficient for a transferee to prove the elements of the affirmative defense.

FACTUAL BACKGROUND

Stanford International Bank operated a Ponzi scheme through its affiliated entities. Stanford targeted the typically high-net-worth sports audiences and became a title sponsor of an annual PGA Tour event. In turn, the cable network broadcasting the event offered Stanford an advertising package. Stanford entered into a two-year agreement with the cable network for marketing services, which the parties agreed to renew for four years. Stanford paid at least $5.9 million to the cable network under this agreement.

The SEC uncovered Stanford's Ponzi scheme and filed a lawsuit against Stanford and related entities, requesting the appointment of a receiver over Stanford. The district court assumed exclusive jurisdiction, seized Stanford's assets, and appointed a receiver. The receiver filed suit under TUFTA to recover the full $5.9 million from the cable network. The district court ruled that although Stanford's payments to the cable network were fraudulent transfers under the TUFTA, the cable network was entitled to the affirmative defense that it received the payments in good faith and in exchange for reasonably equivalent value, and granted the cable network summary judgment.

The receiver appealed the decision to the Fifth Circuit, arguing that the cable network did not give "reasonably equivalent value" in exchange for the $5.9 million it received when it provided the marketing services to Stanford.

COURT ANALYSIS

Initial Decision - The Fifth Circuit reversed the district court's decision and held that the $5.9 million payment to the cable network was avoidable as a fraudulent transfer. According to the Fifth Circuit, under TUFTA, value is to be determined in light of the purpose of the Act to protect a debtor's estate from being depleted to the prejudice of the debtor's unsecured creditors. Further, "consideration having no utility from a creditor's viewpoint does not satisfy the statutory definition." The cable network introduced evidence of the market value of its services, but did not show that its services preserved the value of the debtor's estate or had any utility from the creditors' perspective. Although the cable network's services may have been valuable to the creditors of a legitimate business, such services provided no value to the creditors of a Ponzi scheme. Each new investment in a Ponzi scheme decreases the value of the estate by adding a new liability that can never be legitimately repaid. The cable network did not satisfy the burden under TUFTA to prove value to the creditors. Because the cable network did not prove that any value was given, the Fifth Circuit did not address the second prong of the inquiry concerning reasonable equivalence.

Petition for Rehearing - However, on a petition for rehearing, the Fifth Circuit vacated its opinion and certified to the Texas Supreme Court the question of what showing of "value" under TUFTA is sufficient for a transferee to prove the elements of the affirmative defense. The Fifth Circuit posited whether under TUFTA, is proof of the market value sufficient to establish "reasonably equivalent value" for purposes of the affirmative defense, or must the transferee produce specific evidence to show value of the transfer to the debtor's creditors? The Fifth Circuit stated that such questions may lead to the additional issue of how value might be determined when value is viewed from the "creditor's viewpoint." According to the Fifth Circuit, the Texas Supreme Court has not answered these questions, and Texas cases applying TUFTA provide little guidance in this area.

PRACTICAL CONSIDERATIONS

If the Texas Supreme Court requires the transferee to produce specific evidence to show value of the transfer to the debtor's creditors, this could have the effect of rendering any payment by a fraudulent enterprise avoidable as a fraudulent transfer, regardless of the culpability or remoteness of the transferee from the fraud. Such a decision would also require suppliers and other trade creditors to investigate the affairs of their customers to determine whether they are conducting business with a Ponzi scheme, which is no easy task.

DELAWARE BANKRUPTCY COURT HOLDS SECTION 502(B)(6) 15% CAP APPLIES TO TIME, NOT RENT

Alison Wickizer Toepp
Associate, Richmond

In re Filene's Basement, LLC, No. 11-13511 (Bankr. D. Del. Apr. 16, 2015)

CASE SNAPSHOT

The landlord asserted claims against the debtor following the termination of the unexpired lease. The debtor objected, arguing that the amounts exceeded the 15 percent cap set forth in section 502(b)(6) of the Bankruptcy Code. The court concluded that the 15 percent limit applied to the time remaining in the lease term, not the amount of rent due under the lease. This decision continues the split among "time" and "rent" decisions under this Bankruptcy Code section.

FACTUAL BACKGROUND

In this case, the court considered three claims asserted by a landlord after debtor terminated its unexpired lease. The debtor objected to the landlord's claims on the ground the claim exceeded amounts permitted under section 502(b)(6) of the Bankruptcy Code, which provides that a lessor's claim "for damages resulting from the termination of a lease of real property" should be disallowed to the extent that it exceeds the limits imposed by subsections (A) and (B).

With respect to the landlord's lease termination claim, the debtor and landlord disagreed on the meaning of "15 percent" under section 502(b)(6)(A). Separate from its lease termination claim, the landlord also asserted claims for costs associated with removal of abandoned furniture that the debtor contractually agreed to remove, and for costs to remove a mechanic's lien asserted after the debtor failed to pay a contractor. The debtor argued that these claims arose from the lease, and thus were subject to the section 502(b)(6) cap. The court agreed with the debtor as to the lease termination claim and the abandonment claim, but sided with the landlord on the mechanic's lien claim.

COURT ANALYSIS

The Lease Termination Claim - For claims based on lease terminations, section 502(b)(6)(A) provides that courts shall allow claims except to the extent the claim exceeds "the rent reserved by such lease, without acceleration, for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of such lease…."

The landlord urged the court to find that "15 percent" under section 502(b)(6)(A) is a reference to the amount of rent due for the remaining term of a lease. The debtor, however, argued that 15 percent under section 502(b)(6)(A) refers to the time remaining under an unexpired lease. Courts are divided on the issue, with each side finding support in reported case law.

At least two courts have applied the "rent" approach on equitable grounds "because it allows landlords to recover damages based upon rent increases the parties bargained for when they entered into the lease." The court, however, agreed with the debtor that the "time" approach is consistent with other temporal references in the section, such as "without acceleration" and "not to exceed three years." Citing various published decisions, the court noted that the legislative history and policies underlying the Bankruptcy Code also support its decision to apply the "time" approach in calculating the landlord's lease termination claim.

The Abandonment Claim - Like the "time" versus "rent" issue, courts also are divided on how to determine which claims "for damages result from the termination of a lease of real property." The court found persuasive the Ninth Circuit's opinion applying a narrow view of section 502(b)(6) in *In re El Toro Materials Co., Inc.*, 504 F.3d 978 (9th Cir. 2007). There, the court held that "A simple test reveals whether the damages result from the rejection of the lease: Assuming all other conditions remain constant, would the landlord have the same claim against the tenant if the tenant were to assume the lease rather than rejecting it?" 504 F.3d 980-81.

The court applied the *El Toro* test to the landlord's various claims against the debtor. With respect to costs associated with removing abandoned fixtures and furniture, the court noted the claim would exist regardless of whether the debtor assumed or rejected the lease. The court explained, however, that section 502(b)(6) uses the word "termination," not "rejection." Therefore, the correct inquiry is whether the abandonment claims exists separate from a debtor's lease *termination*. Because the claim for costs associated with removing abandoned fixtures and furniture arose only upon the debtor's termination of the lease, the court determined the landlord's abandonment claim was subject to the limitations of section 502(b)(6).

Having determined the abandonment claim is capped under section 502(b)(6), the court next considered whether the claim falls within "rent reserved." The court held the landlord's damages for removing the abandoned furniture and fixtures are not part of the "rent reserved," and cannot be included in the calculation of the claim under section 502(b)(6) because the abandonment claim damages "are not fixed, regular or periodic charges."

The Mechanic's Lien Claim - The landlord's final claim against the debtor was based on costs associated with removing a mechanic's lien asserted by a contractor after the debtor failed to pay the contractor for servicing elevators and escalators. The court again applied the *El Toro* test, and held that the mechanic's lien claim "exists independent of whether the Lease is terminated. Accordingly, the Mechanic's Lien claim is not subject to the limitations of section 502(b)(6) and the Landlord may assert a separate claim for recovery of those costs."

PRACTICAL CONSIDERATIONS

The court sided with those jurisdictions applying the "time" approach to lease termination claims, concluding that "the text of § 502(b)(6)(A) requires application of the percent cap based on the 'time' approach." Further, the court concluded that while an abandonment claim was subject to the limitations of section 502(b)(6), a landlord's damages relating to a mechanic's lien, however, could be asserted as a separate claim against debtor. Because there is a split of authority on the question of "time" or "rent" under section 502(b)(6), landlords face different results in different jurisdictions.

PRE-PETITION SUBLEASE TERMINATION NOT AVOIDABLE WHERE TERMINATION IS VALID UNDER STATE LAW

Chrystal Puleo
Associate, New York

In re Great Lakes Quick Lube, L.P., Adv. No. 13-2709 (Bankr. E.D. Wis., April 13, 2015)

CASE SNAPSHOT

In considering whether the committee of unsecured creditors in a chapter 11 case could avoid the debtor's pre-petition lease termination transaction as a preference or fraudulent transfer, the court held that a pre-petition sublease termination was not avoidable if valid under state law.

FACTUAL BACKGROUND

The debtor, Great Lakes Quick Lube, L.P., was in the oil change business, and at the height of its business owned and operated 107 oil change stores. Prior to its bankruptcy filing, the debtor agreed to relinquish its leasehold interests in five oil change stores in exchange for the landlord, T.D. Investments, I, LLP, releasing the debtor from all past and future obligations for rent, deferred maintenance, real estate taxes, and other expense payments in connection with these subleases. The debtor's president testified that at the time the debtor entered into the sublease termination agreement with T.D., the debtor was in default on the obligations owed under two of the five sublease agreements, owing what he believed was approximately $50,000 in overdue rent and real estate taxes. In addition, at that time, the debtor was being pressured by T.D. to make necessary repairs to the two defaulting stores, which would have cost the debtor $40,000 - $45,000. Given the debt to T.D., as well as to other vendors and creditors; the debtor's belief that there were only two or three years left on the two subleases in default; and the debtor's desire to avoid bankruptcy, the debtor believed that the sublease termination agreement with T.D. was a good business decision. However, the debtor was unable to avoid bankruptcy, and filed a chapter 11 petition, as well as a motion to reject certain leases, including the two subleases that were in default pre-petition and subject to the sublease termination agreement.

The unsecured creditors committee did not object to the rejection motion but later brought the action at issue against T.D. on behalf of the debtor, seeking to avoid the pre-petition sublease termination agreement as a preference claim or fraudulent transfer claim under sections 547(b) and 548(a)(1)(B) of the Bankruptcy Code, respectively. The committee asserted that the value of the two subleases at issue to the debtor's estate, had they been assumed and assigned, was at least $825,000.

COURT ANALYSIS

The court held that the pre-petition sublease termination agreement was not avoidable under sections 547(b) and 548(a)(1)(B). Looking to the applicable state law, the court found that the sublease termination agreement was not subject to avoidance as a fraudulent transfer or a preference, given that the termination agreement was valid under Wisconsin law, Wis. Stat. § 704.03, and occurred pre-petition. Accordingly, the court reasoned, under Bankruptcy Code section 365(c)(3), the subleases could not be assumed by the debtor as a validly terminated non-residential lease. In addition, the court dismissed the committee's argument that the sublease termination agreement was a collusive agreement, relying on the fact that the debtor believed the agreement to be in its best business judgment at the time. Lastly, in finding support for its holding, the court considered the fact that the sublease termination agreement was included in the debtor's lease-rejection motion, to which the committee did not object.

PRACTICAL CONSIDERATIONS

Lessors dealing with an insolvent lessee may fare better entering into a pre-petition leasehold termination agreement than risking assumption by a debtor in a chapter 11 case for the benefit of the debtor's creditors.

SURETY'S ENTITLEMENT TO SUBROGATION PRECLUDES DEBTOR FROM RETAINING FUNDS

Chrystal Puleo
Associate, New York

In re Pihl Inc., Adversary Proceeding Case No. 13-01384 (Bankr. E.D. Mass., April 14, 2015)

CASE SNAPSHOT

Taking a stance on a split of authority, the court found that a surety is entitled to subrogation as soon as the surety incurs a legal obligation, such as when the principal defaults, precluding a debtor's entitlement to retain funds as property of the estate.

FACTUAL BACKGROUND

The debtor, Pihl, Inc., was in the construction business, specializing in civil engineering projects, and was involved in three projects with the state of Massachusetts. The Insurance Company of the State of Pennsylvania ("ICSP") issued security bonds in connection with these projects, which were secured by an indemnity agreement with Pihl, whereby, in the event of any abandonment or breach of contract in connection with the projects described in the bonds, ICSP would receive, among other things, any and all funds received or sums that may be due on account of the projects described in the bonds.

The debtor filed for bankruptcy in August 2013, terminating all of its employees and ceasing operations within one month. Upon learning of the debtor's default on one of the projects, ICSP sent a demand letter for amounts due under the three bonds totaling $1,072,804, and initiated an action in the district court against the debtor and Middlesex Savings Bank seeking the funds in the debtor's account totaling $680,814.91. In addition, ICSP's parent company, American International Companies ("AIC"), filed a UCC financing statement purporting to take an interest in the collateral security provided for under the indemnity agreement. ISCP succeeded in obtaining a Writ of Attachment on the funds. The chapter 7 trustee brought an adversary proceeding seeking a turnover of the

CONTINUED ON PAGE 19

Surety's Entitlement to Subrogation Precludes Debtor from Retaining Funds—continued from page 18

funds held by the bank, as well as an avoidance of AIC's UCC financing statement and the Writ of Attachment obtained by ICSP.

COURT ANALYSIS

In response to the trustee's action, ICSP sought a declaration that the funds held by the bank were not property of the estate and should be turned over under the terms of the indemnity agreement. ICSP's argument was largely based on the assumption that the funds were proceeds of the bonded projects. ISCP argued that since its equitable subrogation rights extended to funds derived from the projects, the funds never became property of the estate, and ISCP had a claim to the funds superior to the claim of the trustee.

The court held that under Bankruptcy Code section 542(a), if the debtor had a legal or equitable interest in the funds, Middlesex Savings Bank must turn the funds over to the trustee; and it went on to consider whether ICSP had any legal or equitable interest in the funds superior to the debtors because of its equitable subrogation rights, the assignment provisions of the indemnity agreement, or status of the bank as a constructive trust. Noting that the courts are split on the issue of whether a surety must have already paid on a payment bond or completed the work on a performance bond before it is entitled to subrogate funds, the court took the position that a surety is entitled to subrogation as soon as the surety incurs a legal obligation, such as when the principal defaults. Therefore, the court found that when a debtor contractor breaches its contract with a project owner, it would preclude the debtor from retaining the funds, and thus these funds are not property of the estate. However, the court found that since a genuine issue of material fact remained as to when the debtor defaulted, the court could not rule on whether ISCP or the trustee has a right to the funds by summary judgment.

PRACTICAL CONSIDERATIONS

A bondholder may have superior rights to estate property based on its equitable subrogation rights, which are triggered as soon as the surety incurs a legal obligation.

MAKE-WHOLE PREMIUM IS NOT OWED UNLESS THE INDENTURE EXPRESSLY REQUIRES PAYMENT UPON ACCELERATION

Jared Roach
Associate, Pittsburgh

Delaware Trust Co. v. Energy Future Intermediate Holding Company LLC (In re Energy Future Holdings Corp.), 527 B.R. 178 (Bankr. D. Del. 2015)

CASE SNAPSHOT

The indenture trustee objected to the debtors' motion for debtor-in-possession financing to pay off notes that had been accelerated as a result of the bankruptcy, because the debtors did not propose repayment of prepayment premiums. The court held that the noteholders, under the plain language of the indenture, were not entitled to a make-whole payment upon the acceleration of the maturity date following a bankruptcy filing.

FACTUAL BACKGROUND

In 2010, the debtors were involved in the issuance of approximately $2.18 billion in notes. When the debtors filed for bankruptcy, the indenture trustee noticed an Event of Default and accelerated the maturity date of the notes. The debtors sought post-petition financing to, among other things, repay the notes. Certain holders, however, read the indenture to require the debtors to pay a make-whole payment if the notes were repaid prior to maturity. Further, the indenture trustee argued that the debtors' motivation for filing the bankruptcy was to avoid paying the make-whole amounts.

COURT ANALYSIS

The court began its analysis by reviewing the indenture. New York law instructs courts to look within the four corners of a contract to determine the parties' intent. Under New York law, "an indenture must contain express language requiring payment of a prepayment premium upon acceleration; otherwise, it is not owed." Accordingly, the court determined that the indenture did not contain a provision requiring payment of the make-whole premium upon acceleration. The court reasoned that the parties could easily have included language for which the indenture trustee now sought inclusion, but the court was not entitled to re-write the contract. The clear language of the indenture undercut the indenture trustee's argument.

Further, the court found that by accelerating the maturity date, prepayment could not occur. Prepayment can only occur in advance of maturity. The indenture trustee sought court authority to rescind the acceleration notice, but the court determined that sending such a notice would violate the automatic stay because the indenture trustee would be attempting to collect a claim. The court also found that the debtors were in serious financial trouble in the months leading to the bankruptcy and were on pace to miss a large interest payment. The filing was not a tactic to repay the accelerated notes without paying the make-whole payment, but was the final lifeline available to the debtors.

PRACTICAL CONSIDERATIONS

Courts are unwilling to look beyond the four corners of an unambiguous contract. This case reinforces the importance of careful contract drafting, while highlighting the potentially adverse effects a less than ideally worded contract can have on one party.

SECURED CREDITOR AND PURCHASER OF MORTGAGE DEBT PORTFOLIO CANNOT CLAIM LACK OF PRIVITY WITH DEBTOR

Sarah Kam
Associate, New York

In re 256-260 Limited Partnership, Case No. 14-11582 K (Bankr. W.D.N.Y. May 20, 2015)

CASE SNAPSHOT

The U.S. Bankruptcy Court, Western District of New York, held that because the debtor owned the subject property, of record, 10 months before the secured creditor bought the loan, the secured creditor could not now cry foul for lack of privity with the debtor. Its lack of due diligence did not give the secured creditor greater rights against this downstream owner than the original lender would have against the original borrower. However, the court found that the plan was not fair and equitable as to the secured creditor under section 1129(b) of the Bankruptcy Code. The creditor's objection to the debtor's plan was sustained without prejudice to the debtor filing an amended plan.

FACTUAL BACKGROUND

A mortgage loan originated in 1995. The lender sold its rights years ago, and then those rights changed hands several times until the secured creditor acquired them as part of a portfolio in October 2011. The mortgage was in foreclosure at that time, as the debt fully matured in 2010 and no mortgage payments had been made since 2006. The mortgage borrower, Mr. DiGiulio, deeded the property in 1996 to a company he controlled, Eagle, and then in 2003, he caused Eagle to convey the property to Zotar, an affiliate of Mr. DiGiulio, Eagle, and the debtor. On December 30, 2010, Zotar conveyed the property to the debtor. The mortgage instrument did not forbid conveyances of the land without permission of the holder of the mortgage lien.

The secured creditor filed an objection to confirmation of a proposed chapter 11 plan arguing (i) that it cannot be "forced" to become a "lender on this fully-matured obligation because (A) it and the debtor were not in privity of contract and (B) the debtor acquired title in violation of the mortgage; or, alternatively, (ii) the plan is not fair and equitable toward the secured creditor.

COURT ANALYSIS

The court considered whether the fact that the current mortgagee bought a defaulted mortgage upon land that was no longer owned by the original borrower (a matter of public record) permits the new obligee to block the debtor (the current owner of the real estate) from its effort to modify the terms of the secured debt under section 1123(b)(5) of the Bankruptcy Code, because the current mortgagee and the debtor were not in privity of contract on the petition date.

Because the debtor owned the subject property, of record, 10 months before the secured creditor bought the loan that was already in foreclosure, the court ruled that the secured creditor could not now assert lack of privity. Its lack of due diligence did not give the secured creditor greater rights against this downstream owner than the original lender would have against the original borrower.

The court found, however, that the plan was not fair and equitable as to the secured creditor under section 1129(b) of the Bankruptcy Code. The court stated that a plan that would be "fair and equitable" as to the secured creditor ought to reflect the facts (i) that this was initially a $65,000, 15-year loan that presumably was fully secured at its inception in 1995; (ii) that 20 years have gone by so far, and nearly 10 years have gone by without any payment; (iii) yet $112,500 remains due and owing, only $ 69,000 of which is secured; (iv) the plan proposes yet another 10 years; (v) the contract rate of interest was 12.99 percent, and the judgment rate of interest has been 9 percent since entry of judgment of foreclosure and sale on or about May 14, 2013, but the plan proposes only a 4 percent *Till* rate; and (vi) the plan proposes to pay only 13 percent of the unsecured deficiency claim. The plan did not seem "fair and equitable," but, more importantly, it did not propose to pay the secured creditor in a manner that would pass the "absolute priority rule" under section 1129(b)(2)(B)(ii) of the Bankruptcy Code. The creditor's objection to the debtor's plan was sustained without prejudice to the debtor filing an amended plan within 21 days.

PRACTICAL CONSIDERATIONS

A secured creditor must conduct due diligence in connection with the purchase of a mortgage debt portfolio, including reviewing publicly available information,

THE ABSOLUTE PRIORITY RULE APPLIES TO CHAPTER 11 DEBTORS

Jared Roach
Associate, Pittsburgh

Ice House America, LLC v. Cardin (In re Cardin), 751 F.3d 734 (6th Cir. 2014)

CASE SNAPSHOT

An individual chapter 11 debtor sought confirmation of a plan that allowed him to retain the majority of his pre-petition assets while paying a judgment creditor less than 10 percent of its claim. The bankruptcy court confirmed the debtor's plan, over the creditor's objection. On appeal, the Sixth Circuit reversed, holding that the absolute priority rule does apply to individual chapter 11 debtors.

FACTUAL BACKGROUND

The creditor, Ice House America, LLC, manufactures stand-alone ice machines. The debtor owned and operated eight machines in Eastern Tennessee. The debtor also contracted with Ice House to be the exclusive distributor of Ice House's machines in Tennessee. The debtor breached the agreement, and Ice House sued, eventually obtaining a judgment of approximately $1.3 million. The debtor filed a plan that proposed making a single payment to Ice House, out of the equity of his home and ice machines, but keeping his property.

COURT ANALYSIS

The absolute priority rule in bankruptcy requires senior creditors to be paid in full before a junior creditor class receives payment. Restated, an equity owner cannot keep his or her equity interest unless senior creditors are paid in full. In this case, the debtor argued that section 1129(b)(2)(B)(ii) created an exception to the absolute priority rule in individual chapter 11 cases only. The debtor argued that section 1129(b)(2)(B)(ii) allows an individual chapter 11 debtor to except all property of the estate from the absolute priority rule, meaning the absolute priority rule would not apply in individual chapter 11 cases. Ice House argued that the exception created by section 1129(b)(2)(B)(ii) only applies to property acquired by the debtor post-petition.

The Sixth Circuit reversed the bankruptcy court and held that Ice House's interpretation of section 1129(b)(2)(B)(ii) was correct. If the court adopted the debtor's reading, the absolute priority rule would not apply in individual chapter 11 cases. The Sixth Circuit reasoned that if Congress intended to except individual chapter 11 debtors from complying with the absolute priority rule, it would have simply stated as much in the bankruptcy code. As a matter of statutory interpretation, the Sixth Circuit cited the Supreme Court's directive not to "read the Bankruptcy Code to erode past bankruptcy practice absent a clear indication that Congress intended such a departure."

PRACTICAL CONSIDERATIONS

Creditors of individual debtors that file chapter 11 cases should closely scrutinize the debtor's plan to ensure compliance with the absolute priority rule. The debtor must comply with the absolute priority rule if he or she is going to retain any pre-petition property of the estate.

APPLYING SECTION 510(B), COURT SUBORDINATES JUDGMENT CLAIM OF FORMER LLC MEMBER

Christopher Rivas
Associate, Los Angeles

In re Tristar Esperanza Props., LLC, No. 13-60023 (9th Cir., Apr. 02, 2015)

CASE SNAPSHOT

The Ninth Circuit affirmed the subordination of an LLC member's judgment for the amount of her membership interests, finding that subordination of the claim was mandatory under Bankruptcy Code section 510(b).

FACTUAL BACKGROUND

In 2005, O'Donnell paid $100,000 for a minority membership interest in debtor Tristar. In 2008, O'Donnell exercised her right to withdraw from the LLC, and Tristar elected to purchase her membership interest based on the valuation procedure of the operating agreement. The parties were unable to agree upon a value, and arbitrated the dispute, resulting in an award of approximately $400,000 in favor of O'Donnell. The arbitration award was confirmed in a state court judgment of approximately $400,000 in O'Donnell's favor.

In 2011, about one year after the judgment was entered, Tristar filed a chapter 11 bankruptcy petition. In the bankruptcy case, Tristar filed an adversary action seeking to subordinate O'Donnell's judgment claim under Bankruptcy Code section 510(b), which provides for mandatory subordination of any claims "arising from rescission of a purchase or sale of a security of the debtor . . . [or] for damages arising from the purchase or sale of such a security . . ." The bankruptcy court subordinated the claim, and on appeal, the Bankruptcy Appellate Panel affirmed. O'Donnell appealed to the Ninth Circuit.

COURT ANALYSIS

The Ninth Circuit affirmed the bankruptcy court and Bankruptcy Appellate Panel, finding that subordination was mandatory under Bankruptcy Code section 510(b). O'Donnell argued that section 510(b) did not apply because: (i) her judgment was not for "damages," but for a fixed contractual repurchase amount, and (ii) her claim did not "arise from the purchase" of her security interests in the LLC because she converted her equity interests to debt claims prior to the bankruptcy.

The Ninth Circuit disposed of both arguments. First, it held that Bankruptcy Code section 510(b) has consistently been read broadly by numerous circuit courts

CONTINUED ON PAGE 22

(including the Second, Third, Ninth and Tenth Circuits) to apply to any claims where "there is a nexus or a causal connection between the claim and the sale or purchase of securities of the debtor," and that section 510 did not require, for example, a showing of securities fraud. Because O'Donnell sought a judgment pursuant to a contract regarding the purchase value of her securities, there was a sufficient nexus between her judgment claim and the purchase and sale of securities to require mandatory subordination under section 510(b).

Second, the Ninth Circuit ruled that the timing of O'Donnell's claim at the time of the bankruptcy filing was not relevant, finding that the express language in section 510(b) "does not ask what the claim *is*, but what it *arises* from." (Emphasis in original). Regardless whether the claim was a debt claim at the time of the bankruptcy filing, if the claim arose out of the purchase or sale of securities, it was within section 510(b). In so holding, the Ninth Circuit deviated from the decision of bankruptcy courts in New York and Delaware, and an earlier Ninth Circuit Bankruptcy Appellate Panel decision – all of which held that in order for a claim to be subject to subordination under Bankruptcy Code section 510(b), the claimant had to enjoy the "privileges" of equity ownership at the time of the bankruptcy filing.

PRACTICAL CONSIDERATIONS

Tristar reflects a continuing trend by courts to read section 510(b)'s mandatory subordination language broadly, and it serves as a reminder that equity claimants are unlikely to recover anything in bankruptcy, even if they managed to convert their equity claims prior to the bankruptcy filing. This is particularly true in the Ninth Circuit, although the timing of the conversion might still matter in other circuits.

BANKRUPTCY COURT UPHOLDS DEBTOR'S RIGHT TO OFFSET VENDOR OVERPAYMENTS AND TRADE CREDITS AGAINST SECTION 503(B)(9) CLAIMS

Brian Schenker
Associate, Philadelphia

In re ADI Liquidation, Inc., Case No. 14-12092 (KJC) (Bankr. D. Del. May 5, 2015)

CASE SNAPSHOT

In the ordinary course of conducting its food distribution and retail business, the company/debtor accrued refunds for overpayments to vendors and earned trade credits with vendors. The same vendors delivered goods to the company during the 20 days immediately before the company filed for chapter 11 bankruptcy protection; the company did not pay the vendors the amounts owed for such goods. The vendors sought priority treatment of their claims for such amounts as administrative expenses pursuant to Bankruptcy Code section 503(b)(9). The debtor asserted that it could offset against those claims the amounts owed to it for overpayments and trade credits. The bankruptcy court agreed with the debtor.

FACTUAL BACKGROUND

ADI Liquidation, Inc. was a cooperative food distributor that provided distribution and retail services to member retailers. ADI serviced 800 supermarkets, specialty stores, convenience stores and superettes with grocery, meat, produce, dairy, frozen foods, general merchandise, and health and beauty products. ADI obtained such goods from vendors and, in the ordinary course of business, made overpayments to its vendors and earned trade credits from its vendors. When ADI filed for bankruptcy, such vendors asserted priority administrative expense claims against the debtor under Bankruptcy Code section 503(b)(9) for amounts owed to them for goods delivered to ADI during the 20 days immediately before the bankruptcy filing (the "503(b)(9) Claims"). In the bankruptcy case, the debtor sought the bankruptcy court's authority to offset the amounts owed to it by the vendors for overpayments and trade credits against the 503(b)(9) Claims.

COURT ANALYSIS

The bankruptcy court began its analysis with Bankruptcy Code section 558, which provides that the bankruptcy estate "shall have the benefit of any defense available to the debtor as against any entity other than the estate." The court then noted that "a debtor's right to effectuate setoffs, as it exists under state law, is one of the personal defenses preserved by § 558." The court then concluded that "a debtor may exercise its setoff rights that arose prepetition against post-petition claims," and held that the debtor would be permitted to offset the amounts owed to it by the vendors for overpayments and trade credits against the 503(b)(9) Claims.

In reaching such holding, the court addressed several arguments made by objecting vendors. The vendors argued that it was "inequitable" to allow a debtor to exercise its setoff rights that arose pre-petition against post-petition claims, when creditors are not allowed to exercise their setoff rights that arose pre-petition against post-petition claims. The court noted that Bankruptcy Code section 553 does preserve a creditor's pre-petition setoff rights and restricts the exercise of such rights so that pre-petition setoff rights can be applied only to pre-petition debts and obligations. The court reiterated that section 558 treats a debtor's pre-petition setoff rights differently and concluded that the vendors' argument was without merit because the plain language of the Bankruptcy Code "does not treat a debtor's and creditor's right to setoff equally."

The objecting vendors also argued that allowing the debtor to offset the 503(b)(9) Claims "strips the value of those claims, ignores legislative intent and provides a disincentive for trade vendors to continue to supply an entity that is struggling financially," and "violates § 1129(a)(9)(A), which requires full payment of allowed administrative expense claims on a plan's effective date, unless the claimant agrees to different treatment." The court again reiterated that section 558 specifically preserves a debtor's defenses to claims made under section 503(b)(9). The court concluded that giving effect to such defenses did not "strip value" or "ignore legislative intent" or "violate § 1129(a)(9)(A)" because the *allowed*

CONTINUED ON PAGE 23

amount of such claims is only determined after giving effect to such defenses, and only the *allowed* amount of such claims is entitled to any priority treatment under the Bankruptcy Code.

In further elaborating on why it was permitting the debtor to offset the amounts owed to it by the vendors for overpayments and trade credits against the 503(b)(9) Claims, the court adopted the reasoning of another bankruptcy court: "Satisfying creditor claims by extinguishing debt that a creditor otherwise owes to the Debtor does not erode the value of the claims alleged by the creditor. The Claimant gets the benefit of the extinguishment of the debt it owes to the Debtors dollar for dollar. Therefore, the Claimants are not harmed by the Debtors' exercise of the Debtors' § 558 setoff rights. Rather the Claimants are complaining that they are not receiving the windfall that they were perhaps hoping to receive to the detriment of creditors as a whole."

PRACTICAL CONSIDERATIONS

Holders of 503(b)(9) Claims (and other administrative claims) often have the expectation, especially at the outset of a bankruptcy case, that their claims will be paid in full in cash upon confirmation of the debtor's plan. This case makes clear that any expectation for such a "windfall" must be tempered by any offset rights (and other defenses) that the debtor may have that are preserved under section 558. Notably, but unsurprisingly, the official committee of unsecured creditors supported the debtor's exercise of its setoff rights in this case, which freed up cash for distribution to unsecured creditors that otherwise would have gone to pay the 503(b)(9) Claims.

CHAPTER 7 TRUSTEE RECOVERS REPAYMENTS OF 'TRUE OVERDRAFTS' TO DEPOSITORY BANK AS PREFERENTIAL TRANSFERS

Brian Schenker
Associate, Philadelphia

In re Agriprocessors, Inc., Case No. 08-02751, Adversary No. 10-9234 (Bankr. N.D. Iowa April 20, 2015)

CASE SNAPSHOT

A chapter 7 trustee successfully recovered as preferential transfers, Agriprocessors' repayments to a depository bank of "true overdrafts" on the company's deposit account. The bankruptcy court held that the bank's decision to allow nine "true overdrafts" was in fact a decision to extend unsecured credit to the company. Consequently, the company's repayments of such antecedent debt to the bank during the 90 days immediately preceding the company's bankruptcy filing could be avoided as preferential transfers under section 547(b) of the Bankruptcy Code. Ultimately, the court held that the chapter 7 trustee could recover $1,556,782.89 from the bank.

FACTUAL BACKGROUND

During the 90 days immediately preceding the Agriprocessors, Inc.'s bankruptcy filing, the company and the bank engaged in certain overdraft practices under an informal unwritten common understanding. The bank adopted a "pay all" policy for clearing the company's account, which never had a positive daily ledger balance during that time period. Under the bank's "pay all" policy, when the company's checks were presented by the payee's bank through the automated clearinghouse process, the bank would automatically "provisionally settle" all of those checks, resulting in "intraday overdrafts."

The morning of the next business day, the bank would receive the details of which checks were "provisionally settled" in a non-sufficient funds position through the ACH process, i.e., an "intraday overdraft." The bank then had until midnight on that second business day of the "customary two-day banking day" to decide whether to honor such checks.

The bank's practice was to contact Agriprocessors to ensure that the company was wiring a "covering deposit" before the "customary" midnight deadline. On all but nine occasions, the company made the "covering deposit" requested by the bank. On those nine occasions, the bank opted to honor the NSF checks at the midnight deadline, rather than return them for insufficient funds, i.e., "bounce" the checks. By doing so, the bank opted to allow a "true overdraft" on the company's account.

Ultimately, the bank allowed "true overdrafts" in an aggregate amount of $1,556,782.89, which was later repaid to the bank by the company. The chapter 7 trustee successfully argued that such repayments were preferential transfers because the company made them on account of unsecured antecedent debt during the 90 days immediately preceding the company's bankruptcy filing, while the company was insolvent, and the repayments allowed the bank to receive more than it would have in a hypothetical chapter 7 liquidation.

COURT ANALYSIS

As a preliminary matter, the court confirmed its earlier summary judgment ruling that only "true overdrafts" – as opposed to "intraday overdrafts" – are extensions of credit. The court reasoned that an extension of credit existed only after the bank could no longer dishonor the NSF checks, i.e., after the "customary" midnight deadline on the second business day of the "two day banking day." The court noted, however, that an "intraday overdraft" could be considered an extension of credit, if the parties had a written agreement specifying that the bank is obligated to honor overdrafts.

The court further explained that when the bank allowed "true overdrafts," the bank's arrangement with the company became more like a line of credit with interest on advances because the bank charged significant account management fees and overdraft charges for each "true overdraft," which functioned like interest.

CONTINUED ON PAGE 24

This fee-charging further confirmed for the court that the bank was, in fact, advancing unsecured credit to the company. The court noted that had similar fee-charging for "intraday overdrafts" occurred, the court may have considered them to be extensions of credit as well.

In sum, the court concluded that the bank had extended unsecured credit to the company when it allowed each of the nine "true overdrafts" to occur. Given that the parties did not dispute that the company repaid such unsecured antecedent debt during the 90 days immediately preceding the bankruptcy filing, while the company was insolvent, and the repayments allowed the bank to receive more than it would have in a hypothetical chapter 7 liquidation, the court held that the chapter 7 trustee could recover such preferential transfers from the bank in the aggregate amount of $1,556,782.89, unless the bank could establish an affirmative defense under section 547(c) of the Bankruptcy Code.

The court then discussed the two affirmative defenses raised by the bank that: (i) each repayment of each "true overdraft" was part of a contemporaneous exchange for new value; and (ii) each "true overdraft" was incurred by the company in the ordinary course of business and repaid in the ordinary course of business of the company and the bank, or according to ordinary business terms. The court ultimately concluded that the bank had failed to establish either defense.

Regarding the "contemporaneous exchange for new value" defense, the court found that the bank had failed to meet its burden of proof. The court found insufficient evidence that any repayment of any "true overdraft" was made by the company, and accepted by the bank, with a mutual intention that it was in exchange for "new value" or that the bank in fact provided "new value" to the company substantially contemporaneous with any such repayment.

The bank argued that the company made each repayment of "true overdrafts" in exchange for the bank's future "forbearance from returning provisionally honored checks." The court held that "forbearance from exercising a preexisting right" does not constitute new value as a matter of law because "new value means money, or money's worth in goods, services, or credit."

The bank also argued that the company made each repayment of "true overdrafts" in exchange for the bank's agreement to honor "true overdrafts" in the future. Though the court agreed that contemporaneous extensions of new unsecured credit could satisfy the "new value" requirement, the court found that (i) the bank never agreed to honor "true overdrafts" and did so each time only "haphazardly and almost inadvertently"; and (ii) each repayment of a "true overdraft" was not, in fact, substantially contemporaneous with any future "true overdraft" allowed by the bank.

The court then dismissed the notion that any "true overdraft" was incurred by the company in the ordinary course of business or repaid in the ordinary course of business of the company and the bank, or according to ordinary business terms. The court emphasized that the bank had "repeatedly noted that the true overdrafts were exceptional, not ordinary"; were discouraged "unplanned" and "unexpected" events that the parties affirmatively sought to avoid; and fell "outside the customary relationship for these parties and the bank's standard practices."

PRACTICAL CONSIDERATIONS

Interestingly, the court noted that the bank's better affirmative defense, which the bank abandoned at trial, may have been the "subsequent new value" defense under section 547(c)(4) of the Bankruptcy Code. The court specifically stated that if the court "had considered the § 547(c)(4) analysis, the ultimate result in this case may have been different." Under that analysis, any "true overdraft" allowed by the bank after a repayment of a prior "true overdraft" would constitute subsequent new value in the form of new unsecured credit, and such repayment would not be a preferential transfer to the extent such new "true overdraft" was not repaid by the company.

CLAIMS AGAINST SEPARATE DEBTORS MUST BE TREATED SEPARATELY WHEN CASES ARE JOINTLY ADMINISTERED AND NOT CONSOLIDATED

Sarah Kam
Associate, New York

In re Manuel Mediavilla, Inc., Case No. 13-2800 (P.R. Bankr. June 16, 2015)

CASE SNAPSHOT

The United States Bankruptcy Court, Puerto Rico, held that a chapter 11 bankruptcy plan that individual debtors filed for themselves and a corporation they owned must be amended. The plan treated claims a creditor filed against the individuals' bankruptcy estate and the corporation's bankruptcy estate as though the cases had been consolidated even though the court had only granted the debtors' request for joint administration. However, the evidence did not support the creditor's request to convert the chapter 11 cases to cases under chapter 7 of the Bankruptcy Code, under section 1112 of the Bankruptcy Code.

FACTUAL BACKGROUND

Manuel Mediavilla, Inc. (the "corporate debtor") and Manuel Mediavilla and Maydin Melendez (the "individual debtors" and, collectively, the "Debtors") owned several commercial real properties. In 2006, the corporate debtor obtained a loan from Banco Popular de Puerto Rico ("BPPR"), which was guaranteed by the individual debtors and all but one of Debtors' commercial properties. BPPR transferred the loan to PRLP 2011 Holdings LLC ("PRLP") in 2011. Debtors and PRLP were unable to renegotiate the terms of the loan, resulting in the filing of a local court action for collection and foreclosure proceedings. The local court litigation spilled over to the bankruptcy court when the corporate and individual debtors filed for bankruptcy to prevent the execution of a pre-judgment attachment of their rents, and the foreclosure of their real properties, and with the hope of re-negotiating the loan obligation with PRLP. PRLP filed an objection to confirmation of Debtors' joint plan, arguing, among other things, that PRLP's claims were improperly classified since the cases were not substantively consolidated. PRLP also requested that Debtors chapter 11 cases be converted to chapter 7 cases.

COURT ANALYSIS

Section 302 of the Bankruptcy Code allows for joint administration of spouses' bankruptcy cases. There are no provisions in the Bankruptcy Code that expressly govern the administration of other cases. However, Rule 1015(b) of the Federal Rules of Bankruptcy Procedure provides that joint administration may be appropriate when two or more related debtor entities, whether spouses, partnerships or corporations, file for bankruptcy. Administratively consolidated cases remain independent even though they are administered jointly for procedural and practical purposes, to prevent duplicate costs and waste of the parties' and the court's time and resources.

The court allowed Debtors to file a joint disclosure statement and plan since the cases were administratively consolidated. However, the court also warned Debtors that all claims would have to be independently classified and treated for each case. PRLP argued that although Debtors' cases had been administratively consolidated, the extent of PRLP's secured status in each case should be treated separately. The court agreed that both cases have a secured and an unsecured portion whose classification should survive separately, even if, jointly, the claims would be paid in full by both Debtors. Debtors' actions to pool their collateral together for the purpose of only recognizing one secured claim that would be paid in full was equivalent to a substantive consolidation, which had not been requested or approved in these cases. Debtors provided no legal basis for the substantive consolidation of one creditor's claims without consolidating all creditors' claims in both cases. The court required Debtors to amend their plans to properly classify and treat PRLP's claims separately, which could possibly affect the interest rate proposed for the secured claims, the disposable income available in the individuals' case, the feasibility of the plan, or whether the plan violates the absolute priority rule.

The court also denied PRLP's request to convert the chapter 11 cases to chapter 7 cases because of extraordinary circumstances. Debtors had a stable business that was generating revenue for both creditors and the estate. Debtors had made improvements to the properties in the best interest of current and future tenants. Debtors' liquidation analysis also showed that liquidation under a chapter 7 scenario would not yield any dividends to unsecured creditors.

PRACTICAL CONSIDERATIONS

Separate claims against separate debtors must receive separate treatment unless the debtors' estates have been substantively consolidated. Courts may also decline to convert a chapter 11 case to a chapter 7 case where the debtors operate a business that is generating revenue for creditors and their bankruptcy estate.

COUNSEL'S CORNER: NEWS FROM REED SMITH

Robert Simons spoke at the Erie County Bar Association, discussing "The Future Relevance of Chapter 11," on July 24 in Erie, Pa. Robert also presented the webinar, "The Impact of the Supreme Court's Decision To Curb EPA's Power To Regulate Emissions," on August 12.

Anker Sorensen published "French Supreme Court Rules out Liability for Undercapitalising Companies" in the August 2015 issue of *International Corporate Rescue*.

Amy Tonti was a presenter at the Pennsylvania Bar Institute's 20th Bankruptcy Institute on October 8 in Pittsburgh.

REED SMITH COMMERCIAL RESTRUCTURING & BANKRUPTCY GROUP

PRACTICE LEADER

Peter S. Clark II
+1 215 851 8142
(Philadelphia)
pclark@reedsmith.com

CHICAGO

Stephen T. Bobo
+1 312 207 6480
sbobo@reedsmith.com

Aaron B. Chapin
+1 312 207 2452
achapin@reedsmith.com

Theresa Davis
+1 312 207 2777
tdavis@reedsmith.com

Timothy S. Harris
+1 312 207 2420
tharris@reedsmith.com

Melissa A. Mickey
+1 312 207 2426
mmickey@reedsmith.com

Ann E. Pille
+1 312 207 3870
apille@reedsmith.com

Alexander Terras
+1 312 207 2448
aterras@reedsmith.com

FALLS CHURCH

Linda S. Broyhill
+1 703 641 4328
lbroyhill@reedsmith.com

Robert M. Dilling
+1 703 641 4255
rdilling@reedsmith.com

FRANKFURT

Dr. Volker Kammel
+49 (0)69 222289 825
vkammel@reedsmith.com

HONG KONG

Desmond Liaw
+ 852 2507 9834
desmond.liaw@rsrbhk.com

HOUSTON

Carol Burke
+1 713 469 3880
cburke@reedsmith.com

LONDON

Helena Clarke
+44 (0)20 3116 3747
hclarke@reedsmith.com

Jeffery Drew
+44 (0)20 3116 2900
jdrew@reedsmith.com

Emma J. Flacks
+44 (0)20 3116 2922
eflacks@reedsmith.com

Monika Kuzelova
+44 (0)20 3116 3428
mkuzelova@reedsmith.com

Edward Mathison
+44 (0)20 3116 2932
emathison@reedsmith.com

Elizabeth A. McGovern
+44 (0)20 3116 3151
emcgovern@reedsmith.com

Charlotte Møller
+44 (0)20 3116 3472
cmoller@reedsmith.com

Georgia M. Quenby
+44 (0)20 3116 3689
gquenby@reedsmith.com

Victoria Thompson
+44 (0)20 3116 3509
vthompson@reedsmith.com

Estelle Victory
+44 (0)20 3116 3000
evictory@reedsmith.com

LOS ANGELES

Marsha A. Houston
+1 213 457 8067
mhouston@reedsmith.com

Christopher O. Rivas
+1 213 457 8019
crivas@reedsmith.com

MUNICH

Dr. Stefan Kugler, LL.M.
+49 (0)89 20304 131
skugler@reedsmith.com

Dr. Etienne Richthammer
+49 (0)89 20304 141
erichthammer@reedsmith.com

NEW YORK

Arnold L. Bartfeld
+1 212 205 6008
abartfeld@reedsmith.com

Aaron Z. Bourke
+1 212 231 2640
abourke@reedsmith.com

Edward J. Estrada
+1 212 549 0247
eestrada@reedsmith.com

Sarah K. Kam
+1 212 549 0284
skam@reedsmith.com

Christopher A. Lynch
+1 212 549 0208
clynch@reedsmith.com

James C. McCarroll
+1 212 549 0209
jmccarroll@reedsmith.com

Andrea J. Pincus
+1 212 205 6075
apincus@reedsmith.com

Chrystal A. Puleo
+1 212 231 2651
cpuleo@reedsmith.com

John L. Scott
+1 212 205 6099
jlscott@reedsmith.com

Mark D. Silverschotz
+1 212 205 6086
msilverschotz@reedsmith.com

Michael J. Venditto
+1 212 205 6081
mvenditto@reedsmith.com

Lillian Worthley
+1 212 549 0273
lworthley@reedsmith.com

PARIS

Brice Mathieu
+33 (0)1 76 70 40 00
bmathieu@reedsmith.com

Anker Sorensen
+33 (0)1 44 34 80 88
asorensen@reedsmith.com

PHILADELPHIA

Derek J. Baker
+1 215 851 8148
dbaker@reedsmith.com

Scott M. Esterbrook
+1 215 851 8146
sesterbrook@reedsmith.com

Barbara K. Hager
+1 215 851 8864
bhager@reedsmith.com

Jennifer P. Knox
+1 215 851 8190
jknox@reedsmith.com

Brian M. Schenker
+1 215 241 7966
bschenker@reedsmith.com

Claudia Z. Springer
+1 215 241 7946
cspringer@reedsmith.com

Matthew E. Tashman
+1 215 241 7996
mtashman@reedsmith.com

Lauren Zabel
+1 215 851 8147
lzabel@reedsmith.com

PITTSBURGH

Joseph D. Filloy
+1 412 288 3842
jfilloy@reedsmith.com

Jared S. Roach
+1 412 288 3277
jroach@reedsmith.com

Eric A. Schaffer
+1 412 288 4202
eschaffer@reedsmith.com

Robert P. Simons
+1 412 288 7294
rsimons@reedsmith.com

Paul M. Singer
+1 412 288 3114
psinger@reedsmith.com

Luke A. Sizemore
+1 412 288 3514
lsizemore@reedsmith.com

Amy M. Tonti
+1 412 288 3274
atonti@reedsmith.com

David Ziegler
+1 412 288 3026
dziegler@reedsmith.com

PRINCETON

Derek J. Baker
+1 609 520 6390
dbaker@reedsmith.com

RICHMOND

Alison Toepp
+1 804 344 3465
atoepp@reedsmith.com

SAN FRANCISCO

Douglas G. Boven
+1 415 659 5652
dboven@reedsmith.com

Jonathan Doolittle
+1 415 659 5902
jdoolittle@reedsmith.com

SINGAPORE

Troy Doyle
+65 6320 5359
tdoyle@reedsmith.com

Estelle Victory
+65 6320 5319
evictory@reedsmith.com

WILMINGTON

J. Cory Falgowski
+1 302 778 7522
jfalgowski@reedsmith.com

Kurt F. Gwynne
+1 302 778 7550
kgwynne@reedsmith.com

Kimberly E.C. Lawson
+1 302 778 7597
klawson@reedsmith.com

Richard A. Robinson
+1 302 778 7555
rrobinson@reedsmith.com

Commercial Restructuring & Bankruptcy Alert is published by Reed Smith to keep others informed of developments in the law. It is not intended to provide legal advice to be used in a specific fact situation; the contents are for informational purposes only.

"Reed Smith" refers to Reed Smith LLP and related entities. ©Reed Smith LLP 2015.

ReedSmith

The business of relationships.℠