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In This Issue:

WHAT HAPPENS TO COMMITTEE CLAIMS WHEN A CASE IS CONVERTED FROM A CHAPTER 11 CASE TO A CHAPTER 7 CASE?

Peter S. Clark, II
Firmwide Practice Group Leader, Philadelphia

In a recent decision by the Delaware District Court, the judge held that when a bankruptcy case is converted from a chapter 11 case to a chapter 7 case, pending appeals by the Committee of Unsecured Creditors (including an appeal of the conversion order) should be dismissed because the Committee is dissolved upon conversion. The Court distinguished the *Lyons Transportation* case (which allowed a Committee to survive conversation) by noting that the survival in that case was pursuant to a court order and based on the need for the committee's special expertise in the bankruptcy case. *Official Committee of Unsecured Creditors v. Constellation Enterprises.LLC (In re Constellation Enterprises LLC)*, 2018 U.S. Dist. LEXIS 47153 (D. Del. Mar. 22, 2018).

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EQUITABLE MOOTNESS: ALIVE AND WELL IN THE THIRD CIRCUIT

David A. Kazlow
Associate, New York

In re Allied Nevada Gold Corp., 725 F. App'x 144 (3rd Cir. 2018), petition for cert. filed (U.S. Aug. 6, 2018) (No. 18-5548)

CASE SNAPSHOT

In a non-precedential ruling, a three-judge panel in the United States Court of Appeals for the Third Circuit (the **panel**) upheld the district court's refusal to overturn the Bankruptcy Court's 2015 confirmation of Allied Nevada's plan of reorganization, stating that the district court "reasonably rejected" appellant shareholders' request to nullify a plan of reorganization that was by then substantively consummated. The panel rejected the shareholders' arguments that the equitable mootness doctrine invoked by the district court was unconstitutional.

FACTUAL BACKGROUND

Brian Tuttle, Jordan Darga and Stoyan Tachev (collectively, the **appellants**), former stockholders of Allied Nevada Gold Corporation (together with its affiliated co-debtors and appellees, **Allied Nevada**) held stock in Allied Nevada that had been cancelled upon confirmation of Allied Nevada's plan of reorganization. Allied Nevada had filed a voluntary petition for Chapter 11 bankruptcy in the United States Bankruptcy Court for the District of Delaware on March 10, 2015. Moelis & Company LLC, Allied Nevada's financial advisor, estimated the company's value as a going concern was between approximately $200 and $300 million, which valuation left stockholders far out of the money.

By August of 2015, Allied Nevada filed its plan of reorganization and disclosure statement reflecting the terms of a global settlement entered into with its major creditor constituents, which included both a statutorily appointed committee of unsecured creditors and an equity committee. The appellants, who did not sit on either of the official committees, objected to Allied Nevada's proposed plan of reorganization, arguing that it substantially undervalued Allied Nevada. During argument, one of the appellants asked the Bankruptcy Court to stay the confirmation hearing, which it denied as an untimely motion. On October 8, 2015, the Bankruptcy Court confirmed the plan over the appellants' objections, accepting Moelis's valuation and concluding that the plan was fair to all stakeholders. On January 22, 2016, the Bankruptcy Court denied various motions filed by appellants Tuttle and Darga related to requests for standing to prosecute and to appoint an independent examiner and a written motion to stay, among others.

The appellants filed multiple appeals, which were consolidated into two cases before the United States District Court for the District of Delaware. In two separate opinions, issued on September 15, 2016, and February 10, 2017, the district court dismissed the appellants' claims as equitably moot. In each, it rejected their argument that equitable mootness is unconstitutional and then applied the Third Circuit's equitable mootness test, concluding that each factor weighed in favor of dismissal. The appellants then filed an appeal to the Third Circuit challenging the district court's dismissal orders.

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BUYER BEWARE: ANTI-ASSIGNMENT CLAUSES ENFORCEABLE UNDER DELAWARE LAW

Lauren S. Zabel
Associate, Philadelphia

In re Woodbridge Group of Companies, LLC, No. 17-12560, 2018 WL 3131127 (Bankr. D. Del. Jun. 20, 2018)

CASE SNAPSHOT

Bankruptcy Court upholds a provision in a promissory note restricting the power to assign the note, and sustains the debtor's objection to the proof of claim filed by the transferee.

FACTUAL BACKGROUND

Prior to its bankruptcy, the debtor executed various promissory notes in favor of the lender, which were governed by Delaware law and contained anti-assignment language providing that the note is not assignable by the lender without the borrower's prior written consent, and any attempted assignment without such consent shall be null and void. After the bankruptcy was filed, the lender sold the promissory note to an entity that specializes in purchasing bankruptcy claims. The purchaser thereafter filed a proof of claim, and the debtor objected to the proof of claim on the basis of the anti-assignment provision.

COURT ANALYSIS

The court began by noting that claims traders (like the purchaser) are sophisticated buyers that are "fully capable of performing due diligence before any acquisition." Despite the purchasers argument that courts should not police the transfer of claims, the court observed that there are no provisions of the Bankruptcy Code or overarching bankruptcy policy restricting the court's ability to determine and enforce provisions that may restrict the transfer of claims and proceeded to analyze the impact of the anti-assignment provision at issue.

Delaware law distinguishes between clauses that restrict the power to assign and those that restrict the right to assign. If an anti-assignment clause contains express language that subsequent assignments will be void or invalid, the clause restricts the **power** to assign; without such language, the clause merely restricts the **right** to assign. Subsequent assignments of contracts that restrict power of assignment are void, whereas subsequent assignments of contracts restricting the right of assignment merely give rise to a breach of contract action against the party assigning its interest. Finding that the language in the agreement was clear and unambiguous, the court held that the promissory note restricted the power to assign and the lender's assignment to purchase was null and void.

The purchaser then argued that the anti-assignment provision is unenforceable because the debtor breached the promissory note. Rejecting this argument, the court cited to case law holding that upon a breach, the non-breaching party may either cease performing and assume the contract is terminated or continue performance and sue for damages, but it cannot do both and emerge post-breach with more rights than it had pre-breach. The court next distinguished a case cited by purchase, which held that a breach excused the non-breaching party from obligations owed under a non-compete agreement, finding that a non-compete agreement to be "much different" than an anti-assignment provision. The court reasoned that prior to entering into a non-compete agreement, an employee is free to pursue any employment that they'd like and is therefore giving up that right by entering into the contract, whereas prior to entering into a contract with an anti-assignment provision, the party has nothing to assign.

Finally, the purchaser argued that Section 9-408 of the Uniform Commercial Code (UCC) overrides and nullifies the anti-assignment provision. Section 9-408 of the UCC restricts anti-assignment provisions in certain agreements where the anti-assignment provision would impair the creation, attachment or perfection of a security interest and applies "in a payment intangible or promissory note only if the security interest arises out of a sale of the payment intangible or promissory note." Based upon the definition of "security interest," the purchaser argued that the drafters of the UCC intended for any sale of a promissory note to automatically create a security interest, and accordingly, argued that the clause at issue should be nullified under 9-408. The court rejected the purchaser's "selective quoting" and found that the comments to Section 9-408 make clear that the drafters of the UCC did not intend to create such a bright line rule but instead intended for particular applications to be left to the courts for determination. The court further observed that purchaser's reading of Section 9-408 (which applies only to grants of security interests) would render meaningless Section 9-406 of the UCC (which provides that anti-assignment provisions are enforceable in connection with the sale of promissory notes). Accordingly, the court rejected the purchaser's argument, found the anti-assignment clause to be valid and sustained the debtor's claim objection.

PRACTICAL CONSIDERATIONS

Parties interested in purchasing claims or contracts from creditors should be sure to do thorough due diligence to ensure the free transferability of the claim or contract being purchased.

BANKRUPTCY COURT FINDS SUBSTANTIVE CONSOLIDATION OF NON-DEBTORS NOT AN AVAILABLE REMEDY IN SEVENTH CIRCUIT

Christopher A. Lynch
Associate, New York

Audette v. Kasemir, et al. (In re Concepts America, Inc.), Adv. Pro. No. 16 A 691 (Bankr. N.D. Ill. May 3, 2018)

CASE SNAPSHOT

The U.S. Bankruptcy Court for the Northern District of Illinois held that non-debtor substantive consolidation is not an available remedy in the Seventh Circuit and granted defendants' motion to dismiss that part of the Chapter 7 trustee's complaint that sought to consolidate with the debtor a number of related entities that were not in bankruptcy. In doing so, the Court rejected the holdings of a number of other jurisdictions, including at the Circuit level, that have permitted the substantive consolidation of non-debtors, usually predicated on the court's equitable powers codified at section 105(a) of the Bankruptcy Code.

FACTUAL BACKGROUND

Concepts America, Inc. ("Debtor") served as a holding and management company for a group of restaurants controlled, operated and either directly or indirectly owned by defendants Greenfield and Kasemir. Each of the subject restaurants was owned by its own holding company ("HoldCo"), which in turn was either owned by the Debtor or by defendants Greenfield and/or Kasemir. Defendants Restaurants-America Consulting Group, Inc. and Restaurants-America Trademark, Inc. were also owned by Greenfield and Kasemir, as was defendant Prime Bar America, which did not own a restaurant but maintained a bank account where revenue from the HoldCo restaurants was deposited. The complaint alleges that, through Greenfield, Kasemir and the Debtor's employees, the Debtor "helped develop new restaurants, provided legal, financial, operational and managerial services" to the restaurants and provided cash management services to all of the related entities, though it did not receive any compensation for the services it rendered. The Debtor was also the guarantor of the leases for the HoldCos.

The complaint alleges that Greenfield and Kasemir operated the related entities as a single economic unit, that landlords for the restaurants would request financial statements from the Debtor prior to entering into leases with a HoldCo, and the consolidated financial statements "falsely suggested that [the Debtor] owned assets that were producing tens of millions of dollars more in revenue than they actually were." Regardless of the actual ownership of an individual restaurant, most revenue was alleged to have been deposited into two bank accounts, with monies from those two accounts "frequently moved between other comingled accounts" maintained by the Debtor. It is alleged that, beginning in early 2012, the Debtor was insolvent (and has remained insolvent since that time).

An involuntary petition under Chapter 7 of the Bankruptcy Code was filed against the Debtor and the plaintiff was appointed Trustee. The plaintiff commenced the action against defendants asserting claims including substantive consolidation (Count I) and alter ego/piercing the corporate veil (Count II). The defendants moved to dismiss Count I.

COURT ANALYSIS

The Bankruptcy Court granted defendants' motion to dismiss the first count for substantive consolidation of the Debtor with the non-debtor HoldCos. As the Court explained, substantive consolidation contemplates "the merger of separate entities into one entity so that the assets and liabilities of both entities may be aggregated in order to effect a more equitable distribution of property among creditors." At the outset, the Court noted this equitable remedy to be extraordinary particularly because there is no section of the Bankruptcy Code that provides for the relief and that there is a split in authority as to whether a bankruptcy court has the authority to substantively consolidate non-debtor assets and liabilities into the debtor's estate. Many of the courts recognizing this remedy have relied upon section 105 of the Bankruptcy Code, which authorizes courts to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of [Title 11]."

Neither the Court nor the parties were able to locate a reported decision by a panel of the Seventh Circuit in which the substantive consolidation of non-debtors with a debtor was permitted. Relying, however, in part on the Seventh Circuit's demonstrated "lack of enthusiasm for a bankruptcy court's use of 11 U.S.C. § 105 and for creating rights based entirely on considerations of equity," the Court held that "were it presented with the question, the Seventh Circuit would not allow substantive consolidation of a bankruptcy debtor with" non-debtor entities.

In addition to the Seventh Circuit's perceived predispositions, the Court noted a number of other bases for not recognizing the remedy. First, the Court noted that section 303 of the Bankruptcy Code already permits creditors to force an entity into an involuntary bankruptcy proceeding (as was the case with the Debtor). Therefore, using section 105 to accomplish the same end, without the procedural protections of section 303 (for the entity's creditors) "exceeds the confines" of the Bankruptcy Code. Second, as evidenced by Count II of the complaint (which was not subject to defendants' motion to dismiss), the plaintiff has a similar remedy available under state law in the form of its alter ego/veil piercing claim. Should the plaintiff

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Equitable Mootness: Alive and Well in the Third Circuit—continued from page 1

COURT ANALYSIS

In upholding the constitutionality of the doctrine of equitable mootness, the Third Circuit cited the district court's reasoning:

> The constitutionality of the equitable mootness doctrine was raised in In re One2One [Communications], LLC, 805 F.3d 428 (3d Cir. 2015). As stated by the Third Circuit, "[b]ecause we have already approved the doctrine of equitable mootness in [In re Continental Airlines, 91 F.3d 553 (3d Cir. 1996) (en banc)], only the court sitting en banc would have the authority to reevaluate our prior holding. This court may only decline to follow a prior decision of our court without the necessity of an en banc decision when the prior decision conflicts with a Supreme Court decision." [One2One Commc'ns, 805 F.3d at 432-33 (citations omitted).]

(*In re Allied Nevada Gold Corp.*, 569 B.R. 213, 221 n.10 (Bankr. D. Del. 2017). The panel concurred with this reasoning and held that only the court sitting en banc would have the authority to reevaluate its prior holding approving of the doctrine of equitable mootness.

The panel went on to discuss the test for equitable mootness in the Third Circuit noting that recent decisions synthesized the test in two 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.

As to the first step, the panel went through a number of obligations and actions that Allied Nevada had taken since plan confirmation and concluded that its reorganization plan has been substantially consummated. The panel also placed significant weight on the fact that the appellants did not timely seek or obtain a stay, citing a number of Third Circuit opinions where failure to do so would render it inequitable to reverse the challenged Bankruptcy Court order. As to the second step, the panel considered whether granting the appellants' requested relief would require undoing the plan as opposed to modifying it in a manner that does not cause its collapse. In asking the district court to vacate the confirmation order, unwind completed transactions and revalue Allied Nevada, the panel reasoned that the appellants were seeking to have everything done over again, which they felt the district court reasonably rejected.

PRACTICAL CONSIDERATIONS

The doctrine of equitable mootness promotes finality and protects parties that have justifiably relied on the Bankruptcy Court's confirmation order and transactions effectuated pursuant to that order. This decision makes clear that the doctrine of equitable mootness remains alive and well in the Third Circuit. The decision also highlights the importance for plan objectors to exhaustively pursue a stay of the confirmation order pending appeal.

Bankruptcy court finds substantive consolidation of non-debtors not an available remedy in Seventh Circuit—continued from page 3

be successful in prosecuting that claim, the defendant entities will be liable on claims filed against the Debtor. Finally, the Court noted due process concerns with Count I. Specifically, the complaint does not allege whether the defendants' creditors received notice of plaintiff's claim and therefore an opportunity to be heard on the claims, which would directly impact such creditors if the relief sought in Count I were granted.

PRACTICAL CONSIDERATIONS

It should be noted that, although the Court's holding is not binding on other bankruptcy courts, even in the Northern District of Illinois, much less elsewhere in the Seventh Circuit, the bases cited by the Court may present a formidable impediment to a trustee or other party with standing to substantively consolidate non-debtors with a bankruptcy debtor. The organizational structure at issue in this case is commonly seen in a number of closely held businesses, especially in the food services industry. Where substantive consolidation is not available as a remedy, a trustee or creditor with standing may want to explore the other "tools" highlighted by the Court here, including commencing involuntary bankruptcy cases and/or seeking to pierce the corporate veil.

A CREDITOR IS ALLOWED TO BE "SELFISH" WHEN PURCHASING CLAIMS TO BLOCK A PLAN, DESPITE UNFAIR RESULTS TO OTHER CREDITORS. THIS SELFISHNESS, HOWEVER, CANNOT BE COUPLED WITH AN IMPROPER ULTERIOR MOTIVE.

Meghan A. Byrnes
Associate, Philadelphia

Pacific Western Bank, et al. v. Fagerdala USA-Lompoc, Inc., 891 F.3d 848 (9th Cir. 2018)

CASE SNAPSHOT

In a succinct opinion, the Ninth Circuit settled the standard for labeling purchased claims as "bad faith" to prevent those claims from rejecting a plan. The court found that "something more" than a (1) creditor's self-interested desire to block the plan or (2) unfair results to other creditors must be established for a claim to be designated for bad faith. That "something more" is a creditor's intent to seek an advantage it is not entitled to or evidence of some other "ulterior motive."

FACTUAL BACKGROUND

Debtor Fagerdala USA owned real property worth $6 million, and Pacific Western Bank held a senior secured claim on such property. In its proposed plan of reorganization, Pacific Western's claim was placed in Class 1 and, following tax and insider claims in classes 2 and 3, Class 4 consisted of general unsecured claims. All classes were impaired, and as such, Fagerdala needed the approval of at least one impaired class in order to effectuate a cramdown under § 1129(a)(10).

With the express intent to block the proposed plan, Pacific Western endeavored to purchase unsecured claims. Pacific Western conceded that it did not attempt to purchase claims with no value or that were contested; and its own budgetary restraints prevented its purchase of all claims. Even if Pacific Western could afford all unsecured claims, certain unsecured creditors did not respond to or rejected Pacific Western's offers. Ultimately, Pacific Western was able to buy slightly more than half of the unsecured claims by number, representing only 10 percent in value. Thus, with the purchased claims, Pacific Western successfully blocked the plan. Fagerdala moved to disqualify the votes of the purchased claims for bad faith.

COURT ANALYSIS

The Bankruptcy Court granted Fagerdala's motion and designated Pacific Western's claims for bad faith. In its analysis, the Bankruptcy Court first conceded that a creditor is permitted to act in its own self-interest and that purchasing claims to block a plan is not "per se" bad faith and thus grounds for disqualification (or designation) for voting purposes under § 1126(e).

However, the Bankruptcy Court determined that a creditor cannot block a plan using purchased claims if doing so would result in an unfair disadvantage and would be "highly prejudicial" to the remainder of the class. Because Pacific Western only purchased a small percentage of the unsecured debt, the Bankruptcy Court determined that Pacific Western's use of purchased shares would be unfair to the unsecured creditors who owned the majority of value. In so concluding, the Bankruptcy Court refused to consider Pacific Western's reasons as to why it did not purchase more, or all, of the unsecured claims.

On appeal, the Ninth Circuit reversed, finding that the Bankruptcy Court misapprehended the analytical framework used to determine bad faith pursuant to § 1126(e).

First, like the Bankruptcy Court did below, the Ninth Circuit reiterated that purchasing claims for the purposes of blocking a plan does not, on its own, constitute grounds for a bad faith designation. The Ninth Circuit, however, disagreed that Pacific Western's failure to make an offer to all members of a class was, by itself, a factor sufficient to show bad faith. Rather, a determination of good or bad faith is based on a variety of factors, and offering to buy all unsecured claims should merely be viewed as one factor indicative of good faith.

Further, the Ninth Circuit concluded that the Bankruptcy Court erred in resting its determination on unfair **results**, and not Pacific Bank's **motive** in causing such results. Selfishness alone does not support a finding of bad faith, nor does an unfair result to other creditors. Rather, evidence of an improper "ulterior" motive is needed to establish bad faith. Such bad faith motive is defined as a creditor "attempting to obtain a benefit to which it is not entitled." To illustrate, the Ninth Circuit noted that a non-preexisting creditor purchasing a claim for the purpose of blocking an action against it or purchasing a claim to destroy the debtor's business would be evidence of a bad faith ulterior motive.

Because the Bankruptcy Court improperly focused on unfair results and did not examine Pacific Western's motive, the Ninth Circuit remanded for further determination, concluding that Pacific Western should not have been penalized for doing something permitted by the Bankruptcy Code without a specific finding of bad faith motivation.

PRACTICAL CONSIDERATIONS

This opinion provides comfort to creditors who purchase claims to block a plan "out of enlightened self-interest." Such a creditor need not be altruistic or concern itself with potential unfair results to other creditors. However, this creditor must be careful to ensure that its decision to purchase claims is made for a permissible purpose, which is usually to do what is best from an economic standpoint – and not to gain some sort of advantage it would not have received outside of bankruptcy.

THE IMPORTANCE OF A GOOD SALE ORDER

Jared S. Roach
Associate, Pittsburgh

Denunzio v. Ivy Holdings, Inc., et al. (In re East Orange Gen. Hospital, Inc.), Case No. 17-01595 (D.N.J. Jun. 28, 2018)

CASE SNAPSHOT

The United States District Court for the District of New Jersey affirmed the Bankruptcy Court's ruling that a former employee's age discrimination suit against the purchaser of the East Orange General Hospital was impermissible pursuant to the Bankruptcy Court's sale order.

FACTUAL BACKGROUND

The hospital entered into a sale agreement in May 2014 with a purchaser, Prospect EOGH. The sale did not close as originally scheduled and, in November 2015, the hospital filed for relief under Chapter 11 of the Bankruptcy Code. Prior to the bankruptcy filing, in August 2015, the hospital terminated Ms. Denunzio from her job.

Shortly after the commencement of the bankruptcy case, the purchaser and the hospital entered an amended and restated purchase agreement. The hospital provided notice to Ms. Denunzio about the proposed sale and the bankruptcy deadline to file proofs of claim. Ms. Denunzio did not object to the sale and did not file a proof of claim.

The Bankruptcy Court approved the sale of the hospital's assets to Prospect, and the sale order included provisions permanently enjoining parties from asserting successor liability claims against Prospect. The sale closed in March 2016 and, on June 9, 2016, Ms. Denunzio filed a one count lawsuit (alleging age discrimination) against Prospect in the Superior Court of New Jersey. Ms. Denunzio's complaint alleged that Prospect was the successor to the hospital and was not merely a purchaser, as Prospect allegedly was involved in the decision to terminate Ms. Denunzio.

On October 26, 2016, Prospect filed a motion in the Bankruptcy Court to enforce the terms of the sale order by barring Ms. Denunzio from pursuing her state court action. The Bankruptcy Court granted Prospect's motion on November 23, 2016. The Bankruptcy Court held that the sale order barred successor liability claims against Prospect. Ms. Denunzio appealed the decision arguing that the Bankruptcy Court did not have jurisdiction over her state court complaint and even if it did, New Jersey law allows successor liability claims. The district court affirmed the Bankruptcy Court's ruling.

COURT ANALYSIS

The district court began its analysis by reviewing the Bankruptcy Court's jurisdictional limits. Ms. Denunzio argued that the Bankruptcy Court improperly exercised jurisdiction over her state court action by ordering her to dismiss the action. The district court, however, found that the Bankruptcy Court was merely enforcing the sale order, for which it clearly had jurisdiction. The motion to enforce the sale order was a "core" proceeding under 28 U.S.C. § 157(b)(1) because the requested relief related to the sale of the hospital's assets, which was a core proceeding. Further, the district court agreed with the Bankruptcy Court that the enforcement of the sale order concerned the administration of the estate, which is a core proceeding. The district court went on to conclude that enforcement of the sale order could only arise in the context of a bankruptcy case, so the Bankruptcy Court also had jurisdiction pursuant to 28 U.S.C. § 1334(b).

The district court next addressed the Bankruptcy Court's decision to enjoin the state court litigation and order Ms. Denunzio to dismiss the action. The Bankruptcy Court held that it could enjoin the state court action because the action directly contravened Section 363(f) of the Bankruptcy Code, which allows a debtor to sell its assets free and clear of interests in property. Ms. Denunzio's claim arose before the sale, and any post-closing litigation against the purchaser was an attempt to circumvent the Bankruptcy Code's priority scheme. Effectively, Ms. Denunzio was seeking to elevate her priority status as an unsecured creditor by bringing suit against the purchaser and recovering in full. Ms. Denunzio could not upset the sale process.

The district court then addressed Ms. Denunzio's argument that New Jersey's successor liability doctrine authorized tort damages against purchasers. The district court pointed out that Ms. Denunzio cited only a dissent in an opinion as support for her argument and that New Jersey law imposed successor liability in a limited circumstance (the "product-line exception," which was not applicable to Ms. Denunzio's case).

Finally, the district court held that the Bankruptcy Court was not mandated to abstain from ordering Ms. Denunzio to dismiss the state court litigation because enforcement of the sale order was a core proceeding, and mandatory abstention does not apply to core proceedings.

PRACTICAL CONSIDERATIONS

The case provides useful instruction for purchasers and parties that have claims against entities selling assets. For purchasers, it is paramount to have an order approving the sale that states clearly that successor liability claims cannot be brought and are in fact enjoined.

For a party that has a claim against a seller, it is critical to participate in the seller's bankruptcy case and file a proof of claim. It should not be assumed that the claim can be asserted against the purchaser after the sale transaction closes.

CONNECTICUT BANKRUPTCY COURT SIDES WITH SEVENTH CIRCUIT IN CIRCUIT SPLIT REGARDING REJECTION OF TRADEMARK LICENSES AND APPLICATION OF SECTION 365(G) OF THE BANKRUPTCY CODE

Brian M. Schenker
Associate, Philadelphia

In re: SIMA International, Inc., No. 17-21761 (JJT), 2018 WL 2293705 (Bankr. D. Conn. May 17, 2018)

CASE SNAPSHOT

The United States Bankruptcy Court for the District of Connecticut recently addressed the question of whether a trademark licensee can retain the right to use a licensed trademark post-rejection of the license by a debtor pursuant to the Bankruptcy Code. In the case, the Bankruptcy Court held that rejection of a trademark license constitutes a breach of contract under Section 365(g) of the Bankruptcy Code and will not necessarily terminate a licensee's right to use a licensed trademark post-rejection by a debtor. In so holding, the Bankruptcy Court sided with the Seventh Circuit in a current Circuit Split on the issue.

FACTUAL BACKGROUND

SIMA International, Inc. (SIMAI) and Marlys Hanson, Inc. (MHI) were parties to a license agreement (the license) that granted MHI an exclusive right to use all copyrights, trademarks and other intellectual property associated with SIMAI's System for Identifying Motivated Abilities (SIMA). MHI later developed a software program known as CAPS, which reduced the amount of time necessary to perform the SIMA analysis.

SIMAI later commenced a voluntary Chapter 7 bankruptcy case. The Chapter 7 trustee moved to reject the license pursuant to Section 365(a) of the Bankruptcy Code. MHI objected to the trustee's motion and notified the Bankruptcy Court of its election to retain its rights under the license pursuant to Section 365(n). The parties' only dispute was whether MHI's election under Section 365(n) covered and entitled MHI to continue to use the SIMA trademark and preserved MHI's exclusive rights under the license.

COURT ANALYSIS

Before addressing the Bankruptcy Court's analysis, it is important to understand the background legal jurisprudence impacting the Bankruptcy Court's decision.

Under Section 365(n) of the Bankruptcy Code, when a debtor-licensor rejects an "intellectual property" license, the non-debtor licensee has the option to retain its rights to "intellectual property" under the license as such rights existed before the bankruptcy filing, subject to certain limitations. The retained rights include enforcing exclusivity provisions in the license but exclude all other rights to specific performance of the license. If a licensee elects to retain its rights under the license, the licensee must, among other things, continue to pay the royalties due under the agreement.

Trademarks, however, are not included in the Bankruptcy Code's definition of "intellectual property." As a result, a Circuit Split has developed regarding the legal consequences of trademark license rejection. On the one hand, the First Circuit has held that Section 365(n) does not apply to trademarks and that a licensee's right to use a licensed trademark terminates upon rejection of the underlying license agreement. See In re Tempnology, LLC, 879 F.3d 389 (1st Cir. Jan. 12, 2018). On the other hand, the Seventh Circuit has held that Section 365(n) does not need to apply to trademarks to reach the opposite result because Section 365(g) provides that rejection of a trademark license constitutes a breach of contract that does not "vaporize" a licensee's rights to continue to use the trademark. See *Sunbeam Products, Inc. v. Chicago American Manufacturing*, 686 F.3d 372 (7th Cir. 2012).

Against this backdrop, the Bankruptcy Court held that MHI retained the right to use the trademark post-rejection. The Bankruptcy Court grounded its decision on the "plain language" of Section 365(g). Section 365(g) provides that rejection of an executory contract generally constitutes a breach of contract. In so ruling, the Bankruptcy Court declined to follow Tempnology and instead adopted Sunbeam's interpretation of the relationship between sections 365(g) and 365(n). Further, the Bankruptcy Court critiqued the First Circuit's conclusion that the omission of trademarks from Section 365(n) leaves licensees unprotected in the event of rejection, stating that it "overlooks that a licensee could retain use of the debtor's trademark under Section 365(g) because rejection is deemed a breach and, therefore, rejection does not necessarily eliminate the rights provided under the contract."

In sum, the Bankruptcy Court concluded that "[n]either Section 365(g) applying state law, nor Section 365(n), provide a basis to terminate the licensee's equally central and bargained-for rights in the SIMA® trademark."

PRACTICAL CONSIDERATIONS

For now, the Circuit Split remains unchanged, but it will be interesting to see if the Second Circuit obtains an opportunity to weigh in. Also, Tempnology is presently subject to a pending petition for a writ of certiorari with the Supreme Court, which (if granted) would provide additional guidance.

PRICE AT AUCTION ESTABLISHES VALUE OF ASSETS

Lauren S. Zabel
Associate, Philadelphia

In re Aerogroup International, Inc., Case No. 17-11962, 2018 WL 3155250 (KJC) (Bankr. D. Del. Jun. 25, 2018)

CASE SNAPSHOT

Two secured creditors (Creditor A and Creditor B) had competing claims to proceeds of sale of assets to a third party over Creditor A's credit bid. Resolution of the competing claims was dependent upon collateral valuation. The court rejected Creditor B's argument that the value of the collateral should be limited to the amount of Creditor A's credit bid, rather than the eventual sale price.

FACTUAL BACKGROUND

Debtors sold substantially all of their assets at an auction subject to the liens of Creditors A and B. The $25.5 million sale proceeds were placed into escrow pending distribution to Creditors A and B, with the allocation to be determined mutual agreement or order of the court.

At the auction, Creditor A submitted a credit bid of approximately $12.2 million. After making the credit bid, Creditor A asserts that it was asked by debtors to refrain from further credit bidding in order to foster competitive bidding from cash bidders. Creditor A further asserts that it agreed but reserved its rights to make subsequent bids. One of the cash bidders submitted the winning bid. Creditors A and B disagree over whether secured creditor's $12.2 million credit bid was its final bid (Creditor B's view) or merely an incremental bid (Creditor A's view).

Creditors A and B filed various motions seeking valuation of the collateral sold for purposes of determining the respective rights to the sale proceeds. Creditor B moved for summary judgment on one such motion, and its motion for summary judgment was denied.

COURT ANALYSIS

Section 553 of the Bankruptcy Code preserves state law rights of Summary judgment may only be granted when there is no genuine issue of material fact and the movant is entitled to judgment as a matter of law. Creditor B argued that secured creditor's "final" bid (rather than the eventual sale price) established the secured amount of its claim, citing to the Third Circuit cases of *Philadelphia Newspapers* and *Submicron*.

The court began by noting that the motion for summary judgment could be denied solely on the basis that of the genuine issue of fact as to whether secured lender's bid was "final." The court continued, however, to address what it perceived to be a "disingenuous and misleading misinterpretation of Third Circuit law" in Creditor B's reliance on *Submicron* and *Philadelphia Newspapers*.

Evaluating a hypothetical in which a lender credit bid is more than the purported value of its collateral, the *Submicron* court stated that "[a]s Lender holds a security interest in [the collateral being sold], any amount bid for it up to the value of Lender's full claim becomes the secured portion of Lender's claim by definition." Thereafter, the *Philadelphia Newspapers* court stated "Our holding that a credit bid sets the value of a lender's secured interest in collateral does not equate to a holding that a credit bid must be the successful bid at a public auction."

The court found that Creditor B's argument relied upon language taken from these cases without context and failed to account for the fact that "an auction allows the marketplace to determine the value of the collateral, which, in turn, determines the value of the secured portion of the claim. In other words, the highest bid – no matter who makes it – sets the asset's value." Accordingly, the court rejected Creditor B's legal argument that the secured portion of secured creditor's claim is determined by its credit bid, rather than the market price for the collateral and denied the motion for summary judgment.

PRACTICAL CONSIDERATIONS

This decision reinforces the notion that the price obtained at an auction with competitive bidding will be deemed the value of the assets sold.

DETAIL AND TRANSPARENCY ARE NECESSARY ELEMENTS OF AN ADEQUATE DISCLOSURE STATEMENT AND CONFIRMABLE PLAN OF REORGANIZATION.

Meghan A. Byrnes
Associate, Philadelphia

In re CHL, LLC, Case No. 18-00630 (Bankr. E.D.N.C. June 14, 2018)

CASE SNAPSHOT

This short opinion addressed challenges to the adequacy of debtor's disclosure statement and confirmability of the proposed plan of reorganization on six separate and fundamental grounds. For four out of the six grounds, the court found that the disclosure statement lacked adequate information and that the plan was unconfirmable

FACTUAL BACKGROUND

The debtor owned real property that it intended to develop in several phases as a residential subdivision. The disclosure statement described the debtor's plan to sell a series of lots of the residential subdivision to a third-party builder. Under the sale contract, the debtor was responsible for meeting certain developmental benchmarks within 12 months of the sale, including the completion of sewer lines and an amenity center on the property – tasks which contemplated debtor's expenditure of significant funds. In addition, the sale contract contemplated future purchases of additional lots by the third-party purchaser. However, the objectors noted that the disclosure statement did not adequately describe the purchaser and its qualifications.

The objectors further argued that the disclosure statement did not adequately explain the basis for its valuation of the property in its liquidation analysis. The debtors assigned the value of the property $8 million – the amount equal to the highest bid for the property by the lender during prepetition foreclosure proceedings, but did not provide any other estimate of value.

Additionally, the objectors challenged the proposed closing costs of the sale as it was described in the disclosure statement. Without explanation, the disclosure statement noted that the sale contract provided: (1) a 6 percent brokerage fee to an insider who was not previously retained as a professional and (2) a 4 percent administrative fee to the debtors.

Lastly, the objectors claimed that the plan itself was unconfirmable for the following three reasons: (1) the plan violated the absolute priority rule because debtor's principal was permitted to retain his equity interest without any capital infusion; (2) the plan did not provide a secured creditor with a right to credit bid on the property; and (3) the plan improperly created separate classes of unsecured creditors in an effort to eliminate a secured creditor's voting leverage for its deficiency claim.

COURT ANALYSIS

The Disclosure Statement Lacked Adequate Information

The court found that the debtor did not provide adequate information, as required by Section 1125(a)(1) of the Bankruptcy Code, for the following reasons:

> (1) Because the proposed plan relied extensively upon the debtor's relationship with the third-party purchaser and the third-party purchaser's ability to perform under the sales contract, the debtor should have provided the following information about the purchaser: its history as a residential builder; other similar projects; its ownership; its licensing; any pending legal action; its prior relationship with the debtor and its principals; and its capitalization.
>
> (2) Although the court noted that debtor's use of the $8 million bid as a "convenient" valuation, the disclosure statement lacked adequate information because the debtor failed to provide any other estimate of value from any other source; nor did the debtor provide a clear explanation as why the property was worth $8 million in its current condition. The court explained that the bid price might not adequately reflect fair market value because lenders often discount their bids as much as 20 percent at a foreclosure sale to account for disposition costs and the time-value of money associated with holding an asset until liquidation.
>
> (3) The court found that the disclosure statement should have provided a detailed explanation as to why an insider affiliate would earn a brokerage fee (amounting to approximately $265,000 in commissions) and why the debtor was entitled to a 4 percent administrative fee. Specifically, the court found that the disclosure statement should have included additional information about the insider broker, its anticipated work pursuant to the sale contract and the principals of the broker. The court admonished the debtor for lacking transparency and failing to provide any explanation for these fees.

The Plan Was Unconfirmable

Of the three arguments that the plan was unconfirmable – (1) violation of the absolute priority rule; (2) lack of opportunity to credit bid; and (3) improper classification – the court found that the plan was unconfirmable only on the first ground. The court found that the plan was not fair and equitable under Section 1129(b)(2)(B)(ii) because although the creditors were not being paid in full, but the debtor's principal retained their equity interest under the plan without having to provide any infusion of capital or other "new value." The court deferred its determination on (2) and (3) with respect to credit bidding and classification until the confirmation

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STATUTORY TENANTS' RIGHTS UNDER NEW YORK LOFT LAW PREVAIL AGAINST PROPOSED § 363(F) SALE

Maura P. McIntyre
Associate, Pittsburgh

In re Bridge Associates of Soho, Inc., No. 818-71159, 2018 WL 3239825 (Bankr. E.D.N.Y. July 2, 2018)

CASE SNAPSHOT

Debtor's attempt to sell an occupied residential loft building pursuant to 11 U.S.C. § 363 (b) and (f) free and clear of any liens, claims and encumbrances, including any rights of existing occupants fails under New York's Loft Law.

FACTUAL BACKGROUND

In 1982, New York enacted the Multiple Dwelling Law (the Loft Law), to address the illegal conversion of commercial buildings to residential buildings. See N.Y. Mult. Dwell. Law, Art. 7-C, §280-287. The Loft Law was intended to protect tenants in buildings transitioning from commercial to residential use by bringing the buildings into conformity with statutory, regulatory and/or code requirements for residential occupancy. Pursuant to the Loft Law, if a building is occupied without a certificate of occupancy because it fails to meet basic health and safety requirements, no rent may be collected from the occupants.

The debtor is the owner of an occupied loft building in the SoHo district of New York City that has been registered as a building subject to the Loft Law since 1993. The debtor concedes that the building has never been issued a certificate of occupancy for residential use and that the debtor is not currently in compliance with the process for bringing the building into compliance. Accordingly, when this matter was before the Bankruptcy Court, the debtor had no right to collect rent from the building's occupants. As part of the debtor's reorganization efforts, the debtor moved to sell the building free and clear of any liens, claims and encumbrances, including, the occupants' possessory rights under the Loft Law. The building's occupants (the statutory tenants) and New York City Loft Board objected to the sale.

COURT ANALYSIS

In moving to sell the building free and clear of the statutory tenants' possessory rights, the debtor argued that the statutory tenants did not have any possessory interests in the property under Section 286 of the Loft Law because the statutory tenants had not paid rent in decades. Section 286(2)(i) provides, in relevant part, that

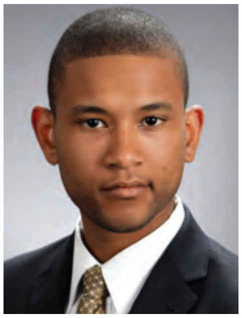
> Prior to compliance with safety and fire protection standards of article seven-B of this chapter, residential occupants qualified for protection pursuant to this article shall be entitled to *continued occupancy provided that the unit is their primary residence, and shall pay the same rent, including escalations, specified in their lease or rental agreement to the extent to which such lease or rental agreement remains in effect or*, in the absence of a lease or other rental agreement in effect, rent adjustments prior to article seven- B compliance shall be in conformity with guidelines to be set by the loft board for such residential occupants within six months from the effective date of this article.

N.Y. Mult. Dwell. Law § 286(2)(i) (emphasis added). The debtor argued that to establish a possessory interest, the statutory tenants were required to meet the primary residency requirement and rent payment requirement of Section 286. The Bankruptcy Court disagreed with the debtor's construction of Section 286 and found that the statutory tenants need only show that the building is their primary residence. The Bankruptcy Court explained that reference to rent payments is only applicable when the owner of the building is entitled to collect rent under the Loft Law. Here, the debtor was not entitled to collect rent payments because the building did not have a certificate of occupancy and therefore the rent requirement of Section 286 was not applicable to the statutory tenants. Having determined that the statutory tenants have a right to remain in the building pursuant to Section 286, the court determined that the statutory tenants are not holdover tenants "without any vested right to remain there." In sum, the statutory tenants' rights of possession conferred by Section 286 of the Loft Law "are rights that cannot be stripped without satisfaction of the requirements of § 363(f)(1) or (4)." As more fully explained in the decision, the debtor failed to show that applicable non-bankruptcy law would allow the sale of the building free and clear of the statutory tenants' interests, and failed to present arguments that rise to the level of a "bona fide" dispute as to the statutory tenants' rights under the Loft Law.

PRACTICAL CONSIDERATIONS

Consistent with Judge Grossman's quote, "if this is an undesirable result, the problem is one to be address by the legislature," landlords can expect that statutory tenants' rights will remain unabridged absent an amendment to the Loft Law.

YOU'RE NOT FIRED: UNITED STATES TRUSTEE'S OBJECTION TO RETENTION OF MANAGEMENT CONSULTANTS FALLS FLAT



Reginald Sainvil
Associate, Miami

In re Nine West Holdings, Inc., et al., No. 18-10947 (SCC), 2018 WL 3238695 (Bankr. S.D.N.Y. July 2, 2018)

CASE SNAPSHOT

The United States Bankruptcy Court for the Southern District of New York (the court) overruled the United States Trustee's (the U.S. Trustee) objection to the application of Nine West Holdings, Inc. and its debtor affiliates (collectively, the debtors) seeking to retain Alvarez & Marsal North America LLC (A&M) to provide the debtors an interim CEO and designate Ralph Schipani as interim CEO. Although retention of distressed management consultants is regularly authorized pursuant to Section 363(b) of the Bankruptcy Code, the U.S. Trustee argued that A&M and Schipani could not be employed by the debtors pursuant to Section 363(b) of the Bankruptcy Code because they were "professional persons" within the meaning of Section 327 of the Bankruptcy Code and employment of professional persons should be accomplished under Section 327 of the Bankruptcy Code. The court overruled the objection and granted the debtors' retention application, noting that the U.S. Trustee's position on the matter "lacked intellectual honesty and consistency."

FACTUAL BACKGROUND

On April 6, 2018, (the petition date), the debtors filed voluntary petitions for relief under Chapter 11 of Title 11 of the United States Code, 11 U.S.C. § 101 *et seq.* (the Bankruptcy Code). Prior to the debtors' Chapter 11 filings, A&M was hired to manage the day-to-day operations of the debtors' business and supplement traditional in-house functions. Schipani was also retained prior to the debtors' Chapter 11 filings and served the debtors in multiple capacities, including interim CEO of Nine West Holdings, Inc. and director of certain of the debtor affiliates. After the petition date, A&M continued to manage the debtors' daily operations. Similarly, Schipani continued to serve the debtors in his capacity as interim CEO of Nine West Holdings, Inc. At all times following retention, A&M and Schipani effectively functioned as company personnel.

On May 6, 2018, the debtors filed an application seeking entry of an order, authorizing the debtors to retain A&M to provide the debtors an interim CEO and certain additional personnel and designate Schipani as the debtors' interim CEO, *nunc pro tunc* to the petition date. The application provided that Schipani would serve as the interim CEO to assist the debtors with their reorganization efforts and their Chapter 11 cases, and A&M would provide additional employees of it and its professional service provider affiliates as necessary to assist in the execution of certain duties. The debtors asserted that retention of A&M and Schipani was appropriate under Section 363(b) of the Bankruptcy Code and explained that the services of A&M and Schipani would substantially enhance their attempts to maximize the value of their estates and successfully complete their restructuring.

On June 21, 2018, the U.S. Trustee objected to the application. The U.S. Trustee objected on the basis that (i) the application improperly seeks relief under sections 105(a) and 363(b), and (ii) A&M cannot meet the disinterestedness requirement of Section 327(a) and, therefore, should be deemed ineligible to be retained under Section 327(a). The U.S. Trustee took the position that Schipani and his A&M team assisted the debtors with substantially all of the major events that occurred during the Chapter 11 proceedings, including but not limited to preparing and signing the debtors' petitions, schedules and statements, the declaration in support of all first day motions, and overseeing the sales process. Based on these activities, the U.S. Trustee argued that A&M and Schipani are "professional persons" that can only be retained under Section 327 of the Bankruptcy Code because they are central figures in the debtors' reorganization. In response to the objection, the debtors argued that Section 327 of the Bankruptcy Code did not apply to management consultants who were initially employed prior to debtors' Chapter 11 filings for general management assistance not related to bankruptcy.

COURT ANALYSIS

Judge Shelley C. Chapman agreed with the debtors and overruled the U.S. Trustee's objection. In reaching this conclusion, the court opined that the U.S. Trustee seemed to ignore the "mountain of precedent" and case law where A&M itself was retained as a management consultant under Section 363(b) of the Bankruptcy Code. While the U.S. Trustee pointed to a distinction between the retention of a chief restructuring officer and a chief executive officer in previous engagements and the case law, the court was not persuaded, noting that the U.S. Trustee's distinction was "nonsensical."

The court addressed sections 363 and 327 of the Bankruptcy Code in ultimately reaching its decision. First, the court observed that the U.S. Trustee's argument that retention of A&M cannot be approved under Section 363 of the Bankruptcy Code had no basis in light of the Jay Alix Protocol, which is a national policy adopted by the U.S. Trustee whereby the U.S. Trustee unequivocally assents to and directs the retention of distressed management consultants pursuant to Section 363 of the Bankruptcy Code as long as certain requirements are satisfied. The court explained that the purpose of the protocol is to prevent a consultant from using its position in one

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You're Not Fired: United States Trustee's Objection To Retention Of Management Consultants Falls Flat—continued from page 11

capacity to benefit itself in another capacity. The court found that the protocol was not violated here, stating that "while Mr. Schipani did in fact serve as a director on a single subsidiary board within two years of the Petition Date, neither he nor any other A&M employee has ever served on the parent boards responsible for approving the prepetition or postpetition retention or compensation of A&M."

Next, addressing the U.S. Trustee's contention that Section 327 of the Bankruptcy Code is the only mechanism available to retain A&M and Schipani, the court determined that neither A&M nor Schipani is a "professional person" as the term is used in the Bankruptcy Code because both were retained prior to the debtors' Chapter 11 filings for the purpose of managing the debtors daily operations. As professional persons are typically those persons retained to administer the bankruptcy estates, the court held that the Section 327 should not apply to A&M and Schipani because they were not actually tasked with administering the bankruptcy estates.

The court concluded that not only were the U.S. Trustee's arguments faulty, but the U.S. Trustee ostensibly failed to consider the harm that would occur to the debtors if A&M and Schipani were not retained pursuant to Section 363 of the Bankruptcy Code. The court noted that the U.S. Trustee's position that consultants hired to carry out the day-to-day operations of a company prior to a Chapter 11 filing cannot be retained under Section 363 of the Bankruptcy Code was untenable because it would make it problematic for Chapter 11 debtors to retain the most deeply involved consultants on a postpetition basis. Finding that such an approach would cause unnecessary harm to Chapter 11 debtors, the court overruled the U.S. Trustee's objection and rejected the notion that management consultants hired by a Chapter 11 debtor prior to a bankruptcy filing may only be retained by a Chapter 11 debtor under Section 327 of the Bankruptcy Code.

PRACTICAL CONSIDERATIONS

The court's decision is a boon for Chapter 11 debtors that seek to retain management consultant firms that previously assisted with day-to-day operations prior to the commencement of any Chapter 11 proceedings. As the court's decision affirms that Section 363(b) of the Bankruptcy Code is an appropriate mechanism for retention of such management consultant firms, future Chapter 11 debtors should face less stiff objections from the U.S. Trustee when seeking to retain management consultant firms under Section 363(b) of the Bankruptcy Code.

Detail and transparency are necessary elements of an adequate disclosure statement and confirmable plan of reorganization.—continued from page 9

hearing so that the debtor could provide a full explanation for classification and its determination to eliminate credit bidding.

PRACTICAL CONSIDERATIONS

In this Opinion, the bankruptcy court shot down state law claims and causes of action that directly contravene an order issued by it, like the pre-Sale conduct (publication of the article) barred by the Sale Order. However, the Opinion indicates that where a bankruptcy court order does not specifically govern a claim or cause of action, like the Plaintiffs' claims arising from Gizmodo's post-Sale conduct, the bankruptcy court will decline to enjoin the claim and will defer to the state court's judgment on the merits of such claim.

Accordingly, practitioners should be diligent in carefully parsing out what third party causes of action would be barred or permitted by an order from the bankruptcy court. In the context of an order approving a "free and clear" sale under the Bankruptcy Code, practitioners should anticipate what claims or causes of action attributable to the seller's conduct could arise, and aim to draft and negotiate broad provisions in the sale order that would protect the buyer from the seller's pre-sale conduct that could bleed over into any post-sale claims.

EIGHTH CIRCUIT BAP AFFIRMS DISMISSAL OF TRUSTEE'S ADVERSARY CASE BASED ON FINALITY OF SALE ORDER

Christopher O. Rivas
Counsel, Los Angeles

In re Veg Liquidation, Inc., 583 B.R. 203 (8th Cir. BAP 2018)

CASE SNAPSHOT

The Eighth Circuit Bankruptcy Appellate Panel held that a final sale order containing Bankruptcy Code Section 363(m) findings regarding the purchaser's good faith are good as to the world and can bind a bankruptcy trustee who was not even appointed prior to the entry of the sale order.

FACTUAL BACKGROUND

The Debtor sold substantially all of its assets pursuant to a fully-noticed bidding procedures and sale motion, which resulted in a sale of all of the Debtor's assets that closed on February 28, 2014. The purchaser was comprised of a group of the Debtor's junior lienholders. The sale order contained a finding that the purchaser was a good faith purchaser under Bankruptcy Code section 363(m) and that there was no collusion under Bankruptcy Code section 363(n). No appeals were filed with respect to the sale order.

Months later, in June 2014, the case was converted to Chapter 7 and a Chapter 7 Trustee was appointed. In 2016, the Trustee filed an action against 25 defendants, including members of the creditors' committee, the Debtor's financial advisors and restructuring officers, and the successful bidder in the 2014 sale. The Trustee's complaint was premised on a theory that the 2014 sale was fraudulent and that there was collusion between the defendants leading up to the sale in order to depress the bid amounts.

The Bankruptcy Court dismissed the Chapter 7 Trustee's action on the basis that, among other things, the final sale order was *res judicata* as to the Chapter 7 Trustee's claims. The Chapter 7 Trustee appealed the decision, arguing, among other things, that he was not in privity with the sale order and therefore not bound by its terms.

COURT ANALYSIS

On appeal, the Eighth Circuit Bankruptcy Appellate Panel affirmed. The Panel held that it need "chase the Trustee down" the "rabbit hole" of privity and *res judicata*, because the protections conferred by Bankruptcy Code Section 363(m) are so expansive that the Trustee's lack of privity to the sale order is irrelevant.

Bankruptcy Code Section 363(m) provides:

> "The reversal or modification on appeal of an authorization . . . of a sale or lease of property does not affect the validity of a sale or lease under such authorization to an entity that purchased or leased such property in good faith, . . ., unless such authorization and such sale or lease were stayed pending appeal."

The Panel determined that it was irrelevant that the Trustee was appointed after the entry of the sale order setting forth the Bankruptcy Code Section 363(m) findings. Citing to the Eighth Circuit's decision in *In re Trism, Inc.*, 328 F.3d 1003, 1006 (8th Cir. 2003), the BAP held that Bankruptcy Code section 363(m)'s protections shield "third parties who rely on the bankruptcy court's order from endless litigation", so long as the Section 363(m) findings are an "integral provision" of the sale order. Citing to the Eighth Circuit BAP's decision in *In re Farmland Indus., Inc.*, 408 B.R. 497, 508 (8th Cir. BAP 2009), the Panel in this case agreed that the Section 363(m) protections in a final sale order are "good as against the world, not merely as against parties to the Proceedings."

The Panel rejected the Trustee's arguments that the Bankruptcy Code Section 363(m) provisions were not "integral" to the sale, finding that the form of the sale order, including the Section 363(m) findings, were express conditions to the sale. The Panel was also not persuaded by the Trustee's argument that the Bankruptcy Court did not review the asset purchase agreement and that the sale order's findings were merely "boilerplate."

PRACTICAL CONSIDERATIONS

The Panel's decision reinforces the rule in the Eighth Circuit that any party -- not just signatories to a bankruptcy sale -- can rely upon the finality of a sale order. The finding should provide additional comfort to prospective purchasers in bankruptcy that a final sale order will protect them against claims, even of parties not previously involved in the bankruptcy proceeding.

BANKRUPTCY COURT ORDER APPROVING FREE AND CLEAR SALE OF ASSETS NOT NECESSARILY IMPEDIMENT TO EQUITABLE RELIEF SOUGHT IN STATE COURT AGAINST PURCHASER

Christopher A. Lynch
Associate, New York

MHS Capital LLC v. Googin, et al., C.A. No. 2017-0449-SG, 2018 WL 2149718 (Del. Ch. May 10, 2018)

CASE SNAPSHOT

The Delaware Court of Chancery ("Chancery Court" or "Court") held that a party's claim for equitable relief from the purchasers of assets in bankruptcy will not necessarily undermine those orders that authorized the transfer of the assets free and clear of all liens, claims and encumbrances. Plaintiff was a member of a limited liability company, which held the right to credit bid on the assets in questions, but the LLC manager and his friends (the other members in the LLC) wrongfully diverted that right to entities owned or controlled by the defendants. The Chancery Court's rationale in denying defendants' motion to dismiss the breach of contract claim was that the Court's broad discretionary power to fashion appropriate equitable relief left open the possibility that it could do so here without interfering with the sale orders. The Court held that ultimately its ability to do so can only be determined following further development of the factual record.

FACTUAL BACKGROUND

The plaintiff, MHS Capital LLC ("MHS") is a Delaware LLC that invests in domestic companies. One such investment is its 23.75% stake in East Coast Miner LLC ("ECM"). Defendant Googin is the manager of ECM and holds an 11.88% interest in ECM; defendant Goodwin holds a 10.69% interest; and defendant Collins a 6.65% interest. The complaint alleges the foregoing individuals are friends. ECM purchased a senior debt note from U.S. Coal, Inc. ("US Coal"), which was secured by a security interest in assets owned by the Licking River ("LR") division of US Coal. This security interest gave ECM the right to credit bid for LR's assets if US Coal entered bankruptcy, which it did in 2014.

Defendant Googin created a separate entity named East Coast Miner II ("ECM II") and, together with Goodwin, set up Licking River Lenders ("LRL"), composed of ECM, ECM II, Googin and Goodwin. Of these four entities and individuals, only ECM had the right to credit bid on LR's assets. Nonetheless, when LR's assets went to sale in the bankruptcy proceeding, Googin allowed LRL to exercise ECM's credit bid rights; LRL became the owner of those assets; and ECM was thereby forced to share the proceeds of those assets with the other three members of LRL: Googin, Goodwin and ECM II. In April 2015, the bankruptcy court entered an order authorizing the sale of these assets to ECM "and/or" ECM II as the "Credit Bid Purchasers" free and clear of liens, claims and encumbrances under section 363 of the Bankruptcy Code.

In addition, Googin allegedly misappropriated other LR assets by forming another entity, Ember Energy LLC ("Ember") in which he held an 83% stake and defendant Collins held the balance. According to the complaint, Googin "misappropriated ECM's proprietary and confidential information and trade secrets" as part of a scheme to effect the assignment of other LR assets to Ember. By a second order entered in April 2015, the bankruptcy court authorized the free and clear sale of these LR assets to Ember.

Upon learning of Googin, et al.'s alleged wrongdoing, MHS filed a complaint with the Chancery Court against the defendants alleging, among other things, claims for breach of contract, breach of fiduciary duties, fraud, breach of the implied covenant of good faith and fair dealing, tortious interference with a contract, unjust enrichment, and misappropriation of trade secrets. MHS claims it does not seek to reverse or modify the sale orders authorizing the sale of the LR assets to ECM II and Ember, but, among other things, seeks to disgorge the monetary proceeds received by the defendants and impose a constructive trust over those proceeds. The defendants moved to dismiss the complaint for failure to state a claim, relying on the exculpation clause set forth in ECM's operating agreement, which precluded monetary damages against Googin (ECM's manager), and the argument that the relief sought would interfere with the bankruptcy court orders entered in US Coal's bankruptcy proceeding.

COURT ANALYSIS

The Chancery Court first addressed MHS's contract claims under the operating agreement, for which MHS asserted it was seeking the equitable remedies discussed above. The Court declined at the motion to dismiss stage to find that the equitable relief that MHS seeks necessarily undermines the bankruptcy court's sale orders, which provide in pertinent part that the purchasers (ECM II and Ember) take title to the assets free and clear of any "encumbrance of any kind" and that "all persons and entities holding … Claims … are … permanently enjoined from asserting … such … Claims of any kind or nature" against the purchasers with respect to the LR assets. Noting that the Court enjoyed "broad discretionary power to fashion appropriate equitable relief" and that the Court may "depart from strict application of the ordinary forms of relief where circumstances require," the Court rejected calls for dismissal of these equitable claims until the facts were better developed and the Court determined whether it could in fact right the alleged wrong without usurping the bankruptcy court orders. The Court did note, however, that it was possible that discovery may reveal

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that any equitable relief may impermissibly modify the bankruptcy court's sale orders and thus not be available to MHS.

The Court, however, dismissed the remainder of the claims against the defendants, the majority of which were against Googin. First, the Court noted that the fiduciary duty claims against Googin were duplicative of the breach of contract claims and, absent an "independent basis for the fiduciary duty claim[]," must be dismissed. MHS's fraud claim also failed as the Court found that the allegation that the purported misrepresentations were made "at some point" between 2009 and 2015 lacked the specificity required when pleading fraud and, further, it was unclear to the Court MHS "relied" on the alleged misrepresentations. The breach of implied covenant of good faith and fair dealing failed because it rested entirely on conduct addressed by ECM's operating agreement and there was no gap that needed filling by an implied contractual term. Further, because the operating agreement governed the parties' relationship, MHS's unjust enrichment claim was dismissed. Also, because MHS failed to allege facts supporting the existence of a trade secret, misappropriation of trade secrets claim against Googin and Collins was dismissed. Finally, because the relief sought in the books-and-records demand will in effect be accomplished through discovery in the surviving breach of contract claim, that cause of action was dismissed without prejudice.

PRACTICAL CONSIDERATIONS

The Court's decision demonstrates that there are no absolutes, even following the sale of assets in bankruptcy under section 363 of the Bankruptcy Code. Although it will necessarily be a fact-intensive inquiry, a party aggrieved by the wrongful conduct of the purchaser (and potentially others related to the sale) may be able to seek equitable recourse in state court.

COUNSEL'S CORNER: NEWS FROM REED SMITH

Paul Singer was recognized by the Pennsylvania Bar Association for outstanding leadership in the legal profession and extraordinary service and long-standing membership in the association.

Claudia Springer was named 2018 Inquirer Influencers of Law for Bankruptcy.

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REED SMITH RESTRUCTURING & INSOLVENCY 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

Monique B. Howery
+1 312 207 2417
mhowery@reedsmith.com

Ann E. Pille
+1 312 207 3870
apille@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
Lloyd A. Lim
+1 713 469 3671
llim@reedsmith.com

Rachel I. Thompson
+1 713 469 3652
rithompson@reedsmith.com

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

Colin Cochrane
+44 (0)20 3116 3924
ccochrane@reedsmith.com

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

Monika Lorenzo-Perez
+44 (0)20 3116 3428
mlorenzo-perez@reedsmith.
com

Estelle Macleod
+44 (0)20 3116 2985
emacleod@reedsmith.com

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

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

Anthony Riddle
+44 (0)20 3116 3578
ariddle@reedsmith.com

Diane Roberts
+44 (0)20 3116 2879
diane.roberts@reedsmith.com

Rebecca Terrace
+44 (0)20 3116 3676
rthorp@reedsmith.com

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

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

MIAMI
Reginald Sainvil
+1 412 288 3626
rsainvil@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
Edward J. Estrada
+1 212 549 0247
eestrada@reedsmith.com

Aaron Javian
+1 212 549 4228
ajavian@reedsmith.com

David Kazlow
+1 212 549 4227
dkazlow@reedsmith.com

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

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

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

Richard J. Tannenbaum
+1 212 549 0233
rtannenbaum@reedsmith.com

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

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

Megan Byrnes
+1 215 851 8166
mbyrnes@reedsmith.com

Scott M. Esterbrook
+1 215 851 8146
sesterbrook@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 S. Zabel
+1 215 851 8147
lzabel@reedsmith.com

PITTSBURGH
Alexis A. Leventhal
+1 412 288 3834
aleventhal@reedsmith.com

Maura P. McIntyre
+1 412 288 3862
mmcintyre@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

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

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

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

WILMINGTON
Emily K. Devan
+1 302 778 7570
edevan@reedsmith.com

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

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