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CAN A SECURED CREDITOR CLAW BACK A RETAINER PAYMENT TO DEBTOR'S COUNSEL?

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This is a question that I get asked frequently. A recent case out of the Bankruptcy Court for the Southern District of Florida concludes that the answer is "no". *See, In re Tuscany Energy, LLC* 2018 Bankr. LEXIS 192 (Bankr. S. D. Fla. 2018). In that case, debtor's counsel was paid a retainer of $200,000 by the debtor a couple months prior to fling its bankruptcy petition. Such funds came from a deposit account held at a bank other than the secured lender. Thereafter, debtor's counsel sought court permission to apply the retainer to approved fees and costs. The secured lender objected alleging that it held a perfected security interest in the deposit account and the retainer funds. The court ruled that although the secured lender had a security interest in the deposit account, the security interest was unperfected because the secured lender did not have "control" over the account, where as, the lien held on the retainer funds by debtor's counsel was perfected by possession and took priority. Not that big of a surprise, but the court did not stop there. It further held that debtor's counsel would win even if the secured lender was perfected because, absent collusion, the Uniform Commercial Code protects a transferee of funds from a deposit account and such transferee takes free and clear of the secured lender's perfected liens.

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SUBCHAPTER S CORPORATION STATUS IS NOT PROPERTY OF A DEBTOR'S ESTATE

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Richard Arrowsmith v. United States (In re Health Diagnostic Lab., Inc.), 578 B.R. 552 (Bankr. E.D. Va. 2017)

CASE SNAPSHOT

The liquidating trustee asserted that the debtor's S corporation status, which corporate status would have enabled the debtor's shareholders to receive tax refunds, was property of the estate that the trustee could claw back through fraudulent transfer laws under chapter 11 of Title 11 of the United States Code (the "**Bankruptcy Code**"). The Bankruptcy Court disagreed.

FACTUAL BACKGROUND

Health Diagnostic Laboratory, Inc. and certain of its affiliates ("**HDL**") offered clinical laboratory services to physicians. In January 2013, federal authorities investigated whether HDL had violated certain federal anti-kickback laws and in April 2015, HDL agreed to a multi-million dollar settlement for alleged violations of the federal False Claims Act. HDL defaulted under its secured loan facilities and filed for chapter 11 bankruptcy protection in June 2015 (the "**Petition Date**"). On September 17, 2015, the bankruptcy court confirmed a plan of liquidation and a liquidating trust was established pursuant to which the liquidating trustee became the successor-in-interest to the debtor's estate.

On January 1, 2015 HDL filed a notice of termination of its S corporation status. Consequently, as of the Petition Date, HDL was subject to C corporation tax.

The liquidating trustee, who had commenced an adversary proceeding against the Internal Revenue Service, certain state taxing authorities, and former shareholders of HDL (the "**Defendants**") on the Petition Date, sought to avoid the revocation of HDL's S corporation status on behalf of the debtor's estate (and subsequent to confirmation of the plan of liquidation, on behalf of the liquidating trust).

The trustee asserted that retroactively reclassifying HDL as an S corporation would enable shareholders to receive tax refunds that the trustee could claw back pursuant to fraudulent transfer provisions under Sections 544(b) and 548 of the Bankruptcy Code. The trustee's theory was based on several hypothetical assumptions. The trustee asserted that if HDL was reclassified prior to the Petition Date as an S corporation, then HDL would file an amended return for 2015. HDL's income losses could then be passed through to shareholders, who would then amend their own returns for 2015, which income tax returns would include HDL's losses (since, as an S corporation, HDL's losses pass through to shareholders), and any income the shareholders claimed in 2015 could be applied against these unused losses carried back two tax years. This would generate tax refunds for the shareholders that the liquidating trustee sought to recover for the benefit of the liquidating trust.

In order to pursue these fraudulent transfer claims, the trustee needed to establish that S corporation status constituted property of the debtor's estate under Bankruptcy Code Section 541. The bankruptcy court held that S corporation status is not "property" under federal tax law, and thus cannot be considered property for the purposes of Section 541 of the Bankruptcy Code. As a result, there was no property to claw back through the Bankruptcy Code's fraudulent transfer laws.

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WHO WANTS RELIEF FROM THE AUTOMATIC STAY? A REFRESHER OF WHAT CAN CONSTITUTE "CAUSE" IN A CONSUMER CASE.

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In re Sterling, Bankr. Case No. 14-12608-shl, 2018 WL 313085 (Bankr. S.D.N.Y. Jan. 5, 2018)

CASE SNAPSHOT

The lender filed a motion for relief from the automatic stay to proceed with a foreclosure action against the real property. The pro se chapter 7 debtor challenged the lender's motion and argued that relief was inappropriate because the lender lacked standing to pursue relief.

FACTUAL BACKGROUND

A non-debtor property owner gave title to the property to the debtor via a recorded mortgage. Neither the prior owner nor the debtor made payments under the Note, and the lender initiated state court foreclosure proceedings. The state court entered a Judgment of Foreclosure and Sale in favor of the lender.

The debtor filed his chapter 7 bankruptcy case on September 15, 2014 and on July 7, 2017, the lender filed its motion for relief from the automatic stay to proceed with the state court foreclosure proceeding. After multiple rounds of briefing, the court granted the lender relief from the automatic stay to proceed with foreclosure proceedings.

COURT ANALYSIS

The court first addressed the question whether the lender had standing to seek stay relief. The court reasoned that because the lender was a "party in interest" because it satisfied the court that it held the note and the mortgage. Accordingly, the lender was a "creditor" as defined by section 101(1)(A) of the bankruptcy code and had standing to pursue stay relief.

The court next addressed whether the lender had "cause" for stay relief under section 362(d) of the bankruptcy code. The court found that the lender proved cause because the debtor had not made any payments on the mortgage since at least March 1, 2008. The law is well established that the failure to make mortgage payments constitutes "cause" for purposes of stay relief.

Further, courts in the second circuit review a list of twelve factors when determining whether cause exists to grant stay relief for pre-petition litigation. The court found that the lender satisfied most of the twelve factors and that allowing the lender to proceed with the foreclosure action would "result in a resolution of the issues relating to the Property and will not significantly interfere with the ongoing bankruptcy case…."

Finally, in response the debtor's myriad objections to the lender's requested relief, the court found that the lender already obtained a state court foreclosure judgment. The court could not allow the debtor to relitigate issues that should have been raised in the state court. Further, the debtor's additional allegations – unclean hands, fraudulent misrepresentation, and criminal law violations – were unsupported and purely speculative.

PRACTICAL CONSIDERATIONS

The key takeaway from this case is affirmation of prior decisions that the debtor's failure to make mortgage payments may constitute "cause" under section 362(d) of the bankruptcy code. Accordingly, a lender pursuing a motion for relief of the automatic stay in a consumer case should always highlight to the court the number of missed mortgage payments.

COURT ANALYSIS

Property of the bankruptcy estate is composed of "all legal or equitable interests of the debtor in property as of the commencement of the case." 11 U.S.C. § 541(a)(1). The bankruptcy court noted that there is no Bankruptcy Code provision which directly answers the question of whether a debtor has an interest in a particular item of property. In this case, the bankruptcy court looked to federal tax law to determine whether S corporation status is a property right for purposes of the fraudulent transfer claims.

The Bankruptcy Court considered six factors, previously established by the Fourth Circuit, to determine if a property right existed under federal tax law: "(1) the right to use; (2) the right to receive income produced by the purported property interest; (3) the right to exclude others; (4) the breadth of the control the taxpayer can exercise over the purported property; (5) whether the purported property right is valuable; and (6) whether the purported right is transferable."[1] In weighing these factors, the bankruptcy court concluded that only one factor leans in favor of classifying S corporation status as property, the debtor's ability to use the tax status to pass their tax liability through to shareholders (the "use" factor). The bankruptcy court, however, stated that the "use" factor was the weakest of the property right factors, as the right to use is meaningless without a right to control the use. In this case, the Debtors had a right to use S corporation status, but they lacked any ability to control their tax classification.

None of the other factors supported the trustee's theory. Ultimately, the Bankruptcy Court determined that the Debtors' lacked the requisite control over S corporation status and found that the right to exercise control over an interest is the essential characteristic defining property. Because election of S corporation status can only be achieved by unanimous shareholder consent, shareholders have the ultimate control over such a decision, not the corporation. Accordingly, revocation of the S corporation status did not confer a property right on the debtor's estate such that the trustee could pursue fraudulent transfer claims against the Defendants.

PRACTICAL CONSIDERATIONS

This decision extends the minority holding, reached only by the Court of Appeals for the Third Circuit, that S corporation status does not constitute a property right in bankruptcy. The bankruptcy court's six factor property right test, previously adopted by the Fourth Circuit in recognizing that certain interests constitute property for federal tax purposes when they embody essential property rights, should provide future courts analyzing this issue with clear guidelines when rendering an opinion.

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1 *Id.* at *25.

NINTH CIRCUIT PERMITS SALE OF REAL PROPERTY FREE AND CLEAR OF LEASEHOLD INTERESTS

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In re Spanish Peaks Holdings II, LLC, 872 F.3d 892 (9th Cir. 2017)

CASE SNAPSHOT

The Ninth Circuit held that although Bankruptcy Code section 365(h) permits a lessee to retain possession of real property after it is rejected, Bankruptcy Code Section 363(f) could nevertheless be used to sell real property free and clear of the lessee's possession.

FACTUAL BACKGROUND

Debtor Spanish Peaks owned a 5,700-acre resort in Big Sky, Montana. Spanish Peaks entered into a 99-year lease for restaurant space with The Pinnacle Restaurant for $1,000 per year, and a 60-year lease for commercial space with Montana Opticom, LLC for $1,285 per year. Both leases were for nominal yearly amounts, and the lessees were owned by an insider of the Debtor.

The Chapter 7 Trustee sought to sell the resort property free and clear of encumbrances, including the two below-market leases, pursuant to Bankruptcy Code Section 363(f). The successful bidder on the property was the Debtor's secured lender. The lessees objected, arguing that Bankruptcy Code Section 365(h) permitted them to remain in possession of the real properties. The Bankruptcy Court approved the sale free and clear of the leases, and the District Court affirmed.

COURT ANALYSIS

On appeal, the Ninth Circuit affirmed. At issue was a potential conflict between two Bankruptcy Code sections:

On one hand, Section 363(f) permits a debtor to sell property "free and clear of any interest in such property", so long as, among other things, "applicable nonbankruptcy law permits sale of such property free and clear of such interest" .

On the other hand, Section 365(h) provides that, although a lease may be rejected by a bankruptcy trustee, "if the term of such lease has commenced, the lessee may retain its rights under such lease (including rights such as those relating to the amount and timing of payment of rent and other amounts payable by the lessee and any right of use, possession, quiet enjoyment, subletting, assignment, or hypothecation) . . ."

The Ninth Circuit held that, although many courts have determined that when Section 363 and Section 365 come into conflict with one another, that Section 365 (which protects lessees) trumps Section 363. However, the Ninth Circuit joined the "minority approach" set forth by the Seventh Circuit in *In re Qualitech Steel Corp. & Qualitech Steel Holdings Corp.*, 327 F.3d 537 (7th Cir. 2003), and held that the statutory provisions were not in conflict with one another. Section 365 governs rejection, whereas Section 363 governs sales. Where a trustee proposed to sell property under Section 363, rather than rejecting it under Section 365, the "free and clear" provisions under Section 363 governed.

The Ninth Circuit did observe, however, that a lessee was free to move for adequate protection under Section 363(e), which provides that a "bankruptcy court must provide adequate protection for an interest that will be terminated by a sale if the holder of the interest requests it", and that under some circumstances, adequate protection would require that the interest holder remain in possession of the interest.

PRACTICAL CONSIDERATIONS

First and foremost, lessees should always insist on subordination, non-disturbance, and attornment agreements (SNDAs) and record their leasehold interests on title. In *Spanish Peaks*, the leasehold interests were so far below market that they likely would not have benefitted even from the adequate protection sections of Section 363(e). However, a lessee with arms-length lease terms and SNDAs in place would have a much better chance at protecting its possessory interests.

FIRST CIRCUIT AFFIRMS DISMISSAL OF FRAUDULENT TRANSFER AND FIDUCIARY DUTY CLAIMS

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Irving Tanning Co. v. Kaplan (In re Irving Tanning Co.)
876 F.3d 384 (1st Cir. 2017)

CASE SNAPSHOT

In *Irving Tanning*, the First Circuit held that the largely debt-financed purchase of a family owned business was not a fraudulent conveyance and did not amount to a breach of fiduciary duties by the company's directors.

FACTUAL BACKGROUND

Events Giving Rise to the Chapter 11 Cases and Subsequent Lawsuits

The holding company debtor ("Prime Delaware") and its operating subsidiaries, "Prime Maine," and "Irving," leather manufacturing companies, were part of jointly administered Chapter 11 cases.

The relationship between the debtors formed years before their bankruptcy petitions. Meriturn Capital, a private equity firm, purchased Prime Maine, a family-owned leather manufacturer, along with Prime Maine's wholly-owned subsidiary, Prime Missouri. Meriturn sought to consolidate Prime Maine with Irving Tanning Company ("Irving"), another leather manufacturer that Meriturn had previously purchased, believing that consolidating the two manufacturers would lower the cost of leather production and allow the surviving entity's products to reach new markets.

Eventually, Meriturn created a holding company—Prime Delaware—to achieve the consolidation. First, Meriturn transferred its stake in Irving to Prime Delaware. Next, Meriturn caused Prime Delaware to purchase Prime Maine from the family shareholders for cash, a note, stock in Prime Delaware, and the granting of employment contracts for two of Prime Maine's shareholders.

Before the transaction, the directors of Prime Maine carefully considered the sale before approving it. They received financial advice from a management consulting firm, accounting advice from an independent public accountant, and legal advice from their counsel. The directors concluded that although some risk was involved, that the transaction would create a stronger entity long term, and that financial projections showed that the sale was likely to succeed.

Meriturn financed its purchase of Prime Maine mainly through $30 million in debt in the form of a loan from its primary lender, secured by the assets of Prime Delaware and all of its subsidiaries.

After the sale, Prime Delaware was able to pay its bills, but encountered financial problems in early 2008 at the inception of the global financial crisis. By 2010, Prime Delaware was insolvent, causing it and the other debtor subsidiaries to file Chapter 11 petitions in late 2010. In 2012, the bankruptcy court confirmed debtors' Chapter 11 plan. The plan provided that a litigation trust acquired the debtors' claims.

After confirmation, the litigation trustee sued the shareholders Prime Maine, seeking to void Prime Maine's sale to Prime Delaware as a fraudulent transfer. Additionally, the trustee sought to hold Prime Maine's directors liable for breach of their fiduciary duties by their approval of the sale.

Procedural History

After a five-day trial with a voluminous record, the bankruptcy court ruled for the defendant shareholders and directors on each count. Despite the bankruptcy court's failure to make specific findings with respect to both Prime Maine and Prime Missouri (as its subsidiary), the trustee never requested that the bankruptcy court make additional factual findings.

Instead, the trustee appealed to the district court, arguing that the bankruptcy court's decision was insufficiently supported by findings of fact and was clearly erroneous. The district court affirmed the bankruptcy court's ruling finding any mistakes made by the bankruptcy court were harmless and that the trustee failed to show breach of fiduciary duty.

COURT ANALYSIS

On further appeal, the First Circuit overlooked the bankruptcy court's lack of detailed findings because the findings in the record were sufficient and the trustee failed to request additional findings. The First Circuit noted, however, that the bankruptcy court only made factual findings respecting fraudulent transfer claim against Prime Delaware, the holding company, and that the bankruptcy court should have made the same determinations with respect to both Prime Maine and Prime Missouri so as to ensure adequate protection of creditors' interests in each subsidiary.

Acknowledging the shortcoming, the First Circuit proceeded to decide the merits of the fraudulent transfer and fiduciary duty claims against each entity separately:

- Fraudulent Transfer:
    - The First Circuit upheld the bankruptcy court's determination that Prime Delaware, the holding company, did not engage in a fraudulent transfer, noting that the bankruptcy court found the necessary facts to support its conclusion. In affirming, the First Circuit found that Prime Delaware received reasonable value in exchange for Prime Maine, and that the value of Prime Maine's stock exceeded the total amount transferred to shareholders in the transaction. In addition, the First Circuit affirmed that the trustee failed to show that Prime Delaware was undercapitalized at the time of the transaction or that it would be unable to pay debts as they became due.
    - The First Circuit found that neither Prime Maine or Prime Missouri engaged in fraudulent transfer, finding that the trustee also failed to prove undercapitalization or a belief from the subsidiaries that they would be unable to pay their debts as they became due. Because Prime Delaware, a non-operating holding company, was found to

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not be undercapitalized or unable to pay its debts, this conclusion necessarily flowed over to both Prime Maine and Prime Missouri as its wholly-owned subsidiaries. Thus, the same evidence the bankruptcy court relied on in evaluating whether Prime Delaware engaged in a fraudulent transfer equally applied to support its findings with respect to the subsidiaries.

- Actual Fraud:
  - The First Circuit declined to review the bankruptcy court's finding that defendants lacked fraudulent intent, reiterating that fraud had to be proved by clear and convincing evidence and that the trustee produced no direct evidence of actual fraud. The First Circuit noted that substantial testimony and documents in the record showed that the merger had the potential to create efficiencies, expand markets, lessen costs and allowed Prime Maine to continue its connection with the brand into another generation.
  - Again, the First Circuit imputed the bankruptcy court's findings with respect to Prime Delaware onto its subsidiaries, Prime Maine and Prime Missouri, finding first that the transaction could not create efficiencies, expand markets, and lessen costs without Prime Maine being successful as well. Moreover, the First Circuit found that the lack of specific findings regarding Prime Maine or Prime Missouri's fraudulent intent did not merit remand because it explicitly found that Prime Delaware—who controlled Prime Maine and Prime Missouri—did not act with intent to defraud.
- Breach of Fiduciary Duty:
  - The First Circuit foreclosed the trustee's fiduciary duty claims, holding that the findings of fact supporting the bankruptcy court's fraudulent transfer analysis foreclose the possibility of fiduciary duty liability. On appeal, the trustee argued that the defendant directors breached their duty of care by failing to properly investigate the transaction and violated their duty of loyalty by self-dealing and approving prohibited distributions and that Prime Delaware's insolvency was directly caused by such breaches. However, the First Circuit was unconvinced of any connection between Prime Delaware's inability to pay its bills in 2009 with the 2007 payment to shareholder defendants in the merger; relying on testimony and an expert report evidencing that unforeseeable increases in chemical energy prices and the financial crisis significantly contributed to Prime Delaware's insolvency.
  - Lastly, the First Circuit found that because Prime Delaware was a holding company without its own operations, the bankruptcy court's finding that the transaction did not cause the insolvency of Prime Delaware flowed to Prime Maine.

PRACTICAL CONSIDERATIONS

Here, the First Circuit emphasized that the bankruptcy court "could have been clearer" in its ruling below in the defendants' favor, and that normally, each defendant entity (i.e. the parents and the subsidiaries) would have to evaluated on each of the counts separately in order to adequately protect the interests of the subsidiaries' creditors. However, the interrelationship of Prime Delaware as a non-operating holding company and the Prime Maine and Prime Missouri as its wholly-owned subsidiaries diminished the need for distinct findings because the findings of fact supporting Prime Delaware would have been the same findings of fact absolving the subsidiaries of the counts against them. Additionally, the First Circuit admonished the plaintiffs for immediately appealing the bankruptcy court's decision as opposed to filing a Rule 52(b) motion requesting additional findings, as the principal and preferred mechanism for challenging the trial court's failure to find facts.

Beyond these procedural considerations, and not explicitly addressed by the First Circuit, this opinion joins other courts who have recently rejected fraudulent transfer and fiduciary duty attaches on transactions undermined by unforeseen events and the 2008 global financial crisis. *See, e.g., In re ATP Oil & Gas Corp.*, 711 F. App'x 216 (5th Cir. 2017) (affirming dismissal of trustee's fiduciary duty and fraudulent transfer claims based on payment of stock dividends and payment of cash bonuses to officers during the two years preceding bankruptcy after a major oil spill in 2010 and moratoria on further drilling); *In re Lyondell Chem. Co.*, 567 B.R. 55, 63 (Bankr. S.D.N.Y. 2017) (holding that trustee failed to prove insolvency, actual fraud, or fault to support breach of fiduciary duty claims, noting that debtor had been "buffeted by unplanned and . . . unforeseeable events . . . and the effect of the Great Recession at the end of 2008").

AN UNDERSECURED CREDITOR WHO ELECTS TREATMENT UNDER 11 U.S.C. § 1111(B) IS ENTITLED TO POST-PETITION ATTORNEYS' FEES AS PART OF ITS SECURED CLAIM

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In re Pioneer Carriers, LLC, No. 16-36356, slip-op. (Bankr. S.D. Tex. Feb 8, 2018)

CASE SNAPSHOT

The United States Bankruptcy Court for the Southern District of Texas (the "Court") recently determined that an undersecured creditor making an election pursuant to § 1111(b) of the Bankruptcy Code is entitled to include post-petition attorneys' fees in its secured claim. The Court's decision is significant because it is a shift from the principle that only an oversecured creditor may include attorneys' fees incurred post-petition as part of its § 1111(b) secured claim.

FACTUAL BACKGROUND

On December 12, 2016, Pioneer Carriers, LLC (the "Debtor") filed a voluntary petition 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 petition date, Equify Financial, LLC ("Equify") extended financing to the Debtor in the principal amount of $389,268.93. The financing was secured by nearly all of the Debtor's non-real property assets. On August 6, 2017, Equify timely filed a proof of claim, asserting that it held a bifurcated claim because the value of the claim exceeded the value of the collateral. The Debtor did not dispute the debt owed to Equify. Indeed, the Debtor set forth Equify's secured claim and unsecured claim in its disclosure statement and plan of reorganization.

On August 16, 2017, Equify timely filed a notice of election under § 1111(b) of the Bankruptcy Code. A § 1111(b) election treats the secured creditor's entire gross claim as secured, notwithstanding the fact that the value of the collateral is some lesser amount. On November 8, 2017, the Debtor filed a second amended plan of reorganization that, among other things, recognized that Equify made a § 1111(b) election. Shortly thereafter, Equify filed an objection to the Debtor's second amended plan because the plan did not include Equify's post-petition attorneys' fees as part of Equify's secured claim. Equify argued that it is entitled to compensation for its post-petition attorneys' fees pursuant to 11 U.S.C. § 502(b). After considering oral argument of counsel for the Debtor and Equify, the Court decided that Equify was entitled to its post-petition attorneys' fees as part of its secured claim.

COURT ANALYSIS

The Court used a two-step approach to reach its conclusion. First, the Court addressed whether Equify had an allowed claim for its post-petition attorneys' fees. For several years, courts have been split on the issue of whether an unsecured creditor like Equify can recover post-petition attorneys' fees. *See SNTL Corp. v. Centre Ins. Co. (In re SNTL Corp.)*, 571 F.3d 826, 840 (9th Cir. 2009) (discussing split and listing cases). While the majority of courts have taken the position that only an oversecured creditor may recover postpetition attorneys' fees, the Court disagreed, explaining that, under the circumstances, Equify was the holder of an allowed unsecured claim for postpetition attorneys' fees because: (i) Equify was an unsecured creditor in that it was holding an undisputed bifurcated claim; (ii) the claim asserted by Equify was based upon prepetition agreements that contained express provisions allowing Equify to recover its reasonable attorneys' fees; and (iii) there is no provision under the Bankruptcy Code that *explicitly* bars Equify's claim for post-petition attorneys' fees despite the fact that Equify is not an oversecured creditor.

Second, upon finding that Equify held an allowed unsecured claim for post-petition attorneys' fees, the Court considered whether Equify's post-petition attorneys' fees should automatically become secured by virtue of Equify's § 1111(b) election. In reaching its decision on this issue, the Court relied on an opinion from the Bankruptcy Court for the Central District of California – *In re Castillo*, 488 B.R. 441 (Bankr. C.D. Cal. 2013) – which recognized that a § 1111(b) election alters a claim for post-petition attorneys' fees from an unsecured claim to an allowed secured claim. The *Castillo* court's rationale was that because none of the § 502(b) exceptions bar allowance of claims for attorneys' fees, post-petition attorneys' fees are no different and may be included in an allowed claim. The Court recognized that this viewpoint was rather novel, but found that the reasoning was exceedingly persuasive. As a result, based on *Castillo*, the Court concluded that if a creditor has an allowed unsecured claim for post-petition attorney's fees, the entire allowed claim should become secured when a creditor makes a § 1111(b)(2) election.

PRACTICAL CONSIDERATIONS

The Court's holding demonstrates that an undersecured creditor's post-petition attorneys' fees may be allowed under certain circumstances. As a result, undersecured creditors should think about post-petition attorneys' fees when deciding whether or not to make a § 1111(b) election. Such elections are not used frequently, but they may offer an undersecured creditor important protections that should be weighed thoughtfully and thoroughly.

JUDGMENT CREDITOR IS TRANSFEREE UNDER UCC 9-332 AND TAKES GARNISHED FUNDS FREE OF LENDER'S SECURITY INTEREST

Christopher A. Lynch
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Charleston Assocs., LLC v. RA Southeast Land Co., LLC (In re Charleston Assocs., LLC), Adv. Pro. No. 10-01452 (Bankr. D. Nev. Dec. 5, 2017)

CASE SNAPSHOT

The U.S. Bankruptcy Court for the District of Nevada recently held that a judgment creditor could retain funds seized pursuant to a writ of execution even though those same funds were subject to lender's perfected security interest. Absent any evidence that the lender had more than a bare security interest in the rents deposited in the accounts, the executing judgment creditor fell within the protections afforded transferees under section 9-332 of the UCC.

FACTUAL BACKGROUND

New Boca Syndications Group, LLC ("New Boca"), as borrower, and US Bank National Association ("US Bank"), in its capacity as trustee, entered into a loan by which New Boca borrowed funds secured by certain real property that generates rental proceeds ("Rents"). In connection therewith, New Boca, US Bank and a depository bank ("Depository Bank") entered into a Cash Management Agreement ("CMA") whereby Rents were deposited into a drop box account (the "Clearing Account") and then periodically swept into another account (the "Cash Collateral Account" and, together with the Clearing Account, the "Accounts"). The Accounts were maintained at the Depository Bank. The CMA provides US Bank with a continuing security interest in the Rents while held in the Accounts. The CMA also contemplates, among other things, that the Cash Collateral Account will be divided into subaccounts for identified obligations related to the property, imposes restrictions on the use of Rents deposited in the Accounts, and provides that in the event of a default US Bank would have sole discretion to administer funds in the Cash Collateral Account, including the right to demand the Depository Bank to pay to US Bank all funds in the Cash Collateral Account. The Accounts were in the name of New Boca and bore its tax identification number, and nothing in the CMA indicates that US Bank had anything more than a security interest in the Rents in the Accounts.

In connection with the instant adversary proceeding, City National Bank ("City Bank") obtained a judgment against New Boca and, pursuant to a writ of execution served on the Depository Bank by the Constable of Las Vegas Township, funds held in the Cash Collateral Account in the amount of $542,343 were seized and remitted to City Bank. US Bank thereafter filed a petition with the Bankruptcy Court for an order directing City Bank to return the garnished funds.

COURT ANALYSIS

The Bankruptcy Court denied the petition, finding that City Bank was a protected transferee under UCC 9-332 and therefore took the garnished funds free of US Bank's security interest. The Court first addressed the terms of the CMA and concluded that US Bank had no ownership in the Rents in the Cash Collateral Account and its interest was limited to a security interest in the Rents therein. In that regard, the Court noted that the CMA "did nothing more than preserve US Bank's security interest in the Rents upon their deposit in both accounts."

Absent any indicia of ownership, the Court then looked to Section 9-332 of the UCC, as adopted in Nevada, which provides in pertinent part:

> A transferee of funds from a deposit account takes the funds free of a security interest in the deposit account unless the transfer acts in collusion with the debtor in violating the rights of the secured party.

The Court noted that there was no dispute that the Accounts contained any funds other than Rents nor that City Bank was not a party to the CMA. There were also no allegations of collusion that might form an exception under UCC 9-332. As such, City Bank fell within the category of transferees protected by section 9-332 and could retain the seized funds notwithstanding US Bank's security interest. The Court also noted that the legislature could have carved out exceptions for encumbered funds such as those at issue in this case, but US Bank was unable to point to a single jurisdiction that had done so.

PRACTICAL CONSIDERATIONS

To avoid this result, a lender should consider regular pending litigation and judgment searches for its borrower in relevant jurisdictions. If the lender promptly calls a default and accelerates the debt, the lender can exercise its rights under the control agreement to set off available cash before an unsecured creditor is able to execute on any judgment.

SETOFFS: IS IT MUTUAL?

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U.S. Bank, National Association v. Rosenberg, 581 B.R. 424 (E.D. Pa. 2018)

CASE SNAPSHOT

The Court determined a setoff to be improper due to a lack of mutuality in a case where a bank held a $6 million guarantee judgment against a debtor and the debtor held a $6 million judgment against the bank and other creditors.. The judgment against the bank was also against other entities, which destroys mutuality. Additionally, the putative debtor assigned his judgment to a third party (a family trust) before the guarantee judgment was imposed, thus immunizing the judgment against setoff. Finally, a bad faith judgment pursuant to section 303(i) of the Bankruptcy Code cannot be set off against the unsuccessful petitioning creditor's claims against the putative debtor.

FACTUAL BACKGROUND

An individual guaranteed various lease obligations for entities that he owned. After a default on the lease, the bank initiated proceedings against the guarantor for breach of the guaranty and ultimately obtained a judgment of $6,506,075.41 against the guarantor. While the guaranty litigation was pending, the bank and various other creditors initiated involuntary bankruptcy proceedings against the guarantor. The involuntary bankruptcy petition was ultimately dismissed, and the guarantor sued the petitioning creditors under section 303(i) of the Bankruptcy Code for costs, attorney's fees and damages for the bad faith filing of the involuntary bankruptcy petition. Before judgment was rendered in the guaranty litigation, the guarantor obtained a $6,120,000 jury verdict on his bad faith filing claims. The bank brought a motion seeking to setoff the claims.

COURT ANALYSIS

Section 553 of the Bankruptcy Code preserves state law rights of setoff. Under Pennsylvania law, debts may be setoff only when the debts between the creditor and the debtor are mutual. Debts are mutual when they involve "the same right and between the same parties, standing in the same capacity." Here, the court found the setoff motion to be legally problematic for multiple reasons. First, the judgment in favor of the debtor was jointly and severally against the bank and other defendants. Because triangular setoff generally does not meet the mutuality requirement, the court found that mutuality was lacking. In addition, the Court found mutuality to be lacking because the judgments are not currently held by the same parties in light of the debtor's assignment of the judgment in his favor to a family trust. Finally, the Court noted that the presence of attorney charging liens that pre-date the judgments entered against the debtor also pose setoff issues, because earlier-filed charging liens have priority over a setoff claim founded on a later judgment.

In addition, the Court also held that setoff should be denied for equitable policy reasons. Generally, courts find that a bad-faith judgment pursuant to section 303(i) of the Bankruptcy Code cannot be setoff against the unsuccessful petitioning creditor's claims against the debtor. The court noted that the judgment entered in favor of the debtor was designed to discourage abuse associated with involuntary filing of bankruptcy, which is an important equitable principle of bankruptcy law that should not be overlooked. Accordingly, the Court determined setoff to be inappropriate.

PRACTICAL CONSIDERATIONS

When asserting a setoff defense, parties should closely analyze the respective rights and identities of holders of the judgments or claims to be set off. In addition, the parties should be mindful of policy considerations that could prevent setoff, including any inequitable, illegal or fraudulent acts of the creditor whose claim would be set off.

CREDITOR'S REFUSAL TO TURNOVER VEHICLE REPOSSESSED PRE-PETITION DOES NOT VIOLATE AUTOMATIC STAY BANKRUPTCY COURT SAYS

Monique B. Howery
Associate, Chicago

In re Dixon, No. 17-31675-beh, 2018 WL 400722 (Bankr. E.D. Wis. Jan. 11, 2018)

CASE SNAPSHOT

The Bankruptcy Court for the Eastern District of Wisconsin denied a debtor's motion to compel turnover of a vehicle repossessed pre-petition. In reaching its decision, the Court held that the parties' lease contract provided for termination of the lease as a consequence of the debtor's default thereunder. Accordingly, the debtor had no interest in the vehicle, nor was the vehicle property of the bankruptcy estate subject to the automatic stay.

FACTUAL BACKGROUND

On June 16, 2017, the debtor entered into a motor vehicle lease with Brite Financial, LLC. The lease required bi-weekly payments commencing June 16, 2017. By September 2017, the debtor had defaulted on her lease payments. Consequently, Brite mailed a Notice of Right to Cure letter to the debtor on September 6, 2017, which the debtor disputed receiving. The Notice set forth the amount of the default, and advised the debtor that if the default was not cured by September 21, 2017, the entire outstanding balance would be accelerated and become immediately due and payable without further notice, demand, or right to cure.

The debtor failed to cure the default by the specified deadline, and as a result, Brite repossessed the debtor's vehicle on November 25, 2017. Shortly thereafter, on December 6, 2017, the debtor filed her bankruptcy petition. She subsequently demanded that Brite return the vehicle, and Brite refused. The debtor then moved to hold Brite in contempt for its refusal to return the vehicle, and for imposition of sanctions on Brite for its alleged willful violation of the automatic stay.

The debtor argued that Brite did not terminate the lease pre-petition and therefore debtor's interest in the lease was an asset of her bankruptcy estate subject to the automatic stay. Brite, on the other hand, argued that the Notice of Right to Cure Default, followed by the repossession of the vehicle, constituted a termination of the lease.

COURT ANALYSIS

The Bankruptcy Court held that the debtor failed to carry her burden of proving that she had an interest in the leased vehicle that became the property of the bankruptcy estate. Thus, Brite did not violate the automatic stay.

The Court began its analysis by discussing the pertinent Bankruptcy Code provisions. Section 542(a) requires that an entity turnover to the trustee, any property it possesses that the trustee may use, sell, or lease under section 363. Sections 363(b) and (d) allow chapter 13 debtors, in the shoes of the trustee, to use, sell, or lease property of the estate. And section 541(a)(1) defines property of the state to include "all legal or equitable interests of the debtor in property as of the commencement of the case."

The Court next discussed that in order for the debtor to establish her right to turnover of the vehicle, she must show that the lease was not terminated pre-petition, i.e., that she had an interest in the vehicle that was subject to the automatic stay, and that Brite violated the stay.

To determine whether the lease was terminated pre-petition, the Bankruptcy Court looked at the language of the lease contract, as well as the applicable Wisconsin statutes. The parties' lease provided that the debtor would be in default if, among other things, "an amount greater than one full payment . . . remained unpaid for more than 10 days after its scheduled or deferred due date." Upon the debtor's default, the lease provided that Bright may terminate the lease, repossess the vehicle, and/or take other actions permitted by law to exercise its rights to the vehicle. The lease also provided that debtor would have no further rights in the vehicle upon Brite's recovery of the vehicle.

The Bankruptcy Court rejected debtor's argument that the lease contract was ambiguous in its use of the word "may" in connection with the remedies available to Brite upon debtor's default. Rather, the Court found that the remedies were provided in both the disjunctive and conjunctive, and the contract did not limit Brite to only one remedy. Acknowledging that the parties did not dispute that the debtor failed to cure the default, the Court concluded that the lease adequately advised both parties as to how each may terminate the lease.

Because the debtor was apprised of the termination options available to Brite, and the debtor was unable to identify any contrary controlling law providing for reinstatement of the lease, the Bankruptcy Court held that it could not compel turnover of the vehicle, nor could it find that Brite violated the automatic stay.

PRACTICAL CONSIDERATIONS

This case reinforces the principle that a well-drafted contract is the first line of defense for creditors seeking to protect their interests in potential bankruptcy actions. To wit, a contract that contemplates and provides for certain remedies upon a borrower's and/or lessee's default serves to increase certainty and reduce risk in lending and leasing transactions.

BANKRUPTCY COURT DENIES SUBSTANTIVE CONSOLIDATION OF NON-DEBTOR PARENTS WITH THE BANKRUPTCY ESTATE OF THEIR SON

Maura P. McIntyre
Associate, Pittsburgh

Manchester v. Kretchmar (In re Kretchmar), 579 B.R. 924 (Bankr. W.D. Okla. 2018)

CASE SNAPSHOT

In a chapter 7 case, the court rejects a trustee's effort to substantively consolidate the debtor and his non-debtor parents. Noting a split of authority, the court adopts the majority view, which holds that substantive consolidation is not an end-run around the requirements of involuntary bankruptcy. Noting another split of authority the court concludes that substantive consolidation can, in "very limited" circumstances, join non-debtors' assets with a debtor's estate, but such relief is not appropriate here, since both the debtor and the non-debtors are individuals.

FACTUAL BACKGROUND

In this adversary proceeding, the chapter 7 trustee and a creditor of the estate (together, the "Plaintiffs") sought substantive consolidation of the non-debtor parents with the bankruptcy estate of their debtor son. The debtor is an individual farmer conducting cattle, ranching, and farming operations on land owned by his parents. In the adversary complaint, the Plaintiffs alleged, among other things, that: (i) the parents and son operated the family farming business as an unincorporated association under variations of the family name; (ii) the parents and son so disregarded legal formalities that they created expectations of shared liability; and (iii) the debtor and parents' assets and liabilities were so intertwined and co-mingled that separating them is prohibitive and prejudices all parties-in-interest. The non-debtor parents moved to dismiss the complaint arguing that substantive consolidation of non-debtors circumvents the requirement and protections of section 3030 of the Bankruptcy Code.

COURT ANALYSIS

As a threshold matter, the Court considered whether it had authority to substantively consolidate a debtor with a non-debtor through a mechanism other than the filing of an involuntary petition under section 303 of the Bankruptcy Code. The Court recognized that the minority view is that substantive consolidation is a "disguised" involuntary bankruptcy which is subject to the requirements of section 303. By contrast, the majority view finds that substantive consolidation is not inconsistent with section 303 of the Bankruptcy Code because substantive consolidation is an independent remedy with a different purpose and "its own protections for the non-debtor built into it." *See NM Holdings, LLC*, 407 B.R. 232, 280 (Bankr. E.D. Mich. 2009). Accordingly, the Court denied the Parent's motion to dismiss based on the section 303 argument.

The Court next considered whether a bankruptcy court has authority to substantively consolidate non-debtor's assets and liabilities into a bankruptcy debtor's estate. Again the Court recognized a split in authority on the issue, with the majority view finding that bankruptcy courts have authority to substantively consolidate bankruptcy cases under their general equitable powers. Consistent with the majority of case law, the Court recently held that "under very limited circumstances [the bankruptcy court] has the discretion, to be exercised sparingly, to substantively consolidate a debtor's state with non-debtors." *Manchester*, 579 B.R. at 932. Recognizing that the Plaintiffs in this case alleged facts which support the typical criteria for substantive consolidation, the Court observed that this case also raised the unprecedented situation wherein both the debtor and non-debtors are individuals. Finding no authority in support of the appropriateness of substantive consolidation under these facts, the Court held that the complaint did not state a claim upon which relief could be granted for substantive consolidation. The Court explained that it could not reconcile the notion that "two or more individuals exercising their own free will [could] constitut[e] one legal economic entity having no economic existence independent from the debtor." Indeed, the Court found it difficult to believe that creditors dealing with an adult child relied on that parents to pay the child's obligations or regarded the parents and child as the same economic entity such that the parents would be liable for all of the child's obligations.

PRACTICAL CONSIDERATIONS

Rather than anticipating or relying on the possibility of substantive consolidation after default, creditors should obtain inter-personal guarantees to secure payment obligations before extending credit.

BANKRUPTCY COURTS WILL ENJOIN CAUSES OF ACTION FILED AGAINST A PARTY WHO PURCHASES DEBTOR'S ASSETS "FREE AND CLEAR," WITH ONE CAVEAT

Meghan A. Byrnes
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Memorandum Decision Regarding Motion to Enforce the Sale Order, *In re Gawker Media LLC*, 581 B.R. 754 (Bankr. S.D.N.Y. 2017)

CASE SNAPSHOT

The bankruptcy court in *Gawker* exercised its power to toss third-party causes of action against a third party purchaser of a debtor's assets based on "pre-sale conduct," as such claims were specifically barred by the order approving the "free and clear" sale. On the other hand, the bankruptcy court declined, on jurisdictional grounds, to enjoin the cause of action to the extent, if any, the claims could be attributed to the buyer's "post-sale" conduct not otherwise barred by the sale order.

FACTUAL BACKGROUND

This decision arises in the hotly-contested bankruptcy of the online media outlet Gawker Media LLC ("Gawker"). Gawker operated several distinct media brands, which included the following brands with corresponding websites: Gawker, Deadspin, Lifehacker, Gizmodo, and Jezebel. Gawker filed for bankruptcy in the Southern District of New York after a string of highly-publicized defamation cases were filed against it.

Two months into the bankruptcy, the bankruptcy court approved Gawker's sale (the "Sale") of substantially all of its assets to its sister company, Gizmodo Media Group LLP ("Gizmodo") free and clear of all liens, claims, interests and encumbrances pursuant to § 363(f) of the Bankruptcy Code.

Ten months following the Sale, Pregame LLC and Randall James Busack (the "Plaintiffs") filed an action in New York State Court for defamation based on an article Deadspin had published ten days after Gawker filed for bankruptcy. Plaintiffs claimed that the article falsely characterized Plaintiffs as engaged in deceptive and predatory business practices in the sports-betting industry. The lawsuit named Gizmodo, successor in interest to Gawker, and Ryan Goldberg, the author of the article, as defendants.

Opposing the suit, Gizmodo filed a motion with the bankruptcy court to bar the state court action in that it violated the terms of the bankruptcy court's order approving the Sale (the "Sale Order"). Gizmodo argued that the Plaintiffs' cause of action was based on pre-Sale conduct and was barred by certain provisions of the Sale Order. In response, Plaintiffs argued that their action was based on post-Sale conduct because Gizmodo refused to remove the article from the Deadspin website despite many requests, and such refusal gave rise to a new, separate cause of action against Gizmodo.

COURT ANALYSIS

The Court examined the following two provisions in the Sale Order which bar any third party claims against the buyer, Gizmodo, for Gawker's pre-Sale conduct:

- First, the Sale Order contained a provision that barred persons holding any "adverse interest" from asserting any claims against Gizmodo based on Gawker's pre-Sale conduct.
- Second, a later provision in the Sale Order "forever prohibited" all persons from commencing or continuing any judicial proceeding against Gizmodo with respect to any Adverse Interest or successor or transferee liability. In the Sale Order, the defined term "Adverse Interest" specifically included "claims against Gawker arising before or after the commencement of the [bankruptcy] case."

The court found that the Plaintiffs' attempts to limit the Complaint to post-Sale conduct was "disingenuous," given that the vast majority of the allegations discuss the publication of the article and the immediate aftermath and do not mention the Sale Order.

Accordingly, the court dismissed Plaintiffs' claims to the extent those claims arose from the actual publication of the article as pre-Sale conduct barred by the Sale Order. In so deciding, the Court relied on New York's "single publication" rule which provides that the publication of a defamatory statement in any medium, although it may have been disseminated thousands of times, only counts as one cause of action. The bankruptcy court further held that because the complaint was filed more than year after publication, the one-year statute of limitations barred the claim regardless.

However, this ruling comes with a caveat. Despite its hard line on pre-Sale conduct, the bankruptcy court deferred judgment on whether the Plaintiffs' claims regarding Gizmodo's post-Sale conduct (to the extent such conduct was adequately pled) violated the Sale Order, stating: "Whether the complaint alleges a legally sufficient post-sale claim against Gizmodo based on republication or some other theory is an issue best left to the state court presiding over the action."

Through its ruling on post-Sale conduct, the bankruptcy court opened the door for Gizmodo to be potentially liable under any other theory, including republication, stating that such issue was "best left to the state court presiding over the action."

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.

COURT APPROVES CONFIRMATION PLAN OF CHURCH USING *TILL* FORMULA TO APPROVE INTEREST RATE ON SECURED LOANS OF LARGEST CREDITOR

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In re Charles Street African Methodist Episcopal Church of Boston, 578 B.R. 56 (Bankr. D. Mass. 2017)

CASE SNAPSHOT

The Amended Chapter 11 Plan of Reorganization (the "Plan") that was filed by the Debtor, Charles Street African Methodist Episcopal Church of Boston (the "Church"), met the requirements for confirmation under 11 U.S.C. § 1129. The Court found, over the objection of the largest secured creditor, that the Plan, which proposed, *inter alia*, to issue new notes to a bank that was the Church's largest creditor and to pay those notes over a 20-year period at an annual rate of interest of 6.3%, was proposed in good faith, met all of the requirements imposed by § 1129 and other applicable provisions of the Bankruptcy Code, and was feasible because there was evidence that the church's income had increased since the end of the recession and would increase further once it emerged from bankruptcy.

FACTUAL BACKGROUND

The Church was founded in 1818 by free African-Americans and declared bankruptcy under Chapter 11 in 2012 after it encountered financial difficulties during the recession that began during the first decade of the 21st Century. The Church proposed a plan of reorganization, which proposed, *inter alia*, to issue new notes to a bank that was the Church's largest creditor and to pay those notes over a 20-year period at an annual rate of interest of 6.3%. The creditor bank objected to confirmation of the Plan in part on the basis of the terms of the new notes and mortgages it would receive. The creditor bank asserted that the Plan was not feasible, was not proposed in good faith, and that the Plan did not satisfy the requirements of 11 U.S.C. § 1129(b)(1), (2)(A)(i)(II) and (2)(A)(iii) that the Plan be fair and equitable because the interest rate of the promissory notes that creditor bank would receive was inadequate to compensate the bank of the risk of non-payment over the notes' twenty year term and therefore to give the bank the indubitable equivalent of the value, as of the date of confirmation, of its secured claims. On the eve of confirmation, the creditor bank expanded its objection by adding that the promissory notes "lack enforceable, standard covenants." The Church filed a response to the creditor bank's objection and the court held a four-day evidentiary hearing on confirmation, at which it heard testimony from witnesses for the Church.

COURT ANALYSIS

The United States Bankruptcy Court for the District of Massachusetts examined both the Plan and the testimony of the Debtor's witnesses under the approach put forth by the Supreme Court in *Till v. SCS Credit Corp.*, 541 U.S. 465 , 474 , 124 S. Ct. 1951 , 158 L. Ed. 2d 787 (2004) (*"Till"*).

In determining whether the proposed notes provided the creditor bank with a present value as of the effective date of the Plan of at least the secured amount of its claims, the court found that the bank must receive an interest rate on the new notes to account for the time value of money and the risk or uncertainty of the future payment under *Till*. Additionally, the court found that the appropriate interest rate used in a "cram-down" note is a factual determination made on a case-by-case basis.

The court then went one to apply the two-step inquiry as prescribed in *Till*. The first determination is whether there is an efficient market from which to take the appropriate interest rate and, if not, the interest rate is determined by starting with the national prime rate, "which reflects the financial market's estimate of the amount a commercial bank should charge a creditworthy commercial borrower to compensate for the opportunity costs of the loan, the risk of inflation, and the relatively slight risk of default." *Till*, 541 U.S. at 479. The prime rate is then adjusted upward by a risk premium to account for the debtor's risk of nonpayment, looking at factors including the circumstances of the estate, the nature of the security, and the duration and feasibility of the chapter 11 plan, and the Supreme Court in *Till* noted that the risk adjustment should typically range between 1-3%. *See id.* at 479-80.

The court largely focused on the testimony of the Church's expert who testified that after researching the matter, he determined that there existed no efficient market for loans to churches and similar religious organizations. This conclusion was reinforced by the paucity and incompleteness of such information as he was able to find, mostly in the nature of advertising, about loans to and bond financing for churches. While the creditor bank suggested that the Church's expert's testimony was faulty because he failed to consider the market for debtor-in-possession loans, the court found the Church's expert's testimony to be credible. The court opinioned that the universe of debtor-in-possession loans to churches in the relevant look-back period is, I suspect, quite small. In addition, the court criticized the creditor bank's argument that "of course" there is an efficient market for bankruptcy loans to religious organizations, because the bank failed to present any evidence regarding that market in support of it's argument.

Under this analysis, the court found that the Church's Plan was proposed in good faith, met all of the requirements imposed by 11 U.S.C. § 1129 and other applicable provisions of the Bankruptcy Code, and was feasible because there was evidence that the Church's income had increased since the end of the recession and would increase further once it emerged from bankruptcy. The Court also found that the interest rate of 6.3% in the Plan represented adequate present value based on a *Till* formula approach (e.g., risk-less rate, plus upward adjustment), since there is no efficient market for bankruptcy loans to religious organizations and churches. The Church's Plan was confirmed over the objection of the creditor bank.

PRACTICAL CONSIDERATIONS

While the court in *Charles* found that no efficient market exists for loans to churches and similar religious organizations, in confirming the Church's Plan with a 6.3% per annum interest rate, they set the bar for loans of a similar kind. In addition, the court emphasized the importance of expert testimony, especially in uncommon lending markets.

DEBTOR HAS NO FURTHER OBLIGATION TO PERFORM UNDER REJECTED TRADEMARK LICENSE AND EXCLUSIVE DISTRIBUTION AGREEMENT

Brian M. Schenker
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Mission Product Holdings, Inc. v. Tempnology, LLC (In re: Tempnology, LLC), 879 F.3d 389 (1st Cir. 2018)

CASE SNAPSHOT

The United States Court of Appeals for the First Circuit addressed an issue that was both of first impression in its circuit and subject to a circuit split among all circuits. Namely, whether a debtor's rejection of an agreement providing a trademark license and exclusive rights to sell the debtor's goods resulted in either (a) the debtor having remaining obligations to perform such agreement or (b) the counterparty having a pre-petition damages claim in lieu of such continued performance. The First Circuit concluded that the rejection of such an agreement leaves the counterparty with only a pre-petition claim for damages.

FACTUAL BACKGROUND

Tempnology made specialized products – such as towels, socks, headbands, and other accessories – designed to remain at low temperatures even when used during exercise, which it marketed under certain brand names. Mission Product Holdings entered into an agreement with Tempnology, pursuant to which it obtained, among other things, exclusive distribution rights related to certain of Tempnology's products and a trademark license to facilitate the use of such distribution rights. With less than a year left on the term of such agreement, Tempnology filed a voluntary petition for chapter 11 bankruptcy and moved to reject such agreement under Section 365(a) of the Bankruptcy Code.

COURT ANALYSIS

The First Circuit began with the statutory framework under section 365 of the Bankruptcy Code. Section 365(a) permits a debtor, with the bankruptcy court's approval, to reject any executory contract that, in the debtor's business judgment, is not beneficial to the company. General speaking, pursuant to Section 365(g), such rejection leaves the contract counterparty with a pre-petition damages claim for breach but not the ability to compel future performance. When the rejected contract, however, is one "under which the debtor is a licensor of a right to intellectual property," the licensee may elect, pursuant to Section 365(n), to "retain its rights … to such intellectual property," thereby continuing the debtor's duty to license the intellectual property.

The First Circuit then explained that the option granted to the licensee by Section 365(n) is strictly limited to protecting rights to intellectual property. Thus, the First Circuit reasoned that Section 365(n) "protects, for example, an exclusive license to use a patent, but does not protect an exclusive right to sell a product merely because that right appears in a contract that also contains a license to use intellectual property." The First Circuit found that this interpretation of the statute aligned with Congressional intent. The First Circuit specifically rejected the argument that an exclusive right to sell a product is equivalent to an exclusive right to exploit the product's underlying intellectual property. The First Circuit explained that such exclusive right "is simply a restriction on the right to sell certain products that, like many products, happen to be made using a patent."

The First Circuit then turned to the issue of the trademark license. The First Circuit began by pointing out that the definition of intellectual property under the Bankruptcy Code does not include a trademark license or any catchall or residual category where one might be included. As a result, the First Circuit concluded that the trademark license was not protected by Section 365(n). The First Circuit also rejected the argument previously accepted by the Seventh and Third Circuits that rejection "leaves in place the counterparty's right to continue using a trademark licensed to it." In so doing, the First Circuit agreed with the Fourth Circuit furthering the circuit split on this issue.

The First Circuit explained that the holdings of the Seventh and Third Circuits were premised "on the unstated premise that it is possible to free a debtor from any continuing performance obligations under a trademark license even while preserving the licensee's right to use the trademark." The First Circuit rejected such premise, explaining that "the effective licensing of a trademark requires that the trademark owner … monitor and exercise control over the quality of the goods sold to the public under cover of the trademark." Therefore, by allowing the licensee's continued use of the Debtor's trademark, the Seventh and Third Circuits were forcing Debtors to choose between performing such monitoring obligations or risking the permanent loss of the value of the trademark. The First Circuit found such choice to be inconsistent with the overarching purpose of Section 365 of the Bankruptcy Code.

PRACTICAL CONSIDERATIONS

Until a Supreme Court decision or Congressional action, the circuit split described above, and the absence of any decision yet from the remaining circuits, should inform a debtor's decision about where to file for bankruptcy protection, if such debtor is seeking to eliminate the type of agreement eliminated in this case. Finally, it should be noted that the First Circuit's opinion contained a dissent. Thus, in undecided jurisdictions, there will be strong arguments available on each side.

THIRD CIRCUIT LIMITS THE REACH OF THE ROOKER-FELDMAN DOCTRINE

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In re Philadelphia Entertainment & Development Partners, 879 F.3d 492 (3d Cir. 2018)

CASE SNAPSHOT

On January 11, 2018, the Third Circuit issued a decision holding that the Rooker-Feldman doctrine does not bar consideration of a Trustee's fraudulent transfer claims.

FACTUAL BACKGROUND

In December 2006, the Pennsylvania Gaming Control Board (the "Board") awarded one of two available casino licenses to developer Philadelphia Entertainment and Development Partners, LP ("PEDP") for a proposed Foxwoods casino along the Delaware River in Philadelphia. In connection with the license, PEDP paid a one-time license fee of $50 million to the Commonwealth, and was required to open its facility and commence operations by May 2009. PEDP was unable to meet that deadline and sought an extension from the Board. The Board extended the deadline for opening the facility to May 2011, provided that PEDP satisfied certain conditions during the extension period. In December 2010, the Board revoked PEDP's license for PEDP's failure to satisfy the Board's requirements. PEDP unsuccessfully challenged the revocation in state court, and ultimately launched an adversary proceeding as part of its bankruptcy case in March 2014.

In its adversary action, PEDP sought recovery of the $50 million license fee and avoidance of the license revocation arguing, among other things, that the revocation of the license was a fraudulent transfer for which it received no value from the Commonwealth pursuant to sections 544 and 548 of the Bankruptcy Code. On April 8, 2016, the Bankruptcy Court dismissed the adversary complaint finding that the Rooker-Feldman doctrine divested the court of subject matter jurisdiction to consider PEDP's claims.

PEDP appealed to the District Court, which on March 28, 2017, affirmed the Bankruptcy Court's dismissal and adopted that court's Rooker-Feldman conclusions. The Trustee[1] timely appealed to the Third Circuit.

COURT ANALYSIS

On appeal, the Trustee challenged the Bankruptcy and District Courts' conclusions that the Rooker-Feldman doctrine barred review of PEDP's fraudulent transfer claims. The Third Circuit reversed the Bankruptcy Court's dismissal of the Trustee's fraudulent transfer claims, concluding that the Bankruptcy Court was erroneous in its belief that the federal courts lacked subject matter jurisdiction over the Trustee's claims.

The Third Circuit declined to weigh-in on the merits of Trustee's fraudulent transfer claims. Instead, it focused its analysis on whether the Rooker-Feldman doctrine was properly applied to deprive the federal courts of subject matter jurisdiction of Trustee's claims.

In its decision, the Third Circuit discussed the tension between application of the Rooker-Feldman doctrine and the prosecution of avoidance claims under the Bankruptcy Code because an avoidance claim seemingly authorizes what the Rooker-Feldman doctrine prohibits—appellate review of state court judgments by federal courts other than the Supreme Court. Noting that the Supreme Court had cautioned against applying the Rooker-Feldman doctrine too broadly,[2] the Third Circuit stated that the doctrine applies when four requirements are met: (1) the federal plaintiff lost in state court; (2) the plaintiff complains of injuries caused by the state-court judgment; (3) that judgment issued before the federal suit was filed; and (4) the plaintiff invites the district court to review and reject the state-court judgment.

In its analysis, the Third Circuit focused on the fourth requirement of its test which asks whether the Trustee invited the Bankruptcy Court to "review and reject" the revocation order entered by the Commonwealth Court. The Third Circuit found that the Trustee's fraudulent transfer claims did not ask the Bankruptcy Court to make an appellate review of the revocation order. Acknowledging that the fraudulent transfer claims and the claims before the Commonwealth Court raised overlapping legal issues, the Third Circuit concluded that the Bankruptcy Court could have determined whether the revocation of the license was a fraudulent transfer under the pertinent provisions of the Bankruptcy Code without rejecting or even reviewing the Commonwealth Court's decision to revoke the license. Accordingly, the Third Circuit concluded that this determination would not have implicated the Rooker-Feldman doctrine.

The Third Circuit also disagreed with the Bankruptcy Court's holding that the Rooker-Feldman doctrine barred review of the fraudulent transfer claim because, as the Bankruptcy Court reasoned, payment for the value of the license was the functional equivalent to invalidating the state court decision. To the contrary, the Third Circuit held that the doctrine does not apply merely because the claim for relief, if granted, would as a practical matter undermine a valid state court order. The Third Circuit explained that the crux of a Rooker-Feldman inquiry is whether it requires the federal court to look at the "bona fides of the prior judgment," not whether "compliance with the second judgment would make it impossible to comply with the first judgment."

PRACTICAL CONSIDERATIONS

This case illustrates the limits of the Rooker-Feldman doctrine as a defense to bankruptcy avoidance actions. Indeed, the implications of this decision may well reach beyond the bankruptcy context and limit the doctrine as a defense in other federal court litigation. Practitioners should therefore be mindful that the trend is for a narrow application of the doctrine, particularly when application thereof would allow a state law to frustrate the goals of bankruptcy policy such as preservation of the bankruptcy estate.

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1 In July 2014, the Bankruptcy Court confirmed PEDP's liquidation plan, which called for the creation of a liquidation trust supervised by the Trustee. The Trustee succeeded to all claims belonging to PEDP.

2 *See Exxon Mobil Corp. v. Saudi Basic Industries Corp.*, 544 U.S. 280, 284 (2005).

TRUSTEE'S CLAIMS BASED ON LOAN TO OWN ALLEGATIONS SURVIVE MOTION TO DISMISS

Christopher A. Lynch
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Baldiga, as Chapter 7 Trustee of Comprehensive Power, Inc., et al. v. Moog, et al. (In re Comprehensive Power, Inc.), 578 B.R. 14 (2017)

CASE SNAPSHOT

The U.S. Bankruptcy Court for the District of Massachusetts' recent decision in *In re Comprehensive Power, Inc.*, denying in substantial part a lender's motion to dismiss claims brought by the borrower's Chapter 7 trustee, underscores the need for a lender that may have designs on ownership of the borrower or its assets to document the loan as consistently as possible with a traditional lender-borrower financing transaction. In addition, to the extent the transaction contemplates the lender appointing a board member, the lender and that person should avoid conduct that may give rise to the appearance of surreptitiously taking control of the borrower or usurping its business opportunities for the benefit of the lender.

FACTUAL BACKGROUND

Comprehensive Power, Inc. (the "Debtor") designs and manufactures high-performance components for the energy sector. In early 2013, Moog, Inc. ("Moog") was identified by the Debtor's investment banker as a potential lender to, investor in, or purchaser of the Debtor. In April of that year, the Debtor and Moog entered into a series of documents including a note, security agreement and option agreement whereby, among other things, the Debtor borrowed $6 million from Moog secured by substantially all of the Debtor's personal property. Pursuant to the option agreement, Moog retained an option to purchase the Debtor's stock at a specified multiple of EBITA during a fixed period, could appoint a director to the Debtor's board, and the Debtor could unilaterally extend the maturity on the note for six months if Moog declined to exercise its purchase option. Moog appointed defendant Gartland, one of its employees, to the Board and, as alleged in the complaint, Gartland received and shared with Moog the Debtor's confidential information and took actions to "extract" value out of the Debtor for Mook's benefit, including "injecting" himself into the Debtor's business operations and representing to the Debtor's customers that "Moog would be stepping in as the Debtor's successor to 'continue the business'." Just months after closing on the loan with Moog, the Debtor's financial condition deteriorated and its sought additional capital from Moog. Less than 10 months after the loan was made, the Debtor defaulted and, according to the complaint, Moog began "to take steps … in order to assume possession and control of the Debtor's assets … for less than fair value."

Among those steps, in October 2013, Moog and the Debtor executed a Collateral Surrender and Consent to Sale Agreement, which, among other things, accelerated the debt due under the note, required the Debtor to cease operations and turn over cash accounts upon demand from Moog and provided Mook access to the Debtor's books and records. In November, the Debtor terminated all employees (fourteen of whom – at the management level and others possessing unique skills – were later rehired by Moog). In January 2014, Moog notified the Debtor that it intended to conduct a UCC Article 9 sale of its collateral in February. At that sale, Moog was the lone bidder and successfully credit bid $2.1 million for the Debtor's assets. Plaintiff alleged that just two years prior, Moog had been willing to purchase the Debtor for $10 million and that other parties had valued the business at between $12 million and $24 million.

In April 2014, certain of the Debtor's creditors commenced an involuntary petition under Chapter 7 and the Plaintiff was appointed Trustee. The Plaintiff commenced the instant adversary proceeding seeking, among other things, (i) to re-characterize Moog's claims as equity; (ii) avoid and recover transfers of property and money of the Debtor to Moog as actually or constructively fraudulent pursuant to §§ 544(b), 548, and 550 of the Bankruptcy Code and provisions of the Massachusetts Uniform Fraudulent Transfer Act (the "UFTA"); and (iii) recover damages for violation of the commercial reasonableness requirement under Article 9 of the UCC. Moog moved to dismiss all counts for failure to state a claim and, with the exception of an equitable subordination claim under 11 U.S.C. § 510(c), the Court denied that motion.

COURT ANALYSIS

With respect to the recharacterization claim, the Court found that the factual allegations and the inferences drawn in favor of the Trustee were sufficient to state a plausible claim. In that regard, the Court took note of the complaint's allegations that (i) Moog's standard practice was to engage in acquisitions, not provide loans, thereby suggesting a "loan-to-own" transaction rather than true lender-borrower relationship; (ii) quarterly interest payments called for in the note were outside of the norm; (iii) the Debtor could unilaterally extend maturity if the option was not exercised by Moog in connection with the option agreement; and (iv) Moog obtained substantive rights including the right to appoint a representative to the Debtor's board and an option to acquire the Debtor's assets or stock. Thus, the Court found the allegations supported a finding that an apparent debt transaction was actually an equity contribution *ab initio.*

The complaint contained numerous counts seeking to avoid as fraudulent transfers "all payments and transfers" to or on behalf of Moog, including the transfer of assets to Moog "at the purported secured party sale." The Court noted first that the claims under section 548 of the Bankruptcy Code and the UFTA claims had substantially the same elements and found that the allegations in the complaint were sufficient to state plausible claims that the transfers to Moog were both constructively and actually fraudulent. With respect to the actual fraud claims, the Court found that the facts and circumstances alleged allowed the Court to draw an inference that Moog's intent to transfer assets to hinder delay or defraud the Debtor' s creditors should be imputed to the Debtor. These allegations included "by October 2013," "Moog had assumed "pervasive and full control of the Debtor" and that "the Moog-installed director acted for Moog's benefit and undertook efforts to extract value from the Debtor for Moog." As to the constructive fraud claims, the Court found that the Trustee alleged sufficient facts to support a claim that Moog effected a "voluntary" or involuntary transfer

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UNCLEAN HANDS POST-FILING A BAR TO FURTHER ACCESS TO THE COURTS

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Baek v. Halvorson (In re Halvorson), 581 B.R. 610 (Bankr. C.D. Cal. 2018)

CASE SNAPSHOT

Divorcing spouses and their families were enmeshed in contentious litigation when the husband, Mr. Halvorson, filed bankruptcy. When the bankruptcy court ordered mediation on related adversary proceeding filed with the bankruptcy court, Ms. Baek, her brother and their counsel worked various law enforcement agencies to have Mr. Halvorson arrested. The Court found that this interference in the mediation was bad faith sufficient to invoke the unclean hands doctrine. The Baeks' claims against the Halvorsons were dismissed with prejudice.

FACTUAL BACKGROUND

Mr. Halvorson and Ms. Baek were parties to extremely contentious divorce proceedings that reached out to encompass claims related to the Baeks' business, real property owned by Mr. Halvorson's mother and even Mr. Halvorson's brother. As part of this extensive litigation, Mr. Halvorson has forged his wife's name on a document and testified at deposition that the signature was genuine. This forgery not only resulted in the entry of a substantial default judgment against Mr. Halvorson, but also in Ms. Baek pressing criminal charges for which Mr. Halvorson was indicted in Oregon. An arrest warrant was issued for Mr. Halvorson in Oregon.

Following the filing of the bankruptcy, the Baeks continued to press various claims against the Halvorsons. The Bankruptcy Court ordered mediation of the claims before it under the auspices of Judge Jury, another Bankruptcy Court judge. The Baeks, with the assistance of their counsel, passed along the fact that Mr. Halvorson would be present at the federal courthouse for mediation to Mr. Demer, the district attorney assigned to prosecute the case against Mr. Halvorson. The Baeks, through counsel, lobbied for Mr. Halvorson's arrest at the mediation. Even while in mediation, the Baeks' counsel was communicating with Mr. Demer to facilitate the arrest. Eventually Mr. Demer passed along the arrest warrant for Mr. Halvorson to the U.S. Marshals who had Mr. Halvorson arrested in the middle of mediation. Unsurprisingly, the remainder of the mediation was scuttled.

COURT ANALYSIS

After the disastrous mediation, the Halvorsons raised the affirmative defense of unclean hands to the claims brought by the Baeks. In its opinion, the Bankruptcy Court addressed, first, whether unclean hands could be used as an affirmative defense when the acts that gave rise to the defense occurred after the filing of the complaint and, second, whether arranging to have Mr. Halvorson arrested at mediation was sufficient to give rise to an unclean hands defense and deny the Baeks access to the Bankruptcy Court, a court of equity.

As to the first point, the Bankruptcy Court held that "[o]ne who comes into equity must come with clean hands and keep those hands clean throughout the litigation." *Halvorson*, No. 8:15-bk-13556-MW at *31 (citation omitted). As a result, bad acts in the course of litigation could give rise to an unclean hands defense.

As for the second point, the Bankruptcy Court held that "[t]he purpose of the unclean hands doctrine is not to protect the defendant - it is to protect the court from becoming an aider and abettor of iniquity. Courts apply the doctrine primarily for their own protection and only secondarily as a matter of defense to the defendant." *Id.* at *36-37. Here, the Bankruptcy Court found that, in having Mr. Halvorson arrested at the mediation, the Baeks acted deliberately to sabotage the mediation. The Bankruptcy Court held that this sabotage of the court-ordered mediation was sufficient to create an unclean hands defense. The Baeks' claims were dismissed with prejudice.

PRACTICAL CONSIDERATIONS

This case serves a reminder of the power of the unclean hands doctrine. Litigants are reminded to keep their hands clean after the filing of the case, even during mediation, lest they incur not only sanctions, but a complete dismissal of their claims.

Trustee's Claims Based On Loan To Own Allegations Survive Motion To Dismiss—continued from page 16

of the Debtor's assets for less than fair and reasonably equivalent consideration at a time when the Debtor was insolvent or rendered insolvent. Again, the allegations supporting this claim relate to the Article 9 sale by which Moog took ownership of the Debtor's assets for an amount far less than the debt or earlier indications of value.

Finally, the Court also found that the Trustee pleaded sufficient facts to support his claim under Article 9 of the UCC, including allegations that (i) Moog did not employ a process intended to generate a reasonable sale price; (ii) the sale price obtained was substantially less than previous valuations of the Debtor's assets and less than the assets would have been appraised for if an appraisal had been conducted; (iii) Moog conducted the auction sale as a formality to consolidate its control the Debtor's assets; (iv) Moog failed to adequately market the property; (v) Moog was the sole bidder at a sale conducted on only fourteen days' notice; and (vi) other potential purchasers were deprived from acquiring the Debtor's assets.

PRACTICAL CONSIDERATIONS

Although the matter was before the Bankruptcy Court on a motion to dismiss and the Plaintiff's well-plead allegations are accepted as true, the Court's decision highlights some areas where non-traditional lenders in particular should proceed with care. Although the long-term desired outcome may be for the lender to take ownership of the borrower (or its assets), the lender should make sure its loan documents do not send mixed signals, which may result in claims such as those in *Comprehensive Power*. Also, when exercising its remedies under UCC Article 9, the lender should be sure to take steps to ensure that the sale is conducted in a commercially reasonable manner.

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COUNSEL'S CORNER: NEWS FROM REED SMITH

Alexis Leventhal was a panelist for Allegheny County Bar Association CLE Program: Snapchat to snap judgements: ethical challenges of managing a law practice and case docket in the social media age.

The firm hired lateral Partner **Aaron Javian** to our New York office.

Lloyd Lim was named a 2018 Texas Rising Star in Bankruptcy & Business.

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