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CAN A LENDER (THROUGH AN AFFILIATE) CONTROL WHETHER A BORROWER CAN FILE FOR BANKRUPTCY?

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Lender liability issues are always of concern during the workout of a troubled loan. Workout officers and their counsel often struggle in trying to determine where the line is between the exercise of legitimate lender remedies and controlling the affairs of the borrower. We are often asked the question of whether, in exchange for various accommodations which allow the borrower to continue to operate, a lender can require its consent in order for the borrower to have the authority to file for bankruptcy. Some courts have held that veto control over the borrower's decision whether to file for bankruptcy is against public policy. In an interesting opinion from the United States Bankruptcy Court for the District of Columbia, the Court upheld requirements that, upon an event of default, the lender's affiliate (which held an equity position in the borrower) had the authority to remove and replace the borrower's manager and had veto power over any decision to file for bankruptcy protection. In the context of a motion to dismiss filed by the lender's affiliate, the court upheld those provisions and even went a step further – it barred the filing of a voluntary petition by the borrower without the consent of the lender affiliate for a period of two years and ruled that, in the case of an involuntary bankruptcy filing, the parties and others are bound by the Court's determination that only the designee of the lender's affiliate is authorized to manage the borrower. It is clear that the Court was bothered by a number of circumstances: (1) the borrower misused funds that were supposed to be used for making interest payments to the lender, (2) the borrower's former manager who filed the bankruptcy case was in jail, (3) the borrower failed to respond to any discovery requests, (4) the borrower presented no evidence that it could manage its affairs, (5) the borrower's assets far exceeded it liabilities, and (6) the borrower failed to establish that it could proceed in a bankruptcy case in a proper way. As the Court was cafeful to limit its holding to the specific facts presented, lenders should be encouraged by the case but cautious in its application. *In re Blue Chip Capital, DC, LLC*, No. 19-00062 (Bankr. D. C. May 31, 2019).

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REVERSING THE BANKRUPTCY COURT, THE DISTRICT OF DELAWARE JOINED THE HOLDINGS OF FIVE CIRCUIT COURTS OF APPEALS AND ALLOWED A SECURED CREDITOR'S UNSECURED CLAIM FOR POST-PETITION ATTORNEY'S FEES.

Alexis Leventhal
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In re Tribune Media Co., No. 1:15-CV-01116-RGA, 2018 WL 6167504 (D. Del. Nov. 26, 2018)

CASE SNAPSHOT

Joining the unanimous holdings of the U.S. Circuit Courts of Appeals that have considered the issue, the District of Delaware allowed a secured creditor an unsecured claim for attorney's fees arising post petition pursuant to a contract between the secured creditor and the debtor under 11 U.S.C. § 506(b).

FACTUAL BACKGROUND

Secured creditor, Wilmington Trust Company ("Wilmington"), appealed the bankruptcy court's holding that sustained the Debtor's objection to Wilmington's unsecured claim for attorney's fees that accrued after the filing date pursuant to its contract with the Debtor permitting such fees. The issue before the Court was whether the language of section 506(b) expressly disallows an unsecured claim for attorney's fees where a secured creditor is not over-secured.

COURT ANALYSIS

The Court's analysis began with the salient Bankruptcy Code provisions: sections 502 and 506(b). As the Court explained, section 502 provides the authority and framework for disallowing claims and section 506(b) addresses which allowed claims are secured claims and that a secured claim is secured to the extent of the value of the underlying property.

The Court, acknowledging the Third Circuit had not addressed the specific issue, surveyed other Circuit Courts and found that the First, Second, Seventh, Ninth, and Eleventh Circuits have unanimously allowed attorney's fees under the circumstances under which Wilmington was asserting its unsecured claim. The Court also mentioned that some bankruptcy and district courts have adopted different and "reasoned" positions than that of the Circuit Courts. Expressly avoiding insertion of the Court in the debate, the Court adopted the position of the Circuit Courts: that

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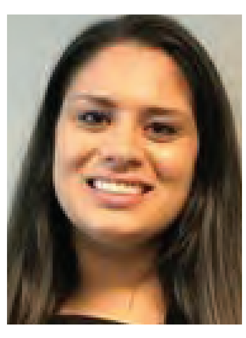
THIRD CIRCUIT ADDRESSES TENANT'S RIGHTS UNDER AN UNEXPIRED REJECTED LEASE.



Katelin Morales
Associate, Wilmington

IDEA Boardwalk, LLC v. Revel Entertainment Group, LLC; Polo North Country Club, Inc. (In re Revel AC Inc., et al.), 909 F.3d 597 (3d Cir. 2018)

CASE SNAPSHOT

The Third Circuit held that when a tenant makes a statutory election to retain its rights under an unexpired commercial lease rejected by a Chapter 11 Debtor, it retains its rights to receive recoupment payments provided for under that rejected lease. Therefore, IDEA Boardwalk, LLC, the tenant, was permitted to reduce its rent obligations under a rejected lease. In addition, the Third Circuit explained that even if a tenant's rights aren't specifically reserved, a tenant can still set off recoupment payments against its obligation for rent under the doctrine of equitable recoupment.

FACTUAL BACKGROUND

When Revel AC Inc. ("Revel") filed for Chapter 11 bankruptcy in 2014, one of its tenants, IDEA Boardwalk, LLC ("IDEA") continued to operate two nightclubs and a beach club on the casino premises.

IDEA and Revel entered into a long-term lease (the "Lease") pre-bankruptcy that contemplated that both Revel and IDEA would make capital contributions to "build out" the IDEA venues before opening them. These capital contributions, especially the relative proportions of capital contributed by IDEA and Revel, were the foundation for rent and recoupment calculations under the Lease. Under the Lease, IDEA would pay rent to Revel each month on a venue-by-venue basis. Each month, the rent for a given venue was calculated to be the distributable cash flow from that venue multiplied by the percentage share of capital contributed to that venue by Revel. In addition, Revel would make certain "recoupment" payments, not to be confused with the doctrine of equitable recoupment, to IDEA in the first four years of the Lease term. IDEA and Revel would determine (a) whether the venue in question had reached a certain threshold in gross sales, and (b) whether it had registered a positive return on capital investment, as measured by comparing the venue's year-to-date distributable cash flow to the portion of IDEA's capital contribution allocated to that venue for the time period in question using a straight-line depreciation over four years. If the venue met the applicable gross-sales threshold, but did not have a positive return to capital net of depreciation, Revel would refund to IDEA the amount necessary to cause the latter to break even for that period.

As Revel worked through its bankruptcy, IDEA filed an adversary proceeding in the Bankruptcy Court seeking to protect its right to continue operating under the Lease. Polo North Country Club, Inc. (the "Defendant") became the defendant in the adversary proceeding when it purchased Revel's assets pursuant to a purchase agreement, dated March 20, 2015 (the "Purchase Agreement,") which provided that the Defendant would purchase Revel's assets free and clear of all liabilities except for those listed in the Purchase Agreement. The Purchase Agreement stated that the Defendant's only surviving liability with respect to the Lease would be a potential one to IDEA for an administrative expense claim, and that the Defendant would acquire certain legal claims Revel may have against IDEA with respect to the Lease. In addition, the sale order authorizing the Purchase Agreement (the "Sale Order") contained two carve-out provisions: (1) a preservation of any rights, including rights of setoff and recoupment, claims and defenses of IDEA with respect to the adversary proceeding; and (2) any rights elected to be retained by IDEA pursuant to section 365(h) of the Bankruptcy Code, after Revel's rejection of the Lease.

Shortly after the Sale Order was entered, the Bankruptcy Court granted Revel's motion to reject the Lease retroactively to September 2, 2014, the date which Revel casino closed its doors. IDEA filed a motion for summary judgment on one of its pending claims in the adversary proceeding, which the Bankruptcy Court granted in part, ruling that IDEA may reduce its rent obligation by the recoupment amounts under the Lease on the grounds that (1) the recoupment provisions of the Lease fall within the ambit of rights preserves under section 365 of the Bankruptcy Code, and (2) IDEA could deduct amounts based on the equitable doctrine of recoupment. The Defendant appealed to the District Court, which affirmed on the same grounds, and now appeals to the Third Circuit.

COURT ANALYSIS

The Third Circuit affirmed both the Bankruptcy Court and District Court's rulings on two grounds.

First, IDEA had the right to reduce its rent obligations by the recoupment provisions in the Lease because IDEA specifically preserved that right in the Sale Order by making an election under section 365(h) of the Bankruptcy Code. Section 365(h) provides for a reservation of tenant rights under a lease, including rights relating to the amount and timing of payment of rent, for the balance of the term of the lease when a trustee or debtor in possession rejects an unexpired lease. The Third Circuit cited *Megafoods Stores, Inc.v. Flagstaff Realty Assocs. (In re Flagstaff Realty Assocs.)*, 60 F.3d 1031, 1034 (3d Cir. 1995), which notes that a tenant who makes an election under section 365 of the Bankruptcy Code is entitled to remain under the same rental terms as are set forth in the lease

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ELEVENTH CIRCUIT HOLDS THAT GOING CONCERN SALE CONSTITUTES "REORGANIZATION" FOR PURPOSES OF MODIFYING RETIREE BENEFITS UNDER SECTION 1114

Lauren S. Zabel
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United Mine Workers of Am. Combined Benefit Fund v. Toffel (In re Walter Energy, Inc.), 911 F.3d 1121 (11th Cir. 2018)

CASE SNAPSHOT

Addressing a "difficult" and "nuanced" issue, the Eleventh Circuit finds that the Retiree Benefits Bankruptcy Protection Act of 1988 (which prohibits a debtor who files bankruptcy from unilaterally terminating payments for retiree health care benefits but permits a bankruptcy court to terminate a debtor's obligation to fund retiree health care benefits when it finds that the termination is necessary for the debtor's reorganization) also allows a bankruptcy court to terminate a debtor's obligation to fund retiree health benefits when termination is necessary for the debtor to sell its assets as a going concern, rather than through a piecemeal liquidation.

FACTUAL BACKGROUND

Under the Coal Industry Retiree Health Benefit Act of 1992 ("Coal Act"), certain retired health workers receive lifelong health care benefits during retirement. The benefits are administered under two multiemployer plans – the UMWA Combined Benefit Fund and the UMWA 1992 Benefit Plan (the "Funds"), which are funded with premiums paid by coal companies and by the federal government. With the decline of coal revenues and the increase of health care costs, coal companies have struggled to pay premiums under the Coal Act.

Walter Entergy filed for chapter 11 protection and sought to sell its assets as a going concern. At the time of the bankruptcy filing, Walter provided health care benefits to 572 retirees and dependents though its individual employer plan and an additional 32 beneficiaries were assigned to Walter for coverage under the Combined Fund (i.e. $147,000 in annual premiums under the Combined Fund).

The sole potential purchaser was only willing to purchase the company if the sale was free and clear of ongoing obligations under the Coal Act. The Retiree Benefits Bankruptcy Protection Act ("RBBPA") prohibits a debtor from unilaterally terminating obligations to fund retiree healthcare benefits, but allows bankruptcy courts to terminate the debtor's obligation to pay if necessary for reorganization. The bankruptcy court determined that the RBBPA would also allow termination if necessary for a going concern sale, rather than a piecemeal liquidation. The court entered an order allowing Walter to reject its collective bargaining agreements, terminated its obligations under its individual plan and to pay premiums to the Funds (the "1113/1114 Order"). After that order was entered, the 572 retirees and dependents that had received benefits under Walter's individual plan became beneficiaries under the 1992 Plan, and the 32 beneficiaries under the Combined fund continued to receive coverage from the Combined Fund. The order essentially shifted the costs of insuring these retirees and dependents to the federal government. The bankruptcy court also approved the sale. The district court affirmed the sale order and the 1113/1114 Order. Walter converted its case to a chapter 7.

COURT ANALYSIS

The court first considered whether the bankruptcy court had jurisdiction to modify the premiums under the Anti-Injunction Act, which prohibits suits challenging the assessment or collection of a tax before the tax is collected. When the Anti-Injunction Act applies, it deprives federal courts of jurisdiction. The court concluded that the premiums owed to the 1992 Fund do not qualify as taxes for purposes of the Anti-Injunction Act and that the premiums owed to the Combined Fund may qualify as taxes, but even if they do, an exception applies. Thus, the court concluded that the bankruptcy court had jurisdiction under the Anti-Injunction Act.

The court next considered whether the premiums owed to the Funds constituted "retiree benefits" for purposes of section 1114 of the Bankruptcy Code. The Funds argued that the obligations do not constitute "retiree benefits" because Walter did not "maintain" the funds as required by section 1114(a) because they did not voluntarily incur the obligation to pay premiums. However, the court concluded that the statutory context supports the conclusion that payments arising from a statutory obligation constitutes "maintaining" a plan for purposes of section 1114, reasoning that the bankruptcy court did not intend for "retiree benefits" only to apply to obligations voluntarily incurred by a debtor. The court also concluded that the cannons of construction did not provide support for narrowing the definition of "maintain".

The court next concluded that the bankruptcy court had authority to terminate Walter's obligation to pay premiums because Walter was reorganizing when it pursued a chapter 11 liquidation. Section 1114(g)(3) permits a bankruptcy court to modify or terminate retiree benefits only if, among other things, the court finds that "such modification is necessary to permit the reorganization of the debtor." In so holding, the court interpreted the term "reorganization" under section 1114(g)(3) as referring to all types of

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Reversing the bankruptcy court, the District of Delaware joined the holdings of five Circuit Courts of Appeals and allowed a secured creditor's unsecured claim for post-petition attorney's fees.—continued from page 1

section 506(b) does not limit the allowability of unsecured claims for post-petition attorney's fees asserted by secured creditors under section 502.

PRACTICAL CONSIDERATIONS

On December 31, 2018, the opinion was appealed to the Third Circuit. Until the Third Circuit decides and, as the Court seemed to intimate, courts within the Third Circuit (or otherwise bound by another Circuit Court opinion) are free to decide the issue in either direction. Accordingly, for purposes of maximizing (or minimizing) the claims of secured creditors, practitioners should be keenly aware of the law of the applicable Circuit.

Third Circuit addresses tenant's rights under an unexpired rejected lease.—continued from page 2

As noted previously, the Sale Order preserved any rights pursuant to section 365 after Revel's rejection of the Lease. Additionally, the Third Circuit found that there was no doubt the rental terms included the right to receive recoupment payments under the Lease, and that invalidating the recoupment provisions in the Lease would actually upend the rent framework established in the Lease.

Second, even if the section 365(h) of the Bankruptcy Code did not extend to the recoupment provisions in the Lease, IDEA would still be permitted to reduce its rent obligations under the doctrine of equitable recoupment. Although not codified, the Third Circuit looked to *In re Univ. Med. Ctr.*, 973 F.2d 1065, 1079 (3d Cir. 1992), and defined recoupment as the setting up of a demand arising from the same transaction as the plaintiff's claim or cause of action, strictly for the purpose of abatement or reduction of such claim. The Third Circuit held that there was a countervailing relationship between the rent obligation and recoupment amounts under the Lease, and thus arise from the same transaction. Additionally, the Third Circuit found that it would be inequitable to require IDEA to pay the full amount of rent without applying the recoupment provisions of the Lease.

PRACTICAL CONSIDERATIONS

A sale free and clear of all liens, claims, encumbrances, and other interests of any kind under section 363(f) of the Bankruptcy Code does not terminate a tenant's rights under section 365(h) of the Bankruptcy Code, even if the tenant does not specifically preserve that right. The doctrine of equitable recoupment is an affirmative defense, and a sale under section 363(f) does not mean a sale free of defenses to claims. Additionally, in the Third Circuit's discussion of the "arising from the same transaction" requirement of equitable recoupment, it considers the net effect of the two relevant provisions. Thus, this decision may provide for an expansion of the meaning of the "arising from the same transaction" requirement to include the consideration of the net effect of two interrelated but different transactions.

Eleventh Circuit Holds that Going Concern Sale Constitutes "Reorganization" for Purposes of Modifying Retiree Benefits Under Section 1114—continued from page 3

debt adjustment under chapter 11, including a sale of assets on a going concern basis, reasoning that reorganization contemplates a business continuing to operate, which a business sold as a going concern does.

PRACTICAL CONSIDERATIONS

This decision was rendered under a set of facts where inability to allow the going concern sale to proceed would have resulted in the closure of the company, the mines and the loss of jobs for many, whereas terminating the debtor's obligation to fund the retiree benefits at issue would not impact the receipt of those benefits by the retirees, as the government would fund the premiums in the debtor's absence.

FILING OF UCC-1 DETERMINATIVE OF PRIORITY IN CONSIGNED GOODS UNDER ARTICLE 9

Jason Angelo
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TSA Stores, Inc., et al. v. Wilmington Savings Fund Society, FSB, as Successor Administrative and Collateral Agent v. M J Soffe, LLC a/k/a M.J. Soffe, LLC (In re: TSAWD Holdings, Inc., et al.), No. 16-10527 (MFW), 2018 WL 6885922, at *1 (Bankr. D. Del. Nov. 26, 2018).

CASE SNAPSHOT

In this adversary proceeding stemming from the chapter 11 cases of The Sports Authority and its affiliates, the United States Bankruptcy Court for the District of Delaware resolved two cross-motions for summary judgment surrounding a dispute over the priority of competing claims in the inventory, and proceeds thereof, sold by clothes manufacturer M. J. Soffe, LLC to TSA on consignment. The Court was tasked with determining who had the senior interest in the inventory: Soffe or Wilmington Savings Fund Society, FSB, in its capacity as Successor Administrative and Collateral Agent under Debtors' term loan agreement. The Court concluded that, because WSFS did not have knowledge of Soffe's consignment interest until after Soffe filed a UCC-1 financing statement, it would grant WSFS's motion for summary judgment, thereby ruling that WSFS had a senior interest in the Disputed Goods prior to the date that Soffe filed its UCC-1 financing statement.

FACTUAL BACKGROUND

TSA, formerly national retailers of sporting goods and active apparel, filed their chapter 11 petitions in March 2016. Prepetition, Debtors were borrowers or guarantors on a $300 million term loan facility, secured by a lien on the Debtors' inventory and proceeds thereof, with Bank of America, N.A. serving as term loan agent until WSFS acceded to the position in late 2015. Part of the Debtors' business plan involved the sale of goods on consignment. Vendors who chose to sell goods to TSA on consignment entered into a 'pay by scan' deal sheet and elected to either be paid on a cost or retail split basis. In 2010, Soffe entered into one of the consignment agreements with TSA, pursuant to which TSA paid Soffe an agreed upon amount after the sale of a consigned good and retained the remaining proceeds. Soffe filed a UCC-1 financing statement just one month prior to the petition date and did not notify WSFS of that filing.

Postpetition, disputes arose regarding the Debtors' right to pledge or sell consigned goods in their possession and, pending the filing and resolution of an adversary proceeding to resolve the issue, the Court permitted the Debtors to sell consigned goods in their possession so long as they continued to make consignment payments to the vendors. WSFS preserved its rights to recoup any payments made to the consignors from the sale of the consigned goods if the Court determined that WSFS, as term loan agent, had a superior security interest in such goods. Thereafter, the Debtors commenced an adversary proceeding against Soffe, seeking declaratory relief on competing claims to the Soffe consigned goods (and their proceeds) delivered prepetition to the Debtors valued at over $5 million (the "Disputed Goods"). WSFS subsequently intervened in the adversary proceeding, asserted that it had a perfected security interest in the Disputed Goods senior to Soffe's interest, and sought disgorgement of their proceeds. In response, Soffe sought a declaration that WSFS's security interest did not attach to the Disputed Goods and that if it did, WSFS's lien was subordinate to Soffe's interest in the Disputed Goods. The Court previously denied WSFS's motion for partial judgment on the pleadings, concluding that an issue of fact—whether Soffe's consignment interest is governed by Article 9 of the UCC—precluded the granting of such relief. The parties then filed cross-motions for summary judgment seeking a determination of their respective interests in the Disputed Goods and their proceeds, with Soffe also seeking dismissal of the Debtors' claims under Bankruptcy Code sections 544 and 547.

COURT ANALYSIS

In rendering its decision, the Court began with an overview of consignment under the UCC. WSFS contended that its interest in the Disputed Goods was superior to Soffe's interest prior to February 2016, when Soffe filed its UCC-1 financing statement, because WSFS filed its financing statement first. Soffe countered that Article 9 of the UCC did not apply because WSFS (through its predecessor in interest) had actual knowledge of its consignment interest and such knowledge was imputed to the term loan lenders. Section 9-102(a)(20) of the UCC defines "consignment" as:

> a transaction, regardless of its form, in which a person delivers goods to a merchant for the purpose of sale and:
>
> (A) the merchant:
>
> (i) deals in goods of that kind under a name other than the name of the person making the delivery;
>
> (ii) is not an auctioneer; and
>
> (iii) is not generally known by its creditors to be substantially engaged in selling the goods of others.
>
> (B) with respect to each delivery, the aggregate value of the goods is $1,000 or more at the time of delivery;

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(C) the goods are not consumer goods immediately before delivery; and

(D) the transaction does not create a security interest that secures an obligation.

N.Y. U.C.C. § 9-102(a)(20). Soffe conceded that its agreement with the Debtors met all requirements of section 9-102(a)(20) of the New York UCC except the requirement that the Debtors' creditors did not have knowledge of the consignment. Soffe argued that WSFS had actual knowledge of the consignment relationship, which satisfies section 9-120(a)(20)(A)(iii) and places the relationship outside the scope of Article 9, while WSFS countered that actual knowledge does not satisfy the exception embodied in section 9-120(a)(20)(A)(iii). The Court held that, if Soffe could establish that WSFS had actual knowledge of its consignment relationship with the Debtors before the Term Loan was made, Article 9 would not apply to its interest in the Disputed Goods.

The Court then considered whether WSFS had actual knowledge of Soffe's consignment relationship with the Debtors. Soffe asserted that Bank of America, while acting as term loan agent for the Debtors prepetition, acquired actual knowledge of Soffe's consignment relationship with the Debtors by virtue of its capacity as co-lender to Soffe's parent, Delta Apparel, Inc. WSFS countered that (i) Bank of America never acquired actual knowledge of the consignment relationship in its capacity as a lender to Soffe's parent; (ii) even if it had, Bank of America had a duty to keep such information confidential; (iii) any knowledge Bank of America learned as lender to Soffe's parent cannot be imputed to it as Agent for the Debtors' Term Loan; and (iv) any knowledge that Bank of America may have learned as a lender to Soffe's parent cannot be imputed to the Term Loan Lenders themselves because Bank of America had no duty as their Agent to disclose it to them. Based on testimony presented by a Bank of America executive, the Court concluded that Soffe failed to demonstrate that any knowledge of Soffe's consignment relationship was actually in Bank of America's 'mind' at the time the Term Loan was incurred, and thus rejected Soffe's attempt to impute knowledge of the relationship to the Term Loan Agent.

The Court rejected each of Soffe's remaining arguments, noting that (i) even if Bank of America had acquired actual knowledge of the consignment relationship, was not at liberty to share that information with the Bank of America divisions administering the Debtors' term loan agreement; (ii) even if Bank of America was at liberty to share information regarding the consignment relationship, Soffe failed to establish that the bank actually did share such information; (iii) even if the existence of the consignment relationship was known to Bank of America generally, Soffe failed to establish that that knowledge was also known to the term loan lenders; and (v) even if Bank of America, in its capacity as a lender to Soffe's parent, had acquired actual knowledge of the consignment relationship that could be imputed to Bank of America generally, that knowledge could not be imputed to the term loan lenders because Bank of America had no duty to give that information to them under its written agreement. Accordingly, because Soffe failed to establish that Bank of America had actual knowledge of the consignment relationship or that such knowledge could be imputed to the term loan lenders, the Court concluded that the relative interests of Soffe and the Term Loan Lenders are governed by Article 9 of the UCC.

Applying the framework of Article 9, the Court noted that under UCC section 9-203(b), a security interest is enforceable with respect to collateral if "(1) value has been given; (2) the debtor has rights in the collateral or the power to transfer rights in the collateral to a secured party; [and] (3) ... (A) the debtor has authenticated a security agreement that provides a description of the collateral," N.Y. U.C.C. § 9-203(b), and that these requirements were met here. Pursuant to UCC section 9-322(a), conflicting perfected security interests rank according to priority in time of filing or perfection, N.Y. U.C.C. § 9-322(a)(1), except where a party obtains a purchase money security interest—such as a consignment interest—in inventory already subject to a prior perfected security interest, id. at § 9-324(b)(1)-(4). In such cases, the later filing party has priority in goods delivered after it has met the requirements of UCC section 9-324(b). *Id.*

Here, Soffe met the requirements of UCC section 9-324(b) when it filed its financing statement on February 4, 2016, and sent a notification letter to WSFS regarding the same. Accordingly, the Court concluded that WSFS's blanket security interest in inventory has priority over Soffe's interest in the Disputed Goods that Soffe delivered to the Debtors before February 4, 2016, and that Soffe has a perfected interest with priority over WSFS's interest in the Disputed Goods that were delivered to the Debtors after February 4, 2016. Finally, the Court dismissed the Debtors' preference claims and claims under section 544's strong-arm provision as moot given that Soffe has a secured interest in Disputed Goods delivered after February 4, 2016, and an interest junior to WSFS's security interest in those goods prior to February 4, 2016. .

PRACTICAL CONSIDERATIONS

This opinion is an important reminder for both lenders and manufacturers that sell to retailers on a consignment basis. First, and most significantly, before shipping anything on consignment, the consignor should at least file a UCC-1 financing statement and, ideally, should obtain an inter-creditor agreement from any lender

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WAGE DEPOSITS INTO ENTIRETIES ACCOUNT CONSTITUTE "TRANSFERS" FOR FRAUDULENT TRANSFER PURPOSES

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Shearer v. Titus (In re Titus), 916 F.3d 293 (3d Cir. 2019)

CASE SNAPSHOT

In the bankruptcy of a lawyer who attempted to evade payment of a large lease creditor, the court finds that when the wages of an insolvent spouse are deposited into a couple's entireties account, both spouses are fraudulent transferees for purposes of Pennsylvania's Uniform Fraudulent Transfer Act. If the wages are commingled with non-fraudulent funds and are used to pay for necessaries and non-necessaries, the court should presume that wage deposits were spent on non-necessary expenditures in proportion to the overall share of wages in the account as a whole.

FACTUAL BACKGROUND

Attorney's prior firm broke a lease and the attorney was on the hood for millions of dollars in unpaid commercial rent. Landlord sought to collect by garnishing the attorney's wages at his new firm. However, his wages were deposited into an account owed by the attorney and his spouse as tenants in the entireties. The attorney filed for bankruptcy, and the landlord's claim became a claim of the bankruptcy trustee. The account contained deposits of both (fraudulent) wages and (non-fraudulent) other sources, and both (permissible) household necessities and (impermissible) other expenditures were paid from the account.

COURT ANALYSIS

The court first determined that the deposit of one spouses wages into an entireties account constituted a transfer for fraudulent transfer purposes insofar as an asset that was initially solely his own was no longer solely his own once deposited (at the wage earning spouse's direction) into an entireties account. An insolvent debtor's spouse is personally liable for a fraudulent transfer, thus both spouses can be individually liable for the fraudulent transfer of the insolvent spouse's wages. The insolvent spouse is also subject to transferee liability even though he is the debtor-transferor as well.

The court next clarified the burden in fraudulent transfer cases involving entireties accounts. A transfer is not "fraudulent" under PUFTA if the wages deposited into the entireties account are used to pay for reasonable and necessary household expenses. The court presumes that funds deposited into an entireties account were not in exchange for reasonably equivalent value – i.e. that wages in question were not spent on necessities. The debtors can rebut that presumption by producing evidence as to the uses of the entireties account. Once the presumption is overcome, the trustee bears the burden of persuasion as to all elements of a constructive fraudulent transfer claim under PUFTA. In a comingled account, the court determined that absent other evidence, the court should presume that spending out of the entireties account was made up of a mixture of wages and nonwage deposits in proportion to the overall ratio of wage to nonwage deposits in the account.

PRACTICAL CONSIDERATIONS

Fraudulent transfer statutes have broad reach, and the deposit of funds owned by an individual insolvent spouse into a comingled entireties account can open the couple up to fraudulent transfer exposure.

Filing Of UCC-1 Determinative Of Priority In Consigned Goods Under Article 9—continued from page 6

that asserts a security interest in the retailer's inventory. As for lenders, the security agreement at issue should contain a clause expressly including consigned goods, rather than the more general "all goods" working usually seen in such agreements.

Clear language on the front end of the deal will help avoid any future litigation over whether a manufacturer is "generally known" as a consignee.

WHOSE CLAIM IS IT ANYWAY? THE FIFTH CIRCUIT COURT OF APPEALS FURTHER CLARIFIES HOW TO DISTINGUISH DIRECT AND DERIVATIVE CLAIMS IN BANKRUPTCY.

Alexis Leventhal
Associate, Pittsburgh

Matter of Buccaneer Resources, L.L.C., 912 F.3d 291 (5th Cir. 2019).

CASE SNAPSHOT

Applying the standard delineated in its previous ruling in In re Seven Seas Petroleum, Inc., 522 F.3d 575 (5th Cir. 2008), the Fifth Circuit affirmed the lower court's ruling that the ex-CEO of a Debtor company had properly brought a claim against a non-debtor third party in state court where the ex-CEO had illustrated he suffered an injury that was not dependent on injury to the Debtor's estate.

FACTUAL BACKGROUND

The Debtor, as it found itself in an increasingly strained financial position, permitted secured creditor, Meridian Capital CIS Fund ("Meridian") greater control and influence over the Debtor's operations. Shortly after filing for bankruptcy, the Debtor filed its long-time CEO ("Burton"). Burton alleged his termination violated the terms of his contract and that Meridian was wrongfully involved in the decision. Burton filed a claim against the Debtor, but then withdrew it and then filed suit against Meridian in state court, alleging tortious interference with contracts along with other tagalong claims. Prior to filing the state court litigation, the Debtor and Meridian had entered into a settlement (the "Settlement") (incorporated in the Debtor's confirmed plan) whereby the Debtor released Meridian from any potential claims the Debtor may have had for $10 million

Meridian removed the case to the bankruptcy court arguing that the claims asserted belonged to the Debtor's estate and, pursuant to the Settlement, were released. The bankruptcy court disagreed, found it did not have jurisdiction to decide the claims of Burton against Meridian, and permitted Burton to pursue his claims in state court. Appeals ensued culminating in the Fifth Circuit's consideration of whether Burton's tortious interference claims against Meridian is direct or derivative as dispositive of whether or not Burton's claims was, ultimately, property of the Debtor's estate.

COURT ANALYSIS

The Court's previous holding in Seven Seas instructed the Court to focus on whether Burton suffered a direct injury or one that is derivative of an injury to the Debtor. If the harm to Burton came about only because of harm to the Debtor, then his injury is derivative, and the claim is property of the estate. To be a direct claim, however, one that Burton can pursue on his own behalf, the Court must find that Burton has illustrated that his injury is not dependent on injury to the estate. With this framework established, the Court reasoned that the injury to Burton may have flowed through the Debtor—the Debtor fired Burton—but not through an injury to the Debtor. In other words, the tortious interference claim Burton asserts is based on an injury that is independent of any injury to the Debtor and, therefore, it belongs to him and not the estate.

While the Court stated that it "readily" found Burton's claim to involve a direct rather than derivative injury, the Court expressed various policy concerns for the implications of its finding. The Court expressed concern that its holding could undermine bankruptcy's ability to gather creditors in a common forum to settle their claims at once or could have a chilling effect on secured creditors offering distressed financing. Despite such concerns, the Court recommitted to its analysis under the issue presented and held that because the tortious interference claim is direct injury to Burton, it is not property of the estate and there is no basis for bankruptcy court jurisdiction.

PRACTICAL CONSIDERATIONS

The Court's decision highlights the utility of its previous holding in Seven Seas as providing a practical and straight-forward framework for distinguishing between direct and derivative claims while pointing out that, while the analysis for making the distinction may be simple enough, the implications may be more complicated.

ULTRA CONFUSION: FIFTH CIRCUIT CLARIFIES "IMPAIRMENT" ANALYSIS BUT SIGNALS FUTURE CIRCUIT SPLIT ON MAKE-WHOLE PREMIUMS AND POST-PETITION INTEREST

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Ultra Petroleum Corp. v. Ad Hoc Comm. of Unsecured Creditors of Ultra Res., Inc. (In re Ultra Petroleum Corp.), 913 F.3d 533 (5th Cir. 2019)

CASE SNAPSHOT

A three-judge panel of the Fifth Circuit Court of Appeals clarified the proper standard of "impairment" as being curtailment of a creditor's claims by a plan of reorganization and not independent disallowance or diminution of a claim caused by operation of the Bankruptcy Code. In contrast to this clarity, the panel remanded two issues to the Bankruptcy Court for a decision involving make-whole premiums and post-petition interest, and in doing so, provided a significant amount of analysis as to how those issues should be decided, signaling a future circuit split.

FACTUAL BACKGROUND

To fund its operations in oil and gas exploration, Ultra Resources Corporation ("**Resources**") issued $1.46 billion in unsecured notes (the "**Notes**") and borrowed $999 million under a revolving credit facility (the "**Facility**"). Resource's parent, Ultra Petroleum Corporation ("**Petroleum**") and affiliate UP Energy Corporation ("**Energy**," and collectively with Resources and Petroleum, "**Debtors**") guaranteed payment of the Notes and the Facility.

As a result of a sharp drop in crude oil prices, the Debtors filed for bankruptcy. However, during bankruptcy, crude oil prices rose to a level where the Debtors became solvent and therefore proposed a plan that would pay creditors in full.

The Debtors' plan classified creditors with claims under the Notes and the Facility (the "**Class 4 Creditors**") as unimpaired—and thus unable to vote on the plan—because the plan would pay them all outstanding principal, pre-petition interest at the contractual rate, and post-petition interest at the federal judgment rate.

Nevertheless, the Class 4 Creditors objected on the grounds that they were, in fact, impaired because the plan did not provide for the payment of (1) a contractual "Make-Whole Premium" to compensate for loss of future interest as required by the Notes upon the filing of a bankruptcy case; or (2) post-petition interest at the contractual default rate (as opposed to the proposed federal judgment rate). In sum, between the missing Make-Whole Premium and the allegedly miscalculated post-petition interest, the Class 4 Creditors asserted that the Debtors owed them an additional $387 million before they could be considered unimpaired under the proposed plan.

In order to expedite confirmation, the parties stipulated that the Class 4 Creditors would be deemed "unimpaired" under the plan, but that the Debtors would set aside $400 million to compensate the Class 4 Creditors if necessary to render them "unimpaired."

After confirmation, the Bankruptcy Court sided with the Class 4 Creditors. It held that the Class 4 Creditors were entitled to the Make-Whole Premium and post-petition interest at the contractual default rate in order to be "unimpaired" because they would have been entitled to these amounts under state law. In so holding, the Bankruptcy Court did not address the Debtors' counterarguments that (1) the Make-Whole Premium should be a disallowed claim as "unmatured interest" pursuant to § 502(b)(2) of the Bankruptcy Code and (2) that the Bankruptcy Code entitles creditors to the federal judgment rate and not the contractual default rate.

COURT ANALYSIS

On direct appeal from the Bankruptcy Court, the presiding Fifth Circuit panel vacated the Bankruptcy Court's holding that the Class 4 Creditors were impaired.

Next, it remanded the issues of whether the Bankruptcy Code actually disallows (1) the claims for the Make-Whole Premium and (2) post-petition interest at the contractual default rate. However, instead of a bare bones remand, the Fifth Circuit provided a meticulous analytical framework suggesting how the Bankruptcy Court should answer these questions.

A Creditor Is Not "Impaired" By a Plan Because it Accounts for the Bankruptcy Code's Disallowance of Certain Claims

The Fifth Circuit noted several times that the Bankruptcy Court's impairment analysis contradicted the sole court of appeals opinion and the "monolithic mountain" of bankruptcy court opinions considering this question.

The Bankruptcy Court's fundamental error was in its misinterpretation of the plain text of § 1124(1) of the Bankruptcy Code, which provides that "a class of claims or interests" is not impaired if "*the plan . . .* leaves unaltered the [claimant's] legal, equitable, and contractual rights." (emphasis added).

The Fifth Circuit clarified that if the Bankruptcy Code first limited recovery of the Make-Whole Premium and post-petition interest, the plan itself did not cause the impairment under the plain language of section 1124(1). Rather, the Bankruptcy Code caused this "impairment." In other words, a plan does not "impair" a creditor so long as it provides the creditor everything the law entitled him to once the bankruptcy began. Thus, the Bankruptcy

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Ultra Confusion: Fifth Circuit Clarifies "Impairment" Analysis but Signals Future Circuit Split on Make-Whole Premiums and Post-Petition Interest—continued from page 9

Court erred in conflating "impairment" caused by the plan itself and harm that was a caused not by the plan, but by operation of the Bankruptcy Code altering the creditors' rights.

The Make-Whole Premium is Likely "Unmatured Interest"

The Bankruptcy Court failed to address the Debtors' arguments the Make-Whole Premium should be disallowed as "unmatured interest" pursuant to § 502(b)(2) of the Bankruptcy Code and that post-petition interest should be limited to the "legal rate" under § 726(a)(5) which it claims is the federal judgment rate set forth in 28 U.S.C. § 1961.

Although deferring to the Bankruptcy Court for a final decision on this issue, the Fifth Circuit was heavy handed in its suggestion that the Make-Whole Premium at issue would be disallowed as unmatured interest pursuant to § 502(b)(2).

First, it reasoned that the Make-Whole Premium was the "economic equivalent" of interest because its purpose is to compensate the creditor for lost future interest due owing to creditors as a result of the debtor's prepayment. Second, it found that the Make-Whole Premium was "unmatured" because—notwithstanding its acceleration upon the bankruptcy filing (which it considered to be an unenforceable *ipso facto* clause)—the Debtors did not owe the Make-Whole Premium on the petition date.

The Fifth Circuit then addressed the Class 4 Creditors' arguments that an oft-used "solvent debtor" exception would apply to entitle them to the Make-Whole Premium, thus creating a carve out of the "unmatured interest" provisions of § 502(b)(2). While passing the bulk of the work on this issue to the Bankruptcy Court, the Fifth Circuit noted that the "solvent debtor" exception was never explicitly codified. Further, it hinted that the "solvent debtor" exception may be obsolete because much of the pre-Bankruptcy Code case law applying this exception was in response to concern over bad-faith filings, which are now remedied by dismissal procedures under § 1112(b).

Post-Petition Interest

Lastly, the Fifth Circuit addressed the proper calculation of post-petition interest. It determined that the "legal" rate identified in § 726(a)(5) is not applicable to the Class 4 Creditors because it only applies to impaired creditors in the Chapter 11 context (citing § 1129(a)(7)(A)(ii)). Instead of analyzing § 726(a)(5), the Fifth Circuit provided two potential "paths" for the Bankruptcy Court's analysis of post-petition interest on unimpaired Chapter 11 claims.

The first path offered by the Fifth Circuit was merely to apply the general post-judgment interest statute, 28 U.S.C. § 1961, which allows interest to be paid at what is commonly known as the "federal judgment rate" set by reference to certain Treasury yields, on the theory that a bankruptcy claim is akin to a federal judgment. The second path would be for the bankruptcy court, applying principles of equity, to fashion its own post-petition interest rate, and noted that at least one court has done this in the past.

PRACTICAL CONSIDERATIONS

Although the Fifth Circuit panel's opinion is rich in historical pre-Bankruptcy Code analysis, it is hard to glean current practical considerations and consequences from the four corners of the opinion. Rather, such considerations come to light in the Class 4 Creditors' motion for rehearing *en banc*, which is still pending as of the writing of this article.

In its statement regarding *en banc* consideration, the Class 4 Creditors noted that the panel's opinion was aberrant in several respects. First, it noted that the panel's opinion was the first Circuit-level case to make a finding that a make-whole premium is the economic equivalent of interest, in direct contravention of three prior Fifth Circuit decisions, along with Second Circuit and New York state court decisions. Second, with respect to interest, Class 4 Creditors argue that the panel's decision is the first since the repeal of § 1124(3) to hold that a creditor who is not paid its contractual interest by a solvent debtor is nonetheless unimpaired.

The Class 4 Creditors argued that such aberrations could "wreak havoc in the lending market" because lenders could no longer rely on make-whole premiums and would raise borrowing costs as a result. They further noted that fixed rate lenders who rely on the ability to lend without the risk of early repayment for regulatory and credit investment rating purposes may be foreclosed from lending altogether if they cannot absorb such risk.

Accordingly, although the case was remanded to the Bankruptcy Court, the panel's opinion forewarned of an impending circuit split absent reversal on *en banc* review.

DELAWARE BANKRUPTCY COURT FINDS ELEVENTH AMENDMENT SOVEREIGN IMMUNITY DOES NOT PREVENT TRUSTEE FROM PURSUING CLAIMS AGAINST STATE OF CALIFORNIA

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In re Venoco, LLC, 596 B.R. 480 (Bankr. D. Del. 2019)

CASE SNAPSHOT

Delaware Bankruptcy Court finds that its *in rem* jurisdiction supersedes the Eleventh Amendment's sovereign immunity protections, and that it otherwise has core, "arising in", and "related to" jurisdiction over adversary case against California.

FACTUAL BACKGROUND

Affiliated Debtors filed voluntary petitions under Chapter 11 on April 17, 2017, and successfully confirmed a plan of liquidation on May 23, 2018. On October 16, 2016, the liquidating trustee filed an adversary complaint against the State of California and the California State Lands Commission asserting inverse condemnation claims based upon California occupancy of the Debtors' facilities without paying rent.

The State of California and the Commission moved to dismiss the complaint on the grounds that it is immune from federal suits under the Eleventh Amendment, that the Trustee did not exhaust its state law remedies, and the Bankruptcy Court lacked subject matter jurisdiction.

COURT ANALYSIS

First, tackling the sovereign immunity question, the Delaware Bankruptcy Court acknowledged that Section 106 of the Bankruptcy Code, which abrogates sovereign immunity as to governmental units, has been found unconstitutional under Third Circuit precedent. However, the Delaware Bankruptcy Court found, under the *La Paloma* decision from Judge Sontchi, that an *in rem* claim brought in a bankruptcy court defeats a state's sovereign immunity. Additionally, the Delaware Bankruptcy Court found that the Commission's actions were attributable to the State of California, and that liability may attach on those grounds, as well.

Second, the Bankruptcy Court found that it had both core, "arising in", and "related to" jurisdiction (even post-confirmation), based upon the fact that California filed a proof of claim in the case and the determination of the claim, as well as the adversary case, would have an "enormous" effect on Debtors' estates.

Lastly, the Bankruptcy Court disposed of California's other arguments, finding summarily that the Trustee was not required to exhaust its state law remedies, and that the Trustee otherwise stated a claim for relief. Further, the Bankruptcy Court declined to abstain, finding that on balance, the most important factors (including disposition of California's proof of claim), weighed in favor of retaining jurisdiction over the adversary case.

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WAKE UP AND SMELL THE COMPROMISE: COFFEE FARMERS CASE ENCOURAGES PRE-BANKRUPTCY WORKOUTS AND PROTECTS PRIORITY STATUS TO SECURED LENDERS WHO COMPROMISE

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Coffee Farmers Cooperative Inc. v. Smith et al. (In re Smith), 596 B.R. 902 (Bankr. M.D. Ala. 2019)

CASE SNAPSHOT

In a workout scenario, a lender who "renews" a note secured by a mortgage, without doling out additional indebtedness, is not providing the borrower a "future advance" that would strip the lender's priority status vis-à-vis an intervening lien.

FACTUAL BACKGROUND

In 2006, farmer Edward Smith and his wife made an agreement with Troy Bank to consolidate their existing indebtedness (evidenced by several notes) into one single note. The consolidated note was secured by mortgages properly executed by the Smiths in the Bank's favor in 2002 and 2006.

In 2009, Coffee Farmers Cooperative Inc. obtained and properly recorded a $183,000 money judgment against the Debtor.

Thereafter, in 2012, despite souring relations between the Smiths and the Bank, the Bank permitted the Smiths to renew the Note. The Bank, however, did not advance any additional funds under the Note pursuant to the terms of the renewal.

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Delaware Bankruptcy Court Finds Eleventh Amendment Sovereign Immunity Does Not Prevent Trustee From Pursuing Claims Against State of California—continued from page 11

The Delaware Bankruptcy Court's decision was appealed to the Delaware District Court, which has stayed the ruling pending appeal on the basis that it is obligated to stay lower court non-frivolous rulings denying Eleventh Amendment sovereign immunity.

PRACTICAL CONSIDERATIONS

Although sovereign immunity fights in bankruptcy court are relatively rare, this decision will have wide-ranging impact on the rights of Debtors and trustees against state entities. Given prior Third Circuit precedent regarding sovereign immunity, as well as the District Court's issuance of a state pending appeal, it is likely that further decisions will be rendered by the District Court and the Third Circuit before the legal issues are settled.

Wake Up and Smell the Compromise: Coffee Farmers Case Encourages pre-Bankruptcy Workouts and Protects Priority Status to Secured Lenders Who Compromise—continued from page 11

In 2017, the Debtor filed under Chapter 12 of the Bankruptcy Code, and proposed a plan that would permit him to keep his land, continue farming, and make payments to creditors.

In an effort to thwart its undersecured status, Coffee Farmers argued that its 2009 judgment lien should have priority over the Mortgages for payment under the plan, because the Bank's renewal of the note was a "future advance."

COURT ANALYSIS

The Middle District of Alabama made quick work in disposing Coffee Farmers' priority claims, finding that the 2012 renewal was not a future advance. In its analysis, the Court posited that under well-settled law, after receiving notice of a junior lien (here, the 2009 judgment lien), the Bank (as a senior mortgagee) would not be protected if it were to make optional future advances under the Note and secured by the Mortgages, and those advances would be subordinate to the intervening 2009 judgment lien.

The Court stressed, however, that the Bank's 2012 renewal of the Note was not a "future advance" because the Bank did not advance any new funds in 2012 and the plain language on the Note confirmed the intent of the parties to merely renew, not advance.

Importantly, the Court rebuffed Coffee Farmers' argument that the 2006 consolidation of the Note and the 2012 renewal evidenced "unusual" circumstances. What the plaintiff labeled as "unusual" the Court labeled as a typical "workout" scenario, emphasizing the importance of such compromises and a court's role in promoting them:

> Workouts between banks and distressed debtors are not at all unusual. Indeed, where one has borrowed money that he cannot repay at the moment, a workout is a rational choice by both lender and borrower. This process should be encouraged. Were the courts to take an unreasonably restrictive approach of what constitutes a renewal, more bankruptcies and more business failures would result.

PRACTICAL CONSIDERATIONS

Coffee Farmers is a good example of a court encouraging lenders to compromise, consolidate, renew, and extend indebtedness without the fear that changes to the loan structure would be viewed as a "future advance." However, in order to keep priority in this scenario, lenders who are just "renewing" a loan and not providing additional capital should make that abundantly clear on any amended loan documents.

COAL ACT BENEFITS WITHIN PURVIEW OF SECTION 1114

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Trustees of the United Mine Workers of America 1992 Benefit Plan, et al. v. Westmoreland Coal Company, et al. (In re: Westmoreland Coal Company, et al.), No. 18-35672, 2018 WL 6920227, at *5 (Bankr. S.D. Tex. Dec. 29, 2018)

CASE SNAPSHOT

Ruling on an issue of great significance to the thousands of Americans who work in coal mines, the United States Bankruptcy Court for the Southern District of Texas recently determined that certain statutory obligations under the Coal Act are "retiree benefits" subject to section 1114 of the Bankruptcy Code. Section 1114 permits a bankruptcy court to modify or terminate retiree benefits only if, among other things, the court finds that "such modification is necessary to permit the reorganization of the debtor." 11 U.S.C. § 1114(g)(3). The Bankruptcy Court determined that the Coal Act obligations are "retiree benefits" subject to section 1114. Because it deemed the issue a matter of public importance, the Bankruptcy Court directly certified its decision to the Fifth Circuit Court of Appeals, where the case remains pending.

FACTUAL BACKGROUND

Shortly after Westmoreland Coal Company and 36 affiliates (the "**Debtors**") filed their bankruptcy petitions in October 2018, the trustees of the United Mine Workers of America 1992 Benefits Plan (the "**Trustees**") filed a complaint concerning the Debtors' obligations under the Coal Industry Retiree Health Benefits Act of 1992 (the "**Coal Act**"), 26 U.S.C. § 9701 *et seq.*, which the Debtors sought to terminate in their bankruptcy cases. The Trustees sought a declaratory judgment from the Bankruptcy Court that the Debtors' Coal Act obligations were not "retiree benefits" subject to section 1114 of the Bankruptcy Code. These obligations at issue included the obligation to (i) pay premiums for retired miners to the two benefit plans that were created by the Coal Act; (ii) provide security to one of the benefit plans; and (iii) maintain an individual employer plan for certain beneficiaries at the level mandated by the Coal Act.

The Debtors then filed a motion for judgment on the pleadings under Federal Rule of Civil Procedure 12(c), and in response, the Trustees cross-moved for judgment on the pleadings. On December 29, 2018, the Bankruptcy Court issued its opinion granting the Debtors' motion for judgment on the pleadings and denying the Trustee's requested relief. The Bankruptcy Court also directly certified its decision to the Fifth Circuit Court of Appeals because (i) it involves a matter of public importance; (ii) no controlling decision has been issued by the Fifth Circuit or the United States Supreme Court; and (iii) resolution of the adversary proceeding will materially advance the underlying bankruptcy case.

COURT ANALYSIS

In reaching its decision, the Bankruptcy Court first considered the legislative histories of both the Coal Act and section 1114. Citing to

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DELAWARE BANKRUPTCY COURT GIVES "GREEN LIGHT" TO POTENTIAL CLAW BACK OF BANK FEES

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Kirschner v. J.P Morgan Chase, et al. (In re Millennium Lab Holdings II, LLC, et al.), Adv. P. No. 17-51840, 2019 WL 1005657, (Bankr. D. Del. Feb. 28, 2019)

CASE SNAPSHOT

Bank servicing and marketing fees charged in connection with a loan transaction are not shielded against fraudulent transfer claims merely because those fees reflected a market rate for the services. Rather, in certain circumstances, these fees should be considered as part of the larger transaction that was value destructive to the borrower and can be clawed back in certain circumstances.

FACTUAL BACKGROUND

A little over a year prior to its bankruptcy, Millennium Labs ("Millennium"), a drug testing company, borrowed nearly $2 billion from various funds and institutional investors in exchange for term loan notes. Some of the proceeds were used to repay and retire existing debt. An even larger portion of the loan proceeds—$1.2 billion—was used to pay dividends and bonuses to Millennium equity holders, managers, and other insiders. The subject of this memorandum opinion, however, focuses on $35.3 million of the loan proceeds ("Bank Fees") paid by Millennium as servicing fees to defendants J.P. Morgan, Citibank, BMO Harris Bank, and SunTrust Bank (the "Banks") as part of the transaction.

The Plaintiff, the trustee of the corporate trust created in Millennium's plan of reorganization, filed suit against the Banks to recover the Bank Fees, arguing that they constituted either an

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Coal Act Benefits Within Purview Of Section 1114—continued from page 13

the United States Supreme Court's decision in *Eastern Enterprises v. Apfel*, the Bankruptcy Court noted that the Coal Act was enacted in 1992 as the byproduct of a lengthy strike that eventually led to Congress passing the Coal Act, which created a new multiemployer benefits plan for retirees and their benefits financed by annual premiums assessed against certain coal operators. 524 U.S. 498, 511 (1998). Generally, the Coal Act covers the health and death benefits that must be provided to retired mineworkers and their beneficiaries. Coal operators are required to (i) pay premiums into the certain benefits plans based on the number of beneficiaries enrolled such plans; (ii) continue to provide benefits to certain retirees under an individual employer plan so long as the operator remains in business; and (iii) must post security in the form of a bond, letter of credit, or cash escrow, in favor of the Trustees in an amount equal to one year of premium liability.

Turning to section 1114, the Bankruptcy Court noted that Congress added the provision to the Bankruptcy Code in 1988 in response to the growing trend of such retiree benefits being unilaterally rejected by debtors. As a protective mechanism, section 1114 deals with the limited instance where the retirees' former employer is a chapter 11 debtor and a modification of benefits is necessary to effect a reorganization by providing a framework for the negotiation of retiree benefits between a debtor and an authorized representative of the retirees. *See* 11 U.S.C. § 1114(f).

The Trustees asserted that section 1114 does not apply to the Coal Act obligations because they are statutorily mandated. However, the Court found the text of section 1114 to be unambiguous, with no limitation on the definition of "retiree benefits" to suggest that Congress intended for statutorily created benefits should be treated any differently from those created by contract. As to the Trustees next argument—that the Debtors do not maintain the relevant benefit plans in whole or in part—the Court quickly dispensed with that notion, indicating that "to suggest that the Debtors' payment of premiums under the Coal Act does not operate to at least partially maintain the underlying benefit programs is to suggest that a table can stand without its legs." The Court summarily rejected the Trustees' additional arguments, including the assertion that the posting of a bond does not constitute "payment" as required by section 1114, and forcefully noted that the Trustees' contention that finding the Coal Act obligations to be within the purview of section 1114 would be futile was merely "a house of cards that cannot stand." Finally, the Court rejected the Trustees' argument that the Coal Act obligations were actually federal taxes subject to the Anti-Injunction Act, which prohibits courts from impeding the assessment and collection of any federal tax. The Court therefore concluded that the Debtors' obligations under the Coal Act were subject to section 1114, granted the Debtors' motion for judgment on the pleadings, and certified its judgment for direct appeal to the Fifth Circuit.

PRACTICAL CONSIDERATIONS

The Court's ruling coincides with a number of recent decision reaching similar conclusions: that retiree benefits mandated by the Coal Act can be renegotiated, and benefit agreement potentially rejected in bankruptcy, under section 1114. To those workers who have relied on the various plans and funds created under the Coal Act, these rulings represent a dire development. It remains to be seen how the Fifth Circuit will approach the arguments on appeal and if the case could make its way to the U.S. Supreme Court due to a potential circuit split.

Delaware Bankruptcy Court Gives "Green Light" to Potential Claw Back of Bank Fees—continued from page 13

actual or constructive fraudulent transfer. In support, the trustee argued, among other things, that the transaction: (1) was not made for reasonably equivalent value because it allocated no funds to operating expenses, thus conveying no operational benefit; (2) left Millennium either insolvent or with inadequate funds to pay additional liabilities arising from their suspicious sales, marketing, and billing practices that had been subject to a federal government investigation and subsequent $256 million settlement; and (3) was consummated for express purpose of funding the dividend to insiders without plans on how the loan would be repaid.

Moreover, the trustee extended criticism to the Banks, stating that notwithstanding their knowledge of the risk involved because of the government investigations, the Banks made misstatements or omissions to investors in an orchestrated effort to obtain a favorable rating and market the loan on Millennium's behalf.

The Banks filed a motion to dismiss both counts, asserting, in essence that the trustee could not adequately prove fraudulent intent for the actual fraud claim, and for the constructive fraud claim, the trustee failed to allege that that the Bank Fees lacked reasonably equivalent value to the services performed.

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COURT ANALYSIS

The Court denied the Defendant’s motion to dismiss, finding that the trustee had sufficiently pled claims for actual fraudulent transfer under § 548(a)(1)(A) and constructive fraudulent transfer under § 548(a)(1)(B).

Actual Fraudulent Transfer

Defendants argued that the trustee failed to adequately plead intent to defraud because the complaint only alleged two of the eleven traditional factors known as “badges of fraud”—inadequacy of consideration and insolvency.

The Court countered that it could consider other factors other than the two asserted “badges of fraud” in its analysis. Namely, the court found that the trustee adequately pled a claim that Millennium intended to hinder, delay, or defraud creditors in the incurrence of the Bank Fees, pointing to several factors beyond the badges of fraud. Namely, the Court emphasized that: (1) Millennium’s business practices were being challenged as illegal on several fronts; (2) the illegality of the business model meant that its revenues were overstated; (3) Millennium was aware that the marketing used to court investors was untruthful; (4) the consummation of the transaction left Millennium unable to pay the loan off and satisfy the claims asserted against it by the government; (5) use of the loan proceeds to fund bonuses was focused on the personal fortunes of insiders and not on the company’s operational health.

Constructive Fraudulent Transfer

The Banks did not dispute the first two elements of a constructive fraudulent transfer claim. Namely, it conceded that the Bank Fees were paid within two years of Millennium’s bankruptcy and that Millennium was either insolvent at the time is paid the Bank Fees, or rendered insolvent by the payment. The Banks only challenged constructive fraudulent transfer on the grounds that the trustee failed to show that the Millennium did not receive reasonably equivalent value for Bank Fees.

In support, the Banks noted that the trustee did not say, and thus could not show, that the $35.3 million charged for bank fees was not the market rate for their services. The Court shut this argument down quickly, citing Third Circuit precedent that payment to a bank of a market-based fee does not conclusively presume receipt of value. Rather, the Court focused on the effect of the entire transaction on Millennium, noting that Millennium had to pay the Bank Fees in order to consummate the transaction, and that the transaction as a whole severely damaged Millennium and left them insolvent and unable to pay any of the claims asserted by the government.

Lastly, the Banks argued that the Court’s “whole-transaction” approach was an improper use of the “collapsing” doctrine, and that the Court unfairly lumped in the Bank Fees along with the dividend and bonus payments, which the Banks argued was the real cause of value destruction. The Court disagreed that it was utilizing the doctrine, but nevertheless stated that based on the facts asserted in the complaint, the trustee was entitled to utilize the collapsing doctrine at trial in showing that the Bank Fees were part and parcel with the loan transaction and subsequent misallocation of loan proceeds.

PRACTICAL CONSIDERATIONS

When examining actual fraudulent transfer, the Court took a “when there’s smoke, there’s fire,” approach. The Court viewed pleading intent as not a formulaic exercise of the traditional “badges of fraud,” but looked to the totality of the less-than-scrupulous activity exhibited by Millennium in marketing, incurring, and allocating the loan proceeds.

With respect to the constructive fraudulent transfer, the Court sent emphasized that although the Banks were providing services at market value in exchange for the Bank Fees, the services themselves were necessary to implement a harmful transaction. Further, the Court noted that the Banks had an active hand in ensuring a successful loan transaction through omissions of material facts regarding Millennium’s business practices to potential investors. This memorandum opinion signals that banks (or other service providers in this arena) can and should bear some responsibility for the overall financial consequences of transactions they assist with and be mindful of the transaction’s potential impact on creditors.

COUNSEL’S CORNER: NEWS FROM REED SMITH

Bob Simons presented the “Coal Industry Outlook: Part II” webinar

Ed Estrada spoke at the 2019 New York Legal Market Conference

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