

Restructuring & Insolvency News



What Happens When the Waterfall Dries Up?

In re Energy Future Holdings Corp., 773 Fed. Appx 89 (3rd Cir. 2019)

With the complex capital structure of the companies finding their way into bankruptcy court these days, and the limited recoveries available from the debtor's assets, we are seeing more and more disputes between creditors on payment priorities and, in particular, over "waterfall" provisions in intercreditor agreements. *In re Energy Future* reminds workout officers and bankruptcy lawyers that the loan documents we inherit from the loan closing are often not as clear as we would like them to be on creditor priority issues. This, of course, often results in a court having to decide what the parties intended, and that can often lead to time consuming and costly litigation with uncertain results.

The waterfall provision in the Energy Future case was fairly common and read like this: "[r]egardless of any Insolvency or Liquidation Proceeding which has been commenced by or against the Borrower or any other Loan Party, Collateral or any proceeds thereof received in connection with the sale or other disposition of, or collection on, such Collateral upon the exercise of remedies under the Security Documents by the Collateral Agent shall be applied" in accordance with the waterfall provision. Noteholders A and Noteholders B disagreed on how the waterfall provision should be applied to adequate protection payments and plan distribution payments. Noteholders A argued that the intercreditor agreement did not apply to such payments. Noteholders B argued that it should (which would result in \$90 million more owed to Noteholders B). In a nonprecedential ruling by the Third Circuit Court of Appeals, the Court ruled that the phrase "Collateral or any proceeds thereof" did not include plan payments (because the payments were made from assets that the Noteholders did not have lien on) or adequate protection payments (because the payments were not derived from the exercise of remedies under the relevant security documents). Hard to say if this is what the parties intended at the time the loan documents were entered into, but one thing that this case and similar ones teach us is that careful drafting of intercreditor provisions at the time the loan documents are entered into will save time and money when/if the company files for bankruptcy.

If you have questions or would like additional information on the material covered, please contact the author below.



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Does Burden of Proof Matter?

Case Snapshot

The tenant (and chapter 11 debtor) appealed the Bankruptcy Court's order in which it allowed for a liquidated damages analysis even though it concluded that the landlord had not met its burden of proof. The District Court reversed the Bankruptcy Court's order and concluded that the Bankruptcy Court's analysis extended improperly after it held that the landlord failed to meet its burden of proof.

Factual Background

The tenant is a fashion retailer of apparel and accessories. On February 1, 2016, the tenant and landlord entered into a real property lease. Under the lease, the landlord was required to deliver to the tenant sole and exclusive possession of the premise on or before July 10, 2016. The lease included a liquidated damages provision that provided the tenant with a rent credit if landlord failed to deliver timely the premise.

Landlord did not deliver possession to the tenant until September 29, 2016, eighty-four days after the required delivery date. On October 11, 2016, tenant advised landlord that, pursuant to the liquidated damages provision of the lease, tenant would apply 755 days of credits in the aggregate amount of \$191,415.41. Tenant would offset the monthly rental against the credit until it was exhausted.

The tenant filed for chapter 11 bankruptcy protection on May 15, 2017. On August 21, 2017, the landlord objected the tenant's proposed cure payment. On September 26, 2017, the landlord supplemented its objection to the proposed cure amount and argued that the liquidated damages provision of the lease was unenforceable and the tenant was not entitled to any credit caused by the landlord's late delivery of the property.

The Bankruptcy Court held that liquidated damages provisions were enforceable under New Mexico law in contracts between sophisticated parties and that the party seeking to invalidate the provision (the landlord) had the burden of proof. The Bankruptcy Court held that the landlord did not meet its burden, and it went on to hold that the tenant did not establish a causal link between the calculation of liquidated damages and harm suffered. In effect, the Bankruptcy Court held that the liquidated damages provision was a penalty.

Analysis

The tenant appealed the Bankruptcy Court's order and argued that once the Bankruptcy Court held that liquidated damages provisions are enforceable under New Mexico law and that the landlord did not satisfy its burden of proof, the court's inquiry should have stopped. The Bankruptcy Court should not have analyzed the causal relationship between the calculation of liquidated damages and the harm suffered.

The District Court agreed with the Bankruptcy Court that liquidated damage provisions are enforceable under New Mexico law and that the party seeking to invalidate the clause bears the burden of proof regarding its unreasonableness. Further, the District Court held that the landlord did not meet its burden.

The District Court's analysis then diverged from the Bankruptcy Court's holding. The District Court held that once the Bankruptcy Court found that the landlord did not meet its burden, the Bankruptcy Court's analysis should have stopped; it should not have analyzed whether the liquidated damage provision was a penalty.

The District Court held that the Bankruptcy Court improperly shifted the burden of proof to the tenant despite the landlord's failure to meet its burden. The District Court concluded its analysis by holding that it was improper for the Bankruptcy Court to re-write the lease. The District Court remanded the case to the Bankruptcy Court with the instruction to deny the landlord's cure amount objection.

Practical Implications

There are two key takeaways from this case. The first is the importance of burden of proof. If a party fails to meet its burden, it should not obtain its requested relief. Second, parties and counsel should ensure a court's ruling does not rewrite the contract in question.



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Third Circuit's Decision Emphasizes Importance of Careful Drafting at Pleading and Appellate Stages

In re SRC Liquidation LLC, 765 Fed. Appx 726 (3d Cir. 2019)

Case Snapshot

The Third Circuit affirmed dismissal of a breach of fiduciary claim brought under Ohio law where the plaintiff failed to allege non-conclusory statements sufficient to support an inference that the defendants acted in bad faith, as required by Ohio law. The Third Circuit also affirmed dismissal of fraudulent transfer claims, where one of the independent grounds for the bankruptcy court's dismissal was not addressed on appeal.

Factual Background

The Liquidating Trustee of a creditor's trust formed in a chapter 11 bankruptcy case filed an adversary complaint against various former officers and directors of the debtor. The first count ("Count I") alleged breaches of fiduciary duties pertaining to a prepetition acquisition that allegedly resulted in the debtor becoming responsible for a large secured debt facility with very unfavorable terms and caused the debtor's demise in less than 2 years. The remaining claims (the "Remaining Claims") allege that bonuses paid to the defendants were fraudulent transfers. The bankruptcy court dismissed Count I with prejudice and the Remaining Claims without prejudice. The district court affirmed. This decision arises out of the appeal to the Third Circuit.

Court Analysis

On appeal, the Liquidating Trustee argued that the lower courts erred by concluding that the complaint did not state plausible claims and by requiring the Liquidating Trustee to plead more than required at the motion-to-dismiss stage. Detailed pleading is not generally required; however, to survive a motion to dismiss, the complaint must contain sufficient factual matter, accepted as true, to state a claim to relief that is plausible on its face. A complaint may be dismissed where an unanswered affirmative defense appears on the face of the complaint.

Regarding Count I, Ohio law imposes a presumption of good faith, such that directors are liable for breach of fiduciary duty only if the director's action or failure to act involved an act or omission undertaken with deliberate intent to cause injury to the corporation or with reckless disregard for the best interests of the corporation. Thus, to allege a breach of fiduciary duty claim under Ohio law, the plaintiff must allege "facts, as distinct from generalized conclusions, which if proved would overcome the presumption of good faith...." In the SRC case, the Third Circuit found that the Liquidating Trustee was required – but failed – to allege facts supporting the plausible inference that the defendants acted in bad faith when they created and relied upon certain financial projections and ultimately decided to complete the prepetition acquisition at issue. Instead, the Third Circuit agreed that the Liquidating Trustee relied upon conclusory statements about the defendants' knowledge regarding the value of the target company and its possible effects on the debtor's financial health at the time of the acquisition. The Third Circuit stated that "[r]equiring non-conclusory allegations does not impose an improper heightened standard" on the Liquidating Trustee. The Third Circuit, thus, affirmed dismissal of Count I and found that dismissal with prejudice was not an abuse of discretion, in light of the bankruptcy court's in-depth analysis of the possibility of salvaging the complaint and determination that amendment of Count I would be futile.

The Remaining Claims assert fraudulent transfer claims. Under both federal and Ohio law, a plaintiff pleading a fraudulent transfer claim must allege, inter alia, that the transfer at issue occurred without receipt of a reasonably equivalent value in exchange. One independent ground for the bankruptcy court's dismissal of the Remaining Claims was the Liquidating Trustee's failure to allege the "reasonably equivalent value" element. However, the Liquidating Trustee did not present argument on that necessary element on appeal. The Third Circuit determined that the Liquidating Trustee's failure to challenge that independent ground for dismissal compelled the court to

affirm dismissal of the Remaining Claims.

Practical Considerations

This case reiterates the importance of careful drafting both at the complaint level and the appellate level. When drafting a complaint, it is important to ensure that non-conclusory facts are alleged which support each required element and address unanswered affirmative defenses. Additionally, in any appeal, it is important to address and present argument with respect to each independent ground for the lower court's decision, as failure to address the argument can lead to affirmance.

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Pledge Of LLP Interest As Security Ineffective Under Delaware Law, Rendering Creditor's Claim Unsecured

In re Mason, 600 B.R. 765 (Bankr. E.D.N.C. 2019)

Case Snapshot

The bankruptcy court granted a chapter 7 trustee's motion for summary judgment regarding the trustee's objection to a secured claim where the collateral was the Debtor's pledge of his interest in a Delaware limited liability partnership ("LLP"). Under Delaware law, the Debtor did not have the power to pledge his interest in the Delaware LLP when he executed a security agreement in connection with a loan provided to a company in which he held an interest. As such, the creditor (i) did not acquire an enforceable Article 9 security interest in the LLP, (ii) could not assert a secured claim, and (iii) only had allowed general unsecured claim due to the existence of a separate personal guaranty signed by the Debtor.

Factual Background

Debtor was one of three managing partners of MMJ Partners, LLP ("MMJ"), a Delaware LLP whose partnership agreement ("Partnership Agreement") provides that it "shall be construed and interpreted in accordance with the laws of the State of Delaware." Debtor also owned a fifteen percent interest in Tier One Solar, LLC ("TOS"). Prior to the petition date, TOS borrowed \$850,000.00 from Mutsy I, LLC ("Mutsy") pursuant to a secured convertible promissory note (the "Note"). Mutsy was wholly owned and managed by Scott Landress ("Landress"), the purported secured creditor.

Debtor executed a personal guaranty and a security agreement (the "Security Agreement") in connection with the Note that purported to grant Mutsy a security interest in "(a) all right, title and interest of [the Debtor] in, to and under the MMJ Partnership Agreement and the partnership interests owned by [the Debtor] in MMJ; (b) all dividends and distributions payable in respect of such partnership interests and (c) all proceeds of the foregoing" to secure payment of the Note. The Security Agreement states that it "shall be governed by and construed in accordance with the laws of the State of New York without reference to conflicts of law rules." In signing the Security Agreement, the Debtor represented (i) that he was the owner of the Partnership Interest; (ii) that the execution of the Security Agreement and the performance and consummation of the transactions contemplated thereunder did not violate or result in a breach of any material contract; (iii) that no consent, approval, or authorization by any other person or entity was required in connection with the performance and consummation of the transactions contemplated under the Security Agreement; and (iv) that he agreed to "perform all acts that may be necessary to maintain, preserve, protect and perfect the Collateral, the Lien granted to Secured Party therein and the perfection

of such Lien.”

Debtor never provided Landress or Mutsy with a copy of the Partnership Agreement, which defines a “Partnership Interest” as all of a partner’s interests in MMJ, including the economic interest (the right to distributions) and management rights. The Partnership Agreement states that “[a]ny Transfer or purported Transfer of a Partnership Interest shall be null and void unless made strictly in accordance with the terms and conditions of [the Partnership Agreement] . . . [N]o Partner or other holder of a Partnership Interest may pledge or hypothecate its Partnership Interest to secure a debt or other obligation of any Person without the consent of the Board.” Further, a Partnership Interest may only be transferred “pursuant to a written, bona fide offer to purchase such Partnership Interest solely for cash . . . and only if such Partner . . . prior to acceptance of such Third Party Offer, delivers a written offer . . . to sell the . . . Partnership Interest . . . to each of the Managing Partners.”

Mutsy was unaware of the aforementioned restrictions when the Debtor signed the Security Agreement, although the Debtor allegedly told Landress that the pledge of his MMJ Partnership Interest was subject to the consent of MMJ’s other partners. After closing, Landress made numerous requests for a copy of the Partnership Agreement and proof of the consent of MMJ’s other partners to the transfer. Debtor failed to respond. Months later, after the Note had matured, Debtor informed Landress that he could not “pledge MMJ” and finally sent Landress a copy of the Partnership Agreement.

Prior to the petition date, Mutsy assigned its interest in the Note to Landress, who thereafter filed a financing statement to perfect his purported lien on the Debtor’s interest in MMJ. Landress filed a proof of claim (the “Claim”) asserting a secured claim in the amount of \$ 1,275,000.00 based on the Note and Security Agreement. The chapter 7 trustee objected to the Claim and asserted that the Debtor could not pledge his interest in MMJ without unanimous consent of MMJ’s other partners. Landress countered that either New York or North Carolina law applied and overrode the restrictions in the Partnership Agreement.

Court Analysis

The bankruptcy court first had to determine which state’s substantive law governed its analysis, which required the application of North Carolina’s choice of law principles. With respect to corporate entities, North Carolina’s internal affairs doctrine recognizes that “only one State should have the authority to regulate a corporation’s internal affairs--matters peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders--because otherwise a corporation could be faced with conflicting demands.” Accordingly, in matters involving a corporation’s internal affairs, courts must “look to the local law of the state of incorporation.” This prevents parties from “side-stepping an entity’s governance document by including a choice of law provision for a state other than the state in which the entity is organized.”

The court was then tasked with determining whether the secured nature of the Claim implicated the internal governance of MMJ. The court determined that the internal affairs doctrine applied due to MMJ’s interest “in maintaining consistency between the contributors of capital and the recipients of distributions.” Therefore, because MMJ was a Delaware LLP, if Delaware law dictated a different result than New York or North Carolina law, the internal affairs doctrine required the court to apply Delaware law. In the court’s view, this result was also consistent with general conflict of laws principles.

First, the court analyzed what the potential results of applying New York or North Carolina law vs. Delaware law. If there were no difference, the internal affairs doctrine would not apply. The court looked to UCC §§ 9-406 and 9-408, as adopted in New York and North Carolina, as applied to anti-assignment provisions in agreements between partners of a partnership. If the Partnership Interest were deemed a payment intangible without any governance rights in MMJ, § 9-406(d) would invalidate any provision within the Partnership Agreement which “prohibits, restricts, or requires the consent of . . . the account debtor” to “the assignment or transfer of, or the creation, attachment, perfection, or enforcement of a security interest in . . . the payment intangible.” UCC § 9-406. The court concluded that this “could conceivably yield the result in the Debtor being able to override the terms of the Partnership Agreement.” If the partnership interest were treated as a general intangible, inclusive of the Debtor’s governance rights in MMJ, § 9-408 would invalidate any provision within the Partnership Agreement prohibiting the “creation, attachment, or perfection” of a security interest in the partnership interest. UCC § 9-408. In this situation, while Landress could not enforce his lien against MMJ, the lien would still attach to the Partnership Interest.

Turning to Delaware law, the court held that Delaware has an interest in enforcing its laws that determine the rights, obligations and property interests of members of LLPs that are organized and exist under Delaware law. The court found that application of Delaware law was also the outcome the UCC drafters predicted when they noted that “it might be inappropriate for a designation of applicable law by a debtor and secured party under Section 1-301[s choice of law provisions] to control the law applicable to an independent transaction or relationship between the debtor and an account debtor.” UCC § 9-401, cmt. 3

Under the Delaware UCC, “[e]xcept as otherwise provided . . . whether a debtor’s rights in collateral may be

voluntarily or involuntarily transferred is governed by law other than this Article.” 6 Del. C. § 9-401(a). In turn, the Delaware Revised Uniform Limited Partnership Act provides that “[u]nless otherwise provided in the partnership agreement[, a] partnership interest is assignable in whole or in part,” although “[a]n assignment of a partnership interest does not dissolve a limited partnership or entitle the assignee to become or to exercise any rights or powers of a partner” 6 Del. C. § 17-702(a)(1)-(2). Here, the Partnership Agreement restricts the assignment of partnership interests in whole or in part, and under Delaware law, the provisions of the Partnership Agreement govern assignability. “A transfer of a partner’s economic interest in the partnership in violation of a restriction on transfer contained in a partnership agreement is ineffective.” 6 Del. C. § 15-503(f).

As set forth in UCC § 9-203(b), a debtor must have rights in the collateral or the power to transfer rights thereto in order for there to be an enforceable security interest. Here, because Debtor did not have the power to transfer rights in his Partnership Interest when he executed the Security Agreement, the court found that Landress did not have an enforceable security interest in the Partnership Interest or any related distributions. However, because of the separate personal guaranty executed by the Debtor, the court found that Landress did have an unsecured claim.

Practical Considerations

The moral of this story is that proper due diligence is paramount in all secured lending situations. Had the creditor required the Debtor to provide a copy of the Partnership Agreement before executing the Note and Security Agreement, and had the creditor sought advice of counsel, the creditor almost certainly would not have signed either document until Debtor obtained the consent of his other partners. The decision is also an important reminder that in many situations, the laws of the state of incorporation apply with respect to a corporation’s internal affairs, regardless of forum or the existence of a separate clause regarding governing law.

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Rejection Constitutes Breach Not Rescission

Mission Product Holdings, Inc. v. Tempnology, LLC, 139 S.Ct. 1652 (2019)

Case Snapshot

In this case, the United States Supreme Court determined whether a licensor’s rejection of an executory trademark license would deprive the licensee of the right to continue to use the trademark post rejection. The Court concluded that, since rejection only result in a “breach”, rejection does not result in the elimination of the license itself. Therefore, the licensee may continue to use the license post rejection.

Factual Background

The facts of this case are not unlike numerous other cases involving executory contracts. A debtor, faced with an unfavorable executory contract, filed a bankruptcy case and proceeded to reject the contract. After rejection, the contract counterparty wanted to continue to enjoy the benefits that the contract originally conferred; however, the debtor argued that, because the contract was rejected, the contract was no longer in effect.

The debtor here argued that certain provisions of § 365 of the Bankruptcy Code are very clear about the continuing nature of a counterparty’s rights post rejection (i.e., in real property lease and certain intellectual property

scenarios). Therefore, the debtor argued that Congress must have intended that a rejection would eliminate the contract in all other contexts. The Court quickly rejected that argument noting that these discrete provisions do not create a general rule. The Court held that nothing in the Bankruptcy Code was meant to alter the applicable non-bankruptcy rights of a counterparty after a breach of contract.

Analysis

The Court began its analysis with the language of § 365 of the Bankruptcy Code. The Code makes clear that upon rejection, the debtor is relieved of the obligation to perform. Rejection simply provides a “court authorized” breach of the contract. The contract is deemed breached; however, the rejection does not “terminate” or “vaporize” the counterparty’s rights. The counterparty maintains a claim for damages but also may continue to enjoy whatever rights the counterparty would have under that contract. Since a breach would not eliminate the counterparty’s previously agreed to rights outside of bankruptcy, the Court concluded that the analysis should be no different in bankruptcy.

There were two additional opinions in this case. The first was a concurring opinion by Justice Sotomayor. In that concurrence, Justice Sotomayor argued that the “continuing rights” analysis of the majority opinion is presumed because applicable non-bankruptcy law provided for such. If applicable non-bankruptcy law could not allow the counterparty’s continuing exercise, it may be a different result.

Finally, Justice Gorsuch dissented on standing grounds. Because the trademark license at issue in this case expired by its terms before the Court took up the case, Justice Gorsuch argued that the case was no longer “live” for a determination. Therefore, he argued that the Court should dismiss the petition as improvidently granted. The majority attempted to address Justice Gorsuch’s position by arguing that the petitioner had preserved its rights through a damage claim; however, Justice Gorsuch argued that the natural contractual expiration eliminated the counterparty’s continuing rights in any event.

Practical Implications

The Supreme Court’s decision – confirming that rejection only results in a “breach” – does not eliminate the underlying executory contract. The monetary effect of the breach is addressed in the proof of claim process; however, the non-monetary effect of that breach – under applicable non-bankruptcy – is still an area requiring some further analysis and explanation.

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Contempt For Violating Discharge Injunction Determined by Objective Standard

Taggart v. Lorenzen, 139 S.Ct. 1795 (2019)

Case Snapshot

In this case, the United States Supreme Court clarified the standard to determine whether a creditor should be sanctioned for violating the discharge injunction. Two different standards had been posited for the Court. First, the creditor argued that if proof could be established that the creditor subjectively believed that its actions would violate the discharge, the court could issue civil contempt against the creditor. On the other hand, the debtor proposed that courts should implement a “strict liability” standard; if the creditor intended to take the action and

the action violated the discharge, then the action itself should result in civil contempt.

Factual Background

Here, the debtor received a discharge. After discharge, the debtor continued to oppose certain litigation by creditors against property that was no longer property of the estate. After a successful result, those creditors took the position that the debtor's actions post discharge created liability and the creditors obtained a state court judgment against the debtor. The creditor asserted that it believed that the debtor's actions "returned the debtor to the fray" post discharge and the money judgment obtained did not relate to prepetition acts. The creditor took the position that its actions did not violate the discharge because it did not subjectively believe its actions would violate the discharge. The debtor went back to bankruptcy court and sought a determination that the creditor's personal judgment against him post-discharge was for prepetition acts and, therefore, violated the discharge injunction. The bankruptcy court issued sanctions and those sanctions were reversed at the bankruptcy appellate panel and the court of appeals. The Debtor appealed.

Analysis

In a unanimous decision, the Court established the standard for determining whether a creditor's acts violated the discharge injunction. The Court held that the bankruptcy discharge operates as an injunction that bars creditors from collecting on any debt that has been discharged under the Bankruptcy Code. See 11 U.S.C. § 524. Therefore, if the debtor was discharged, any acts taken to collect on a prepetition claim would violate the discharge injunction. The Court further held that the bankruptcy court has the right to enforce its own orders. See 11 U.S.C. § 105. Therefore, the Court held that to the extent that the creditor takes an action in violation of the discharge, that creditor can be sanctioned through the court's exercise of its contempt powers. The Court analyzed the two different theories presented and rejected both.

In traditional civil contexts, contempt is an appropriate remedy when there is no objectively reasonable basis to conclude that the action would not violate the injunction. Therefore, the Court held that the same standard should apply in the bankruptcy discharge context. The creditor could be held in civil contempt for violating the discharge injunction if the court concluded that there was "no fair ground for doubt" that the action taken by the creditor violated the discharge. Since the lower courts here applied varying (and in all instances incorrect) legal standards, the case was remanded for a determination of whether the creditor's actions here met that standard.

Practical Implications

The Supreme Court's decision here will allow all parties – including creditors seeking collection of amounts due – better certainty on how collection activities post discharge constitute civil contempt.

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Sixth Circuit Bankruptcy Appellate Panel addresses whether post-petition payments were authorized by the Bankruptcy Court's Cash Collateral Orders and whether those Cash Collateral Orders are binding on the Trustee

Scott E. Eisenberg v. Toledo-Lucas Country Port Authority (In re BX Acquisitions), 2019 WL 1768144 (B.A.P. 6th Cir. Apr. 19,

Case Snapshot

The Trustee attempted to avoid post-petition payments made to the Toledo-Lucas County Port Authority, arguing that: (1) the post-petition payments were not authorized by the Bankruptcy Court's Cash Collateral Orders because the debt accrued pre-petition; and (2) even if the post-petition payments were authorized by the Bankruptcy Court, proper notice was not given to all interested parties. The Sixth Circuit Bankruptcy Appellate Panel rejected the Trustee's argument, holding that whether the post-petition payments were for pre-petition obligations is irrelevant because the Cash Collateral Orders specifically authorized the Debtor to make the payments, and that all interested parties received adequate notice.

Factual Background

BX Acquisitions, Inc. (the "Debtor") was a Delaware corporation that provided customized logistic solutions to the transportation and distribution industries, with its principal place of business in a facility in Ohio, owned and operated by the Toledo-Lucas County Port Authority (the "Port Authority").

The Debtor and the Port Authority were part of a pre-petition management agreement (the "Management Agreement") in which the Debtor paid a fixed annual fee, due semi-annually, to the Port Authority for use of the facility. This management agreement was later amended to provide that the Debtor would pay a fixed fee of \$500,000 on or before December 31 of each contract year.

On November 2, 2015, the Debtor filed a voluntary Chapter 11 petition that included reference to the Management Agreement with the Port Authority on its Schedule G. On that same day the Debtor filed a Motion to use cash collateral with an attached budget that excluded any payment due to the Port Authority. The Bankruptcy Court entered an order shortening time and the hearing on the Motion was held on November 3, 2015. The Bankruptcy Court granted the Motion, with no objection from any parties, and entered the Agreed First Interim Order, which did include a budgeted payment to the Port Authority of \$208,685.45. Notice of the Agreed First Interim Order, with language of the Agreed Second Interim Order (together with the Agreed First Interim Order, the "Cash Collateral Orders"), was sent out to creditors. Both notices mentioned payments to the Port Authority. The Bankruptcy Court later entered the Agreed Second Interim Order with no objections from any parties. The Debtor made three post-petition payments to the Port Authority amounting to a total of \$150,000.

As it became apparent that the Debtor could not reorganize, the Bankruptcy Court granted the Debtor's Motion to reject the Management Agreement and confirmed the Debtor's plan of liquidation, which established the BX Acquisitions, Inc. Liquidating Trust and appointed a Liquidating Trustee (the "Trustee").

The Trustee filed a complaint initiating an adversary proceeding, alleging that the \$150,000 in payments to the Port Authority constituted unauthorized, post-petition transfers subject to avoidance under 11 U.S.C. § 549. The Port Authority, in its answer, maintained that the payments were authorized by the Cash Collateral Orders and, if not authorized, were post-petition payments on post-petition debt made in the ordinary course of the Debtor's business.

The Trustee and the Port Authority filed cross-motions for summary judgment and the Bankruptcy Court granted the Port Authority's motion, concluding that the payments to the Port Authority were not avoidable. The Trustee appealed the Bankruptcy Court's decision.

Court Analysis

The Sixth Circuit Bankruptcy Appellate Panel (the "Panel") affirmed the Bankruptcy Court's ruling.

11 U.S.C. § 549(a) states that a trustee may avoid a transfer of property of the estate that occurs after commencement of the case if it is "not authorized under this title or by the court." See *Sloane v. Anderson*, 511 B.R. 481, 497 (Bankr. S.D. Ohio 2013).

The Panel noted that a "cash collateral order is a kind of consent decree" that should be construed as a contract for enforcement purposes. *Ohio Farmers Ins. v. Hughes-Bechtol, Inc.*, 2000 WL 1091509 (6th Cir. July 27, 2000). Thus, in reviewing the Cash Collateral Orders, the Panel looked at the explicit and plain language for clear manifestations of intent. The Panel determined that the Cash Collateral Orders clearly reflected the intent to pay the Port Authority pursuant to the Management Agreement, as both Orders included the payment in the budget and no party objected to either Order. Therefore, the Cash Collateral Orders should be binding on subsequently appointed trustees.

The Panel further explained, though, that the Cash Collateral Orders would only be binding on the Trustee if proper notice was provided to parties in interest, pointing to *Terlecky v. People's Bank, N.A.*, 456 B.R. 349 (Bankr.

S.D. Ohio 2011).

The Panel determined that the Cash Collateral Orders, attached budgets, and related hearings gave parties sufficient notice under 11 U.S.C. § 363 and Federal Rules of Bankruptcy Procedure 2002 and 4001. The Panel highlighted the fact that the voluntary Chapter 11 petition and budgets attached to the Cash Collateral Orders all identified that post-petition payments would be made to the Port Authority. The Panel explained that if a party wanted to object to those payments, it had multiple opportunities and should have done so prior to both Cash Collateral Orders being entered by the Bankruptcy Court. Furthermore, the Panel noted that the fact that the Motion for use of cash collateral was heard on an expedited basis is common practice and has no bearing on whether notice was insufficient.

Finally, the Panel explained that whether the post-petition payments to the Port Authority were for pre or post-petition obligations is irrelevant for avoidance purposes because those payments were “specifically authorized” by the Bankruptcy Court.

Practical Considerations

A trustee or any other party cannot collaterally attack an order of the Bankruptcy Court through an adversary proceeding. Objections to motions, including cash collateral motions, should be made prior to the entering of an order. Additionally, the Panel suggests in its opinion, that payments to a creditor for pre-petition obligations may not be avoided when an order of a Bankruptcy Court authorizes such payments.

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Are Payments to a Creditor by a Third Party on Behalf of a Debtor Avoidable?

Stevens, Littman, Biddison, Tharp & Weinberg, LLC v. Walters (In re Wagenknecht), No. CO-18-093, 2019 WL 2353534 (B.A.P. 10th Cir. June 4, 2019)

Case Snapshot

In the Tenth Circuit, the rule is solidifying: payments made to a creditor from a third-party on behalf of a debtor may be avoided as a preferential transfer. In an unpublished opinion, the Bankruptcy Appellate Panel for the Tenth Circuit (the “BAP”) applied and upheld the Tenth Circuit Court of Appeals’ holding in *Parks v. FIA Card Servs., N.A.* (In re Marshall), 550 F.3d 1251 (10th Cir. 2008) which provides that funds controlled by the debtor and transferred to a creditor by a third-party, may constitute a preferential transfer avoidable under section 547 of the Bankruptcy Code. Specifically the BAP, affirming the bankruptcy court, held that payment to a debtor’s creditor by a third-party constitutes a transfer of “an interest of the debtor in property,” satisfying that criteria for purposes of finding the payment to be a preferential transfer.

Factual Background

Prior to the petition date, Stevens, Littman, Biddison, Tharp & Weinberg, LLC (the “Law Firm”) provided legal services to the Debtor. By the end of 2015, the Debtor owed the Law Firm \$21,672.65. On January 11, 2016, the Debtor executed a promissory note (the “Note”) in favor of Sharon Wagenknecht, his mother (“Ms. Wagenknecht”),

in the amount of \$21,672.65. Thereafter, the Debtor's mother paid \$21,672.65 to the Law Firm

Less than 90 days later, on January 29, 2016, the Debtor and his spouse filed a Chapter 13 petition. In their Statement of Financial Affairs, the Debtor stated that a payment of \$20,000 for legal services was made in January 2016 "by Sharon Wagonknecht on behalf of Debtor." The Debtor and his spouse subsequently voluntarily converted their case to Chapter 7 and a Chapter 7 Trustee was appointed. Thereafter, the Trustee initiated an adversary proceeding against the Law Firm, seeking to avoid and recover the \$21,672.65.

The Law Firm and Trustee filed cross motions for summary judgment. The Law Firm argued, as a matter of law, that there was not a transfer of an interest of the Debtor, and the estate was not diminished by the payment to the Law Firm. Trustee argued that the Debtor had an interest in the transferred funds and the transfer was therefore an avoidable preference under the reasoning of Marshall. The Bankruptcy Court held in favor of the Trustee.¹ Appeal was taken by the Law Firm whereby the BAP was asked to determine whether the bankruptcy court erred when granting summary judgment to the Trustee on his claim to avoid and recover as preferential the payment by Ms. Wagonknecht to the Law Firm.

Court Analysis

Under § 547(b): a transfer is avoidable if it: (1) is of an interest of the debtor in property; (2) is for the benefit of a creditor; (3) is made for or on account of an antecedent debt owed by the debtor before the transfer was made; (4) is made while the debtor is insolvent; (5) is made on or within ninety days before the date the bankruptcy petition was filed; and (6) allows the creditor to receive more than the creditor would otherwise be entitled to receive from the bankruptcy estate.

Finding all other criteria of 547(b) satisfied, the BAP noted that the only element of the Trustee's preferential transfer claim that is at issue is whether the payment to the Law Firm was a "transfer of an interest of the debtor in property" and that the Tenth Circuit, in Marshall, has adopted two tests for determining whether a transfer was of an interest of the debtor in property for purposes of § 547(b). As the BAP explained, the first is the dominion/control test; and the second is the diminution of the estate test—the BAP found that the transfer constitutes a transfer of an interest of the debtor in property under both tests.

The BAP first determined, that the Debtor's exercise of his ability to control the loan proceeds is evidenced by his execution of the Note in which he agreed to pay Ms. Wagonknecht for a loan, the proceeds of which were transferred directly to his creditor. "The Debtor could have refused to accept a loan from Ms. Wagonknecht if the proceeds were not distributed to him, but he did not do so. In his Statement of Financial Affairs, the Debtor states that Ms. Wagonknecht paid the Law Firm on his behalf." Accordingly, the BAP reasoned that there is no material distinction between these facts and those of Marshall, where debtors directed a creditor to pay another creditor.

As to diminution of the estate, the BAP stated the rule pursuant to Marshall: "[a] transfer of loan proceeds (an asset) diminishes the bankrupt's estate." The BAP noted that there were no facts in Marshall to support this finding; however, the rule is valid based upon the purpose served by recovery of preferential transfers and, quoting the Tenth Circuit, "the issue is whether any asset, regardless of how fleeting its presence in the bankrupt's estate during the relevant [lookback] period of time, should be ratably apportioned among qualified creditors or permitted to benefit only a preferred creditor." Applying this reasoning and holding to the facts before it, the BAP found that the Debtor's estate was diminished by the transfer.

Practical Considerations

On its face, the BAP's holding, like the holding in Marshall, broadens the scope of transfers that may be avoidable as preferences and, arguably, sets forth a rule that will result in more consistent (albeit potentially less favorable) treatment of unsecured creditors. A payment by one creditor to another on behalf of a debtor is not merely the substitution of creditors, but a preferential transfer that will leave both creditors seeking payment from the estate.

1. In its motion for summary judgment, the Law Firm further supplemented the uncontroverted facts agreed upon between the parties which supplement relied upon an affidavit of Ms. Wagonknecht. The Trustee disputed the affidavit's admissibility. The bankruptcy court found the affidavit inadmissible. This issue was also appealed and the BAP reversed the bankruptcy court on this point, but found such error harmless as to the bankruptcy court's ruling on the preferential transfer which the BAP affirmed.



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