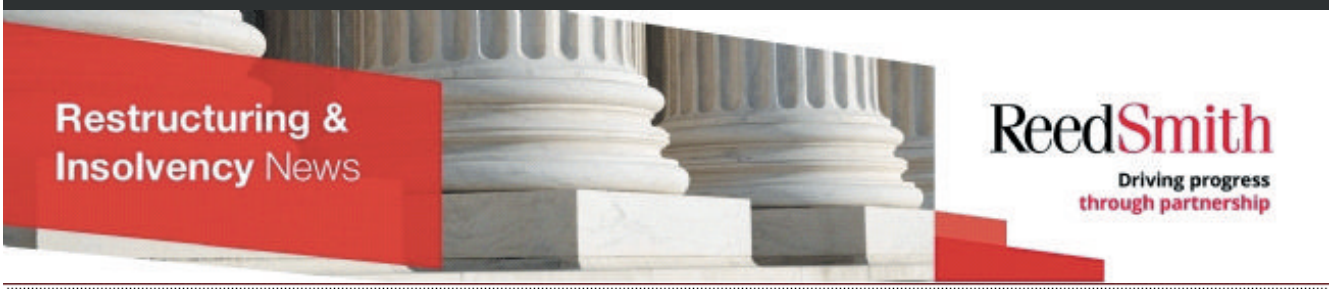

When Does ERISA Control Group Liability Arise for Private Equity Investors?

Sun Capital Partners III LP v. New England Teamsters & Trucking Industry Pension Fund, No. 16-1376 (1st Cir. Nov. 29, 2019).

Withdrawal liability under ERISA can be a significant factor considered by private equity funds in making investments in portfolio companies. And it becomes an even more significant factor if the private equity fund is determined to be a member of the company's "control group" in which case the fund (and perhaps its partners) can have joint and several liability. Such liability can arise by establishing that a private equity investor owns 80% or more of the company.

But what if two related funds have made investments in the company and one of the investors owns 30% of the company and the other investor owns 70% of the company? Can the ownership interests be aggregated? Can a "partnership-in-fact" be created, especially when it is demonstrated that the two funds are run by the same two individuals and those individuals control the general partners of both funds and the funds pool resources, expertise and personnel.

The federal district court said "yes" but on appeal the First Circuit disagreed and held that a "partnership-in-fact" was not created since the two funds invested in different portfolio companies, held themselves out as independent funds, were distinctive business entities, had primarily different investors and investments, and the operating agreements contained provisions that disclaimed any sort of partnership. Yet, in the end, the Fifth Circuit was swayed by less technical considerations and focused on its concerns that holding such funds liable for withdrawal liability could cause a likely disincentive for important private equity investments in underperforming companies which could worsen the financial position of multi-employer pension funds. The Court, however, left open the possibility that liability could arise under ERISA if it is established that the private equity investor is engaged in a "trade or business."

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Prohibition of assignment of promissory note claims enforceable under Delaware law

Contrarian Funds, LLC v. Woodbridge Grp. of Cos., LLC (In re

Woodbridge Grp. of Cos., LLC), 606 B.R. 201 (D. Del. 2019)

Case Snapshot

The District Court for the District of Delaware affirmed the bankruptcy court's ruling sustaining a debtor's objection to a claim on the basis that the claim arose from an assignment of rights under a promissory note. The terms of the promissory note unambiguously prohibited the assignment, and such prohibition of assignment was not contrary to Delaware law.

Factual Background

Woodbridge Mortgage Investment Fund 3A, LLC (the Debtor) issued three promissory notes (the Notes) to Elissa and Joseph Berlinger (the Assignors). The Notes expressly prohibited the assignment of any rights thereunder without the Debtor's prior written consent. The Notes further provided that any assignment without such consent would be "null and void." The Notes made reference to the respective loan agreements, which further provided that assignment of "any rights" without consent would be null and void. The Notes and loan agreements were to be governed by Delaware law.

The Debtor, along with several other Woodbridge entities, filed for bankruptcy. The Debtor had indisputably committed a payment default under the Notes, giving rise to a $75,000 claim held by the Assignors. Despite the language of the Notes, the Assignors subsequently assigned their claim to Contrarian Funds, LLC (the Assignee). The assignment transferred both any "right, title and interest" in the Assignors' claim to the Assignee, as well as "all causes of action" in connection with the Notes and claim. The Assignee then filed a proof of claim in the Debtor's bankruptcy case for $75,000, attaching copies of the assignment agreements and Notes.

The Debtor then filed a claim objection on the basis that, because the Notes prohibited the assignment, the claim was unenforceable and therefore should be disallowed under 11 U.S.C. section 502(b)(1). The bankruptcy court agreed and sustained the Debtor's objection. The Assignee then appealed the decision, alleging that: (1) the Notes' anti-assignment provisions were unenforceable under the Bankruptcy Rules and Delaware law; (2) the anti-assignment provisions were made unenforceable by the Debtor's payment default; and (3) section 9-408(a) of the Uniform Commercial Code (UCC) preempted the Notes' anti-assignment provisions.

Court Analysis

The district court first addressed the Assignee's argument that Federal Rule of Bankruptcy Procedure (FRBP) 3001(e) mandates a policy of free assignability of claims. Rejecting this analysis, the court upheld the bankruptcy court's finding that FRBP 3001(e) merely provides guidelines for when claims are assigned – it does not require that claims be freely assignable.

Turning next to state law, the district court noted that Delaware courts recognize the enforceability of anti-assignment provisions while construing such provisions narrowly. The court distinguished between clauses limiting the "right" to assign, and those limiting the "power" to assign. Assignments made contrary to a right of assignment are valid, but result in a breach of contract by the assigning party. Conversely, assignments made contrary to a power of assignment are void. Language restricting the power to assign a contract must be express and unambiguous. The Notes expressly provided that "any . . . assignment [without Debtor's consent] shall be null and void." The court accordingly affirmed the bankruptcy court's finding that this provision was a clear and unambiguous prohibition of the power to assign.

In its appeal, the Assignee attempted to distinguish between "assignment of rights" under a contract and "assignment of causes of action." The Assignee relied upon section 322(1) of the Restatement (Second) of Contracts for this proposition, arguing that the Notes merely prohibited assignment of performance and not assignment of causes of action (such as a claim). The district court found that section 322(1) only directs that anti-assignment provisions be limited to assignment of performance if a contrary intention is not evinced by the contract. Here, the court found such a contrary intent in the clear and unambiguous language prohibiting assignment.

The court quickly disposed of the Assignee's other arguments. The Assignee's argument that the anti-assignment provision was voided by the Debtor's payment default would allow it to "emerge post-breach with more rights than they had pre-breach," which was a clear impossibility. As to the Assignee's contention that section 9-408 of the UCC invalidated anti-assignment provisions, the court simply found that the plain language of section 9-408 limited its import to assignments of security interests. The Assignee had loaned no money to the Debtor and did not otherwise hold any security interest. Section 9-408 was therefore inapplicable to the situation.

Practical Implications

Woodbridge serves as a cautionary tale to both drafters of contracts and purchasers of claims in Delaware. In order for an anti-assignment provision to be absolutely enforceable, it must clearly and unambiguously state that such assignment is invalid and void. Otherwise, the assignment will likely be found to be valid and merely result in a breach. Assignees of claims should likewise be careful to check for such language before accepting assignment, or else risk their claims being disallowed as unenforceable after the fact.

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

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New Jersey tax certificate foreclosure is avoided as preference

Hackler v. Ariana Holdings Co., LLC (In re Hackler), 938 F.3d 115 (3rd Cir. 2019)

Case Snapshot

In this case, the U.S. Court of Appeals for the Third Circuit concluded that a New Jersey tax certificate foreclosure was avoidable as a preference under section 547(b) of the Bankruptcy Code.

Factual Background

After the debtors failed to pay real property taxes, the New Jersey municipality conducted a tax certificate sale with respect to the outstanding taxes. In accordance with applicable New Jersey tax sale, bidding occurred and a tax certificate was sold. After the tax certificate was not redeemed in accordance with the statutory period, the tax certificate holder commenced a strict foreclosure. In accordance with applicable state law, the certificate holder obtained title to the property on account of the unpaid, unredeemed tax certificate.

Within 90 days of the foreclosure, the debtors filed a bankruptcy case and commenced an adversary proceeding seeking to avoid the foreclosure as a preference under section 547 of the Bankruptcy Code. The tax certificate holder objected, arguing that the sale could not be avoided under "principles of federalism" because it was a lawfully conducted state tax foreclosure sale.

Both the bankruptcy court and the district court held that the transfer was preferential and ordered it avoided. The tax certificate holder appealed to the Third Circuit.

Court Analysis

The Third Circuit began with the plain language of the preference statute and concluded – without much analysis – that each of the statutory elements of section 547(b) of the Bankruptcy Code were met. Here, the foreclosure of the property resulted in a transfer of title to the certificate holder on account of an antecedent debt (i.e., outstanding real estate taxes); therefore, the preference elements were easily met. The court spent most of its analysis addressing the "objections" raised by the tax certificate holder.

The tax certificate holder first argued that the foreclosure of the tax certificate could not be a preference in accordance with the Supreme Court's decision in *BFP v. Resolution Trust Corp.*, 511 U.S. 531 (1994). In that decision, the Supreme Court held that a mortgage foreclosure sale could not constitute a fraudulent transfer under section 548 of the Bankruptcy Code. The Third Circuit here quickly noted that there are substantial distinctions between section 548 of the Bankruptcy Code (dealing with fraudulent transfers) and section 547 of the

Bankruptcy Code (dealing with preferential transfers). Each requires a significantly different analysis. Importantly, the fraudulent transfer statute requires proof of "reasonably equivalent value." Here, the preference statute did not include any such proofs and simply required avoidance if each of the statutory elements were met. While the sale of the tax certificate itself was subject to open and active bidding, the bidding did not have any relationship to the value of the property (unlike a sheriff-type sale). Once that tax certificate was sold, the right to foreclose was strict and absolute. There was no further right to expose the property to a subsequent sale. Second, the court noted that there is a footnote in the *BFP* decision specifically holding that *BFP* does not apply to tax sales or other "forced sales" since the considerations may be somewhat different. Therefore, the court ruled that the *BFP* holding did not prevent the conclusion that the tax sale foreclosure could be a preference under the terms of the statutory language.

The court then analyzed whether avoiding the transfer under section 547 would constitute a violation of the Tax Injunction Act. The Tax Injunction Act precludes federal courts from restraining the collection of state taxes under state law. Here, the court held that the transfer did not have any impact on the state's interest in the collection of tax (through the sale of tax certificates). It merely affected the ultimate enforcement of those certificates. For all those reasons, and since there were no other defenses pled, the court held that the statutory elements of the preference were met and required the transfer to be avoided.

Practical Implications

It is likely that this analysis comes as a surprise to practitioners who have consistently relied upon the Supreme Court's *BFP* decision in fraudulent transfer defenses. However, as the Third Circuit notes, the analyses are different. It appears the certificate holder did not attempt to raise any of the statutory defenses outlined in section 547(c). It is unclear whether those could even apply, but by focusing on the policy arguments, the court consistently came back to the statutory plain language analysis and its application to the foreclosure itself.

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Say what you mean and mean what you say: district court holds parties to the letter of their intercreditor agreement

Ad Hoc Group of Second Lien Creditors v. LNV Corp. (In re La Paloma Generating Company LLC), 2019 WL 4674865 (D. Del., Sep. 24, 2019)

Case Snapshot

This case involved a dispute under an intercreditor agreement, which resulted both in the appeal of the bankruptcy court's confirmation order and an appeal of a bankruptcy court decision concerning the relative rights between certain creditors under the intercreditor agreement. Due to a pre-petition expiration of UCC financing statements, certain liens were unperfected as of the petition date. The first lien lender and the debtor entered into a settlement, pursuant to which certain funds would be contributed to a "Subject Fund" to be distributed in accordance with an intercreditor agreement between the first and second lien lenders. The bankruptcy court confirmed the debtor's plan and, in a separate decision, held that the "Subject Fund" fit within the broad definition of "Collateral," which included property **intended to be** collateral, such that the payments allocated to the second lien lenders must be paid to the first lien lenders under the terms of the intercreditor agreement. The second lien lenders appealed the

confirmation order and the intercreditor decision. On appeal, the district court first held that the appeals were neither equitably moot nor barred by section 363(m) of the Bankruptcy Code. The district court then proceeded to affirm the bankruptcy court decision.

Factual Background

As of the petition date, the debtor (La Paloma) had two classes of secured creditors: first lien lenders (LNV), owed approximately $330 million; and second lien lenders (2L Group), owed approximately $110 million. The obligations owed to LNV and 2L Group were secured respectively by first and second priority liens on substantially all of La Paloma's assets. LNV and 2L Group were party to an intercreditor agreement, which governed the parties' rights with respect to all property "constituting or *intending to constitute*" collateral for the respective facilities. Pursuant to the intercreditor agreement, 2L Group subordinated its liens to the liens held by LNV, regardless of "the perfection of or avoidability of such Liens or claims secured thereby," "any defect of deficiencies in, or failure to perfect, the Liens securing the First-Lien Obligations" or "any other circumstances whatsoever."

Given their subordination, under the intercreditor agreement, the 2L Group agreed not to "receive any Collateral or any proceeds of Collateral in connection with the exercise of any right or remedy … with respect to any Collateral in its capacity as a creditor, unless and until the Discharge of First-Lien Obligations has occurred." 2L Group agreed to pay over all collateral and proceeds thereof to LNV until the first lien obligations were paid in full.

As of the petition date, some of the liens were unperfected due to the collateral agent's failure to continue certain UCC-1 financing statements and were potentially avoidable under section 544(a) of the Bankruptcy Code. LNV and the debtor entered into a settlement (memorialized in a plan), pursuant to which LNV agreed to credit bid $150 million of its debt to buy the debtor's assets and to make other amounts available to unsecured creditors. In exchange, the debtor agreed to release all avoidance actions against the collateral agent and preserve the liens for LNV's benefits. The settlement valued the potentially unencumbered assets at $63.3 million. The ratable portion of the $63.3 million allocated to the second lien obligations (approximately $30 million and referred to as the "Subject Fund") was to be transferred to a liquidating trust for distribution in accordance with the intercreditor agreement. The Subject Fund was to be funded from the debtor's operations and was (or proceeds thereof were) to remain collateral notwithstanding any transfer.

Because LNV was undersecured, 2L Group was entirely unsecured. In its view, the Subject Fund should have been treated as unencumbered and distributed to 2L Group as unsecured creditors under their proofs of claim. The bankruptcy court confirmed the plan over 2L Group's objections, and deferred consideration of whether 2L Group could receive distributions without violating the priority scheme provided for by the intercreditor agreement. In a subsequent decision, the bankruptcy court determined that 2L Group was not entitled to receive distributions under the terms of the intercreditor agreement. 2L Group appealed both the confirmation order and the intercreditor determination. LNV moved to dismiss the appeals pursuant to the doctrine of equitable mootness and section 363(m) of the Bankruptcy Code.

Court Analysis

On appeal, the district court first addressed LNV's motion to dismiss. The court held that the appeals were not equitably moot because (i) 2L Group was not seeking to reinstate claims resolved by the plan, but rather to continue litigating claims left unresolved by the plan; and (ii) the dispute about whether 2L Group or LNV was entitled to the $30 million Subject Fund was a two-party dispute that would not unravel the plan. Additionally, the district court held that section 363(m) does not apply because 2L Group's pursuit of the intercreditor dispute would not impact the validity of the sale.

Turning to the merits, under the plan, LNV and 2L Group are the only unsecured creditors recovering from the liquidating trust and it is undisputed that 2L Group's allowed claim entitles it to *pari passu* distributions from the liquidating trust. The dispute is whether 2L Group must then turn over that recovery to LNV under the intercreditor agreement. The intercreditor agreement requires 2L Group to turn over distributions if: (a) the distribution is "Collateral or proceeds thereof"; (b) the distribution was received "in connection with the exercise of any right or remedy" by 2L Group; (c) the exercise of rights or remedies related to the collateral; and (d) the exercise of such rights or remedies was in contravention of the intercreditor agreement.

Initially, the district court found that 2L Group waived its arguments with respect to the distributions, which were made up of collateral or proceeds thereof. Even if the argument had not been waived, the court rejected 2L Group's argument because the intercreditor agreement specifically defined "Collateral" as all property "constituting or *intending to constitute*" collateral, and provided that the contracted-for priority was not intended to be disrupted by issues concerning, among other things, avoidability of or defects concerning the liens, including failure to perfect. Thus, the court determined that the intercreditor "prohibits 2L Group from circumventing the [intercreditor's] priority scheme due to any defects in LNV's liens" and concluded that the Subject Fund is collateral. The court then determined that 2L Group's filing of proofs of claim constituted an exercise of remedies under the terms of the intercreditor agreement, such that receiving payment on account of the proofs to claim

would contravene the intercreditor agreement. Accordingly, the district court affirmed the bankruptcy court's decision regarding the intercreditor agreement. Because that plan did not purport to modify the intercreditor agreement, the court also affirmed the confirmation order.

Practical Considerations

The decisions by the bankruptcy court and the district court in this case demonstrate the general rule that intercreditor agreements are not only upheld but strictly adhered to by bankruptcy courts. Here, the potential that certain assets may have been unencumbered as of the petition date did not alter the fact that they nonetheless fit within the extremely broad definition of "Collateral" subject to the intercreditor agreement. Parties should carefully consider the language agreed to in intercreditor agreements, as they will likely be required to strictly abide by the terms thereof.

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A creditor's retention of pre-petition repossessed collateral after a bankruptcy case is not a violation of the automatic stay

In re Denby-Peterson, 941 F.3d 115 (3d Cir. 2019)

Case Snapshot

In this case, the U.S. Court of Appeals for the Third Circuit further deepened a circuit split and held that a creditor's retention of collateral that had been repossessed pre-petition but retained post-petition would not violate the automatic stay. The Third Circuit's decision aligns with decisions from the Tenth and D.C. Circuits and is in conflict with the decisions from the Second, Seventh, Eighth and Ninth Circuits. It would appear that this case is ripe for a petition for certiorari to the U.S. Supreme Court.

Factual Background

The facts in this case are relatively simple and straightforward. Pre-petition, as a result of defaults by the debtor, the secured creditor repossessed certain collateral. After repossession, the debtor commenced a chapter 13 bankruptcy case and issued a demand for the creditor to return the repossessed collateral to the debtor. The creditor refused. Thereafter, the debtor commenced a turnover action under section 542 of the Bankruptcy Code and sought sanctions under section 362(k) for willful violation of the automatic stay. In support of the request for sanctions, the debtor argued that the continued retention of the collateral post-petition – after demand was made for turnover – was the creditor's exercise of control over property of the estate, which necessitated sanctions.

Court Analysis

The bankruptcy court held a two day trial and concluded that turnover was appropriate; however, the court determined that there was no willful violation of the automatic stay unless and until such time as the turnover order was violated. The debtor appealed and the case was affirmed on appeal. The debtor further appealed to the Third Circuit.

In a rather lengthy opinion, the court explained that the simple retention of pre-petition repossessed collateral after

the bankruptcy did not violate the automatic stay. The court was cognizant of the turnover obligations expressed in the Bankruptcy Code; however, because such obligations were not "self-effectuating," a creditor's retention of pre-petition repossessed collateral after the commencement of a bankruptcy case did not constitute the requisite "exercise of control" under the language of section 362. The court went through a lengthy analysis of the language of section 362 and held that the "exercise of control" required an affirmative act to gain the control. Simply having the control pre-petition and retaining it post-petition was not a sufficiently affirmative act to compel section 362(k) sanctions.

The court bolstered its analysis by focusing on the language of section 542 of the Bankruptcy Code (i.e., the turnover provision). In reviewing that provision, the court acknowledged that the language is mandatory. However, the court noted that turnover is not automatic, highlighting that certain conditions must be met for turnover to be appropriate. Moreover, the Federal Rules of Bankruptcy Procedure specifically require a turnover action to be commenced via an adversary proceeding – with appropriate due process. The court also noted that turnover was not "self-effectuating" under pre-Bankruptcy Code practice. Finally, the court noted that the Supreme Court's precedent in *Maryland v. Strumpf*, 516 U.S. 16 (1995) affirmed a bank's right to administratively freeze assets and retain them without violating the turnover provision. The court reasoned that if the turnover provision was self-effectuating, the Supreme Court's determinations in *Strumpf* could not be reconciled with the immediate demand to surrender collateral upon a request of the debtor.

Practical Considerations

Therefore, in the Third Circuit until a debtor properly obtains a turnover order (which a creditor refuses), a creditor's retention of pre-petition repossessed collateral post-petition will not violate the automatic stay.

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Involuntary conversion to a chapter 7 when rehabilitation hopeless

Mumma v. Vara (In re Mann Realty Assocs.), No. 1:18-CV-683, 2019 U.S. Dist. LEXIS 168132 (M.D. Pa. 2019)

Case Snapshot

Although a court only needs one basis of cause to convert a case to chapter 7, multiple instances existed in this case due to the principal's gross mismanagement of the debtor and the unlikelihood that the debtor could reestablish its business in the face of substantial losses. Once cause for conversion is established, the burden shifts to the debtor to show that, due to unusual circumstances, conversion is not in the best interest of creditors. Here, the court found "nothing 'unusual' about corporate mismanagement or poor economic performance." As the debtor's proposed plan included selling 11 of its 12 properties, liquidation through a chapter 7 trustee did not provide a substantially different result for creditors.

Factual Background

Mann Realty, the debtor, owned 12 properties: 11 commercial real estate pieces and one quarry. The quarry was the most valuable property, valued at $12 million. The debtor had significant equity in some of the properties, although its equity was possibly inflated. The debtor prepared a disclosure statement and plan of reorganization

wherein the debtor intended to pay creditors by selling all its properties except the quarry and using the quarry to generate income.

Certain facts called into question the debtor's ability to generate income and reorganize into a going concern. At the time, the quarry was flooded and unable to be mined. Part of the debtor's plan was to commence litigation against the quarry's holdover tenant and compel payment of overdue rent and from drainage of the quarry. The debtor's monthly operating reports showed net operating losses. Based on these facts, the trustee moved for dismissal because Mann Realty had suffered "substantial or continuing loss to or diminution of the bankruptcy estate" and had "fail[ed] to timely provide information reasonably requested."

At the time of the hearing, the trustee and the debtor agreed to the appointment of a chapter 11 trustee, but three of the four creditors in attendance objected and favored conversion. The Court converted the case to chapter 7 for cause, based primarily on the misleading testimony of and gross mismanagement by Robert Mumma, the debtor's principal. The monthly operating reports showed substantial losses over nine months and the financial documents inaccurately reported income and inflated the value of assets by at least $8 million. Mumma took unauthorized loans and made improper payments to the debtor. The court did not find Mumma's testimony credible; in particular, his testimony regarding the quarry was contradictory.

Court Analysis

The court reviewed the decision to convert under an "abuse of discretion" standard and concluded that the bankruptcy court did not abuse its discretion in converting the case. Conversion decisions are governed by the burden-shifting scheme in 11 U.S.C. section 1112. The courts may not convert or dismiss a case if: (1) there are "unusual circumstances establishing that converting or dismissing the case is not in the best interests of creditors and the estate"; (2) "there is a reasonable likelihood that a plan will be confirmed" within a "reasonable period of time"; (3) the grounds for cause are not given under section 1112(b)(4)(A); and (4) the grounds for cause include an act or omission for which there is a "reasonable justification" and that will be "cured within a reasonable period of time." *Id.* section 1112(b)(2). Once cause is established, the burden shifts to the opposing party to identify unusual circumstances that weigh against conversion.

Although the court only needs one basis for cause to convert, here, multiple such bases existed: gross mismanagement and a continuing loss without a reasonable likelihood of rehabilitation.

The court found ample evidence in the record of gross mismanagement. The debtor violated its fiduciary duty to creditors by, accidentally or intentionally, inaccurately reporting income. The bankruptcy court found that the debtor's financial documents were not trustworthy. For example, when testifying, Mumma was unable to account for $8 million in assets reflected on the financial documents. Mumma also made unauthorized payments to and took unauthorized loans from the debtor.

The court also found evidence to support the bankruptcy court's finding that the bankruptcy estate experienced a substantial or continuing loss without a reasonable likelihood of rehabilitation. The negative operating cash flows shown over nine months on the monthly operating reports established a continuing loss or diminution of the estate. The court further discussed the fact that rehabilitation required a showing that the debtor could reestablish the business, not that the debtor could confirm a plan. Here, the record did not show that the debtor could reestablish the business: the debtor struggled to generate cash flow to pay its mortgage and tax obligations, only two properties generated rental income (and one was scheduled to be sold), the debtor lacked future contracts, and the quarry needed a large cash infusion to become operational again.

The debtor did not present evidence of unusual circumstances that weighed against conversion: "[t]here is also nothing 'unusual' about corporate mismanagement or poor economic performance." Nothing in the record supported the debtor's assertion that conversion was less beneficial to the creditors than the appointment of a chapter 11 trustee. In fact, the debtor's plan was to sell all of its holdings except the quarry; liquidation by a chapter 7 trustee did not have a substantially different result for the creditors. "Only when the likely outcome for creditors would be 'vastly superior' under Chapter 11 do unusual circumstances exist."

Practical Considerations

This decision not only provides additional guidance relating to the "cause" analysis with respect to involuntary conversion to a chapter 7 but also gives an evergreen warning that the debtor-in-possession must comply with its fiduciary duties to successfully emerge from the bankruptcy process.

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The importance of an unambiguous "reservation of rights" provision

Emerald Capital Advisors v. Victory Park Capital Advisors (In re KII Liquidating), Bankr. Case No. 17-11101-LSS (D. Del. Sep. 30, 2019)

Case snapshot

On September 30, 2019, a Delaware federal judge overturned a bankruptcy court's order dismissing with prejudice an unsecured creditors' committee's (the Committee) adversary proceeding. The federal court held that the July 2017 sale order (the Sale Order) – in which the bankruptcy court approved a $63 million transaction with the successful bidder, Jansan Acquisition LLC (Jansan) – contained certain "reservation of rights" language, which explicitly preserved the Committee's ability to challenge the validity of the liens of a certain secured creditor, Victory Park Capital Advisors LLC (Victory Park).

Factual background

Katy Industries, Inc. and its debtor affiliates (the Debtors) filed for chapter 11 relief on May 14, 2017 (the Petition Date) to consummate a sale of substantially all of their assets to Jansan, their debtor-in-possession (DIP) lender and proposed stalking-horse purchaser. Jansan was a joint venture between the Debtors' pre-petition second-lien lenders (i.e., Victory Park and Centrex), which contributed their secured debt (the Second-Lien Debt), and Highview Capital, LLC, which contributed the cash needed to provide DIP financing to the Debtors.

On June 12, 2017, the newly-appointed Committee objected to final approval of the DIP financing and the proposed bidding procedures, noting that "it was specifically investigating whether the most recent $7.5 million of advances by Victory Park prior to the Petition Date (the 'Challenged Advances') were more properly characterized as an equity infusion or [were] susceptible to equitable subordination pursuant to 11 U.S.C. § 510(c)." Opinion, at 3 (internal quotations omitted). In other words, the Committee questioned, in part, whether such advances could qualify to be part of Jansan's credit bid.

Ultimately, the bankruptcy court entered the final DIP order, which provided the Committee with the ability to challenge the "allowed" amount of the Second-Lien Debt until a certain date (i.e., a challenge period). With respect to the sale, and as the only bidder, Jansan's $63 million stalking-horse bid – including a $36.7 million credit bid – prevailed. The Committee, still investigating the $7.5 million advances, filed an objection to the Debtors' proposed sale order. Ultimately, the Debtors, Jansan, and the Committee agreed to the following language in the Sale Order:

> "***Notwithstanding anything to the contrary contained in this Order or in the Final APA***, entry of this Order and approval and consummation of the transactions contemplated hereby ***shall not limit or otherwise affect*** the rights ***or remedies*** of the Debtors' estates or the Committee with respect to any "Challenge" as defined in paragraph 26 of the Final DIP Order.

Opinion, at 5. On July 18, 2017, the bankruptcy court approved the revised Sale Order. On July 21, 2017, the parties closed upon the transaction.

Four days later, the Committee initiated an adversary proceeding, challenging Victory Park's $7.5 million advances. Victory Park and Jansan moved to dismiss the alleged claims, arguing that the approval and consummation of the sale had terminated the Committee's rights and remedies regarding its "challenge" of Victory Park's Second-Lien Debt, which was part of the credit bid. In response, the Committee argued that the "reservation of rights" language in the Sale Order expressly preserved its rights. Ultimately, the bankruptcy court

dismissed the Committee's complaint with prejudice. In reaching its decision, the bankruptcy court found that "there is no practical, useful remedy that results in any recovery to the estate," as "neither recharacterizing nor subordinating the Advances would enhance any potential distribution to creditors." Opinion, at 8. Restated, Jansan's bid was the only qualified bid, even if $7.5 million of Jansan's credit bid was disqualified.

On appeal, the district court overturned the bankruptcy court's order, finding its rulings inconsistent with the "reservation of rights" language in the Sale Order.

Court analysis

The district court found that the bankruptcy court committed a reversible error in not giving effect to the original sale order, "particularly given the Committee's reasonable reliance on that order in standing down from pressing its 'Challenge' rights at the July 17, 2017 sale hearing." Opinion, at 12. Moreover, the final DIP Order provided the Committee with the right to challenge the "allowed" amount of the Second-Lien Debt:

> "At the time the Sale Order was entered, the "allowed" amount of the Second-Lien Debt that Jansan would be entitled to credit bid under § 363(k) remained subject to the Committee's "Challenge" rights under paragraph 26 the Final DIP Order. [. . .] The unambiguous language of this provision, combined with the unambiguous language of Paragraph 48 of the Sale Order, combine to make clear that Appellant's Challenge survived both entry of the Sale Order and the closing of the transactions."

Opinion, at 13 (citations omitted). In other words, the Committee's right to challenge the lien was preserved in both the Sale Order and final DIP order – and that right survived both the approval and closing of the sale.

Practical considerations

Courts are not known to upset the finality of an approved section 363 sale. *See generally* 11 U.S.C. section 363 (m) (protecting sales made in "good faith" from reversal or modification on appeal unless the court stays the implementation of the sale order while the appeal is pending). However, a well-drafted and unambiguous "reservation of rights" provision can effectively preserve a party's rights and remedies. Indeed, Victory Park and Jansan spent some time arguing that the term "Challenge" was "highly general" and, therefore, not adequately defined. The district court disagreed, finding that the term "Challenge" was sufficiently broad enough to capture all of the Committee's claims. In all, clear and precise drafting is critical, particularly when it comes to preserving one's rights.

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The Fifth Circuit affirms the Equitable Mootness Doctrine and presents an unusual take on Cramdown Rates

Dropbox, Inc. v. Thru, Inc., et al. (In re Thru, Inc.), 3:17-cf-1958-G 2018 BRL 386690 (N.D. Tex. Oct. 19, 2018), aff'd 2019 BL 414468 (5th Cir. Oct. 28, 2019).

Case Snapshot:

With barely a few paragraphs' commentary, the three-judge Fifth Circuit panel affirmed the dismissal of a

creditor's appeal of a bankruptcy confirmation order as equitably moot and reaffirmed the continued vitality of the doctrine in this circuit. Dig a bit deeper, however, and the decision suggests a subtle rebuke of those dissenting voices that have argued in recent decisions in other circuits for a substantial restriction of the doctrine's application in all but the most complex reorganizations of publicly-traded companies.

In equally terse language, the Fifth Circuit also affirmed the use of the federal judgment rate—as opposed to a traditional *Till* rate—to satisfy the "fair and equitable" standards of § 1129(b) as to a dissenting class of *unsecured* creditors. In doing so, the panel reasserted the Fifth Circuit's view of the limited precedential value of *Till*'s "splintered" decision.

Factual Background:

Thru, Inc., provides business customers with a robust cloud-based virtual file system for the sharing of data directly and through a variety of software platforms. In 2003, Thru developed a feature for its electronic file sharing services, which it called "dropbox." To make a long story short, subsequent litigation between Thru and the now universally-recognized Dropbox, Inc., resulted in a $2.3 million judgment against Thru, prompting Thru to seek protection in chapter 11 of the Bankruptcy Code in early 2017. (The tortured details of the principal litigation between Dropbox and Thru, though interesting reading, were largely irrelevant to the rulings that followed.)

In its case, Thru proposed a plan of reorganization that would repay all unsecured creditors (including Dropbox) in full over time with interest at the federal judgment rate, which then stood at 1.22%. Despite the promise of payment in full, Dropbox opposed confirmation of the plan on a variety of grounds, including that the federal judgment rate was insufficient to satisfy the "fair and equitable" requirements of § 1129(b)(2)(B) and the Supreme Court's seminal holding in CSC Credit Corp. v. Till.

In response, Thru argued in a hotly contested trial that the "prime plus" formulation endorsed in *Till* was not controlling in the case of a dissenting class of *unsecured* creditors, but that the federal judgment rate nevertheless actually complied with the *Till* plurality because the federal judgment rate provided an objective standard that properly reflected the benefit to unsecured creditors who would likely have received only a fraction of their claims in a liquidation. After a hotly contested trial, the Bankruptcy Court confirmed the plan, finding as well that the federal judgment rate was sufficient to satisfy the "fair and equitable" cramdown requirements of § 1129 (b). Dropbox appealed, raising a dozen points of error, but did not seek a stay of confirmation pending appeal.

Thus unstayed, Thru consummated the plan, exited bankruptcy, and began to normalize its operations. In addition to making various plan distributions and other payments to creditors, in the months and years following plan confirmation Thru entered into several dozen customer contracts representing millions of dollars of revenue, entered into a two-year hosting service agreement to completely replace its digital storage infrastructure, and announced a new strategic partnership agreement with a publicly-traded software company.

At the same time, Thru moved to dismiss the appeal under the doctrine of equitable mootness, which is "firmly rooted in Fifth Circuit jurisprudence." *Bank of New York Trust Co. v. Official Unsecured Creditors' Committee (In re Pac. Lumber Co.)*, 584 F.3d 229, 240 (5th Cir. 2009). The district court agreed with Thru and dismissed the majority of Dropbox's claims as equitably moot. Among those claims not dismissed as moot, the district court considered the merits of Dropbox's challenge to bankruptcy court's holding that the plan was fair and equitable and affirmed the adoption of the federal judgment rate as sufficient in the circumstances to satisfy cramdown under § 1129(b)(2)(B). Dropbox appealed both holdings to the Fifth Circuit.

Court Analysis:

On appeal to the Fifth Circuit, Dropbox challenged not only the court's application of the equitable mootness doctrine but the legitimacy of the doctrine itself. Raising a new argument not presented to the district court, Dropbox highlighted a 2015 decision in which a Third Circuit declined to dismiss an appeal as equitably moot where it deemed the reorganized debtor to have entered into only "routine" transactions post-confirmation. *In re One2One Comms., LLC*, 805 F.3d 428 (3d Cir. 2015). Distinguishing such transactions from those in cases involving the involving the issuance of publicly traded debt or securities, the Third Circuit panel concluded that a debtor engaged in more ordinary transactions did not establish the level of third party reliance necessary to sustain a finding of equitable mootness. In effect, Dropbox argued that the case was not sufficiently complex to warrant application of the equitable mootness doctrine

Despite the arguments presented, the Fifth Circuit panel made short work of the matter, wholly affirming both the district court's dismissal of the appeal as equitably moot and its approval of the federal judgment rate to satisfy the requirements of § 1129(b)(2)(B).

On the continued viability of the equitable mootness doctrine, the panel matter-of-factly upheld the established contours of the three-part test for its application, and declined utterly to take up Dropbox's offer to consider the complexity of the underlying business in its analysis. Noting that reversal would frustrate the expectations of creditors and customers who relied on the confirmed plan in accepting payments and entering into new

transactions, the panel concluded that the plan “had progressed too far for the relief to be practically be granted.”

Turning to the second issue, the Fifth Circuit found no clear error in the district court’s ruling, observing that although the federal judgment rate was lower even than the rate of inflation, “it provided unsecured creditors the amount of money they would receive outside of bankruptcy.”

Practical Considerations:

With the opportunity to tackle two novel arguments—one aimed at narrowing use of the equitable mootness doctrine, the other offering a new perspective on the cramdown of unsecured creditors—it is curious that the panel elected for such a cursory affirmance. Whatever the reason, the reliability of confirmation orders in the Fifth Circuit remains solidly intact as *Till*’s precedential value narrows further.

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

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