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In This Issue:

ARE BREAKUP FEES AT RISK?

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A bankruptcy court decision out of the United States Bankruptcy Court for the District of Oregon has caused some concern in the DIP lending market. The case involves a pretty typical fact pattern. Prior to the filing of the bankruptcy case, the debtor reached an agreement with a DIP lender on the terms of post-petition financing, including a $250,000 breakup fee if the debtor chose another post-petition lender. As it turned out, the debtor agreed on a much more favorable post-petition financing deal with its pre-petition lender. The first DIP lender then sought to collect the $250,000 breakup fee after the case was filed. The court said that while the first DIP lender had a claim against the debtor for the breakup fee, it was a general pre-petition unsecured claim and not an administrative expense claim. The reasons: (1) the contract for the fee was with the pre-petition debtor and not the post-petition debtor in possession; and (2) the first DIP lender did not provide a "substantial benefit" to the debtor.

Both of these reasons are questionable. First, as the court noted, the first DIP lender agreed to keep its offer open until a final order was entered on the financing, and that should be enough consideration to make it a post-petition transaction. Second, it seems clear that the debtor did receive a substantial benefit since the pre-prepetition lender provided a much more favorable DIP loan knowing that the debtor had a fall back deal with the first DIP lender. There are things the first DIP lender could have done differently, like getting the debtor in possession to reaffirm the contract post-petition, but we think the court came out on the wrong side of law on this one. *In re C&K Market, Inc.*, No. 13-84561 (Bankr. Or. Apr. 8, 2014).

CREDIT BIDDING RIGHTS LIMITED, CAPPED BY DEBT PURCHASE AMOUNT

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In re Fisker Automotive Holdings, Inc., 2014 Bankr. LEXIS 230 (Bankr. D. Del. Jan. 17, 2014)

CASE SNAPSHOT

A secured creditor's right to credit bid in a Bankruptcy Code section 363 sale may be capped at the amount paid by the creditor who purchased the debt from the prior lender.

FACTUAL BACKGROUND

Debtor Fisker Automotive borrowed $168.5 million from the United States in or around 2010 through the Department of Energy (DOE), pursuant to which the DOE had first-priority liens in the debtor's assets. In October 2013, Hybrid Tech Holdings, LLC, purchased the DOE's position in its loan facility with Fisker, and was assigned the DOE's senior lien position in the debtor's assets. Hybrid and Fisker entered into discussions regarding Hybrid's acquisition of Fisker's assets and entered into an Asset Purchase Agreement pursuant to which Hybrid would purchase Fisker's assets in a Bankruptcy Code section 363 sale for consideration consisting primarily of a $75 million credit bid.

Fisker filed a voluntary chapter 11 bankruptcy petition in November 2013, and filed a motion for approval of the section 363 sale. The official committee of unsecured creditors opposed the sale and sought to prohibit Hybrid from credit bidding, or, alternatively, to cap Hybrid's credit bid at $25 million, the amount Hybrid paid the DOE for the debt. In a surprising decision, that appears to depart from the spirit of the U.S. Supreme Court's ruling in the 2012 *RadLax Gateway Hotel* decision (which stressed the importance of a secured creditor's credit bidding rights), the bankruptcy court ruled that Hybrid was permitted to credit bid at the sale, but only up to the $25 million amount that it paid for the debt.

COURT ANALYSIS

The bankruptcy court analyzed Bankruptcy Code section 363(k), which provides that in the context of a section 363 sale of assets subject to a lien, "unless the court for cause orders otherwise the holder of [the secured] claim may bid at such sale, and, if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property." The bankruptcy court acknowledged that a secured creditor was permitted to credit bid its allowed claim, but also held that a court had the authority under section 363(k) to order otherwise "for cause."

The bankruptcy court relied heavily on a footnote in the *Philadelphia Newspapers* decision, where the Third Circuit opined, in *dicta*, that a "court may deny a lender the right to credit bid in the interest of any policy advanced by the Code, such as to ensure the success of the reorganization or to foster a competitive bidding environment." Relying on this footnote, the *Fisker* court rejected Hybrid's argument that the "for cause" exception under section 363(k) should be "limited to situations in which [a]secured creditor has engaged in inequitable conduct," holding that the "argument has no basis in the statute."

The bankruptcy court found that Hybrid's proposed $75 million credit bid would not only chill bidding, it would effectively prevent any bidding. The bankruptcy court also found that a "highly attractive and capable" alternative purchaser was interested in bidding at the auction, and would not do so if Hybrid's bid was not capped. The court also found that the amount of Hybrid's secured claim was uncertain because it was only partially secured. Lastly, the court was critical of the speed with which Fisker and Hybrid sought to accomplish the sale, finding that other parties were only given 24 business days to challenge the sale to Hybrid.

Based on these factors, the bankruptcy court found that there was sufficient cause to limit Hybrid's credit bid to $25 million, ruling that to "do otherwise would freeze bidding." Notably, although the bankruptcy court cited no examples of another bankruptcy court capping a credit bid in this way, it concluded that it had "followed precedent" (presumably, the *Philadelphia Newspapers* footnote), and that an uncapped bid "would be unprecedented and unacceptable." Hybrid

CONTINUED ON PAGE 6

COURT UPHOLDS CREDITOR'S SECURITY INTEREST DESPITE POST-PETITION LAPSE OF FINANCING STATEMENT

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American Bank FSB v. Miller Brothers Lumber Co., Inc., No. 1:12CV720 (M.D.N.C. Oct. 23, 2013)

CASE SNAPSHOT

The issue was "whether a post-petition lapse of a financing statement permits a chapter 11 debtor in possession, with its powers as a lien creditor under section 544(a)(1), to take priority over a creditor that had a properly perfected security interest as of the petition date." The bankruptcy court found that it does; the district court reversed, finding that, "under North Carolina law, the bank/creditor's security interest has priority over the DIP's powers as a lien creditor acquired as of the date of the commencement of the action and while the security interest was perfected."

FACTUAL BACKGROUND

In October 2006, the debtor and the bank entered into a master lease transaction that the parties stipulated was a financing transaction under North Carolina law and subject to the Uniform Commercial Code as adopted in North Carolina. The bank filed its initial UCC financing statement to perfect its security interest in the equipment subject to the master lease in late October 2006, but neglected to file a continuation statement within the six months prior the five-year expiration date of the initial financing statement. The debtor's bankruptcy filing occurred in September 2011, almost two months prior to the lapse of the financing statement. Accordingly, as of the petition date, the bank's financing statement was still effective and valid.

The bank filed a secured proof of claim and moved for adequate protection or, in the alternative, for relief from stay. The bankruptcy court denied the bank's motion, stating that the financing statement had lapsed post-petition, giving the debtor the capacity to avoid the security interest pursuant to section 544 of the Bankruptcy Code. On appeal, the district court reversed

COURT ANALYSIS

The Bankruptcy Code authorizes a trustee or debtor in possession to avoid a transfer of an interest in personal property to the same extent as a hypothetical lien creditor who extends value and obtains a judgment on the petition date. While bankruptcy law determines the status as a hypothetical judgment lien creditor, state law signifies the importance or legal effect of that status.

In the case at hand, all parties agreed that the bank had a priority perfected security interest as of the petition date. They also agreed that the bank's financing statement lapsed approximately seven weeks later. The dispute was over the legal effect of the lapsing while a bankruptcy case was pending. The bank argued that its rights were fixed on the petition date and that state lien law has little, if any, role to play thereafter. The DIP, however, pointed to a number of Bankruptcy Code provisions requiring evaluation of the secured creditor's claim throughout the bankruptcy process. The court held that the bank had priority over the DIP's avoidance powers as a lien creditor as of the petition date when the security interest still was perfected. In rendering its decision, the court noted that it was not determining when the creditor's rights are fixed in bankruptcy or whether a junior secured creditor would take priority over a senior secured lender whose financing statement lapsed post-petition: consideration of the first issue was not dispositive to its ruling and determination of the latter issue was not before the court.

The court began its analysis with the applicable UCC provisions, giving significant weight to section 9-317(a), which subordinates an unperfected secured creditor to a judicial lien creditor if the judicial lien arises before the security interest is perfected, and to section 9-515(c), which governs the effect of a lapsed financing statement. According to section 9-515(c), "[u]pon lapse, a financing statement ceases to be effective and any security interest ... that was perfected by the financing statement becomes unperfected, unless the security interest is perfected otherwise." This subsection further provides that if the security interest becomes unperfected upon lapse, "it is deemed to never have been perfected as against a purchaser of the collateral for value."

While the court did not find ambiguity in the statute, the court acknowledged a difference in opinion resolving the same issue in other districts. Consequently, the court cited to a host of canons for statutory construction to address the appearance of ambiguity in the statutory scheme of section 9-515(c). In reversing the bankruptcy court, the court held that it had erred in relying solely on the second sentence of subsection 9-515(c) governing the loss of perfection when a financing statement lapses, and on the changes to the Bankruptcy Code authorizing secured lenders to file continuation statements post-petition to maintain perfection. Instead, the district court examined the entire statutory scheme of section 9-515(c) and hinged its ruling on the subsection's last clause. That clause extended the benefit of the "deemed never to have been perfected" only to purchasers of collateral for value, and excluded lien creditors from its scope. Consequently, the filing of the initial financing statement dictated whether the secured party was perfected before the lien creditor and determined their respective priorities under subsection 9-317(a). A secured party's subsequent lapse in perfection had no consequence for that particular priority scheme.

The court found support for its rulings in the 2001 revisions to section 9-515(c), which expressly deleted the inclusion of lien creditors from the scope of entities against whom a lapsed UCC is deemed never to have been perfected. Additionally, bankruptcy trustees are included within the UCC definition of "lien creditor." Consequently, the court deduced that, after 2001, trustees (and by extension DIPs) no longer received the benefit of the "deemed never to have been perfected" position. The court found additional support in the comments to the UCC. Comment 3 to section 9-515(c) was particularly instructive and set forth an illustrative timeline of events where: first, the secured party perfected its security interest by filing an initial financing statement; second, the lien creditor obtained its judgment; and third, the financing statement lapsed. According to the official commentary, the secured party, in that situation, still has priority over the lien creditor because the lien creditor was not a "purchaser of the collateral for value."

CONTINUED ON PAGE 6

TRUSTEE CAN USE LIEN-CREDITOR STATUS AND AVOIDANCE POWER DEFENSIVELY, EVEN AFTER LIMITATION PERIOD

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Grant, Konvalinka & Harrison, P.C. v. C. Kenneth Still (In re McKenzie), 737 F.3d 1034 (6th Cir. 2013)

CASE SNAPSHOT

In a precedential opinion, the United States Court of Appeals for the Sixth Circuit resolved two issues of first impression in the Sixth Circuit related to deciding motions for relief from the automatic stay imposed by section 362 of the Bankruptcy Code. The first issue was which party bears the burden on a lift-stay motion of establishing the validity and perfection of the creditor's security interest in the debtor's property. The Sixth Circuit concluded that the creditor bears the burden. The second issue was whether a bankruptcy trustee can use its hypothetical lien-creditor status and avoidance powers to oppose such a motion after expiration of the two-year statutory limitation on avoidance actions. The Sixth Circuit concluded that the bankruptcy trustee can use such status and powers defensively notwithstanding the passing of the statutory limitation period.

FACTUAL BACKGROUND

Several weeks before filing for chapter 11 bankruptcy, Mr. McKenzie executed a promissory note and pledge agreement in favor of Grant, Konvalinka & Harrison, P.C. ("GKH") for the purpose of securing legal fees owed by him to this law firm. The pledge agreement originally listed almost two dozen entities in which Mr. McKenzie held an ownership interest, and was later amended to list several more.

After Mr. McKenzie's chapter 11 case was converted to a chapter 7 case, GKH moved for relief from the automatic stay to proceed against the various equity interests pursuant to its remedies under the pledge agreement. The chapter 7 trustee opposed the motion on the basis that the pledges of the equity interests constituted preferential transfers. The bankruptcy court concluded that GKH had failed to carry its burden of establishing valid and perfected liens in the equity interests, and that the chapter 7 trustee could use its avoidance powers defensively even after the expiration of the limitations period. On appeal, both the district court and Sixth Circuit affirmed the bankruptcy court's conclusions.

COURT ANALYSIS

The issue of whether GKH, as the creditor, had the burden to establish valid and perfected liens in the debtor's equity interests on its motion for relief from the automatic stay was one of first impression in the Sixth Circuit. The Sixth Circuit also noted that the parties had not cited to any relevant district court or circuit court decisions from any other jurisdictions, indicating that it may be the first appellate court to address the issue. The Sixth Circuit further noted, however, that numerous bankruptcy courts had reached the conclusion that the creditor had the burden to prove the validity and perfection of its liens.

GKH took the opposite position based on section 362(g), which provides that "(1) the party requesting such relief has the burden of proof on the issue of the debtor's equity in property; and (2) the party opposing such relief has the burden of proof on all other issues." GKH argued that the plain language of the statute provides that GKH did not have the burden to prove its lien.

The Sixth Circuit disagreed, concluding that whether a valid and perfected security interest exists is determinative of whether the debtor has equity in the property. Thus, to prove the ultimate issue, the creditor must first prove that it has a valid and perfected lien. The Sixth Circuit also noted that requiring a creditor to establish its lien is sound judicial policy because the creditor is likely in the best position to show that its lien is valid and perfected.

The Sixth Circuit then addressed the second issue of first impression – whether the chapter 7 trustee could use its avoidance powers defensively even after the expiration of the limitations period. The Sixth Circuit noted that numerous bankruptcy courts have answered that question in the affirmative, as well as the Ninth Circuit. The Sixth Circuit agreed.

The Sixth Circuit explained that there is an important difference under the Bankruptcy Code between an affirmative and defensive recovery on avoidance actions, concluding that the recovery on defensive actions is limited to only an offsetting claim by section 502(d) of the Bankruptcy Code. Section 502(d) "requires disallowance of a claim of a transferee of a voidable transfer *in toto* if the transferee has not paid the amount or turned over property received under the sections under which the transferee's liability arises." The Sixth Circuit concluded that the effect of section 502(d) is not subject to the two-year statute of limitations for affirmative recoveries of avoidance actions provided by section 546(a)(1)(A), further noting that this interpretation comports with the general principle that limitations periods do not apply to defenses.

PRACTICAL CONSIDERATIONS

In confirming the majority position on both issues, the Sixth Circuit has provided additional clarity on these important and routinely relevant areas of bankruptcy law.

DENYING SUMMARY JUDGMENT, COURT HOLDS THAT ORRI MAY FACE RECHARACTERIZATION AS DEBT

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NGP Capital Resources Company v. ATP Oil & Gas Corp., Case No. 12-03443 (Bankr. S.D. Texas, Jan. 6, 2014)

CASE SNAPSHOT

In denying a motion for summary judgment, the court found triable issues of material fact under Louisiana law, holding that overriding royalty interests could be recharacterized as debt rather than as a royalty interest, even if the conveyance was facially consistent with an ORRI. The court ruled that the term ORRIs would only be safe from recharacterization as debt if they were (1) completely consistent with an ORRI under state law, and (2) inconsistent with a loan under state law. The court found that the subordinated interest provision and the interest rate-based formula used to define the terminating condition were potentially inconsistent with a term ORRI. The court also found that several factors raised issues of material fact as to whether the transaction was consistent with a debt instrument.

FACTUAL BACKGROUND

The interests at issue relate to outer-continental shelf lands leased by the debtor from the United States under the Outer Continental Shelf Lands Act (the "OCS Leases"). NGP purchased Term Overriding Royalties in six OCS Leases for $65 million. Under the agreement, NGP is entitled to its proportionate share of the proceeds of any and all hydrocarbons produced, saved, and sold from the properties for each production month. The parties evidenced the transactions pursuant to documents titled "Conveyance of Term Overriding Royalty Interest" and "Purchase and Sale Agreement." According to these documents, the debtor conveyed a Term ORRI that terminated when the cumulative Royalty Payments equaled the Total Sum, defined as the full amount of the primary sum, plus interest accruing at a notional rate on the unliquidated balance of the primary sum outstanding from time to time during the period from the date of the conveyance. The agreements were amended from time to time to increase the amount of the primary sum due under the transaction and the notional interest rate.

The debtor argued that the ORRI due under OCS Leases were disguised financing transactions and were not a sale or absolute conveyance of a property interest to NGP. As such, the funds that otherwise would be due and payable as ORRI constituted property of the debtor's estate.

COURT ANALYSIS

In bankruptcy, the characteristics of a property interest are determined by state law; in this case, Louisiana law controlled. In Louisiana, the nature of the rights attaching to the ORRI depends on whether the royalty is created by the lessee's reservation under a lease or by the lessee's grant under a separate agreement. If it is the latter, "a much lower degree of duty to the royalty owner" is owed by the lessee.

In determining whether the ORRI was a sale or a disguised financing transaction, the court rejected NGP's threshold arguments. First, the court rejected NGP's argument that courts are bound by the parties' intent behind a transaction as evidenced purely by the words chosen to document the transaction. Citing to long-standing precedents, the court maintained it is well-established under Louisiana law that courts are not bound by the label parties place on a written agreement, and that words only have import and are binding when they accurately describe the relationships that exist. When words are used to alter or disguise actual relationships, the words and the parties' intent have no bearing on the legal effect of the transaction. Second, the court rejected NGP's argument that, to recharacterize the transaction as financing, the transaction had to meet all of the requirements for a loan under Louisiana law and none of the characteristics of a sale. The court ruled instead that for NGP to prevail on summary judgment, NGP would have to show that the transaction was wholly consistent with a Term ORRI under Louisiana law, and at least one inconsistency with the definition of a loan under Louisiana Law. Anything less would create triable issues of fact.

The court started its substantive analysis with the nature of a Term ORRI under Louisiana law compared with the conditions set forth in the NGP transaction. According to the court, Term ORRIs are overriding royalties that terminate after the occurrence of a specified event and are not measured by reference to production costs. Under Louisiana law, they are considered a "real right" in "incorporeal immovable property."

The court found the following terms and conditions in the NGP Transaction to be consistent with a Term ORRI: (1) the presence of a reversionary interest; (2) use of multiple parcels to fund payment of the ORRI; (3) the exclusive control and operation of the subject parcels and wells by the debtor-operator; and (4) a sharing in the post-production costs between NGP and the debtor. The court held that the mere presence of a reversionary interest in the Term ORRI by the lessee was not inconsistent with a Term ORRI under Louisiana statutory law, which recognizes that mineral rights are terminable. Relying on the implicit holdings of prior court decisions, the court held that requiring payment of a Term ORRI out of several subject properties and across leases did not, by itself, render the transaction inconsistent with a Term ORRI under Louisiana law. Further, providing the debtor-operator with exclusive possession and operating control over the wells and leases was consistent with Louisiana law's treatment of ORRIs as passive interests in property. Finally, while an ORRI requires the owner to hold its interest free of the expense of production (i.e., the costs of getting the oil and gas to the surface), it is not uncommon for the owner of an ORRI to share in the post-production costs, (e.g., third-party pipeline transportation costs). Consequently, none of these terms in the NPG transaction gave cause to recharacterize it as a loan transaction.

The court did, however, find the subordination provision and payment terms to create a triable issue of fact. NGP agreed to subordinate its right to receive the Term ORRI in favor of a third party. The court found that creating such a conditional obligation to pay the Term ORRI was inconsistent with the idea of an absolute conveyance of a property interest. The court examined case law and found three circumstances in which placing conditions on payment of the ORRI was consistent with a Term ORRI: (1) subordinating payment in favor of the grantor's operating costs; (2) conditioning payment on certain production levels; and (3) conditioning payment on the acquisition of additional parcels for production. None of these fit NGP's election to subordinate its Term ORRI interests in favor of obligations the debtor owed to an independent third party.

CONTINUED ON PAGE 10

Credit Bidding Rights Limited, Capped by Debt Purchase Amount —continued from page 2

immediately sought leave from the District Court to appeal the decision, but leave was denied, and the District Court agreed that the Third Circuit previously recognized in *Philadelphia Newspapers* that a secured creditor could be denied the right to credit bid in order "to foster a competitive bidding environment."

PRACTICAL CONSIDERATIONS

The *Fisker* decision is the first step in what may be a developing trend of bankruptcy courts restricting a secured lender's credit bidding rights under Bankruptcy Code section 363. Although the Supreme Court has affirmed the importance of a secured creditor's credit bidding rights, it has not addressed the *dicta* set forth in the *Philadelphia Newspapers* footnote. Relying on this footnote, the *Fisker* decision has created new uncertainties for secured creditors seeking to assert credit bidding rights in bankruptcy sales. In particular, Fisker creates uncertainty for investors interested in purchasing a prior lender's debts with the intent of quickly credit bidding the debt to purchase the borrower's assets in a pre-packaged bankruptcy sale.

Within months of the *Fisker* decision, it was cited favorably by a bankruptcy court in the Fourth Circuit, in the Eastern District of Virginia, in *In re Free Lance-Star Publishing*, 2014 Bankr. LEXIS 1611 (E.D. Va. April 14, 2014), where the court limited a secured creditor's right to credit bid because of the creditor's "overly zealous loan-to-own" strategy. The *Free Lance-Star* court opined that the secured creditor "unduly" influenced the bidding process by encouraging the debtor to file bankruptcy, rushed the debtor through a bankruptcy sale, and made other prospective bidders aware of the secured creditor's credit bidding rights.

Perhaps stemming the tide, most recently in *In re Charles Street African Methodist Episcopal Church of Boston*, 2014 Bankr. LEXIS 2264 (Bankr. D. Mass. May 14, 2014), the bankruptcy court permitted a creditor to credit bid the full amount of its claims in a bankruptcy sale, although the bankruptcy court did require the secured creditor to deposit cash, rather than a credit bid, in payment of the $50,000 break-up fee. In *Charles Street*, the debtor asserted setoff counterclaims to the secured creditor's proof of claim that, if valid, were sufficient to eliminate the secured claim in its entirety. On this basis, the debtor argued that cause existed to limit the credit bidding under Bankruptcy Code section 363(k) because there was a "bona fide dispute" regarding the secured claim. The bankruptcy court disagreed that the setoff claims presented a sufficiently bona fide dispute because there was no evidence of a dispute regarding the validity of the loan agreements, the priority or perfection of the liens, or the amounts due under the agreements. Notably, however, the bankruptcy court was careful to explain that it was not addressing the "types of cause" at issue in *Fisker* and would not opine on the validity of the decision.

It remains to be seen whether other circuits will be persuaded by these decisions, but the *Fisker* and *Free Lance-Star* cases are cautionary tales for purchasers seeking to acquire a company's debt in order to purchase the company in bankruptcy. Such purchasers should be mindful of the amount of influence they exert over a debtor and the speed with which they pursue a bankruptcy sale.

Court Upholds Creditor's Security Interest Despite Post-Petition Lapse of Financing Statement—continued from page 3

The district court brushed over Comment 4 to section 9-515(c), which discusses the effect a bankruptcy has on a lapsed statement, and contains an explicit warning that subsection 9-515(c) imposes a new burden on the secured parties to file continuation statements during the debtor's bankruptcy case. According to the district court, the clear warning extends only to cover loss in priority in favor of "purchasers of the collateral for value," not to lien creditors. According to the court, the Bankruptcy Code did not dictate a different result.

The Bankruptcy Code makes a distinction between a trustee's or DIP's position as (1) a hypothetical lien creditor who extends credit and obtains a judicial lien as of the petition date; and (2) a bona fide purchaser of real property without notice of defects. Since real property is not at issue in the case (or indeed in any UCC financing statement), avoidance powers arising from the DIP's status as a bona fide purchaser of real property did not apply and would not trigger the benefits of a lapsed statement being deemed never to have been perfected. Implicit in the court's ruling is that a hypothetical lien creditor deemed to have extended value as of the petition date under the Bankruptcy Code also cannot be deemed a purchaser of the collateral for value under the UCC. The UCC does not define a "purchaser of the collateral for value," and its definition of a "lien creditor" – unlike the Bankruptcy Code avoidance provisions – does not contain any concept of having extended value to the debtor.

The court briefly addressed the revisions to the Bankruptcy Code excepting continuation statements from application of the automatic stay, and to the UCC where a creditor's obligation to file a continuation statement is no longer tolled by the pendency of a bankruptcy case – stating that neither revision had a dispositive effect on its ruling. Only the timing of the secured creditor's initial perfection vis-à-vis a trustee or DIP as a hypothetical judgment lien creditor mattered, not any subsequent lapse in perfection.

PRACTICAL CONSIDERATIONS

Based upon this court's ruling, a secured creditor with a perfected security interest in personal property as of the petition date will trump the avoidance powers of a bankruptcy trustee or DIP, even if its financing statement lapses post-petition. As the court noted, however, there is a split in authority on this issue. Not all courts have determined that a trustee or DIP is denied the protections of a purchaser of the collateral for value given their status as a hypothetical lien creditor deemed to have extended value to the debtor as of the petition date. Additionally, the district court appears to acknowledge that the seniority of a secured lender whose financing statement lapses post-petition is not likely to survive an adversary action filed by a junior secured lender seeking to determine the extent and priority of their respective liens. To sidestep uncertainty and unnecessary litigation costs, secured creditors should take advantage of the exception to the automatic stay and timely file UCC-3 Continuation Statements to maintain perfection, and steer clear of any question as to their priority perfected status during bankruptcy.

PREFERENCE DECISION MAY EXPAND CIRCUMSTANCES IN WHICH TRUSTEES SEEK RECOVERY FROM SENIOR AND JUNIOR LIENHOLDERS

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In re Vassau, 499 B.R. 864 (Bankr. S.D. Cal. 2013)

CASE SNAPSHOT

In a chapter 7 case, the Bankruptcy Court for the Southern District of California held that payments made to a fully secured first lienholder could be preferential transfers as to the undersecured junior creditor, who received no money but received the benefit of an increase in their equity position as a result of the payments paying down its debt.

FACTUAL BACKGROUND

Bank of America had both a first and second priority lien on real property owned by the debtor. The value of the real property was sufficient to fully secure the first lien, but only part of the second lien. In the 90 days prior to the petition being filed, the debtor made 10 payments to the bank in payment of the first lien. No payments were made on the second lien.

The trustee sued the bank solely in its capacity as junior lienholder on the theory that, although the second lien received no payments, the effect of the 10 payments was to reduce the amount of the first lienholder's claim and correspondingly increase the value of the second lienholder's security interest in the real property. On summary judgment, the court agreed, and determined that the transfers met all five elements of section 547(b), and were, therefore, avoidable transfers as to the junior lienholder.

COURT ANALYSIS

In its holding, the bankruptcy court analyzed Bankruptcy Code section 547(b). The junior lienholder stipulated that of the five elements of section 547(b), three elements were satisfied: (b)(2) the transfers were for an antecedent debt; (b)(3) the transfers were made while the debtor was insolvent; and, (b)(4) the transfers were made within 90 days of the petition. The junior lienholder disputed the first and fifth elements that: (b)(1) the transfers were "to or for [their] benefit;" and, (b)(5) the transfers enabled the junior lienholder to "receive more than [it] would receive if the case were a case under chapter 7."

As to the first element, the junior lienholder argued that the transfers were not intended "for their benefit," but rather were intended for the benefit of the senior lienholder (the court treated the junior and senior lienholder positions as though they were distinct parties). The court found that intent was irrelevant under the plain statutory language of Section 547(b)(1), and the only relevant fact was that the payments actually indirectly benefited the junior lienholder.

As to the fifth element, the junior lienholder argued that there was no liquidation and that the real property was abandoned by the trustee, and, thus, the junior lienholder did not receive more as a result of the case being under chapter 7. The court acknowledged that most chapter 7 cases do not result in an actual liquidation of funds or distribution to creditors, but held that in a hypothetical liquidation, which is what the fifth element assumes, the junior lienholder was better off as a result of the transfers because the transfers caused the value of the bank's security interest to increase.

The court ruled, on summary judgment, that the payments to the senior lienholder were avoidable transfers as to the junior lienholder. In so holding, the court acknowledged that it "recognize[d] that it may be seen as somewhat unfair to require a creditor such as [the junior lienholder] to 'return' money it never physically 'received.'" In *dicta*, the court opined that it made sense for the trustee to sue the junior lienholder instead of the senior lienholder, because the junior and senior lienholder positions were held by the same bank in this case. Notably, the court speculated that because the senior lienholder is the "initial transferee," "in cases in which [the junior and senior lienholders] are separate [entities], it seems that a trustee might find it simpler to recover the transfers from the direct transferee."

PRACTICAL CONSIDERATIONS

The court's decision is remarkable both for its holding and for its *dicta*. As to the holding, junior lienholders should not be surprised to find that trustees will start pursuing them for transfers that they did not even receive. As to the *dicta*, fully secured senior lienholders on loans where there are undersecured junior lienholders should not be surprised to find that trustees may start pursuing them for transfers they received in good faith, under a theory that they are derivatively liable as the "initial transferee" for the benefits indirectly received by the junior lienholder party. Although such derivative liability does not appear to have any support under the Bankruptcy Code, the *dicta* in this court's decision may provide trustees with new ammunition to pursue avoidance claims.

LIENS MAY ATTACH WHERE PARTIES CLEARLY INTENDED, EVEN WHERE DEED OF TRUST IS DEFICIENT

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VA BENE TRIST, LLC v. Washington Mutual Bank, No. 12-15169 (9th Cir., Feb. 25, 2014)

CASE SNAPSHOT

The Ninth Circuit upheld the bankruptcy court's ruling that a secured creditor's liens may attach to real property even where the trustor under the deed of trust was not the actual property owner, but where the trustor held himself out to be the owner, was the property owner's manager, and where the parties all clearly intended that the property secure the loan at issue.

FACTUAL BACKGROUND

Debtor VBT's manager, David Menken, borrowed more than $1 million from lenders to refinance the purchase of certain real property in Arizona pursuant to a promissory note that was secured by a deed of trust on the property, which was purportedly owned by Menken. Even though the note was executed by Menken in favor of the lender, and the deeds of trust identified Menken as the trustor, title to the property actually remained in VBT's name – not Menken's. The note was sold and assigned to Washington Mutual Bank, which held the original note.

After Washington Mutual foreclosed on the property, the debtor filed a chapter 12 bankruptcy petition and objected to Washington Mutual's claims, arguing among other things that (1) the bank did not timely file a proof of claim, (2) the bank did not have standing to enforce the note, and (3) there was no lien on the real property under the deed of trust. The bankruptcy court found in favor of Washington Mutual, ruling that (1) the bank had no obligation to file any proof of claim to maintain its security interest, (2) the bank had standing to sue under the note because it held the original, which was indorsed in blank, and (3) either the doctrine of reformation or equitable subrogation permitted the court to impose a lien on the property in Washington Mutual's favor. The rulings were appealed to the district court, which affirmed, and were then appealed to the Ninth Circuit.

COURT ANALYSIS

The Ninth Circuit, on appeal, also affirmed. The Ninth Circuit held that a secured lender need not file a proof of claim to preserve its lien, and, thus, the timeliness of its proof of claim was irrelevant. On the issue of standing, the court held that under Arizona revised statute 47-3205, a note indorsed in blank is payable to the bearer, and, thus, Washington Mutual had standing to enforce the note when it proved that it held the original note, which was indorsed in blank. On the third issue, regarding the validity of lien, the court agreed that under a theory of either equitable subrogation, replacement mortgage, or reformation, the bankruptcy court had the authority to impose a lien on the property, based on the fact that the loan clearly intended to include a security interest on the subject property, and any failure to properly perfect the interest was because of the mutual mistake of the parties or fraudulent acts by Menken. The Ninth Circuit also rejected VBT's argument that section 544(a)(3) granted VBT the status of a bona fide purchaser, because the Deed of Trust and the Notice of Trustee's sale each put any hypothetical purchasers on constructive notice of Washington Mutual's liens.

PRACTICAL CONSIDERATIONS

Neither the Ninth Circuit nor the district court's decision specified whether the secured lender conducted a title search, or why such title search did not reveal that the property owner was not the same party as the trustor; but secured lenders either originating or purchasing loans should be vigilant to ensure that their named trustors are also the owners of the subject property. Similarly, secured lenders should ensure that they obtain adequate title insurance in order to protect themselves from deficiencies in a deed of trust. However, even where all such precautions fail, secured lenders should be comforted by the fact that a clear mistake, like the one at issue in VA BENE TRIST, may not prove fatal to the secured lender's liens, although the litigation of these issues may prove to be costly.

SEPARATE JUDGMENTS AGAINST HUSBAND'S AND WIFE'S GUARANTIES OF THE SAME LOAN CANNOT BE CONSOLIDATED

Brian Schenker
Associate, Philadelphia

ISN Bank v. Rajaratnam, 83 A.3d 170 (Pa. Super. 2014)

CASE SNAPSHOT

The Superior Court of Pennsylvania recently resolved a matter of first impression related to obtaining judgment liens on marital property, which influences recommended loan documentation in Pennsylvania. The question was whether a judgment obtained against the husband in one action for amounts owed under an individual personal guaranty of a loan could be consolidated with a judgment obtained against the wife in a separate action for amounts owed under a later, separate and joint guaranty of the same loan.

Despite both judgments relating to the same underlying debt, the Superior Court concluded that the judgments could not be consolidated and, therefore, the judgment creditor could not seek recovery against marital property – only individual property of the husband or wife.

FACTUAL BACKGROUND

ISN Bank made a construction loan to Tower Apartment Partnership, LLP. At that time, Mr. Rajaratnam, the principal of Tower, executed and delivered a guaranty agreement under which he guaranteed the loan. Two years later, the bank agreed to extend the maturity of the loan by one year. At that time, Mr. Rajaratnam and Mrs. Rajaratnam executed a guaranty agreement under which they both guaranteed the loan.

The loan to Tower eventually went into default, and the bank confessed judgment against Mr. Rajaratnam under his original individual guaranty. Later, the bank

CONTINUED ON PAGE 10

INDIVIDUAL COMMITTEE MEMBERS MUST MAKE A ‘SUBSTANTIAL CONTRIBUTION’ TO RECEIVE PAYMENT OF ATTORNEY’S FEES

Sarah Kam
Associate, New York

Davis v. Elliot Management Corp., et al. (In re Lehman Brothers Holdings Inc., et al.), No. 13-Civ. 2211, 2014 WL 1327980 (S.D.N.Y. Mar. 31, 2014)

CASE SNAPSHOT

U.S. District Court, Southern District of New York Judge Richard Sullivan vacated the bankruptcy court approval of a plan provision awarding attorney’s fees and costs to individual members of the unsecured creditors’ committee. The district court held that the individual committee members could have their attorneys’ fees paid only to the extent they made a “substantial contribution” to the bankruptcy case under section 503(b)(3)(D) and 503(b)(4) of the Bankruptcy Code, and remanded for further proceedings.

FACTUAL BACKGROUND

Individual members of the unsecured creditors’ committee sought to recover attorneys’ fees and costs by inserting a provision in the plan allowing such recovery as “administrative expense claims.” After plan confirmation, committee members made application for these payments, but the trustee objected. The bankruptcy court allowed payments, and the trustee appealed

COURT ANALYSIS

Unlike the fees of professionals retained by an official committee, the fees incurred by individual committee members are excluded under section 503(b) of the Bankruptcy Code. In *Lehman*, the individual committee members attempted a work-around by adding a provision to the plan that allowed individual committee members to recover reasonable attorney’s fees as “administrative expense claims.” Following confirmation of the plan, the individual committee members made application for these payments, but the U.S. Trustee objected. Judge Peck acknowledged that the Bankruptcy Code did not authorize payment of individual committee members’ attorneys’ fees, but held that it did not forbid such payments. He reasoned that the payments were not inconsistent with any Bankruptcy Code provision and were therefore permissible under section 1123(b)(6), which permits a plan to include any provision that is not inconsistent with the Bankruptcy Code. The U.S. Trustee appealed.

In his decision, the district court judge concluded that section 503(b) of the Bankruptcy Code is the exclusive avenue for payment of administrative expenses and it excludes individual committee members’ attorneys’ fees. Therefore, he ruled that individual committee members could not have their attorneys’ fees treated as administrative expenses solely on the basis of their committee membership. However, the district court remanded the case to the bankruptcy court to determine whether the individual committee members made a “substantial contribution” under sections 503(b)(3)(D) and 503(b)(4) of the Bankruptcy Code.

PRACTICAL CONSIDERATIONS

This decision has no direct bearing on the ability of an indenture trustee or an individual committee member to seek reimbursement of fees on the basis that it made a “substantial contribution to the case.” However, given the subjectivity of a “substantial contribution” finding, it remains important for an indenture trustee to negotiate for plan provisions permitting the indenture trustee to seek reimbursement of its fees and expenses from bondholders by exercising the indenture trustee’s contractual rights to reimburse its expenses from any distributions made under the plan.

PAYMENT OF CLAIMANT’S FEES UNDER SECTION 506(C) ONLY MADE IN NARROW CIRCUMSTANCES

Brian Schenker
Associate, Philadelphia

In re Towne, Inc., 536 Fed. Appx. 265 (3d Cir. 2013)

CASE SNAPSHOT

In a non-precedential opinion, the United States Court of Appeals for the Third Circuit affirmed a bankruptcy court’s decision to deny a request of the debtor-in-possession’s special counsel to have its approved fees and expenses paid from the proceeds of a collateral sale pursuant to section 506(c) of the Bankruptcy Code. The Third Circuit agreed with the bankruptcy court that fees and costs of the debtor’s counsel are ordinarily only paid from the proceeds of a collateral sale, if such proceeds exceed the debt secured by such collateral. The Third Circuit also agreed with the bankruptcy court that the special counsel’s fees and expenses did not qualify for the exception to that rule under section 506(c), which allows certain fees and expenses to be charged to, and paid from, the collateral prior to repayment in full of the secured debt.

FACTUAL BACKGROUND

A law firm served as the special counsel to the underlying chapter 11 case, and in that role, the firm received an offer from a third party to purchase the debtors’ assets. When the parties failed to reach agreement, the case was converted to a chapter 7 case, and the law firm withdrew. Following the sale of the assets, the bankruptcy court approved payment to the law firm of fees and expenses of nearly $90,000. The firm argued that it was entitled to collect this payment from the proceeds of the collateral sale under section 506(c). The bankruptcy court denied the motion, the district court affirmed, and the firm appealed.

COURT ANALYSIS

Section 506(c) allows a claimant to “recover from property securing an allowed secured claim the reasonable, necessary costs and expenses of preserving, or

CONTINUED ON PAGE 11

Denying Summary Judgment, Court Holds that ORRI May Face Recharacterization as Debt—continued from page 5

Additionally, the payment terms raised a triable issue of fact; specifically, NGP's use of a notional rate of interest (14 percent) accruing on the unpaid balance of a primary sum due, and dictating the expiration of the Term ORRI. NGP designed a Term ORRI transaction that generated a specified rate of return, and that insulated it from the fluctuations in oil and gas production and pricing. This, the court held, was inconsistent with traditional ORRI transactions, which base repayment obligations on production. Consequently, these factors were inconsistent with the character and nature of a Term ORRI.

After determining that the NGP transaction was not wholly consistent with an ORRI transaction under Louisiana law, the court examined whether it was consistent with a secured or unsecured loan transaction under Louisiana law.

The court concluded it was not akin to a secured loan. NGP did not possess rights typically associated with a secured transaction. For example, NGP had no foreclosure rights, no preferential rights to proceeds, and no right to appoint a receiver; even with an appointed receiver, NGP would have no control over whether the subject properties were sold or operated, or how they were operated.

The court, however, found support from multiple sources to characterize the NGP transaction as an unsecured loan. Under Louisiana law, an unsecured loan creates an unconditional obligation to repay the loan regardless of fluctuation in currency. While the Term ORRI in the NGP transaction was calculated by reference to oil and gas production, and while there was no express guaranty by the debtor to pay royalties, a genuine issue of material fact nonetheless existed. The court ruled that where the risk of non-payment is minute and unlikely, it can create a loan transaction even though there is no absolute promise to pay under the agreement. Here, NGP's SEC filings stated there was very little risk of capital loss and that it regarded the Term ORRI as producing a "guaranteed 16% return." Such statements by NGP evidenced its belief that the likelihood of receiving its royalties plus interest was a certainty and not conditional.

The court ended its analysis by citing to Fifth Circuit case law deciding the tax treatment for an ORRI retained by a lessee after conveying its interests in an oil and gas lease to a third party for a sum certain, and an ORRI, plus interest. The Fifth Circuit rejected recharacterizing the transaction as a note obligation because the lessee did not take on any new risks that he had not borne as the owner of the leasehold interest. Accordingly, use of the interest rate was not calculated to reflect any "new" risk taken on by the lessee. This differs from a third party advancing money in exchange for repayment out of production. In that case, the interest rate used is directly tied to the new risk assumed by the third party in connection with payment of the ORRI and the oil and gas production.

In summary, the court found the following characteristics supported a loan transaction: (1) both parties treated the NGP transaction like a loan; (2) NGP represented the transaction as a loan to the public; (3) the economic substance of the transaction supported finding it was a loan because the risk of nonpayment was so low it effectively became the debtor's absolute promise to pay; and (4) NGP was a third party purchasing the ORRI and assumed a new risk in the transaction that was compensated by the notional rate of interest. With these findings, the court denied NGP's motion for summary judgment in favor of a trial on the ultimate characterization of the ORRI as either NGP's property interest or the debtor's loan obligation.

PRACTICAL CONSIDERATIONS

The difference between an absolute conveyance of a property interest and a mere obligation to pay on a loan, especially an unsecured loan, has tremendous implications in bankruptcy. If NGP held the ORRI as an absolute conveyance, the ORRI is no longer property of the estate. It is not subject to the automatic stay, NGP is free to accept and apply the ORRI as it sees fit, and the debtor has no ability or capacity to retain the ORRI to fund its estate, to assume, reject, or alter the agreements giving rise to the ORRI. As a secured loan, NGP could demand adequate protection payments and would have priority in repayment of the ORRI obligations, but the money otherwise funding the ORRI nonetheless would be useable by the debtor's estate, and NGP's rights, title, and interest in the ORRI would be bound up in the administration of the bankruptcy estate. As an unsecured loan, however, NGP has no right to adequate protection payments, and no priority right to repayment out of the lease proceeds ahead of unsecured creditors, and it could be subject to preference liabilities for payments it received within 90 days of the bankruptcy case. As the court notes, resolution of the character of an ORRI as an absolute conveyance or a loan turns on state law. In Louisiana, where a distinction is drawn between an ORRI retained by a lessee and an ORRI purchased by a third party, a third party may want to give due consideration and weigh the pros and cons of structuring the transaction as a secured transaction to ensure that, at a minimum, it protects its rights to adequate protection payments and a priority distribution, while mitigating its risk of preference liability for pre-petition payments.

Separate Judgments against Husband's and Wife's Guaranties of the Same Loan Cannot Be Consolidated—continued from page 8

filed a complaint and obtained judgment against Mrs. Rajaratnam, but not Mr. Rajaratnam, based on her obligations under their joint guaranty. The bank then moved to consolidate the two judgments so that it could execute against, and seek satisfaction from, marital property. The trial court denied the motion.

COURT ANALYSIS

On appeal, the Superior Court began its analysis by noting that no procedural rule exists in Pennsylvania that provides the relief sought by the bank, i.e., the consolidation of two or more judgments entered against different people in different proceedings. The Superior Court then concluded that even if such a procedural rule existed, it would be contrary to substantive Pennsylvania law.

Under Pennsylvania law, a husband and wife are treated as a distinct legal entity and own property as tenants by the entireties. While each has a right of survivorship, property owned by them jointly is property of the marriage. Thus, any disposition of marital property requires the joint act of both husband and wife – neither husband nor wife can dispose of marital property without the consent of the other. Similarly, a creditor of one member of the marriage but not the other is barred from seeking execution against marital property. To execute against marital property, a creditor must obtain a judgment against both husband and wife.

Based on these long-established legal principles, the Superior Court reasoned that a joint act was required to create a joint debt that may serve as the basis for judgment liens on marital property. Thus, the Superior Court held that two

CONTINUED ON PAGE 18

A NEW VALUE CHAPTER 11 PLAN REQUIRES A GENUINE MARKET TEST TO AVOID ABSOLUTE PRIORITY RULE VIOLATION

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In re NNN Parkway 400 26, LLC, et al., 505 B.R. 277 (Bankr. C.D. Cal. 2014)

CASE SNAPSHOT

The chapter 11 debtors' primary undersecured creditor objected to confirmation of the proposed reorganization plan and sought relief from the stay, arguing that: the plan violated the absolute priority rule; classes had been improperly gerrymandered; and the plan was not feasible. After a contested evidentiary hearing, the court refused to confirm the plan, holding that: a "new value earned" chapter 11 reorganization plan requires a genuine market test for the value of the equity; the creditor's deficiency claim could not be gerrymandered where the guarantor was insolvent; and the artificial impairment of a consenting class could not be the result of the abuse of conduct. Further, because the court concluded that the barriers to confirmation were formidable and unlikely to be resolved in the near future, the court granted the undersecured creditor's motion for relief from stay on the grounds that there was no reorganization in prospect.

FACTUAL BACKGROUND

The debtors, comprised of 31 affiliated limited liability companies, owned undivided tenancies in common in real property. The filing debtors owned approximately 86 percent of the ownership in the property, and there were at least four non-debtor tenants in common who owned the remaining 14 percent. In the jointly administered cases, the debtors' proposed plan of reorganization was opposed by the major creditor in the case – a lender owed approximately $27 million secured by first mortgage. Because the property was determined to be worth only $21 million, this creditor was unsecured in the amount of approximately $6 million. This creditor represented about 99.79 percent of all debt in the consolidated cases.

The lender objected to confirmation of the proposed plan, asserting that (1) the plan violated the absolute priority rule, (2) the plan improperly classified a class of creditors as a separate consenting impaired class, (3) the debtors failed to meet their burden of showing that they had a means of implementing the plan and that the plan was feasible, and (4) the lender was being improperly denied its right to credit bid.

COURT ANALYSIS

The debtors did not propose to pay the unsecured creditors in full, but proposed keeping their interests, thus raising objections under the absolute priority rule. The court looked to the U.S. Supreme Court's holding in *Bank of America Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle Street Partnership*. The Court there required a debtor to show a contribution of sufficient "new value" in order to comport with the absolute priority rule; the *LaSalle* Court explained that the new value must be "market tested" to determine its sufficiency and validity.

CONTINUED ON PAGE 13

Payment of Claimant's Fees Under Section 506(c) Only Made in Narrow Circumstances—continued from page 9

disposing of, such property to the extent of any benefit to the holder of such claim." In other words, section 506(c) is designed to allow a claimant who has expended funds to preserve or dispose of collateral to recover those funds from the secured creditor who directly benefitted from them, thus "preventing a windfall to the secured creditor at the expense of the claimant."

The Third Circuit has been clear that section 506(c) applies only under "sharply limited" circumstances, where (1) the expenditures are reasonable and necessary to the preservation or disposal of the property, and (2) the expenditures provide a direct benefit to the secured creditors. Thus, in determining whether the approved fees and expenses of the debtor's special counsel could qualify for special treatment under section 506(c), the Third Circuit focused on whether the fees and expenses were necessary and whether the special counsel had provided any direct benefit to the secured creditor.

The special counsel argued that it had "exposed" the collateral for sale, solicited prospective bids, and drafted purchase agreements during the debtor's chapter 11 bankruptcy case. The Third Circuit noted, however, that none of the special counsel's efforts resulted in an actual sale of the collateral during the chapter 11 bankruptcy case. Instead, the collateral was sold by a chapter 7 trustee after the debtor's bankruptcy case was converted and the special counsel ceased to be involved. Furthermore, the collateral was sold to a buyer who testified that its interest in the collateral did not arise from anything the special counsel had done. Based on those facts, the Third Circuit concluded that the special counsel's fees and expenses were not necessary to the sale of the collateral and did not provide any direct benefit to the secured creditor.

The Third Circuit further noted that the bankruptcy court had correctly concluded that the primary benefit of the special counsel's legal services was to the debtor and not to the secured creditor, specifically referencing the fact that many of the special counsel's services were actually contrary to the secured creditor's interests. Finally, the Third Circuit stated that the special counsel needed to show more than its limited cooperation in its initial efforts to effectuate a collateral sale to establish that the secured creditor consented to its fees and costs receiving special treatment under section 506(c).

PRACTICAL CONSIDERATIONS

The result in the case, and that the Third Circuit continues to limit the application of section 506(c) to "sharply limited" circumstances, is certainly reassuring for secured creditors. Nevertheless, secured creditors need to be mindful of the risks that section 506(c) poses to them in bankruptcy cases, especially where collateral sales are likely. Secured creditors should attempt to obtain waivers of the debtors' rights under section 506(c) early on, e.g., as part of any agreement on the debtor's use of cash collateral.

CONTINUING THE SPLIT, COURT RULES DEBTOR HAS NO POSSESSORY INTEREST IN WEB ADDRESS AND PHONE NUMBER

Melissa Mickey
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Alexandria Surveys, LLC v. Alexandria Consulting Group, LLC, Bankr. 13-CV-00891 (E.D. Va., Nov. 7, 2013)

CASE SNAPSHOT

The district court reversed the bankruptcy court decision and held that a debtor does not have a property interest in web addresses or telephone numbers. Even if the debtor had some possessory interests in the use of the telephone numbers or web address, the district court found that those interests were the product of executory contracts that were rejected by the trustee. As such, the district court held that these items could not be sold as part of the bankruptcy estate.

FACTUAL BACKGROUND

Debtor Alexandria Surveys International LLC filed a chapter 11 petition March 3, 2010. The case converted to a chapter 7 January 27, 2012, and eventually closed. After the case closed, a new company started by the debtor's principals, Alexandria Survey LLC, acquired the telephone numbers and web address of the debtor. One month later, a third party, Alexandria Consulting Group, LLC, filed a motion to reopen the case and offered to buy from the chapter 7 trustee certain of the debtor's personal property remaining in the bankruptcy estate that was not scheduled (specifically, the debtor's customer lists, files, web page, and telephone and fax numbers). The motion was opposed by the debtor, but the bankruptcy court issued an order reopening the case. Alexandria Survey LLC was not a party to that proceeding.

The chapter 7 trustee provided notice of the upcoming sale of assets to which Alexandria Survey LLC objected, claiming that the assets at issue became abandoned when the case closed. The trustee conducted the auction and Alexandria Consulting Group LLC successfully purchased the assets. The bankruptcy court granted the trustee's motion for turnover of the assets over Alexandria Survey LLC's objection. The bankruptcy court found that the debtor's physical files and computers were listed in the debtor's schedules and were therefore abandoned when the case was closed, but survey and title files, server and its digital files, web address and telephone numbers, were not listed in the debtor's schedules and therefore were not abandoned, and could be sold as part of the bankruptcy estate. Alexandria Survey LLC appealed.

COURT ANALYSIS

On appeal, Alexandria Survey LLC argued that (1) Alexandria Consulting Group LLC was not an "interested party" and therefore had no standing to move to reopen the debtor's estate; (2) the web addresses and telephone numbers sold to Alexandria Consulting Group LLC at auction were not the debtor's property and therefore could not be property sold as part of the bankruptcy estate; and (3) the servers were listed on the debtor's Schedule B and were included under "computers."

Under section 350(b), the court explained, the bankruptcy court may reopen a case "to administer assets, to accord relief to the debtor, or for other cause." Federal Rule of Bankruptcy Procedure 5010 permits a case to be reopened "on motion of the debtor or other party in interest." Under section 1109(b), "party in interest" is defined as "the debtor, the trustee, a creditors' committee, an equity security holders' committee, a creditor, an equity security holder, or any indenture trustee." The court found that because Alexandria Consulting Group LLC did not fit within any of these categories, it was not an "interested party" within the meaning of section 350(b). Thus, Alexandria Consulting Group LLC was without standing to reopen the debtor's bankruptcy case, and any sale of the debtor's assets to Alexandria Consulting Group LLC was void.

Although the district court found that the sale of the debtor's assets to Alexandria Consulting Group LLC was invalid because Alexandria Consulting Group LLC lacked standing to reopen the estate, the court found it necessary to rule on the status of the web address, telephone numbers and servers in the event that the bankruptcy estate was validly reopened in the future. Noting that there is a split of authority among the circuits as to whether telephone numbers and web addresses are considered property of the estate, the district court found that the Fourth Circuit has not specifically addressed the issue. The district court explained that the contours of the property interests assumed by the trustee are determined by state law. Looking to Virginia law, the district court relied on the recent Virginia Supreme Court case, *Network Solutions, Inc. v. Umbro International, Inc.*, which held that a web address and telephone number could not be garnished by a judgment creditor because the debtor lacked a property interest in these items. In the absence of controlling Fourth Circuit precedent, the district court followed *Network Solutions* and concluded that Virginia does not recognize an ownership interest in telephone numbers and web addresses. Since neither was property of the debtor's bankruptcy estate, the district court found that neither was subject to sale by the trustee.

Even if the debtor did have a property interest in the use of the telephone numbers and web address, the court found that these interests were the product of executory contracts that were rejected by the trustee before the estate was reopened. Therefore, any possible property interest in the telephone numbers and web address was abandoned when the trustee failed to assume the service contracts, and could not be sold as part of the debtor's estate.

Finally, with respect to the debtor's servers, the court determined that the servers were included among the "computers" listed in Schedule B. The court found that the servers were desktop computers used in that capacity, and further found no basis for distinguishing between computers used as traditional desktops and computers used as servers when Schedule B listed "computers" broadly. As such, the servers were abandoned and were no longer property of the debtor's estate.

Based on the foregoing, the district court ruled in favor of Alexandria Surveys LLC on each of the three issues raised on appeal and reversed the bankruptcy court's decision.

PRACTICAL CONSIDERATIONS

Although the Eastern District of Virginia held that a debtor does not have a property interest in web addresses or telephone numbers, the district court's decision is at odds with courts in other jurisdictions that have held that subscribers have a property interest in these items. Given the split in authority, potential purchasers should seek the advice of bankruptcy counsel when negotiating an asset purchase agreement that includes a debtor's web address or telephone numbers.

The *NNN* court noted that *LaSalle* was "frustratingly vague" as to what exactly a debtor must do to "market test" the interest at issue. The debtors argued that they effectively met the *LaSalle* suggestion of an ability to file a competing plan as a means of "market testing" because, at least as to the lead debtor, the exclusivity period of section 1121(b) had lapsed. Essentially, the debtors argued that the lender could have filed a competing plan. This argument was not persuasive because the exclusivity period as to several other of the debtors had not passed when the plan was filed (which triggered the further period found at section 1121(c)(3)), and any meaningful reorganization of these interests would require that they all be addressed.

The debtor also attempted to show that their private marketing efforts had constituted a de facto "market test" since they tried to reach out to investors to purchase equity. The court emphatically rejected that argument. The court explained that what constitutes a threshold "market test" must be evaluated on a case-by-case basis. The court noted that "[n]o conduct log was kept .. [n]o advertisements of any kind were undertaken….whether in commercial real estate, investor debt or even magazines or otherwise." The court stated, "This court does not hold that in every case an investment banker must be hired, whose fee is tied to finding the most money on the best terms. But engagement of such a person with that goal and motivation would help. The court does not hold that advertisements in targeted local and national newspapers are also required or that they would even be appropriate in every case. But the court does hold that debtors bear the burden of showing that the new money offered is the most and best reasonably attainable after some "market test" in order to cram down over the objections of a non-consenting class of unsecured creditors. This probably requires, at a minimum, a demonstration of a systematic effort designed to "market test" the deal." The court rejected the debtors' arguments and found that the debtors failed to show that the *LaSalle* requirements of the absolute priority rule were satisfied.

The debtors classified the $6 million unsecured deficiency claim separately from another class of unsecured creditors, which held a total of $43,307 of general unsecured claims. The smaller class was the sole consenting impaired class. The court rejected this proposed classification as improper gerrymandering. In making this decision, the court noted that such a classification would only stand if the debtors could "articulate a reasonable business justification for the separate classification not involving gerrymandering of the vote." The only business justification offered by the debtors was that there existed a guaranty of the undersecured lender's claim.

While the court noted that a guaranty has been held by the 9th Circuit B.A.P. to be grounds for separate classification, the court cited with approval *In re South Loop 2656*, for the proposition that the bare existence of a guaranty by itself cannot be determinative unless there is also a showing that the guarantors "are solvent in a meaningful way." Here, the court concluded that the guaranty did not provide a meaningful recovery source, and thus rejected the attempt to separately classify the claims as the debtors had proposed.

The court also summarily rejected an attempt by the debtors to rely on a separate claim of less than $10,000 for loans secured by a truck as an improper attempt at "artificial impairment," which the court explained was "a form of gerrymandering [which] when abusively used is held to be antithetical to the good faith which must be at the center of any reorganization effort."

Turning to the debtors' attempt to show the means of implementation under section 1123(a)(5), the court asked, "Is this plan even possible?" The factual findings called into serious question the ability to reorganize because the debtors held only 86 percent of the tenants in common ownership interest of the property. In rejecting the debtors' argument, the court agreed "with the lender that this summary approach, without the non-debtor [tenants in common] even before the court, may well amount to an unconstitutional taking of property without due process, and may also amount to adjudication over non-estate property for which this court's jurisdiction is at least questionable in a post-*Stern v. Marshall* world."

The court further noted that, even if it assumed jurisdiction, it was not inclined to extinguish the rights of a non-consenting, non-debtor entity over non-estate property for no consideration absent a declaratory judgment action filed as an adversarial proceeding.

PRACTICAL CONSIDERATIONS

This opinion is significant because it casts a common sense view on the otherwise murky jurisprudence surrounding the cram-down process. For example, the court required genuine efforts by the debtors to "market test" the new value plan, and the court even spelled out the kind of investor outreach program that must be undertaken to demonstrate this "market test." In addition, the court's holding that a guaranty provide a meaningful recovery source as a requirement to justify separate classifications adds a practical analytical framework for gerrymandering allegations. Finally, the court's emphatic rejection of the artificial impairment is likely to be cited as authority for parties claiming that a debtor improperly created an impaired consenting class, and thus the separate classification should be rejected as improper gerrymandering.

CHAPTER 11 DEBTOR MAY NOT USE OR ALLOCATE RENTS TO BIFURCATE CREDITOR'S CLAIM

Chrystal Puleo
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In re Surma, Case No. 11-37991 (MBK), (Bankr. D.N.J., Feb. 4, 2014)

CASE SNAPSHOT

In an individual chapter 11 case, the United States Bankruptcy Court for the District of New Jersey held that a debtor may not use or allocate rents that are subject to a pre-petition absolute assignment of rents to a mortgagee against only the secured portion of a bifurcated claim in a proposed plan of reorganization, and denied approval of the debtors' disclosure statement because the proposed plan was unconfirmable on its face.

FACTUAL BACKGROUND

The debtor, Surma, owned a multifamily home encumbered by two mortgages held by SunTrust Mortgage Inc. The original mortgage was in the amount of $375,200, and a second mortgage was in the amount of $93,800. The property had a fair market value of approximately $250,000. In addition to the two mortgages, the debtor executed an absolute and unconditional assignment of rents in favor of SunTrust prior to the bankruptcy petition, and prior to any default under the mortgages. The debtor resided in one of the three separate apartments in the property and rented out the other units. The debtor also derived income from his full-time employment as an electrician, where he earned approximately $52,000 per year.

The case originated as a chapter 13 case and was converted to a chapter 11 case after the court entered an order enforcing SunTrust's assignment of rents and denying the debtor's chapter 13 plan. In chapter 11, the debtor filed a plan and disclosure statement, proposing, among other things, to bifurcate SunTrust's secured claim. The debtor also proposed cramming down SunTrust's secured claim to the fair market value of the property, and applying the rents from the property to satisfy the secured portion. The debtor's proposed plan would leave SunTrust with a general unsecured claim for any deficiency under the mortgages. SunTrust objected to the debtor's proposed use of the property's rents under the plan, arguing that it retained the right to apply the rents against both secured and unsecured claims pursuant to the assignment of rents.

COURT ANALYSIS

In analyzing both the debtor's chapter 11 plan and the disclosure statement, the bankruptcy court relied heavily on the Third Circuit case *In re Jason Realty LP*, 59 F.3d 423 (3d Cir. 1995), where the court held that under New Jersey law, an absolute assignment of rents, as part of commercial mortgage financing, is an additional security for repayment of the note that transfers to the assignee upon execution. Therefore, the court in *Jason Realty* found that the debtor no longer retained an interest in the rents subject to assignment, such that the rents were property of the debtor's estate, and accordingly, the debtor could not utilize the rents to satisfy its reorganization plan. Under *Jason Realty*, assigned rents are "unavailable for use, allocation, or utilization in any plan."

The debtor argued that *Jason Realty* should not apply, as he was not "utilizing" the assigned rents in his proposed plan or reorganization. However, the bankruptcy court dismissed the debtor's claim, finding that by bifurcating SunTrust's secured and unsecured claim, the debtor was coercing SunTrust into allocating the rents to the secured portion of its claim in contradiction to its economic interests. The bankruptcy court held that to allow a plan to allocate the rents in a way that would limit SunTrust from using them to satisfy the unsecured portion of the claim would contravene the purpose of using the assignment of rents as independent collateral.

In relying on *Jason Realty*, the bankruptcy court distinguished *In re Parks*, 2012 WL 6061670 (Bankr. D.N.J. Dec. 6, 2012), which considered this issue in the context of a chapter 13 proceeding and held, in favor of the debtor, that section 506(d) required that both a mortgage lien and an assignment of rents should be avoided when the interests are not supported by the value of the collateral. The bankruptcy court concluded that section 506(d) did not govern the resolution of the issue in the case, and did not override the application of New Jersey law under *Jason Realty* because section 506(d) only applied when the underlying claim was disallowed, whereas the claim in this case was an allowed claim, secured by real estate.

The bankruptcy court was also persuaded by the Third Circuit's decision in *First Fidelity Bank v. McAteer*, 985 F.2d 114 (3d Cir. 1993), in which the court determined that the creditor was the primary beneficiary under the debtor's life insurance policy, and thus, because the creditor's rights were unalterable under the plan, the debtor's estate could not collect the proceeds of the plan in excess of the allowed secured claim. Comparing the facts, the bankruptcy court held that similar to a secured party's absolute right to life insurance proceeds, here SunTrust had acquired an absolute right to the property's rents to satisfy its secured debt.

PRACTICAL CONSIDERATIONS

Secured creditors should contest efforts by a debtor who has absolutely assigned rents to a claim to use, allocate, or utilize the rents as part of its chapter 11 plan of reorganization. Rents assigned to a mortgagee pre-petition are not property of the estate and cannot be used to fund a chapter 11 plan of reorganization. As long as the creditor's claim is secured, any effort to allocate the rents in a way that disadvantages the creditor's economic interests negates the purpose of assigning rents as separate collateral.

COURT ANALYZES WHETHER HOTEL REVENUES ARE AN INTEREST IN REAL OR PERSONAL PROPERTY

Chrystal Puleo
Associate, New York

In re Hari Ram, Inc., Case No. 1:13-bk-06524MDF (Bankr. M.D. Pa., March 5, 2014)

CASE SNAPSHOT

In a chapter 11 case, the United States Bankruptcy Court for the Middle District of Pennsylvania denied a debtor hotel operator's motion to use the secured creditor's cash collateral. The court held that the creditor failed to take the steps required to terminate the debtor's interest in the hotel revenues pre-petition, and that therefore, the revenues remained property of the estate at the time the debtor filed its petition. However, regardless of whether revenues from a debtor hotel operator are considered property of the bankruptcy estate, the revenues constituted the secured creditor's cash collateral, and the debtor did not sustain its burden of demonstrating that it could adequately protect the creditor from suffering a loss in the value of its interest in the collateral while the debtor reorganized.

FACTUAL BACKGROUND

The debtor, Hari Ram, Inc., was the owner and operator of two hotels located in Mechanicsburg and Enola, Pennsylvania. Magnolia Portfolio, LCC held a mortgage on the Mechanicsburg hotel, an assignment of rent from the property, and a security interest in various personal property of the debtor, including accounts receivable, rents, and "payments." The security interest in the personal property was perfected by the filing of a UCC statement. Under the assignment of rents, "Rents" was defined as "all rents, revenues, income, issues, profits, and proceeds," from the hotel in Mechanicsburg. Additionally, Magnolia held two mortgages executed with the non-debtor Gurugovind, LLC, which were also secured by the Mechanicsburg hotel and assignments of rent from the property. The mortgages were cross-collateralized, and upon default on one of the loans to Gurugovind, Magnolia attempted to collect proceeds generated by the Mechanicsburg hotel. In response, the debtor filed a voluntary bankruptcy petition under chapter 11, where it sought to use the Mechanicsburg hotel's revenues and provide Magnolia with a replacement lien on future receipts as adequate protection. The debtor argued that the Mechanicsburg hotel revenues were not an interest in real property so that they belonged to the secured creditor, Magnolia, but were instead personal property that became property of the estate after the bankruptcy filing.

COURT ANALYSIS

The bankruptcy court highlighted the split of authority between the Third Circuit and the Pennsylvania Supreme Court as to whether to characterize the assignment of rents as an interest in real or personal property. The court looked to the Third Circuit's holding in *Commerce Bank v. Mountain View Village, Inc.*, 5 F.3d 34 (3d Cir. 1993), that Pennsylvania law reflects the title theory of mortgages, and opinions of Pennsylvania state courts, which adopt an intermediate view defining a mortgage as both a conveyance and a grant of security interest. Finding that the specific issue in this case was a matter of first impression, the court looked to other jurisdictions in order to determine whether the assignee of an assignment of hotel revenues may curtail the assignor's rights by declaring a default and demanding direct payment of revenues. After considering both the majority position – that hotel revenues are personal property because hotel guests have a more limited property interest – and the minority position adopted by the Fifth and Ninth Circuits – that room revenues should be considered an interest in real property in order to best preserve the parties' intention to create a security interest in the revenues – the court was persuaded by *dicta* in *In re W. Chestnut Realty of Haverford, Inc.*, 166 B.R. 53 (Bankr. E.D. Pa. 1993), aff'd, 173 B.R. 322 (E.D. Pa. 1994). The *Chestnut Realty* court held that hotel revenues are not rents because of the different status of a tenant and a licensee under Pennsylvania law: a tenant is given the right to possess and use the landlord's premises in subordination of the landlord's title in consideration of the payment of rent, while the rights of a licensee are more limited to a general authority to do a particular act upon another's land without any possession rights. The bankruptcy court determined, however, that it was not necessary to clarify whether hotel revenues were personal property because Magnolia did not establish that it properly terminated the debtor's interest in the hotel revenues pre-petition by either taking possession of the hotel or notifying the hotel's tenants to direct rents to Magnolia. Therefore, the bankruptcy court held that the revenues were property of the estate at the time of the debtor's chapter 11 petition.

The bankruptcy court then turned to the question of whether Magnolia, as a secured creditor, was adequately protected for its interest in the Mechanicsburg hotel revenues. Pursuant to the terms of the security agreement, Magnolia retained a security interest in the Mechanicsburg hotel revenues as personal property of the debtor. The bankruptcy court found that unlike other forms of cash collateral, a pre-petition security interest in hotel room revenues continues to attach to post-petition revenues under section 552(b)(2) of the Bankruptcy Code. Under these circumstances, the offer of a replacement lien on the post-petition rents is meaningless because the creditor already has a lien on these assets. Although the debtor predicted that the Mechanicsburg hotel's operations would soon be profitable, that was not enough to provide adequate protection to Magnolia. Furthermore, the debtor's projections did not include the payments due under all of the mortgages, and were therefore not sufficient to protect Magnolia's secured interest. The debtor failed to sustain its burden to prove that it was able to safeguard the secured creditor from the diminution in the value of its interest in the collateral while the debtor attempted to reorganize.

PRACTICAL CONSIDERATIONS

A debtor could not cut off the rights of a secured creditor in hotel room revenues that were property of the estate. Regardless of the split of authority on how to characterize revenues, debtors that request cash collateral have a difficult burden to prove that they can protect the secured interest, even if the revenues are characterized as personal property.

COURT UPHOLDS INSIDER RELEASES BECAUSE OF SUBSTANTIAL CONTRIBUTIONS OF NEW VALUE

Lauren Zabel
Associate, Philadelphia

In re 710 Long Ridge Road Operating Company, II, LLC., et al., Case No.: 13-13653 (DHS) (Bankr. D.N.J., March 5, 2014))

CASE SNAPSHOT

The NLRB opposed the nursing home debtors' plan that contained third-party releases of certain non-debtors who were potentially liable under the NLRA, and who were making substantial new value contributions. The objecting parties also objected on the basis that the plan unfairly discriminated between classes of similarly situated creditors. The court found that certain of the third-party releases were permissible under the circumstances, whereas others were not, and that the best interest of creditors test was satisfied. Subject to adjustment of the third-party releases, the plan was confirmed.

FACTUAL BACKGROUND

The plan proposed by the debtor sought to group its unsecured creditors into two separate classes: those classified as "ongoing trade vendors" and those that were not. The plan was to be funded in substantial part by contributions of certain insiders of the debtor. Other insiders of the debtor agreed to waive large claims against the estate. The plan also included third-party releases of certain insiders of the debtor.

COURT ANALYSIS

As to the objection to the inclusion of third-party releases, the court determined that the appropriate standard under which to evaluate the permissibility of non-consensual third-party releases in the Third Circuit is whether the releases are fair, necessary for reorganization and supported by specific factual findings. To implement that standard, the court determined that two factors are determinative, namely, that the success of the debtor's reorganization bears a relationship to the release of the non-consensual parties, and that, in exchange for the release given, the releasees have provided a critical financial contribution to the debtor's plan that is necessary to make the plan feasible. Through that lens, the court found that under the "extraordinary circumstances" of the case, third-party releases were appropriate for the insiders who were directly contributing cash or waiving large claims. The court found, however, that third-party releases were inappropriate for more remote insiders (i.e., individual managers, directors and employees) who were not directly funding the plan. The court rejected the argument that those insiders' "contribution to an open dialogue" was cognizable new value.

As to the second objection, the objecting parties contended that the plan unfairly discriminated between the classes of unsecured creditors. In assessing this objection, the court approved disparate treatment between a trade creditor class and a class containing union claims. The court found that the trade creditor class had agreed to improved credit terms that benefited the debtors. The court also found that the disparate treatment was proposed in good faith.

Subject to adjustment of the third-party releases, the plan was confirmed.

PRACTICAL CONSIDERATIONS

This decision reiterates the fact that non-consensual third-party releases are only granted in extraordinary circumstances, and the court is likely to look to whether such a release is absolutely essential to confirmation, and whether the releasee provides substantial value to the estate in exchange for the release.

COURT DENIES CONFIRMATION BECAUSE OF FAILURE TO OBTAIN INFORMED CONSENT OF THIRD-PARTY RELEASES

Lauren Zabel
Associate, Philadelphia

In re Neogenix Oncology, Inc., Case No. 12-23557-TJC (Bankr. D. Md., March 11, 2014)

CASE SNAPSHOT

The debtor, with the support of the official committee of equity security holders, sought confirmation of a liquidating chapter 11 plan. The United States Trustee objected to confirmation on the basis that (1) the section 1129(a)(10) requirement that, if the plan impairs any class of creditors, at least one impaired class must accept the plan without counting the votes of insiders, was not met, and (2) the plan impermissibly contained a third-party release. The court overruled the trustee's first objection to confirmation, finding that the plan satisfied section 1129(a)(10). The court, however, upheld the trustee's second objection, finding that the third-party release provisions could not be approved. Thus, the court denied confirmation. The court applied the *Dow Corning* factors in making its decision.

FACTUAL BACKGROUND

The debtor proposed a plan consisting of six classes, only two of which were impaired. The first impaired class, Class 3, consisted of 13 current and former directors of the debtor who held indisputably valid indemnification claims against the bankruptcy claim. The second impaired class, Class 5, consisted of those holding interests in the debtor in the form of the debtor's common stock. The plan contemplated that the members of Class 3 would give up their indemnification rights in exchange for a release by Class 5 members. Class 3 was the only class of impaired claims entitled to vote on the plan, and voted unanimously to accept the plan.

COURT ANALYSIS

The trustee objected first on the basis that section 1129(a)(10) was not satisfied because all of the members of Class 3 were insiders of the debtor and, therefore, no impaired class had voted in favor of the plan. The court concluded that the relevant time for determining insider status is the time that voting occurs or, at the earliest, at the time the plan is proposed. Four members of Class 3 were

CONTINUED ON PAGE 18

SETTLEMENT PAYMENT CONSTITUTES ANTECEDENT DEBT IN PREFERENCE ACTION

Jeanne Lofgren
Associate, Pittsburgh

In re Metal Foundations, LLC, Case No. 13-02337-JAD (Bankr. W.D. Pa., Jan. 21, 2014)

CASE SNAPSHOT

A settlement agreement arising out of a pre-petition lawsuit between Metal Foundations and Stirling Energy had been executed following the bankruptcy filing of Metal Foundations. Stirling paid Metal Foundations $43,750 in accordance with the settlement agreement, and shortly thereafter filed its own bankruptcy petition. The Stirling bankruptcy trustee sought to recover the payment as a preferential transfer. Metal Foundations filed a motion to dismiss, arguing that the payment was not a preferential transfer because it was not based on antecedent debt, and/or it was a contemporaneous exchange for new value.

In denying the motion to dismiss, the court found that Stirling's allegations of antecedent debt were sufficiently plausible. The court found that Stirling did not receive new value in exchange for the payment because the settlement agreement plainly stated that Stirling had the right to engage in the activities that had been the subject of the pre-petition lawsuit. Therefore, Stirling could not receive value for something that it already possessed.

FACTUAL BACKGROUND

The parties had a pre-petition business relationship. Stirling was in the business of designing and developing solar power solutions for utility-scale renewable energy power plants. Metal Foundations, LLC designed and developed metal foundations usable in the solar industry. Before its bankruptcy filing, Metal Foundations filed a complaint against Stirling alleging, among other things, breach of contract, fraud, violation of Pennsylvania's Uniform Trade Secrets Act, and unfair competition. About six months later, Metal Foundations filed its chapter 11 bankruptcy case and a chapter 11 trustee was appointed. The parties settled the litigation and the court approved the settlement in August 2011. In January 2012, Metal Foundations' chapter 11 case was converted to a chapter 7 case.

According to the settlement agreement, Stirling paid Metal Foundations $43,750, which was deposited by Metal Foundations September 2, 2011. In exchange, Stirling received a release of all claims, no admission of liability, and an express provision acknowledging, among other things, Stirling's unrestricted right to make, purchase, use, install and sell metal foundations for solar dishes.

Later that month, Stirling filed its own chapter 7 bankruptcy petition in Delaware. The Stirling chapter 7 trustee filed an adversary action against the Metal Foundations chapter 7 estate seeking recovery of the $43,750 as a preferential payment. The Metal Foundations chapter 7 trustee filed a motion to dismiss the adversary action for failure to state a claim upon which relief could be granted.

COURT ANALYSIS

The court began by listing the elements of a preference action: a transfer of the debtor's interest in property; to or for the benefit of a creditor; on account of an antecedent debt; made while the debtor was insolvent; within 90 days of the bankruptcy filing; and allowing the creditor to receive more than it would in a chapter 7 liquidation. The court noted that a defense to preference liability exists if the transfer is made in exchange for contemporaneous new value.

Metal Foundations argued that the settlement payment was not on account of antecedent debt and was given in exchange for new value. The Metal Foundations trustee relied upon a Third Circuit Court of Appeals ruling, *Lewis v. Diethorn*, 893 F.2d 648 (3d Cir. 1990), where a home builder and prospective home owner settled their claims that required the home builder to pay a sum certain to the home owner, and required the home owner to terminate the lawsuit and remove a *lis pendens* clouding title to the subject property. The home builder then filed bankruptcy. In denying the home builder bankruptcy estate's request for recovery of the settlement payment as a preferential transfer, the Third Circuit Court of Appeals held that all elements giving rise to a preference claim had not been satisfied. Specifically, there was no antecedent debt. Additionally, the exchange of the settlement payment for negating the litigation risk and increasing the value of the property by clearing title would be a defense to any preference liability because it constituted a contemporaneous exchange of new value.

After noting that the Third Circuit ruling had been oft-criticized and not widely followed, the bankruptcy court distinguished the *Lewis* case from the one before it. Utilizing the broad definition of "debt" in the Bankruptcy Code that covers any liability, contingent or not, that accrues prior to the bankruptcy filing, the court held that Stirling sufficiently alleged its settlement payment was on account of an antecedent debt. Additionally, when viewing the facts in the light most favorable to Stirling, it was not clear to the court that Stirling did not already possess the proprietary information that Metal Foundations claimed had been unlawfully acquired by Stirling. Consequently, the grant in the settlement agreement of Stirling's unfettered right to manufacture, use or sell the metal foundations for solar dishes would not have provided any new value to Stirling. As such, the only new value Stirling received would be the freedom from risk of litigation, and that was insufficient for granting Metal Foundations' motion to dismiss.

PRACTICAL CONSIDERATIONS

Entering into a settlement agreement with a counterparty that is financially at risk of bankruptcy requires careful crafting to mitigate preference liability. Where unencumbered property is not available, not practical, or lacks value to secure a claim, structuring the settlement such that value to the at-risk counterparty is contemporaneous and exceeds merely resolving litigation uncertainties can provide a defense to preference liability in the Third Circuit.

Court Denies Confirmation Because of Failure to Obtain Informed Consent of Third-Party Releases—continued from page 16

no longer directors at the time the plan was proposed and, therefore, the court determined that they were not insiders of the debtor, despite the fact that their claims arose solely by virtue of their former positions as directors. The court next considered whether those four former directors had a relationship so close to the debtor as to warrant careful scrutiny, and concluded that two directors did not. Because Class 3 contained two non-insiders, each of which voted in favor of the plan, the court overruled the trustee's first objection.

The second objection was made on the basis that the release of the Class 3 members by the Class 5 members was impermissible. The court analyzed the release provisions in light of the six-factor balancing test set forth by the Sixth Circuit in *Dow Corning*, and concluded that, although three factors weighed in favor of approval, the total balance of the factors weighed against approval of the third-party releases. The court acknowledged that it could nevertheless approve such a provision if the impacted party consented, but found that Class 5 did not give informed consent to the plan. Accordingly, the court determined the Class 3 release to be impermissible and sustained the objection. Because the Class 3 members would not have voted in favor of the plan absent inclusion of the release, the court denied confirmation.

PRACTICAL CONSIDERATIONS

When crafting a chapter 11 plan, it is important to keep in mind that "insider" status is likely to be measured from the time that the plan is proposed or voted upon, rather than at the time the claims of those class members arose. Additionally, this decision reiterates the stringent lens through which third-party releases are viewed. Unless the impacted party consents to inclusion, or unless removal of the release provision will not impact the confirmability of the plan, inclusion of a third-party release could lead to an expensive, time-consuming and unsuccessful journey down the confirmation path.

Separate Judgments against Husband's and Wife's Guaranties of the Same Loan Cannot Be Consolidated—continued from page 10

spouses must act together in the same transaction to incur a joint liability. In the present case, the bank obtained the separate judgments against the Rajaratnams pursuant to separate documents, in separate transactions, and for separate considerations.

The bank argued that although it had two separate judgments based on liability under two different agreements, the requisite "joint act" was nevertheless satisfied because both husband and wife had signed the later joint guaranty and thus agreed to be jointly liable for the loan. The Superior Court disagreed. The Superior Court concluded that Mr. Rajaratnam's liability under the later joint guaranty had never been judicially determined because suit had never been filed against him on that guaranty. Thus, it could not be assumed that he had any liability under that guaranty.

The Superior Court then noted that the bank could have sued both husband and wife under the later joint guaranty, but either chose not to or failed to. The Superior Court concluded that such decision or failure "doomed" any future attempt to execute against marital property.

PRACTICAL CONSIDERATIONS

Based on this case, it is clear that a lender should obtain a joint guaranty from a husband and wife whenever recovery against marital property is important, even where an individual guaranty already exists from one of them. Obtaining individual guaranties at separate times or under separate documents will likely not be sufficient to seek recourse against marital property.

COUNSEL'S CORNER: NEWS FROM REED SMITH

Peter Clark was named to the United States Lawyer Rankings 2014 List of the Nation's Top 10 Bankruptcy Lawyers.

Amy Tonti presented a webinar entitled, "Legacy Liabilities: Related Restructuring and Bankruptcy Issues" May 13.

Michael Venditto and **Sarah Kam** presented, "What Every Transactional Attorney Needs to Know About Bankruptcy" at Reed Smith University May 13.

Eric Schaffer and **Sarah Kam** presented "What Every Litigator Needs to Know About Bankruptcy" at Reed Smith University March 31.

Anker Sorensen published the following: "The 'Florange Law' Deprived of its Main Significance by the French *Conseil Constitutionnel* in its Decision of 27 March 2014," in *International Corporate Rescue*; "Bankruptcy and Financial Restructuring Law Issues in France," a chapter in *Bankruptcy and Financial Restructuring Law 2014*; and, "SA Rhodia v SA Sanofi: Maternity Obligations do not Extend to Funding the Offspring in Spin-offs," in *International Corporate Rescue*.

Derek Baker has made several presentations to lenders concerning "Issues and Recent Trends In Bankruptcy Impacting Secured Lenders." The presentations focused on positioning a secured lender's rights pre-bankruptcy, outlining bankruptcy and bankruptcy alternatives, highlighting recent issues in bankruptcy cases affecting secured lenders, and introducing strategies to assist secured lenders in addressing these new trends.

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