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CR&B Alert

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LENDERS BEWARE


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A new troubling case from California allows borrowers to present evidence of prior oral statements of a lender which contradict the terms of the written agreement between the parties with a standard integration clause. Marsha Houston of our Los Angeles office writes more about the case below.

On January 14 2013, the California Supreme Court overturned a rule that lenders and parties to contracts have long relied upon to prohibit the admission of parol evidence of terms outside the four corners of the agreement. In *Riverisland Cold Storage, Inc. v. Fresno-Madera Production Credit Association*, No. S190518, 2013 Cal. LEXIS 253 (Cal. Jan. 14, 2013), Riverisland Cold Storage (and related borrowers and guarantors) defaulted on a loan provided by Fresno-Madera PCA in 2007. On March 26 2007, the parties entered into a written forbearance agreement with a standard integration clause that provided that the lender would forbear from collection efforts until July 1 2007 in exchange for the borrowers' pledge of eight parcels of additional real estate to secure the loan. Thereafter, the borrowers defaulted under the forbearance agreement and the lender began foreclosure proceedings. Although the borrowers repaid the loan in full and the foreclosure proceedings were dismissed, the borrowers and guarantors filed suit against the lender, seeking damages for fraud and negligent misrepresentation, and including causes of action for rescission and reformation of the forbearance agreement.

Plaintiffs alleged that they met with the lender's senior vice-president, who represented to them that the lender would forbear from collection for two years and would require the pledge of only two parcels of real estate in connection with the forbearance agreement. Plaintiffs acknowledged that they signed the agreement (and presumably eight separate deeds of trust), and claimed that they did not read it, relying instead upon the representations of the lender's representative.

The lender successfully moved for summary judgment, alleging that the plaintiffs' claims were barred by the parol evidence rule from presenting evidence of prior oral agreements which contradicted the terms of the written agreement. Plaintiffs asserted that this was consistent with the 70-year-old decision of the California Supreme Court in *Pendergrass*, which held that a "fraud exception" to the parol evidence rule could not be asserted to prove a fraudulent oral promise that directly contradicted the written terms of the agreement. Plaintiffs won on appeal when the California Court of Appeals held that the fraud at issue was a misrepresentation of fact, not a fraudulent promise (a distinction recognized in *Pendergrass* and its progeny).

The California Supreme Court affirmed the Appellate Court and overturned its own decision in *Pendergrass*, finding that the decision was confusing, difficult to apply and did not account for the principle that fraud undermines the very validity of the parties' agreement and that when fraud is proven, it cannot be held that the parties had a meeting of the minds.

For decades, lenders have relied upon *Pendergrass* and integration clauses in agreements to protect them against claims by borrowers of fraudulent misrepresentations by loan officers. Apparently, lenders and contracting parties will no longer be able to rely upon this defense in California. While one cannot prevent a party from asserting fraudulent misrepresentation, and it is not clear exactly what precautions might convince the courts to exclude parol evidence, we recommend: insisting that borrowers and guarantors have counsel review the documents; providing a separate document acknowledging that borrowers and guarantors were represented by counsel and that each of them and counsel have read and understood the terms of the loan documents which are named and providing at least the salient terms of any restructure in the separate document; insisting upon a pre-negotiation agreement; providing sufficient time for the borrowers and guarantors to review the documents; and, stating such in the documents.

INTERNATIONAL INSOLVENCY LAWS: WILL ONE SIZE FIT ALL? THE DEBATE CONTINUES


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A recent Isle of Man case, *Interdevelco Limited v. Waste2energy Group Holdings plc*, demonstrates that the debate around how courts should approach international insolvency legislation rages on. The decision emphasised the importance of the principle of universality, the concept that there should be one insolvency proceeding under which all creditors' claims can be collectively assessed and administered. This approach contrasts with that taken by the Supreme Court of England and Wales in the two recent cases of *Rubin v. Eurofinance SA* and *New Cap Reinsurance Corporation v. AE Grant*, where the Supreme Court of England and Wales held that international insolvency laws would not pre-empt or supersede any substantial aspect of English law.

In the cases of *Rubin* and *New Cap*, the Supreme Court of England and Wales examined the framework of the UNCITRAL Model Law on Cross-Border Insolvency (the "Model Law"), which was designed to assist adopting states with effectively addressing cross-border insolvencies through a "modern, harmonized and fair framework." Both cases examined how the Model Law applied and whether or not it resulted in substantive changes in existing domestic laws.

The Model Law's goals were, in its authors' words, to implement modest yet significant changes to international insolvency law. The Model Law addresses cooperation between courts in various jurisdictions when an insolvency proceeding is pending in multiple jurisdictions, or where creditors or assets are contained in multiple jurisdictions. What is "cooperation" under the Model Law, as incorporated into the laws of England and Wales in the Cross-Border Insolvency Regulations 2006 (the "CBIR"), and its intersection with English law, was the subject of the Supreme Court's decisions in *Rubin* and *New Cap*.

It is worth noting that in *Interdevelco*, the court adopted the universalist approach regardless of the fact that the Isle of Man is not a signatory to the Model Law, and therefore the willingness of the Manx court to apply such an approach is perhaps the more surprising.

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'FAIR AND EQUITABLE' MEANS MORE THAN AMORTIZATION SCHEDULE

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All too often, a secured creditor's negotiation and litigation of chapter 11 plan confirmation issues centers disproportionately on the amortization schedule of a secured claim and lacks focus on other issues that shift risk or otherwise have significant economic impact on the relative rights of the parties. In a decision rendered in December 2012 in connection with an appeal of a confirmation order by a secured creditor, a United States District Court Judge in Tennessee reminds us that material modifications to a secured creditors' rights go beyond the interest rate and loan repayment schedule.[1]

Pursuant to the Bankruptcy Code, a chapter 11 plan should only be confirmed without resorting to the Bankruptcy Code's cramdown provisions if each class of claims has accepted the plan or is not impaired.[2] Absent satisfaction of the foregoing criteria, a plan proponent may confirm a plan over the objection of a class of creditors through a cramdown if the plan does not "discriminate unfairly" and is "fair and equitable."[3] With regard to a class of secured claims, the "fair and equitable" language of the Bankruptcy Code requires that if the debtor is retaining the secured creditor's collateral and proposing that the secured creditor retain its liens, the secured creditor receives payments that equal the current value of the bankruptcy estate's interest in the applicable collateral.[4]

In *Federal National Mortgage Association v. Village Green I GP*, Judge Anderson of the United States District Court for the Western District of Tennessee was confronted with an appeal from a Bankruptcy Court order confirming a chapter 11 plan that contemplated the cramdown of a secured claim held by Federal National Mortgage Association ("Fannie Mae"). The plan proposed by the debtor, Village Green I GP, provided for, among other things, the modification of certain loan documents to eliminate the requirement that monthly tax, insurance and capital reserve payments be made to Fannie Mae. In sharp contrast to the pre-petition loan documents, under the modified terms contained in the plan, Village Green would escrow those funds and provide quarterly reports to Fannie Mae. In addition, the terms of the plan provided Village Green with greater discretion over the management of the property, including the ability, without the consent of Fannie Mae, to change property managers or make changes to the property management contract.

Fannie Mae objected to confirmation and argued, among other things, that the modifications to its rights as a secured creditor "increased the risk of loss and shifted the increased risk in violation of the fair and equitable standard."[5] The Bankruptcy Court confirmed the plan and overruled Fannie Mae's objection. On appeal, the district court noted that, "it does not appear that the Bankruptcy Court squarely addressed Fannie's argument about the fairness and equity of the plan's modifications of the loan documents."[6] Accordingly, the district court remanded "so that the Bankruptcy Court can address the issue more fully in the first instance."[7]

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PRE-PETITION SECURITY LICENSE IN PROCEEDS OF FCC LICENSE CONTINUES POST-PETITION – *TRACY BROADCASTING* OVERTURNED

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In re Tracy Broadcasting Corporation, No. 11-1453 (10th Cir., Oct. 16, 2012)

CASE SNAPSHOT

The Tenth Circuit held that a creditor with a pre-petition security interest in the proceeds of an FCC license continues to have a lien on the proceeds of a post-petition sale of that license, overruling the district court and bankruptcy court decisions that held that the "too speculative" pre-petition lien could not attach to post-petition sale proceeds. [We discussed the bankruptcy court's opinion of this case in the June 2011 *CR&B Newsletter*].

FACTUAL BACKGROUND

Tracy Broadcasting operated a radio station under a license issued by the Federal Communications Commission. Tracy executed a note and security agreement with Valley Bank & Trust Company, under which Valley Bank was granted a lien on the proceeds of any sale of the FCC license. Tracy subsequently filed for chapter 11 bankruptcy, and a judgment creditor brought an adversary action to determine the extent of Valley Bank's security interest. Section 552(a) prohibits pre-petition liens on post-petition property, but section 552(b) provides an exception to this rule and permits a lien to attach to the post-petition sale proceeds of property that was secured pre-petition. In this case, the bankruptcy court held that Tracy's pre-petition lien on future sale proceeds was "too speculative," because it was contingent both on a sale being approved and on FCC approval of the sale. Because there was no pre-petition lien on such hypothetical sale proceeds, there could be no lien on the post-petition sale proceeds. The district court affirmed, and Valley Bank appealed.

COURT ANALYSIS

This court reversed the lower courts, holding that because the FCC and Nebraska state law both recognized the right of a lender to obtain a security interest in the future sale proceeds of a license, it made economic sense for the lien to attach at the time of the security agreement – not at some later sale date.

Although the FCC does not permit liens on a license itself, it recognizes the importance of permitting liens on the proceeds of sales of such licenses so that license-holders may find willing lenders in the capital market. Likewise, Nebraska's UCC section 9-408, which was revised in 2000, expressly permitted

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SECURED CREDITOR DOES NOT PARTICIPATE IN BANKRUPTCY CASE, COURT ALLOWS LIEN TO PASS THROUGH PLAN CONFIRMATION

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In re S. White Transp., Inc., 473 B.R. 695 (S.D. Miss. 2012)

CASE SNAPSHOT

The first priority secured creditor, who did not file a claim or participate in any way with the bankruptcy case until after the debtor's plan was confirmed by the court, filed a complaint for declaratory judgment, asking the court to determine that its lien was not affected by the plan confirmation and that it retained its first priority lien on the property. The bankruptcy court ruled against the lienholder, and held that the lien was voided by virtue of the plan confirmation. The district court reversed, applying a Fifth Circuit test to hold that because the lienholder had not participated in the bankruptcy case, its lien was not voided.

FACTUAL BACKGROUND

S. White Transportation, Inc. executed a note and deed of trust in favor of Acceptance Loan Company, Inc., which gave Acceptance a lien on White's real property (an office building). Three other entities subsequently made loans to White, which loans were also secured by the same office building. There was no dispute that these liens were junior to the Acceptance lien; however, the debtor disputed the validity of this lien and it was the subject of state court litigation.

White filed for chapter 11 bankruptcy, identifying the Acceptance lien as "disputed" on its schedule of secured creditors. Acceptance received notice of White's bankruptcy, but did not file a proof of claim, or any objections. The debtor's plan was confirmed and provided for a release of the lien. Following issuance of the confirmation order, Acceptance sought declaration from the bankruptcy court that its lien was not affected by the confirmation. "In short, Acceptance sought to amend the plan to provide that its lien passed through the bankruptcy unaffected." The bankruptcy court, however, held that the lien was voided, and Acceptance appealed.

COURT ANALYSIS

The district court began its discussion by stating that, "as the Fifth Circuit has observed, the general rule has been that liens pass through bankruptcy unaffected." Section 1141(c) creates a limited exception to the general rule and provides that, except as otherwise provided in the plan, and after confirmation of a plan, the property dealt with by the plan is free and clear of all claims and interests of creditors. In order for the statutory provision to void a lien, the Fifth Circuit has held that four conditions must be satisfied: the plan must be confirmed; the property that is subject to the lien must be dealt with by the plan; the lienholder must participate in the reorganization; and the plan must not preserve the lien.

The court stated that the crux of the dispute was whether Acceptance "participated" in the reorganization. Looking to Fifth Circuit precedent, the court pointed out that the participation test requires judicial interpretation, and that courts vary in

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GREENS FEES NOT 'RENTS, PROCEEDS OR PROFITS' OF BLANKET LIEN, AND NOT CASH COLLATERAL

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In re Premier Golf Properties, L.P., BAP No. SC-11-1508-HPaJu (9th Cir. BAP, Aug. 13, 2012)

CASE SNAPSHOT

The Ninth Circuit B.A.P. affirmed the bankruptcy court decision that post-petition income from greens fees and driving range fees were not "rents, proceeds, or profits" of the secured lender's pre-petition blanket security interest on all real and personal property (and "all proceeds thereof") within the meaning of section 552(b), and thus were not cash collateral.

FACTUAL BACKGROUND

Premier Golf Properties, L.P. owned and operated a golf club in California. Far East National Bank loaned $11.5 million to Premier, and Premier granted the bank a blanket security interest in all of its real and personal property, and "all proceeds thereof."

Following its chapter 11 filing, Premier continued to operate the golf club as a debtor in possession, opened a new bank account designated for cash collateral, and segregated into this account pre-petition cash and receivables. Premier, however, did not place post-petition revenue in its new account. The bank filed an emergency motion, asserting that the debtor was using the bank's cash collateral without the bank's consent and without providing adequate protection. The debtor argued that it was operating the estate from its own post-petition income, and that the income was not proceeds, profits, or products of the bank's collateral. The bankruptcy court agreed with the debtor, and denied the bank's motion. The bank appealed.

COURT ANALYSIS

The bank focused its appeal on greens fees and driving range fees, so the B.A.P. limited its discussion to these revenues.

Section 363(c)(2) prohibits a debtor in possession from using cash collateral—which by statute includes cash, negotiable instruments, deposit accounts or other cash equivalents—absent court authorization or consent from the entity with a security interest in the collateral. A creditor's pre-petition security interest does

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DETERMINING WHETHER A CHAPTER 11 PLAN IS UNCONFIRMABLE WITHOUT A CONFIRMATION HEARING

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In re American Capital Equipment, LLC, 688 F.3d 145 (3d Cir. 2012)

CASE SNAPSHOT

The Third Circuit Court of Appeals held that bankruptcy courts have the authority to determine that a proposed chapter 11 plan is unconfirmable at the hearing on the plan's disclosure statement, if it is obvious that the plan is patently unconfirmable, rendering a confirmation hearing futile. This is the first Court of Appeals to explicitly confirm the holdings of lower courts that bankruptcy courts have such authority, and the court provided guidance as to what constitutes a patently unconfirmable plan and how to ensure due process when making such a determination. The practical implication of this holding is that opponents to a proposed plan can attempt to stop the confirmation process before interested parties, including the debtor, engage and expend significant resources in solicitation, discovery and a contested confirmation hearing.

FACTUAL BACKGROUND

In 1998, Skinner Engine Companies, Inc. was acquired by American Capital Equipment, LLC by means of a leveraged buyout. Because of Skinner's lack of cash flow to maintain its operations and service its secured debt, Skinner and American Capital each filed chapter 11 petitions for bankruptcy relief. Though Skinner faced more than 29,000 personal injury claims related to its alleged use of asbestos from the 1930s through the 1970s, Skinner's bankruptcy filing was not caused (even in part) by the asbestos claims. In fact, the asbestos claims had been overwhelmingly unsuccessful.

After eight years of bankruptcy proceedings, four failed attempts to confirm a plan, and selling substantially all of its assets to satisfy the claim of its secured creditor, Skinner sought the bankruptcy court's approval of a disclosure statement describing a plan where asbestos claimants would be allowed to opt-in to an alternative claim resolution process. This process would provide expedited determinations of claims ultimately against Skinner's insurers, provided that the claimants consented to a 20 percent surcharge of any recovery obtained from the insurers. The 20 percent surcharge would be used by Skinner to pay the plan's administrative costs and thereafter unsecured creditors (other than asbestos claimants), who would have otherwise received no recovery on their claims. In short, Skinner was attempting to access the insurance recoveries of the asbestos claimants to fund the plan and pay other unsecured creditors by offering the asbestos claimants an alternative to the court system and traditional tort remedies, which alternative claim resolution process severely limited the substantive and procedural rights of the insurers, thereby increasing the likelihood of insurance recoveries – all in apparent conflict with Skinner's contracts with its insurers.

Skinner admitted that no plan would work without the surcharge. The bankruptcy court found that the plan was unconfirmable, and Skinner appealed.

COURT ANALYSIS

The Third Circuit affirmed the bankruptcy court's findings at the hearing on the disclosure statement (1) that the plan was patently unconfirmable because it was not feasible in violation of section 1129(a)(11) of the Bankruptcy Code, and was not proposed in good faith in violation of section 1129(a)(3); and (2) that the chapter 11 bankruptcy case should be converted to a chapter 7 case because Skinner had proved unable to effectuate a confirmable plan within a reasonable period of time.

The court found that the bankruptcy court had not erred in finding the plan to be unconfirmable without first holding a confirmation hearing. Confirming the holdings of several lower courts, the Third Circuit held that bankruptcy courts have the authority to determine that a proposed chapter 11 plan is unconfirmable at the hearing on the plan's disclosure statement, if it is obvious that a confirmation hearing would be futile because the plan described by the disclosure statement is patently unconfirmable. The Third Circuit cautioned, however, that bankruptcy courts must ensure due process by providing sufficient notice to interested parties that confirmation issues will be considered at the hearing on the disclosure statement, and by taking care to not prematurely convert a hearing on a disclosure statement into a confirmation hearing.

The court also clarified that a plan is patently unconfirmable only where (1) confirmation defects in the plan cannot be cured by creditor voting results and (2) those defects concern matters upon which all material facts are not in dispute or have been fully developed at the disclosure statement hearing.

The Third Circuit then found that the bankruptcy court had not erred in finding that the plan was patently unconfirmable because it was not feasible in violation of section 1129(a)(11) and was not proposed in good faith in violation of section 1129(a)(3). In so finding, the Third Circuit noted that interested parties had received sufficient notice that confirmation issues would be addressed at the hearing on the disclosure statement, and, thus, due process had been protected.

Regarding feasibility, the court noted that a plan is not feasible if its success hinges on future litigation that is uncertain and speculative because such success is only possible, not reasonably likely. Using that standard, the Third Circuit found that the plan was not feasible because (1) its sole source of funding was the 20 percent surcharge to be assessed on insurance proceeds recovered through the alternative claim resolution process for asbestos claims; (2) the asbestos claims had been overwhelmingly unsuccessful thus far and, therefore, the success of such litigations and recovery of insurance proceeds was highly uncertain and speculative; and (3) in any event, the 20 percent surcharge would only be assessed if and to the extent the asbestos claimants opted in to the alternative claim resolution process, which they may choose not to do. The Third Circuit further held that the plan's lack of feasibility could not be cured by creditor voting results and, because Skinner had admitted that no plan would work without the surcharge, all material facts related to feasibility were not in dispute.

Regarding good faith, the court noted that a plan is proposed in good faith only if it will fairly achieve a result consistent with the objectives and purposes of the Bankruptcy Code. Using that standard, the Third Circuit found that the plan had not been proposed in good faith because "it establishes an inherent conflict of

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LOAN 'PARTICIPANT' THAT BEARS NO RISK IS NEITHER A 'PARTICIPANT' NOR A CREDITOR

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In re Brooke Capital Corp., 2012 WL 4793010 (Bankr. D. Kan., Oct. 5, 2012)

The dispute involved competing interests in the proceeds of a stock sale. The stock of the debtor's subsidiary was pledged as security for repayment of a loan. The lender obtained funding for the loan from various participants pursuant to agreements where the failure of the debtor to repay the loan reduced the participant's exposure on loans the participants had outstanding with an affiliate of the lender. The court determined that parties bearing no risk of repayment in a seller's loan to the borrower are not true participants, but rather are creditors making a loan to the seller. In this case, the court re-characterized the transactions as loans to the seller and not loans to the borrower/debtor. As such, the purported participants had no security interest in the stock securing the seller's loan, and they were not entitled to a share of the proceeds from the stock sale.

FACTUAL BACKGROUND

The transaction at issue involved Brooke Corporation, and several subsidiaries including Brooke Capital Corporation (the debtor in this case), Brooke Capital Advisors (BCA, a wholly owned subsidiary of the debtor), First Life America Corporation (FLAC, also a wholly owned debtor subsidiary), and Aleritas Capital (a subsidiary of Brooke Corporation).

On December 31, 2007 (prior to its bankruptcy filing), the debtor and BCA entered into a commercial loan agreement and stock pledge and security agreement, in which the loan amount was stated to be $12.3 million. (These agreements referred to a separate note, but no note document was ever produced.) The debtor granted BCA a security interest in all of the debtor's FLAC stock.

With respect to the BCA-debtor loan, BCA executed documents entitled "Participation Certificate and Agreement" with three entities; each of these entities owed money to Aleritas. Among BCA's obligations was the obligation to repurchase each participant's interest on or before a date certain. (These three participants and their certificates/agreements will be referred to as "Guaranteed.") BCA also executed a document entitled "Participation Agreement" with a fourth entity, the Bank of Kansas. Unlike the Guaranteed participants, BCA did not agree to repurchase this bank's participation.

Each document purported to sell fractional interests called "participations" to each of these four entities, and each document stated that the FLAC stock was the collateral for the BCA loan to the debtor. None of these "participants" filed a UCC financing statement. Separately, Aleritas agreed to reduce the amount the Guaranteed participants owed Aleritas by any shortfall they incurred respecting their participation in the BCA-debtor loan, but Aleritas made no such arrangement with the Bank of Kansas, as this entity did not owe Aleritas any debt.

Also on December 31, 2007, Citizens Bank loaned $9 million to the debtor, which was secured by stock in affiliates of the debtor, but not the FLAC stock. The debtor soon defaulted on this loan, however, and Citizens and the debtor entered into workout negotiations. Citizens and the debtor executed a note amendment and security agreement, which gave Citizens a security interest in all of the debtor's personal property – including the FLAC stock. Citizens filed a UCC financing statement in an effort to perfect its security interest.

As 2008 progressed, the financial condition of Brooke Capital Corporation worsened, until it finally filed a chapter 11 petition. The bankruptcy court authorized the trustee to sell FLAC's stock, which was sold for $2.5 million. The case was converted to chapter 7. Citizens filed a declaratory judgment action to determine the rights in the proceeds from the sale of FLAC stock.

COURT ANALYSIS

While Citizens, the Guaranteed entities and the Bank of Kansas put forth many arguments in support of their respective positions, the court focused on those it deemed necessary to its decision. As a threshold matter, the court found sufficient evidence of the BCA-debtor loan and security interest, despite the lack of an actual note.

The court then found that the Citizens-debtor workout agreement was "in effect a subordination agreement, under which BCA agreed upon the sale of the FLAC stock to subordinate its first lien in the proceeds to Citizens' second lien in the same collateral." The court also found that this agreement was enforceable against the debtor notwithstanding its bankruptcy filing, given that there were no objections in the case, and the court also looked to section 510(a) of the Bankruptcy Code, which preserves the effect of subordination agreements. Citizens would thus be entitled to the proceeds by virtue of its superior lien, "unless the [loan participation] Defendants as holders of participation interests in the BCA-Debtor Loan have superior claims."

The court examined the Guaranteed participant interests separately from the Bank of Kansas, and concluded that the interests of the Guaranteed entities should be re-characterized as loans to BCA. The court reached this conclusion based on the answer to "the most important question … whether the alleged participant is subject to the risk of loss resulting from default by the underlying borrower." Here, BCA promised to repurchase the contributions of the Guaranteed entities, and Aleritas promised to credit their loan balances to the extent of any non-payment from the BCA-debtor loan, so that they bore no risk of loss. Moreover, "while true loan participants are allowed to rely on their lead lender's perfection of security interests to protect their interests, purchasers of participations that are re-characterized as loans to the lead are not entitled to rely on that perfection." The court determined that the Guaranteed entities were not holders of perfected security interests in the FLAC proceeds. Instead, they were creditors of BCA and had no security interests in the collateral pledged to secure the BCA-debtor loan.

Utilizing the same precedents and reasoning, the court held that the Bank of Kansas did bear a risk of loss, and was therefore a true loan participant.

With this analysis, the court acknowledged that the decision of BCA to subordinate its interests in the stock in favor of Citizens could not bind the Bank of Kansas without the bank's express consent. Therefore, the court ruled that the Bank of Kansas was entitled to its 14.5 percent share of the FLAC proceeds, and that Citizens was entitled to the remainder.

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In *Rubin* and *New Cap*, the Supreme Court addressed whether the CBIR overrides substantive English law and implements a different standard for insolvency matters, or whether it is a complementary tool to be read in harmony with established law. The Supreme Court's judgments in these cases rely on a plain reading of the CBIR and the judgments reflect the Supreme Court's finding that the CBIR does not prevent or displace any substantive aspect of English law. In *Rubin*, the judgment went so far as to say that "the introduction of judge-made law extending the recognition and enforcement of foreign judgments would be only to the detriment of United Kingdom businesses without any corresponding benefit."

In *Rubin*, the English Supreme Court refused to recognise a judgment entered by a U.S. Bankruptcy Court because it did not comply with established English law on recognition of foreign judgments, and found that nothing in the CBIR required a different standard for insolvency matters. In *New Cap*, the English Supreme Court again applied English common law but to different facts, and held that an order entered by a foreign insolvency court was enforceable because the court had jurisdiction over the party, and the order otherwise complied with the English standard for recognition of foreign judgments.

While the Manx court's decision in *Interdevelco* does not, arguably, hold as much sway as decisions handed down by the Supreme Court of England and Wales, its significance should not be underestimated. The decision in *Interdevelco* was based on previous case law (most notably the universalist approach of Lord Hoffman in *Cambridge Gas Transportation v. Navigator Holdings*, another Isle of Man case that was decided by the Privy Council, the Isle of Man's equivalent to the Supreme Court in England and Wales, and a persuasive authority for English courts generally) which, before the Supreme Court's recent decisions in *Rubin* and *New Cap*, had committed itself to a global and universalist approach. Lord Hoffmann was a great champion of the principle of universality and in another case he even went as far as to describe it as the "golden thread running through English cross-border insolvency law since the 18th century." In *Rubin*, the Court of Appeal had originally come down in favor of this universalist approach, but the Supreme Court took a different view with the majority judges heavily criticizing this line of authority. For instance, Lord Collins stated that the dicta in *Cambridge Gas* did not justify the result which the Court of Appeal in *Rubin* had reached, contending that "[t]his could not be an incremental development of existing principles, but a radical departure from substantially settled law."

In *Interdevelco*, echoing Lord Hoffman's approach, the Manx court held that while it had jurisdiction to wind up the company in question, because it had been incorporated in the Isle of Man, the most appropriate forum was the United States and declined jurisdiction to order the liquidation. In explaining the reasons behind its decision the court remarked: "An unnecessary duplication of substantive insolvency proceedings in more than one jurisdiction is undesirable. It inevitably involves further delay, expense and inconvenience. The substantive insolvency proceedings should be confined to one jurisdiction with other courts worldwide, where necessary, acting in an ancillary capacity and recognising and assisting the jurisdiction of the primary court in an orderly progression and conclusion of the substantive insolvency proceedings."

This judgment shows the Manx court's determination to take a global view in accordance with the principles of universality and go where the Supreme Court of England and Wales has been reluctant to venture. Interestingly, the decision reached by the Manx courts in the case was made prior to the outcome of the Supreme Court's decision in *Rubin*, and the judgment of *Interdevelco* even remarked, rather optimistically, that "[W]e await their judgment in *Rubin* with interest. Hopefully the Supreme Court will further survey and map the boundaries of the principle of universalism." It is not clear whether the Manx court would therefore have taken the same approach as it did in *Interdevelco* had the judgment in *Rubin* and *New Cap* been handed down sooner.

The cases discussed here and their diverging approaches have drawn attention to the disjointed nature of international insolvency law and how such law may be inadequate given the realities of today's global economy. Specifically, the judgments bring to the forefront the debate of whether the increasingly global nature of many businesses and the resultant potential for cross-border insolvencies necessitate the adoption of substantive cross-border insolvency laws, or if substantive insolvency law is really best left to individual jurisdictions.

Following the collapse of Lehman Brothers, Nortel, and MF Global, amongst others, the focus on cross-border insolvencies has increased. It is clear that the issues faced in *Rubin*, *New Cap* and *Interdevelco* will not be unique and courts will increasingly need to address the intersection of international insolvency law with domestic laws. Should efforts then be made to develop a clear law on the treatment of judgments issued by various insolvency courts? While this seems to have a number of benefits, as emphasized in *Interdevelco*, in terms of harmonizing proceedings, minimising cost and time and maximising an insolvent entity's estate, the negative implications should not be overlooked. Beyond the logistical challenges of having multiple jurisdictions sign up to laws that may vary widely from their established domestic legislation, a number of other issues are to be considered:

- Is it appropriate for a country to adopt insolvency laws and procedures that could significantly depart from legal standards otherwise applicable to its citizens?
- Do the benefits of having a standardised multi-jurisdictional insolvency law outweigh the implications of jurisdictions treating certain foreign judgments differently?
- Would attempts to standardise enforcement of insolvency judgments lead to increased forum-shopping by multi-national companies seeking to obtain favourable judgments, while skirting otherwise applicable substantive legal requirements?

These questions are not simple and cause concern for many jurisdictions. What is clear is that the intention and impact of the Model Law continues to divide courts. The decisions in *Rubin* and *New Cap* highlight the view that insolvency, although unique in many ways, remains subject to the substantive domestic laws applicable across jurisdictions. The decision made in *Interdevelco*, however, shows that some courts are willing to take that extra step to embrace a universal approach and "see international insolvency matters in the global context in which they arise," regardless of whether this impacts on domestic legislation or causes prejudice to local creditors. It is yet to be seen whether other courts and jurisdictions will follow suit, and how the Manx decision in *Interdevelco* will impact upon future decisions made by other courts in other jurisdictions.

CHANCERY COURT EXAMINES FACTORS OF PROXIMATE CAUSE IN DELAWARE TORTIOUS INTERFERENCE CLAIM

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Soterion Corp., et al. v. Soteria, et al., C.A. No. 6158-VCN (Del. Ch. Ct., Oct. 31, 2012)

CASE SNAPSHOT

The Chancery Court of Delaware analyzed the necessary factors to prove a case for tortious interference of contract. Specifically, the court undertook an analysis of the "but-for" test, as applicable to proximate cause, to determine whether wrongful conduct was the cause of the alleged harm. The court held that, while the conduct was wrongful and intentional, it was not the proximate cause of the alleged injury. In a small victory for the plaintiffs, however, the court held that the defendants' conduct constituted bad faith. Accordingly, the court ordered the defendants to pay the plaintiffs' attorneys' fees.

FACTUAL BACKGROUND

The Jones family (the father and son are referred to as "Jones" and Margaret Jones is referred to as "M. Jones") owned and operated a number of medical imaging centers. In order to sell a large stake of the business, Jones transferred assets to a holding company, which was partly owned by another entity and held preferred units in Soteria Imaging Services, LLC. Upon completion of the partial sale, Jones invested in Soteria through Soterion Corporation and held common units in Soteria.

Soteria's imaging business struggled and would be unable to make payments on a $9.5 million senior note that had been used to fund the acquisition of the imaging assets. Soteria's board of managers decided to explore selling non-core imaging centers to raise cash. The divestiture strategy contravened the desires of M. Jones, the board member appointed by Soterion; she wished to sell all of Soteria's assets.

After some time, two parties emerged as potential buyers for separate facilities: Lake Cumberland and Tenet. One week prior to the board meeting at which management would seek approval for the Lake Cumberland sale, Jones sent a fax to the CEO of Lake Cumberland informing him of an ongoing lawsuit (involving an unrelated plaintiff) against Soteria (the Juju Litigation). Jones also attached to the fax a draft complaint against Soteria that Jones claimed would be filed the next day. (The complaint was not filed for another three months.) The draft complaint alleged, among other things, that: (1) Soteria was selling the imaging center without proper board authorization, and (2) Soteria did not own all of the assets it planned to sell. Lake Cumberland eventually backed out of the deal to purchase the imaging center.

Tenet also learned of the litigation by Jones against Soteria and began softening its interest in the imaging center. The Jones litigation against Soteria was ultimately dismissed. Following the conclusion of that litigation, Soteria and Tenet resumed negotiations, but that imaging center's income was falling, so Tenet backed out of that deal.

When Jones filed the complaint, Jones knew that the allegations against Soteria were false. Soteria counterclaimed (Counterclaim Plaintiffs) and alleged that the filing of the complaint constituted tortious interference with prospective business relationships because both potential purchasers walked away from the deals. Soteria also sought the payment of its attorneys' fees from Jones (Counterclaim Defendants), arguing that the complaint was filed in bad faith. (While the Soteria board distrusted M. Jones, there was no evidence that she participated in the allegedly tortious conduct.)

COURT ANALYSIS

To establish tortious interference with a prospective business opportunity under Delaware law, the plaintiff must prove: (1) the reasonable probability of a business opportunity, (2) the intentional interference by the defendant with that opportunity, (3) proximate causation, and (4) damages. This court also relied on section 767 of the Restatement (Second) of Torts for the circumstances under which threatened or filed litigation can constitute improper interference. Section 767 requires proof that either the interfering party had no belief in the merit of the suit, or, although having some belief in the merit, the interfering party institutes or threatens to institute litigation in bad faith, intending only to harass the other party and not to bring the claim to final adjudication.

The court found that the first prong of the test was satisfied with respect to Lake Cumberland and Tenet, and then discussed whether the Counterclaim Defendants' behavior was the proximate cause of the failed sales. Delaware courts utilize the traditional "but for" test, which states, "the defendant's conduct is a cause of the event if the event would not have occurred but for that conduct; conversely, the defendant's conduct is not a cause of the event, if the event would have occurred without it." Applying this test, the court held that the Counterclaim Defendants' behavior did not cause the potential sales to fall through. Notwithstanding Jones's intent and ill will in sending the fax, the court found that Lake Cumberland pulled out of its deal because of the Juju Litigation, not the threatened litigation by Jones. Moreover, the Juju Litigation was material information that Soteria should have disclosed previously. With respect to the Tenet deal, the court found that Tenet dropped out because of the declining financial condition of that imaging center, not because of the Jones lawsuit.

While the court held that the Counterclaim Defendants' conduct was not the proximate cause of the cancelled sales, the court did find that it was bad faith conduct, because Jones knew the core allegations were false. The court therefore awarded Soteria its attorneys' fees.

PRACTICAL CONSIDERATIONS

The opinion sets a high bar for parties contemplating filing a complaint for tortious interference with a prospective business relationship. The Counterclaim Defendants exhibited egregious behavior, but the court ultimately found their actions were not the cause of the failed business deals. Further, this case sets a standard for "proximate cause" and connecting the injury to the appropriate cause. Finally, this case proves a cautionary tale to parties filing knowingly false and harassing actions – you may be liable for your counterpart's legal fees.

SECTION 546(b) FILINGS SUFFICIENT OBJECTION TO OVERCOME PRIMING LIEN OF DIP LENDER

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The Newhall Land and Farming Company v. American Heritage Landscape, LP, et al. (*In re Landsource Communities Development LLC, et al.*) Adv. No. 09-51074 (KJC), (Bankr. D. Del., Aug. 30, 2012))

CASE SNAPSHOT

The debtor, a land management company, obtained DIP financing that purported to prime the pre-petition liens of all creditors who did not file an objection to the proposed financing. The debtor sought declaratory judgment that two pre-petition mechanic's liens were primed because the holders of those liens had not formally objected to the DIP motion. The court held for the lien holders who, by filing section 546(b) Notices of Perfection prior to the entry of the final DIP order, took action sufficient to provide notice of their objection to the priming of their liens.

FACTUAL BACKGROUND

Newhall Land and Farming Company is a property development and land management company. With respect to one of its properties, Newhall executed two pre-petition contracts – the first with AHL, a landscape contractor, and the second with R&R, a general engineering contractor. AHL and R&R obtained and recorded mechanic's liens arising out of these contracts against this property. Newhall subsequently filed a chapter 11 petition, and shortly thereafter, filed a motion to approve DIP financing. The terms of the DIP financing granted the DIP lender priming liens over all other liens, except those fitting the credit agreement's definition of "Permitted Liens" – "any Liens that would otherwise be Primed Liens, to the extent the holder of such Lien files an objection or other responsive pleading with the Bankruptcy Court to such Lien being a Primed Lien at any time prior to the entry of the Final Order."

Neither AHL nor R&R filed objections to the DIP motion, although each filed section 546(b) Notices of Perfection simultaneous with or subsequent to the hearing on the final DIP financing, but prior to the entry of the Final DIP Order. The debtor sought a declaratory judgment that AHL's and R&R's liens were primed because they both failed to formally object to the DIP motion.

COURT ANALYSIS

The debtor argued that the failure of these creditors to file a formal objection to the DIP motion constituted tacit consent to the priming of their mechanic's liens. AHL and R&R argued that the filing of their section 546(b) Notices of Perfection prior to the entry of the Final DIP Order "indisputably manifested [their] intentions to maintain the priority of their mechanic's liens," and served as "other responsive pleadings" within the meaning of that term in the DIP credit agreement.

Although the court acknowledged that DIP lenders "understandably" need to be able to rely on the efficacy of final financing orders, the court ultimately agreed that the filing of a section 546(b) notice constituted a "responsive pleading" within the definition of Permitted Liens in the credit agreement. In so holding, Judge Carey noted that he is "loathe to allow incineration of valid liens, clearly falling within the safe harbor of section 546(b), in light of the lienholders' undisputed efforts to assert their rights. In the particular circumstances before me, I conclude that the section 546(b) notices filed by the Defendants were sufficient to alert Newhall that they opposed the priming of their liens by the DIP Liens." The court concluded that because the notices of perfection were filed prior to the entry of the Final DIP Order, as required by the credit agreement, the record did "not support a finding that the Defendants waived their rights or consented tacitly to the priming of their liens." The court granted summary judgment in favor of AHL and R&R.

PRACTICAL CONSIDERATIONS

This case exemplifies the caution bankruptcy judges exercise when granting priming liens and determining the lien priority thereafter. Because bankruptcy courts will imply the terms of the DIP credit agreement precisely when determining lien priority, this case evidences the import of extremely careful drafting. DIP lenders need to make absolutely sure that holes through which pre-existing lien holders can squeeze to get to the head of the lien priority line are closed as tightly as possible. To ensure that final DIP orders present an accurate picture of the lien priority, DIP lenders should also require that any objections to subordination be made prior to the final hearing on the DIP financing motion.

SEPARATION OF CLAIMS SOLELY ON THE BASIS OF PERSONAL GUARANTY NOT PERMITTED

Christopher Rivas
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In re 18 RVC, LLC, Case No. 812-72378-reg (Bankr. E.D.N.Y., Oct. 22, 2012)

CASE SNAPSHOT

A single-asset real estate debtor proposed to separately classify the unsecured deficiency portion of the sole secured creditor's claim from the other class of unsecured creditors in order to cram the plan down on the secured creditor. The debtor asserted that the deficiency claim should be classified separately because the secured lender had the personal guaranty of the borrower's principal, whereas the other unsecured creditors did not. The secured creditor objected to the gerrymandering of claims. The court disagreed with the debtor, holding that separating otherwise similarly situated creditors solely on the basis of the existence of a personal guaranty was not legally permissible.

FACTUAL BACKGROUND

The debtor's sole asset was a commercial building. The property was encumbered by a mortgage lien held by New York Community Bank. NYCB

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DISCRIMINATION IN CLASSIFICATION OF CLAIMS OKAY, SO LONG AS NOT UNFAIR DISCRIMINATION

Joe Filloy
Associate, Pittsburgh

In re Sea Trail Corporation, Case No. 11-07370-8-SWH (Bankr. E.D.N.C., Oct. 23, 2012)

CASE SNAPSHOT

The court denied the objections of the Bankruptcy Administrator and the Unsecured Creditor's Committee, and confirmed the chapter 11 debtor's proposed plan of reorganization. The court found that the classification of two classes of unsecured creditors – trade creditors and shareholders that had made loans to the debtor, was done with a reasonable basis, and was not made in bad faith, and that, while the classification did discriminate against those creditors, it did not "unfairly" discriminate.

FACTUAL BACKGROUND

The debtor, Sea Trail Corporation, proposed a plan for confirmation that established 16 classes. Class 14 comprised general unsecured claims greater than $1,000 (primarily trade creditor claims), and Class 15 comprised the general unsecured claims arising from shareholder loans. The plan provided that certain of the debtor's assets would be liquidated for the benefit of Class 14, while others would be dedicated to Class 15. The debtor presented evidence that it based the division of assets on what it perceived were conflicting interests, i.e., the general unsecured trade creditors would prefer to liquidate the assets in the short term and the shareholder creditors were willing to accept less liquid assets in order to maximize their gains in the long term. Class 15 was the only impaired class that voted to accept the Plan. The Administrator and Committee asserted that the classification was improper because it unfairly discriminated against Class 14, and that the plan was not fair and equitable to Class 14.

COURT ANALYSIS

The court focused on two issues regarding whether a cramdown under Bankruptcy Code section 1129(b)(2) could be accomplished. First the court analyzed whether the separate classification of Class 14 and 15 unsecured claims was proper. The court concluded that the debtor established a legitimate reason for separately classifying Classes 14 and 15 because these unsecured creditors had different, and somewhat contradictory, interests. The court found, "Generally speaking, trade creditors are accustomed to short-term lending processes with an expectation of being repaid within a relatively short time period … [whereas] [t]he shareholders in the instant case have expressed a willingness to accept property pursuant to the Plan which may have to be held for some time to maximize its value for distribution." Additionally, the court found that although the assets the debtor proposed to provide Class 14 were not as liquid as originally thought, this did not change the analysis of whether the separate classification scheme was legitimate.

The court then turned to the question of whether the plan unfairly discriminated against Class 14. Noting that section 1129(b)(1) prohibits "unfair discrimination,"

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CONTINUING 'MATERIAL' OBLIGATIONS RENDER LICENSE AGREEMENT EXECUTORY – *LEWIS BROTHERS* AFFIRMED

Christopher Rivas
Associate, Los Angeles

Lewis Brothers Bakeries Incorporated v. Interstate Brands Corporation (In re Interstate Bakeries Corporation), 690 F.3d 1069 (8th Cir. 2012)

CASE SNAPSHOT

The trademark licensee appealed the district court's ruling that a perpetual license agreement was an executory contract that the debtor could reject. The Court of Appeals affirmed, finding that the perpetual license agreement, one of two contemporaneous agreements relating to a sale of tangible and intangible assets, was an executory contract because it defined certain continuing and outstanding obligations as "material." The dissenting opinion argued that the license agreement was integrated with the asset purchase agreement, and that all material obligations of the integrated agreement had been substantially performed, so that the license agreement was not truly executory.

FACTUAL BACKGROUND

In 1996, Interstate Bakeries contemporaneously executed an asset purchase agreement and license agreement with Lewis Brothers Bakeries, whereby Interstate sold certain operations and assets to LBB, and granted a perpetual, royalty-free, exclusive license to use certain brands and trademarks. In 2004, Interstate and affiliates filed petitions for chapter 11, and in 2008, Interstate contended that the LBB license agreement was executory, subject to assumption by the estate. LBB filed an adversary proceeding, seeking a declaratory judgment that the license agreement was not an executory contract. The bankruptcy court held that the license agreement was executory, the district court affirmed, and LBB appealed to the Eighth Circuit Court of Appeals.

COURT ANALYSIS

The court began its analysis by stating the Eighth Circuit's definition of an executory contract – "a contract under which the obligation of both the bankrupt and the other party to the contract are so far underperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other." The court then turned its attention to the case upon

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COURT ADOPTS 'ADDITION THEORY' IN APPLYING UNNECESSARY ADEQUATE PROTECTION PAYMENTS

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In re Geijsel, et al., Case No. 10-43979-11 (Bankr. N.D. Texas, Aug. 24, 2012)

CASE SNAPSHOT

The court adopted the "addition theory" for application of unnecessary adequate protection payments, relying on the narrow circumstances set forth in section 552(b) of the Bankruptcy Code that allow a creditor to retain its security interest in cash or other collateral acquired by the debtor post-petition. The court also held that the chapter 11 debtors' proposed plan was not feasible, and was not fair and equitable to the objecting creditor. As such, the court denied confirmation.

FACTUAL BACKGROUND

The owner/operators of a dairy farm had entered into a number of loan agreements with Lone Star, and in connection with these loans, Lone Star held validly perfected security interests in all assets of the borrowers. The various loans and security interests were cross-collateralized. The borrowers filed chapter 11 petitions, and sought confirmation of the proposed reorganization plan. Lone Star was the priority secured lender, and the total of its claims was $9.77 million. Lone Star objected to plan confirmation, asserting that the plan was not, among other things, feasible, and was not fair and equitable. After a lengthy discussion and analysis, the court agreed with Lone Star, and denied confirmation.

COURT ANALYSIS

The court thoroughly analyzed the issues before it, and highlighted several weaknesses in the debtors' position, including: (1) the volatility of the dairy business; (2) the weakness of the debtor's financial projections, as measured against actual performance from the petition date; and (3) the lack of a cash cushion. Those weaknesses, when viewed in light of the plan terms, rendered the proposed plan infeasible, and unfair with respect to Lone Star.

At the core of the court's conclusion were its findings regarding the adequate protection payments on Lone Star's claim. The value of Lone Star's "hard collateral" in this case – namely, cattle, equipment, etc. – was volatile because of the nature of the dairy industry, which fluctuates from time to time based on weather conditions, feed prices and/or milk prices. As a result, the debtors made adequate protection payments to Lone Star during the pendency of the bankruptcy case in order to protect against the possible diminution in collateral value. In connection with plan confirmation, however, the bankruptcy court determined that the component fluctuations had, in reality, offset each other, so that the aggregate value of the hard collateral was generally stable. In doing so, the bankruptcy court found that "the so-called adequate protection payments were, in a sense, unnecessary." The court then evaluated how these "unnecessary" adequate protection payments should be applied.

The court first identified a line of authority holding that, when post-petition cash collateral is used to make unnecessary adequate protection payments, those payments should be applied to reduce the secured portion of a creditor's claim. "The logic behind this position, labeled the 'subtraction' view, is that creditors should get nothing more and nothing less than their allowed claim." The court noted, however, that the "subtraction view" is a minority position. Instead, it adopted the "addition view," which "acknowledges that section 552(b) allows a creditor, under narrow circumstances, to retain a security interest in cash or other collateral that the debtor acquires after the filing of bankruptcy. Thus, a creditor that has an interest preserved by section 552(b) (like Lone Star) is simply entitled to more than one that does not hold such an interest." Under the addition view, "if a creditor bargained for and received a perfected security interest in post-petition proceeds, then that creditor should not have to subtract this additional, separate collateral already received from the value of the other collateral remaining as of the effective date of the plan."

In the instant case, the adoption of the "addition view" and the allocation of the post-petition adequate protection payments against the total value of Lone Star's claim – and not merely the secured portion thereof – rendered Lone Star oversecured, and entitled it to post-petition interest, costs and fees. In light of the increased claim values, the bankruptcy court determined that the proposed plan did not treat Lone Star in a fair and equitable manner. Among other things, the bankruptcy court objected to the use of Lone Star's post-petition cash collateral to pay creditors in junior positions, especially because: (1) Lone Star would not receive any additional collateral in return for such use, and (2) the debtors had insufficient cash reserves to protect their ability to make payments under the plan when financial difficulties arose. Furthermore, the bankruptcy court found the plan was not feasible because, among other things, the financial projections had proved to be overly optimistic. Based on the foregoing, the court denied confirmation of the plan.

PRACTICAL CONSIDERATIONS

Section 552(b) essentially allows a creditor who has a pre-petition security interest in "proceeds, products, offspring, or profits" of secured property, to retain its security interest in the proceeds, etc., acquired by the estate after the commencement of the bankruptcy case. The court acknowledged that a creditor that is able to satisfy the narrow 552(b) circumstances is entitled to more than a creditor that cannot satisfy the criteria.

Loan 'Participant' that Bears No Risk is Neither a 'Participant' nor a Creditor—continued from page 6

PRACTICAL CONSIDERATIONS

If the participant does not bear risk of loss in the loan, then it cannot rely on the lead lender for perfection of the security, and must file a financing statement on its own behalf to obtain a perfected security interest, and priority over any subsequent participants or creditors.

‘Fair and Equitable’ Means More Than Amortization Schedule—continued from page 3

In considering cramdown of a secured claim and the applicable “fair and equitable” standard, judges, commentators and practitioners often focus solely on payment terms or, in other words, the appropriate term for the loan and rate of interest that generally are calculated with reference to the decision of the United States Supreme Court in *Till v. SCS Credit Corp.*, 541 U.S. 465 (2004), and the decision of the Sixth Circuit Court of Appeals in *In re Am. Home Patent Inc.*, 420 F.3d 559 (6th Cir. 2005). In some instances, chapter 11 plans do not even reference other post-confirmation terms for secured claims.

Although the *Village Green* decision is not the first case where non-arithmetic terms of a modification to a secured claim were given some attention, very few published decisions directly address the issue. Accordingly, in applying the “fair and equitable” standard to the facts of a particular case, it is often difficult to quantify the appropriate weight to provide to modifications of terms other than the proposed amortization of a secured claim. Courts will assess these issues on a case-by-case basis.

To make matters more difficult, many proposed plans in practice do not expressly outline terms for the treatment of secured claims that are not arithmetic or computational, but rather merely provide for the timing and amount of payments to the holders of secured claims. Moreover, in some cases, there is often no reference to the issuance of modified documents to evidence or perfect secured claims, or, other than the timing and amount of payments, any other rights associated with a secured claim. In these situations, absent an objecting secured creditor and the attention of the bankruptcy court to the issue, a debtor may later take the position that the secured claimant is not entitled to the issuance of new documents to evidence or perfect its secured claim, or to any protection not expressly provided for in the plan.

Loan agreements often span 75 to 100 pages or more in complex transactions. Without hesitation, any secured lender will tell you that those pages are filled with many important rights in addition to the interest rate and loan repayment schedule. Courts have often held that a confirmed plan replaces the pre-petition agreement between a debtor and a creditor. Thus, secured creditors and their counsel should not focus on the interest and repayment schedule while ignoring or giving short shrift to the other important terms that are necessary to protect the collateral, and enable the secured creditor to enforce its secured claims after a plan is confirmed.

In most instances, irrespective of the amortization of a secured claim, a plan will not be fair and equitable with respect to a secured claim absent documents that evidence and perfect the secured claim and include additional protections including, at a minimum, covenants/negative covenants and default and remedy provisions.[8] When considering the “fair and equitable” standard in the course of plan negotiations or a contested confirmation hearing, secured creditors and their counsel would be well-advised to focus substantial attention on the terms of the document that will govern its post-confirmation secured claim, and on any proposed modifications to the terms of the pre-petition loan documents. Absent the necessary attention to these issues, after confirmation, a secured creditor may incur great difficulty and expense trying to preserve the value of its collateral and enforce its secured claim.

1) *Federal National Mortgage Association v. Village Green I, GP,* No. 12-21b3-STA-tmp 2012 WL 6045896 (W.D. Tenn. Dec. 5, 2012). This opinion also addresses other objections to confirmation of the plan before the District Court that are beyond the scope of this article.

2) 11 U.S.C. § 1129(b)(1).

3) Id.

4) See 11 U.S.C. § 1129(b)(2)(A).

5) *Fed. Nat. Mtg. Assoc. v. Village Green at *8*

6) Id.

7) Id.

8) See, e.g., *In re P.J. Keating Co.*, 168 B.R. 464, 473 (Bankr. D. Mass. 1994) (citations omitted) (“The covenants to be included in the loan documents of a cramdown need not precisely track the covenants in the parties’ existing loan agreement. Yet the covenants should not leave the lender so bare of protection as to greatly increase the risk or require a corresponding increase in the interest rate.”)

Pre-Petition Security License in Proceeds of FCC License Continues Post-Petition – *Tracy Broadcasting* Overturned—continued from page 3

liens on general intangibles, including hypothetical sale proceeds of licenses. The court recognized that, at the time a security interest is granted, there is often a possible hypothetical future sale that is contemplated by the parties and the lien on such future hypothetical sale is valuable to the lender. To hold otherwise would create problems for FCC licensees seeking to raise capital, and would be contrary to the FCC’s policy of allowing liens on sale proceeds in the first place.

Because the lien on future sale proceeds of a license attaches at the time of the security agreement (presumably, upon perfection of the lien), the lien “rides through” the bankruptcy under section 552(b) and attaches to the post-petition proceeds of a sale of that license.

The court reversed and remanded the case to the bankruptcy court.

PRACTICAL CONSIDERATIONS

The Tenth Circuit joins the Ninth Circuit, and lower courts in several other jurisdictions, in its holding. The court’s practical, economically rational decision creates far more certainty for lenders seeking to obtain liens on FCC license proceeds. However, given the ongoing split in authority, lenders should seek the advice of bankruptcy counsel when negotiating a security agreement involving FCC license proceeds.

Greens Fees Not ‘Rents, Proceeds or Profits’ of Blanket Lien, and Not Cash Collateral—continued from page 4

not extend to after-acquired property of the debtor under section 552(a), but section 552(b) provides a narrow exception to that rule. Section 552(b)(1) allows a pre-petition security interest to extend to the post-petition “proceeds, products, offspring, or profits” of collateral if the security agreement expressly provides for such post-petition extension, and if the security interest has been properly perfected. The court noted that “a creditor is not entitled to the protections of section 363(c)(2) unless its security interest satisfies section 552(b).”

To prevail on its motion to prohibit the debtor from using greens fees and driving range fees, the bank had to show both that its security interest attached to the fees, and that the fees were “proceeds, products, rents or profits” of the pre-petition collateral.

The bank first argued that the fees were rents for use of the debtor’s real property. The court applied the general test (the “*Zeeway* test”) adopted 25 years earlier for determining whether income from real property constitutes rents: “If the income is produced by the real property, it is considered rents; but if the income is the result of services rendered or the result of the specific business conducted on the property, then it does not constitute rents.” Following the *Zeeway* test, other courts had concluded that greens fees were not directly tied to or wholly dependent on the use of the real property, but were the result of the operation of the golf course business and services rendered on the property. The court held that, under the *Zeeway* test, greens and range fees collected by the debtor were not rents because the fees derived from services and the debtor’s business operations.

The bank alternatively asserted that the fees were proceeds or profits of the collateral. There was no dispute that the debtor collected fees from golfers in exchange for a temporary license to use its facilities. The court noted that section 552(b) is intended to cover after-acquired property—like the fees—only to the extent the fees are “directly attributable to the prepetition collateral” without the addition of estate resources, such as the debtor’s post-petition maintenance work on the land (e.g., watering, fertilizing, cutting, re-positioning holes). The court held that the fees were not proceeds of the bank’s collateral because “revenue that the Golf Club generates post-petition on the licenses is not merely from issuing a license to its customers but is largely the result of the Golf Club’s labor and own operational resources, which make the license valuable to golfers.”

The court then turned to the question of whether the fee revenue constituted proceeds of other general intangible property. Because the transaction between the debtor and its customers was a simultaneous grant of a temporary license to play in exchange for payment, there was no account or payment intangible, and thus, “no proceeds of the collateral generated.” Further, the court noted that the bank had to have possession of the revenue in order for a security interest in the fees to be perfected.

Finally, the court concluded that the fees were not “profits” from the collateral, because “profits” in section 552(b) refers to the sale of real property.

The court affirmed the bankruptcy court denial of the bank’s motion.

PRACTICAL CONSIDERATIONS

This holding is in line with decisions addressing revenue generated from restaurants, nursing homes and racetracks, and is further evidence of the balance that the Bankruptcy Code strikes between giving a debtor the opportunity to free itself from pre-petition obligations and make a fresh start, and upholding a secured creditor’s right to maintain a bargained-for interest in certain items of collateral. The section 552(b) exception, allowing the extension of a security interest to after-acquired property, is a narrow one, and this court found that the bank’s blanket security interest was too wide to fit through this narrow exception.

Determining Whether a Chapter 11 Plan Is Unconfirmable Without a Confirmation Hearing—continued from page 5

interest under circumstances that are especially concerning.” Here, the court found that the plan “set up a system in which Skinner would be financially incentivized to sabotage its own defense[s],” while at the same time being contractually obligated to cooperate with its insurers in advancing such defenses. The Third Circuit further noted that it was troubled by the fact that the alternative claim resolution process that created this inherent conflict of interest also severely limited the substantive and procedural rights of the insurers.

Finally, the Third Circuit found that the bankruptcy court had not abused its discretion in converting the chapter 11 case to a chapter 7 case because Skinner had been unable to effectuate a confirmable plan within a reasonable period of time, and there was not a reasonable possibility of a successful reorganization within a reasonable period of time.

PRACTICAL CONSIDERATIONS

Under the Third Circuit’s holding, so long as due process is protected, a bankruptcy court may determine at a hearing on a disclosure statement whether a confirmation defect exists in a proposed plan that renders the plan patently unconfirmable, and is not required to force the parties to proceed with the expense of solicitation, discovery, and a contested confirmation hearing. Thus, the Third Circuit’s holding provides opponents to a proposed plan with a potentially powerful litigation tool at the time of the hearing on the disclosure statement. Instead of merely filing a routine “adequate information” objection, plan opponents can attempt (based on solid authority) to stop the entire plan confirmation process at the disclosure statement hearing. As a result, the hearing on the disclosure statement may have increased importance to a debtor’s overall bankruptcy case, and debtors may need to be prepared to defend their plans at an earlier stage in the bankruptcy case, in particular, with respect to feasibility and whether the plan’s provisions create conflicts of interest. Finally, after this decision, bankruptcy courts may feel less inclined at the disclosure statement hearing to clog their dockets with “visionary or impracticable schemes for resuscitation.”

Secured Creditor Does Not Participate in Bankruptcy Case, Court Allows Lien to Pass Through Plan Confirmation—continued from page 4

their approaches. Some courts have held that the only participation necessary is the receipt by the creditor of notice of the plan and the opportunity to object. There was, however, no factually analogous Fifth Circuit precedent, nor was there controlling Fifth Circuit precedent setting forth what constitutes "participation." The court stated that it found no controlling or persuasive authority that "held that the participation requirement is satisfied by receipt of notice alone." Therefore, the court was "of the view that the weight of persuasive authority supports the conclusion that more than the mere receipt of notice is necessary to satisfy [the Fifth Circuit's] participation requirement."

The court also stated that "extinguishing Acceptance's lien under these circumstances would be inequitable," given that it enjoyed first priority and that under the debtor's plan, Acceptance received nothing while the junior creditors were paid in full over time. Moreover, "had [the debtor] wished to conclusively resolve the question of the validity of the lien within the bankruptcy after Acceptance failed to file a proof of claim, it could have brought Acceptance into the fray by filing a proof of claim on behalf of Acceptance and initiating an adversary proceeding." The debtor did not take any such action, and so the validity of the lien was never presented to or determined by the bankruptcy court.

The district court held that the Acceptance lien was not voided upon confirmation of the plan, and reversed and remanded the case.

PRACTICAL CONSIDERATIONS

The case supports the basic proposition that property rights, namely security interests, pass through bankruptcy unaffected. However, lienholders considering taking the same route as Acceptance Loan run the potentially significant risk of being deemed to "participate" in the bankruptcy case, and thus, losing out entirely. Secured creditors are cautioned to take active roles designed to protect their interests.

Separation of Claims Solely on the Basis of Personal Guaranty Not Permitted—continued from page 9

also held the personal guaranty of the debtor's principal. Facing foreclosure, the borrower filed for chapter 11. The debt owed to NYCB was $1.1 million, and the property's value was alleged to be $820,000. The debtor's proposed plan separated NYCB's claim into secured and unsecured classes, and separately classified NYCB's unsecured class from the other very small pool of unsecured creditors, in the hopes that the small pool of separately classified unsecured creditors would be an impaired class that would vote in favor of the plan to satisfy section 1129's cramdown requirements. NYCB made it clear that it would not vote in favor of the debtor's plan, and if its unsecured claim was classified with the other unsecured creditors, its vote would carry that class and render the plan unconfirmable.

COURT ANALYSIS

The debtor relied on a Ninth Circuit B.A.P. decision, *Wells Fargo Bank, N.A. v. Loop 76 LLC*, 465 B.R. 525 (B.A.P. 9th Cir. 2012), in which the court upheld the separate classification of the unsecured claims based, in part, on the existence of a personal guaranty. This court rejected the holding of *Loop 76*. The court relied on a Second Circuit case, *In re Boston Post Road Limited Partnership*, as well as the decisions of the majority of courts considering the issue, to determine that the existence of a personal guaranty, "with no other legitimate reason for separately classifying" claims, was not legally permissible to separately classify a claim.

The *Boston Post Road* case involved a separation of otherwise similar claims solely on the basis of the existence of a personal guaranty. That court stated that "approving a plan that aims to disenfranchise the overwhelmingly largest creditor through artificial classification is simply inconsistent with the principles underlying the Bankruptcy Code. A key premise of the Code is that creditors holding greater debt should have a comparably greater voice in reorganization. The debtor must adduce credible proof of a legitimate reason for separate classification of similar claims." Citing a New York bankruptcy court case, the court also noted that recourse and nonrecourse creditors "are of equal rank with equal rights within chapter 11." The court further cited a California bankruptcy court case that declined to follow *Loop 76*.

The court concluded that "the Debtor's separate classification of NYCB's unsecured deficiency claim, in this case, is an improper gerrymandering of classes intended to obtain the vote of an impaired class of creditors and not for any other legitimate reason."

PRACTICAL CONSIDERATIONS

An undersecured creditor will often have a sufficiently large unsecured claim to defeat cramdown attempts by a debtor, but the *Loop 76* case called this issue into question where the creditor took the extra precaution of obtaining a guaranty by the debtor. Undersecured creditors should be on the lookout for attempts by a debtor to gerrymander their claims, and should be prepared to contend with minority decisions like *Loop 76* that might give a bankruptcy court grounds to permit such gerrymandering to save the debtor's case.

Discrimination in Classification of Claims Okay, So Long as Not Unfair Discrimination—continued from page 10

and not simply discrimination of any kind, the court applied a four-part test applicable in the Fourth Circuit. Under this test, the court must consider: whether there is a reasonable basis for the discrimination; whether the plan can be confirmed and consummated without the discrimination; whether the discrimination is proposed in good faith; and, the treatment of the classes discriminated against. The court also noted that the magnitude of discrepancy between the percentage of recovery for classes is often controlling in a court's analysis of discrimination, i.e., the greater the magnitude, the more likely a court will find the plan unfairly discriminates. The debtor's evidence established that the Class 14 creditors would likely receive a greater percentage of their claims than the Class 15 creditors, and that they would likely receive a greater percentage than if their claims were combined in a single class with the Class 15 claims. The court evaluated the other three factors, and concluded that the Class 14 claims were not unfairly discriminated.

Finally, the court addressed the question of whether the plan was fair and equitable. The plan opponents argued that the plan violated the absolute priority rule by making payments to Class 15, a class made up of equity holders, without paying Class 14 in full. The court disagreed, pointing out that the payments to Class 15 creditors were not going to be made "on account of" their status as equity holders. "Rather, the shareholders in Class 15 are receiving this property based on their legal status as unsecured creditors of the debtor."

The court confirmed the plan.

PRACTICAL CONSIDERATIONS

This opinion provides support for debtors and plan proponents to classify unsecured (non-equity) shareholder claims separately from general unsecured claims. It also adds to the body of cases that finds unfair discrimination is not present where the magnitude of difference of recovery between the discriminated class and non-discriminated class is not great.

Continuing 'Material' Obligations Render License Agreement Executory – Lewis Brothers Affirmed continued from page 10

which LBB relied in support of its position, *In re Exide Technologies*, 607 F.3d 957 (3d Cir. 2010), which involved a similar factual situation. Exide Batteries had sold operations and assets to EnerSys, and executed a perpetual license of its trademarks in conjunction with the sale. Several years after all assets had been transferred and consideration paid, Exide filed for bankruptcy, and sought to assume the license agreement. The *Exide* court held that all obligations had been substantially performed, and that the license agreement was therefore not executory, and not subject to assumption.

Unlike in *Exide*, here the court determined that material obligations of performance remained, pointing to a provision in the license agreement that explicitly required that LBB continue maintaining the quality of goods sold, and that its failure to do so would constitute a "material breach" entitling Interstate to terminate the agreement (as well as other ongoing "material" obligations under the license agreement). There were no similarly material ongoing obligations in *Exide.* The ongoing obligations therefore made the license agreement an executory agreement that was subject to assumption.

Dissenting Opinion – Judge Colloton dissented, based on his finding that the license agreement and the contemporaneous asset purchase agreement constituted a single integrated agreement, and that the majority failed to find material obligations outstanding on both sides of the contract. Without mutual material obligations outstanding, the dissent argued that there could be no executory contract.

PRACTICAL CONSIDERATIONS

As this decision makes clear, "perpetual licenses" may not, in fact, be perpetual in the bankruptcy world. Careful drafting and bankruptcy planning may save such a license post-bankruptcy, and, as we cautioned in the June 2011 *CR&B Alert* in which we discussed the district court's decision in this dispute, such contracts for perpetual licenses require very careful drafting with the advice of a bankruptcy attorney.

COUNSEL'S CORNER: NEWS FROM REED SMITH

Presentations

Marsha Houston spoke October 15, 2012, at the Los Angeles Bankruptcy Forum Dinner Program, "Six First-Day Motions in Sixty Minutes." This program addressed such first-day motions as Cash Collateral, Utilities, Critical Vendors, Insider Compensation, Employee Issues and existing Cash Management Systems.

Jeanne Lofgren spoke December 7, 2012, in Pittsburgh for the Allegheny County Bar Association's 25th Annual Bankruptcy Symposium on "Oil and Gas Law Update – Intersection with Bankruptcy Law."

Bob Simons and **Luke Sizemore** were speakers at the Bankruptcy Inns of Court November 29, 2012, at the Chapter 9 Municipal Bankruptcies program. This program included such additional speakers as Bankruptcy Judges Mary France, Harrisburg, Pennsylvania, and Tom Bennett, Jefferson County, Alabama.

Bob Simons was a presenter for the National Business Institute's Bankruptcy Litigation 101 program in Pittsburgh November 9, 2012.

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