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SELLERS BEWARE—UNAUTHORIZED PAYMENTS FROM 'CASH COLLATERAL' WILL BE AVOIDED

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Marathon Petroleum Co., LLC v. Cohen (In re DELCO Oil, Inc.), **599 F.3d 1255 (11th Cir. March 16, 2010)**

CASE SNAPSHOT

Suppliers to chapter 11 debtors-in-possession should always ensure that they are not being paid from the debtor's "cash collateral" without court approval. Marathon Petroleum Company supplied products to debtor Delco Oil in the ordinary course of its business during the bankruptcy case, but was forced to return all of the post-petition payments it received from Delco, pursuant to section 549 of the Bankruptcy Code. Marathon was required to return these payments because they were deemed part of the cash collateral that was secured by Delco's pre-petition creditor, CapitalSource Finance. Marathon provided valuable goods to Delco in exchange for payment, and was unaware that Delco was using cash collateral to make payment. Unfortunately for Marathon, section 549 strictly mandates the return of unauthorized post-petition payments. Further, UCC 9-332(b) (which outside of bankruptcy cases ordinarily protects innocent transferees of deposit accounts from claims by prior lien claimants) did not apply because the issue was not one of lien priority, but of unauthorized transfers.

FACTUAL BACKGROUND

On October 16, 2007, Delco Oil, Inc. filed for chapter 11 bankruptcy protection, and was permitted by the court to continue operating its business as a debtor-in-possession. Delco moved for approval to use its cash collateral, which was secured by properly perfected UCC-1 filings by CapitalSource, but the court denied the motion on CapitalSource's objection. (Section 363(a) of the Bankruptcy Code defines "cash collateral" to include cash, negotiable instruments, deposit accounts, and other cash equivalents, whether existing before or after the filing of a bankruptcy petition.)

Marathon, which supplied products to Delco pre-petition, continued to do so after the bankruptcy filing. After its bankruptcy filing, but before the court ruled on its motion to use its cash collateral, Delco paid $1.9 million in cash to Marathon in exchange for the products. (The funds for these payments came from what turned out to be covertly created bank accounts hidden from CapitalSource. Marathon was not aware of Delco's machinations.) Ultimately, Delco voluntarily converted its case to chapter 7, and the newly appointed chapter 7 trustee initiated actions against Marathon to avoid the payments under section 549(a) of the Bankruptcy Code. The bankruptcy trustee successfully recovered the post-petition payments to Marathon, and Marathon appealed.

COURT ANALYSIS

The Bankruptcy Code prohibits the post-petition use of cash collateral by a debtor-in-possession or a trustee, unless the secured party or the bankruptcy court authorizes the use of the cash collateral. As part of its decision to authorize the use of cash collateral, the bankruptcy court must find that the secured party's interest in the cash collateral is adequately protected.

Section 549(a) of the Bankruptcy Code allows a trustee to recover unauthorized post-petition transfers of property. To avoid such a transfer, the trustee need only show that a transfer of property of the debtor's estate was made following the filing for bankruptcy, and that the transfer was not authorized by the Code or the court.

The chapter 7 trustee successfully avoided the payments to Marathon under the deceptively simple theory that the post-petition payments to Marathon were made from Delco's cash collateral without the court's or CapitalSource's approval, and were thus not authorized under section 363(a). Because the transfers were not authorized, section 549(a) mandated their return.

Marathon raised several failed arguments in its attempt to keep the $1.9 million. First, Marathon argued that the funds were not cash collateral under state UCC law. Specifically, UCC section 9-332(b) provided that transferees take funds from deposit accounts free of a security interest, so long as the transferee did not collude to violate the rights of the secured party. The court disposed of the argument as irrelevant. The issue was not whether CapitalSource had a priority lien over the cash under the UCC, but whether the debtor was permitted to transfer the cash in the first place. Because the debtor clearly did not have the requisite authorization, the transfers to Marathon fell squarely within the prohibitions of section 549(a).

Marathon also argued that a material question of fact existed as to whether the funds it received were identifiable proceeds of CapitalSource's secured collateral. Marathon suggested that the cash may have come from some other source, but failed to provide sufficient evidence to contravene CapitalSource's blanket security interest. Although the issue was not addressed in the opinion, it is ironic (and unfortunate for Marathon) that the source of the cash funds in the accounts may very well have come from Delco's sale of Marathon's products.

Marathon also argued that, because it had given Delco inventory in exchange for the money, it had given equivalent value, and thus no harm had been done to the bankrupt estate or CapitalSource. The court rejected this argument as well, pointing out that there was no "equivalent value" defense under section 549.

The Circuit Court denied each of Marathon's arguments, and held that the trustee could avoid and recover the payments made to Marathon.

PRACTICAL CONSIDERATIONS

Creditors and suppliers to debtors-in-possession must be extra cautious about the source of post-petition payments coming from the debtor. Bankruptcy courts typically permit a debtor-in-possession to use its cash and other assets to continue operating. After all, one of the purposes of chapter 11 is to allow a debtor a chance to reorganize its affairs through the continued operations of its businesses. Nevertheless, it is clear that a debtor cannot use cash collateral that is secured by one of its creditors, to pay its suppliers or other creditors, unless

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the debtor obtains either the secured creditor's permission or a court order allowing it to do so.

The lesson is quite clear: any party that plans to supply products to a debtor-in-possession should get assurances and should independently investigate whether the debtor is paying from its cash collateral. In Marathon's case, the fact that CapitalSource had objected to Delco's request to use its cash collateral, and the fact that CapitalSource had a blanket lien on Delco's assets, were red flags that warranted extra investigation.

THE THIRD CIRCUIT EXPANDS THE SUBSTANTIAL-PERFORMANCE TEST TO DETERMINE IF A TRADEMARK LICENSE CONTRACT IS EXECUTORY

In re Exide Technologies, **607 F.3d 957 (3rd Cir. June 1, 2010)**

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CASE SNAPSHOT

This is an interesting case of seller's remorse. Debtor Exide sought to take back its battery trademark from EnerSys by rejecting the licensing agreement under section 365 of the Bankruptcy Code. Exide attempted to do this even though EnerSys had long since purchased Exide's battery business and exclusively used the trademark for 10 years under the parties' agreements. The Bankruptcy Court and District Court ruled that the agreement was executory and, therefore, subject to rejection under section 365. The Third Circuit Court of Appeals disagreed, and found that EnerSys had substantially performed its obligations under the agreements; thus, the agreements were not executory and could not be rejected by Exide. The court further held that it was expanding the substantial-performance test beyond construction and employment law cases.

FACTUAL BACKGROUND

In 1991, Exide agreed to sell its industrial battery business to EnerSys Delaware, Inc., for $135 million. The assets sold included manufacturing plants, inventory, and, at issue here, a perpetual, exclusive, royalty-free license to use the "Exide" trademark in the battery business.

Exide continued to operate its other business lines under its own trademark, and EnerSys made and sold batteries under the Exide name and trademark. In 2000, Exide desired to re-enter the battery business, and attempted to regain its name and trademark from EnerSys as part of a strategic goal to unify its corporate image, and use its name and trademark on all products that it produced. EnerSys agreed to shorten the non-competition provisions in the agreements to permit Exide to re-enter the business, but refused to sell the "Exide" trademark back to Exide. Exide purchased a battery company, and began selling batteries under a different name. This put Exide in direct competition with EnerSys products sold as "Exide" batteries. This endeavor did not succeed, and Exide filed for chapter 11 bankruptcy protection in 2002.

Seeing an opportunity to take back the deal, Exide filed a motion to reject its agreement with EnerSys under section 365(a) of the Bankruptcy Code, arguing that the contract was executory, and that rejection of the agreement terminated EnerSys' rights under the agreement. The Bankruptcy Court and the District Court agreed, and held for Exide. EnerSys appealed to the Circuit Court of Appeals.

COURT ANALYSIS

The Bankruptcy Code does not define "executory contract." Courts have defined the term to mean a contract under which the obligations of both the bankrupt and the other party are so far underperformed that the failure of either party to complete performance constitutes a material breach, excusing the performance of the other party.

Conversely, if either party has substantially performed—in other words, if neither party had any material obligations remaining—the agreement could not be executory. To determine whether substantial performance had been rendered here, the court considered several factors:

- The ratio of performance rendered to that not rendered
- The quantitative character of the default
- The degree to which the purpose behind the contract had been frustrated
- The willfulness of the default
- The extent to which the aggrieved party had already received the substantial benefit of the promised performance

The Court of Appeals did not buy Exide's arguments that the contract had not yet been substantially performed. EnerSys paid the $135 million purchase price in full, used all of the assets transferred, assumed Exide's liabilities, and had used the Exide trademark consistently for 10 years. Indeed, the court ruled that both parties had already substantially benefitted from their performance. The remaining terms of the agreement were minor, i.e., use restrictions, quality standards provisions, indemnity obligations, and further assurances obligations, and had either expired or had been treated by Exide as unimportant terms. As such, the facts were clear that the contract had substantially been performed.

Exide also argued that the substantial-performance test was irrelevant, because it had previously applied only in construction and employment cases. The Court of Appeals disagreed, identifying a 2007 case from the Second Circuit that had applied the test in another context. Moreover, the Court of Appeals

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The Third Circuit Expands the Substantial-Performance Test to Determine if a Trademark License Contract is Executory —continued from page 3

also “conclude[d] that we will not confine the doctrine to construction and employment contract cases.”

Accordingly, because the agreement did not contain at least one ongoing material obligation, it was not an executory contract and could not be rejected by Exide.

CONCURRING OPINION DISCUSSES THE REJECTION OF TRADEMARKS

Circuit Judge Ambro wrote separately to address the Bankruptcy Court’s determination that “[r]ejection of the Agreement leaves EnerSys without the right to use the Exide mark.” Judge Ambro reasoned that the rejection of a trademark license agreement did not deprive the non-debtor party of its use of the trademark. The debtor’s rejection would permit it to use the trademark, as before, but it did not take away the other party’s contractual rights to use the trademark.

Judge Ambro cited a string of decisions in other circuits holding that the rejection of a contract was not the same as a rescission of the contract. Although rejection relieved the debtor of its burdens under the contract, it did not, *per se*, take away the benefits of the contract from a non-debtor party. (Interestingly, section 365(n) of the Bankruptcy Code creates similar protections for non-debtor parties for intellectual property, but does not include trademarks in its definition of “intellectual property.”)

This concurring opinion cannot be relied upon as precedent, since it is not part of the central holding of the case. It is informative, however, and could be useful in a trademark licensee’s argument that trademark license rejection should not be used to freely allow a licensor to take back trademark rights it bargained away.

PRACTICAL CONSIDERATIONS

Although companies considering filing for bankruptcy often think that section 365’s rejection provisions are a panacea, they should analyze—with an experienced bankruptcy attorney’s help—whether key contracts can actually be rejected before filing for bankruptcy.

COURT BREAKS FROM MAJORITY RULE, GRANTING RETIREES POST-PETITION RIGHTS GREATER THAN PRE-PETITION RIGHTS

***IUE-CWA v. Visteon Corporation,* 2010 WL 2735715 (3rd Cir. July 13, 2010)**

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CASE SNAPSHOT

The Third Circuit Court of Appeals broke from the Second Circuit, and a majority of lower court decisions, to give union and non-union retirees more protections in bankruptcy under their benefit plans than were provided for in the benefit plans themselves. The Court of Appeals held that section 1114 of the Bankruptcy Code, which sets forth strict procedures for obtaining modification of retiree benefit plans, requires the debtor to abide by those procedures before cancelling retiree health and life insurance benefits. This decision prohibits a debtor-employer from unilaterally terminating such benefits, even if the benefit plan itself permits the debtor to do so. Although the majority of courts in other circuits have ruled that Congress could not have intended to give more benefits post-petition to retirees than they had under their contracts pre-petition, the Court of Appeals disagreed, holding that the broad language in section 1114 is unambiguous on its face and that Congress did indeed intend to give retirees additional protections from the debtor and its other creditors.

FACTUAL BACKGROUND

The Industrial Division of the Communication Workers of America union represented hourly workers at manufacturing plants owned by Visteon Corporation. Visteon provided health and life insurance benefits to retirees, as set forth in the collective bargaining agreements and the summary plan descriptions. In the plan descriptions, Visteon reserved “the right to suspend, amend or terminate the Plan … at any time….”

On May 28, 2009, Visteon filed a petition for chapter 11 bankruptcy. Visteon continued to operate as a debtor-in-possession, restructuring with the goal of successfully emerging from bankruptcy.

Within weeks of the filing, Visteon moved the Bankruptcy Court under section 363(b)(1) (which has far less onerous restrictions than section 1114) for permission to terminate all retiree benefits. The court granted Visteon’s motion. This affected some 8,000 people in all, 2,100 of whom were represented by this union. The union appealed to the District Court, which affirmed the termination. The union then appealed to the Third Circuit Court of Appeals.

Section 1114

Section 1114 provides procedural and substantive protections for retiree benefits during a chapter 11 case. The primary subsection at issue, 1114(e), provides: “[n] otwithstanding any other provision of this title, the [trustee or debtor] *shall timely pay and shall not modify any retiree benefits*” unless the court orders, or the trustee and the authorized representative of the retirees agree to, the modification of such benefits (emphasis added). Section 1114 requires a debtor to make a modification proposal to retirees, disclose its financial information, and to meet and confer with retirees in good faith discussions. If such efforts fail, the court will only grant a motion to modify benefits over retiree objections if the retirees refused to accept the proposal without “good cause,” and the “modification is necessary to permit the reorganization of the debtor and assures that all creditors, the debtor, and all of the affected parties are treated fairly and equitably….”

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Court Breaks from Majority Rule, Granting Retirees Post-Petition Rights Greater than Pre-Petition Rights—continued from page 4

The Bankruptcy and District Courts both concluded—consistent with the majority of courts that have ruled on the issue— that since Visteon had the right to terminate the benefits at-will outside of bankruptcy, it continued to have that right during bankruptcy. Essentially, those courts held that restricting Visteon's contractual right to terminate benefits during bankruptcy would give the union greater rights in bankruptcy than the union had outside of the process, which would serve no bankruptcy purpose. Therefore, these courts concluded, section 1114 was inoperable here.

The union appealed, arguing that the plain, unambiguous language of section 1114 made no exceptions for benefit plans that permitted unilateral termination. The retirees argued that section 1114 was enacted, along with its counterpart section 1129(a)(13), as the primary components of the Retiree Benefits Bankruptcy Protection Act of 1988. The union noted also that this legislation was the direct result of public and Congress' dismay regarding the actions of LTV Corporation, which during its 1986 bankruptcy, terminated the health and life insurance benefits of 78,000 retirees without notice.

COURT HOLDING

The Court of Appeals held "that section 1114 is unambiguous and clearly applies to any and all retiree benefits, including the ones at issue here. Moreover, despite arguments to the contrary, the plain language of section 1114 produces a result which is neither at odds with legislative intent, nor absurd. Accordingly, disregarding the text of that statute is tantamount to a judicial repeal of the very protections Congress intended to afford in these circumstances."

However, the Court of Appeals also ruled that these protections were somewhat fleeting, and that upon the entry of a plan confirmation order, section 1129 permitted the debtor to unilaterally terminate benefits under the express language of its agreements—assuming that the debtor did not modify retiree rights under 1114 before entry of the confirmation order.

COURT ANALYSIS

The Court of Appeals acknowledged that its decision was at odds with the majority of bankruptcy and district courts that had addressed this issue, and was seemingly in tension with a Second Circuit opinion as well. "We are convinced that in reaching these contrary conclusions as to the scope of section 1114, these courts mistakenly relied on their own views about sensible policy, rather than on the congressional policy choice reflected in the unambiguous language of the statute." The Court of Appeals supported its decision on three grounds: the language of the statute; legislative intent; and, lack of absurdity in this statutory interpretation.

Plain Statutory Language

The court began by analyzing the language of the statute. The section states that the bankruptcy trustee "shall timely pay and shall not modify any retiree benefits," except through the procedures set forth in the statute. The only subsection of 1114 that limits this requirement deals with high-income retirees. Otherwise, section 1114 does not allow a debtor or trustee to terminate or modify retiree benefits outside of the procedures set forth in the statute—not even if the benefit agreement permits unilateral termination.

The Court of Appeals ruled that other courts were mistaken in their findings that section 1114 was rendered ambiguous by the language of 1129(a)(13). Unlike section 1114, section 1129(a)(13) requires that a debtor's reorganization plan provide for "the continuation after its effective date of payment of all retiree benefits … for the duration of the period *the debtor has obligated itself* to provide such benefits (emphasis added)." In other words, section 1129(a)(13) recognizes that a debtor may not have obligated itself to provide such benefits. Based on the seeming inconsistencies, the majority of courts have ruled that Congress must have intended section 1114 to have a similar "carve-out." The Court of Appeals disagreed, holding that Congress said what it meant, and meant what it said, and that the differences between the two statutory sections must have been intentional.

The court also addressed a relatively recent amendment to section 1114; namely, 1114(l). This subsection requires a court to reinstate retiree benefits to the status the benefits had just prior to any modification that a debtor made in the 180-day period before filing a bankruptcy petition. The court believed that this subsection strengthened its reading of section 1114(e), and provided "additional evidence of the coherence of the statutory scheme Congress has created here. . . . Although we think that the language of section 1114 was always unambiguous, this subsection certainly reinforces our view of the text."

Legislative History

Second, the Court of Appeals rejected Visteon's "cherry-picking favorable snippets of legislative history." The court cited the comments of several representatives and senators involved in drafting the legislation, as well as conference reports, in support of its reading of the statute. For example, the court cited the Senate Conference Report: "Section 1114 makes it clear that when a Chapter 11 petition is filed retiree benefit payments *must be continued without change until and unless* a modification is agreed to by the parties or ordered by the court. Section 1114 *rejects any other basis* for trustees to cease or modify retiree benefit payments." (Emphasis added in the opinion.)

The court even spent time reviewing the impetus behind the enactment of section 1114, the LTV Corporation bankruptcy and termination of benefits for 78,000 retirees. LTV's actions affected union and non-union employees. "Congress accordingly was fully committed to ensuring that both union and non-union employees would be equally protected by the Retiree Benefits Bankruptcy Protection Act."

Absurdity

Lastly, the court rejected Visteon's argument that it would be absurd to interpret "section 1114 to give retirees more rights under Chapter 11 than they would have outside of bankruptcy." The Court of Appeals ruled that Congress clearly intended to give additional protections to retirees during the pendency of a bankruptcy case, precisely when the debtor felt the most intense pressure from its creditors to terminate the benefits of its retirees. The court ruled that it was for this very

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Court Breaks from Majority Rule, Granting Retirees Post-Petition Rights Greater than Pre-Petition Rights—continued from page 5

reason that, after entry of an order confirming a plan of reorganization, and after these pressures were alleviated, section 1129(a)(13) once again permitted the debtor to unilaterally terminate these benefits if the agreements so provided (assuming no section 1114 modifications were made before confirmation).

"Far from being 'absurd,' a literal interpretation of section 1114 reveals a remedial and equitable statutory scheme that, consistent with Congress' concerns when enacting the RBBPA, attempts to prevent the human dimension of terminating retiree benefits from being obscured by the business of bankruptcy."

CONCLUSION

The Third Circuit Court of Appeals held that section 1114 is clear and unambiguous on its face. Visteon could not unilaterally terminate the retiree benefits without abiding by the procedures set forth in section 1114, even though Visteon had the contractual right to terminate the benefits outside of bankruptcy. "We need not, and should not, be concerned with whether retiree benefits should be extended greater protection during bankruptcy than otherwise; that is a job for Congress. We need only give effect to the law Congress has enacted."

However, so long as a debtor does not modify the subject agreements during the case under section 1114, it can regain its contractual rights to unilaterally terminate such benefits after the court approves its plan of reorganization.

PRACTICAL CONSIDERATIONS

If a company finds itself in a financial position where it can wait to unilaterally terminate benefits after confirmation (after section 1114 is no longer a bar), the company should be careful to not modify retiree benefits during the pendency of bankruptcy proceedings in such a way that it loses the contractual right to terminate post-bankruptcy under section 1129(a)(13).

LANDLORDS SUCCESSFUL IN OBTAINING STUB RENT AS AN ADMINISTRATIVE EXPENSE UNDER SECTION 503

In re Goody's Family Clothing, Inc. **- F.3d – 2010 WL 2671929 (3d. Cir. June 29, 2010)**

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CASE SNAPSHOT

The United States Court of Appeals for the Third Circuit held that the landlords are not precluded from seeking payment of "stub rent." Debtors often manipulate their bankruptcy filing date so that they can take advantage of existing case law interpreting section 365(d)(3) of the Bankruptcy Code, which holds that rental payments that are "due" prior to the filing of bankruptcy (even if the payment relates to occupancy after the bankruptcy filing) are not obligations that are required to be paid pursuant to the terms of the Bankruptcy Code. Thus, for many "first-day-of-the-month" leases, a debtor will file on a day after the first day of the month, arguing that the rental payment was due pre-petition and therefore the debtor can occupy the premises for the remainder of the month post-petition without the payment of any rent. This period is often referred to as the "stub period."

FACTUAL BACKGROUND

Goody's Family Clothing manipulated its bankruptcy filing in this manner. Goody's did not pay any rent for the month in which it filed for bankruptcy; however, it commenced paying regular lease payments on the first day of the month immediately following the bankruptcy filing. During the stub period, Goody's conducted going-out-of-business sales, securing a substantial return on the inventory sold and, in the process, obtained payment from the liquidation agent, for the agent's occupation of the space during that stub period.

Various landlords argued that they should be entitled to receive compensation for the debtor's occupation of the space during the stub period. Since the landlords could not seek recovery under section 365(d)(3) of the Bankruptcy Code (the section that governs the landlord's right to payment), the landlords sought recovery under section 503, the more traditional section of the Bankruptcy Code which governs allowance of administrative claims. The landlords argued that the ongoing occupation of the space during the stub period conferred an "actual necessary benefit on the estate," and that the expense associated with that occupation should be paid to the landlords. The debtor argued that section 365(d)(3) of the Bankruptcy Code was the exclusive right of recovery for landlords for post-petition occupation, and therefore no payment for the stub period could be made. The Bankruptcy Court granted the landlords' claims for the amounts due during the stub period and the District Court affirmed. Goody's took an ultimate appeal to the United States Court of Appeals for the Third Circuit.

COURT ANALYSIS

The Third Circuit began by underscoring its prior holdings that section 365(d)(3) of the Bankruptcy Code provides a mechanism for payment to landlords for the occupation of space during the post-petition period. The court noted, however, that the landlords were not seeking payment pursuant to section 365(d)(3); rather, the landlords were seeking authority under a separate and distinct section of the Bankruptcy Code for the stub period. The court quickly dismissed the debtor's argument that section 365(d)(3) was the exclusive remedy for post-petition occupation. While section 365(d)(3) references section 503 of the Bankruptcy Code, 365(d)(3) simply excuses a landlord's obligations to

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Landlords Successful in Obtaining Stub Rent as an Administrative Expense Under Section 503—continued from page 6

comply with the otherwise extensive evidentiary burdens of section 503 to obtain administrative expense status. The Bankruptcy Code does not make section 365(d)(3) the exclusive avenue for payment, nor does it preempt or supplant section 503. Therefore, a landlord is not prohibited from seeking payment under the "more stringent" section 503 standards.

After holding that a landlord could seek a claim for the stub period under section 503(b)(1), the court went on to explain that, to successfully obtain an administrative claim, the landlord must prove that the occupation of the space conferred an "actual and necessary benefit" to the debtor in the operation of its business. Noting that mere occupancy will not always confer "an actual and necessary benefit" on the estate, the court stated that the debtor here enjoyed a clear benefit beyond mere occupancy. Goody's conducted substantial going-out-of-business sales during the stub period, and collected an occupancy fee from its going-out-of-business sales agent. Therefore, it was clear that the occupation of the space during that stub period resulted in an easily identifiable benefit to Goody's, both in the conduct of the sales and in the recouping of expenses associated with occupation.

PRACTICAL CONSIDERATIONS

This case confirms the holdings of several lower courts within the Third Judicial Circuit, and confirms that landlords whose rent is not paid for the stub period can seek redress. However, the opportunity to seek redress involves a substantial evidentiary undertaking for the landlord. Often, the "one-month" rent associated with the debtor's filing manipulation does not justify seeking the increased burden to establish the allowance of a claim under section 503(b)(1) of the Bankruptcy Code; however, where the debtor has so clearly obtained a benefit from the occupation of the space during the stub period, this case confirms the landlord's entitlement to seek the claim so long as it can meet its requisite evidentiary burden.

DELAWARE BANKRUPTCY COURT FINDS APPOINTMENT OF EXAMINER NOT REQUIRED EVERY TIME THE STATUTORY DEBT THRESHOLD IS EXCEEDED

***In re Spansion, Inc.*, 426 B.R. 114 (Bankr. Del. April 1, 2010)**

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CASE SNAPSHOT

At the confirmation hearing regarding a chapter 11 debtor's plan of reorganization, the Bankruptcy Court considered an *ad hoc* committee of convertible noteholders' motion to vacate the order approving the debtors' disclosure statement. The motion was based on allegations that the debtors had engaged in misconduct and misrepresentation. In its motion, the *ad hoc* committee also moved for the appointment of an examiner under section 1104(c)(2) of the Bankruptcy Code, which provides for the appointment of an examiner when a debtor's debts exceed $5 million. Despite the express language of 1104(c)(2), the Bankruptcy Court denied the *ad hoc* committee's motion, finding that the statutory language does not require the appointment of an examiner in every instance when the debt threshold is exceeded.

FACTUAL BACKGROUND

Spansion, Inc. designed and manufactured semiconductor devices. When the economy took a severe downturn in 2008, demand for Spansion's products did as well. Spansion (and several subsidiaries) filed chapter 11 bankruptcy petitions in March 2009. Over the course of several months, Spansion negotiated with different creditors and interest holders, including the unsecured creditors committee, senior secured noteholders, junior noteholders, and unsecured and equity holders, attempting to finalize its reorganization plan. It was undisputed that Spansion's debt exceeded $5 million.

Over various objections, Spansion's disclosure statement was approved by the Bankruptcy Court, and its plan of reorganization was scheduled for a confirmation hearing. Spansion's reorganization plan included various distribution options for creditors, as well as various sources for the funding of the plan. Spansion intended to make a rights offering of new common stock to several classes of creditors, and a "backstop" rights offering to a specific investor.

Prior to submission of the plan to the Bankruptcy Court, the *ad hoc* committee of convertible noteholders made an alternative equity financing proposal to Spansion, which Spansion rejected, and which was not incorporated into its plan.

Days prior to the scheduled confirmation hearing, the *ad hoc* committee filed a motion seeking to vacate the order approving the disclosure statement and seeking the appointment of an examiner or trustee under section 1104(c)(2) of the Bankruptcy Code.

COURT ANALYSIS

The *ad hoc* committee alleged that the disclosure statement contained intentionally misleading information, and that Spansion had engaged in fraud or other misconduct. Primarily, the *ad hoc* committee argued that Spansion had misrepresented its financial forecasts, utilizing unreasonably conservative projections, thereby under-valuing the company and unfairly impacting unsecured creditors. The *ad hoc* committee argued that an examiner should be appointed under section 1104(c)(2) to investigate these alleged misrepresentations.

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Delaware Bankruptcy Court Finds Appointment of Examiner Not Required Every Time the Statutory Debt Threshold is Exceeded —continued from page 7

Appointment of an Examiner

Section 1104(c)(2) of the Bankruptcy Code provides that, after notice and a hearing, "the court shall order the appointment of an examiner to conduct an investigation of the debtor as is appropriate, including an investigation of any allegations of fraud … if … the debtor's fixed, liquidated, unsecured debts, other than debts for goods, services, or taxes … exceed $5,000,000."

Because Spansion's debts exceeded $5 million, the *ad hoc* committee argued that the statute required the Bankruptcy Court to appoint an examiner. The Bankruptcy Court disagreed, however, based upon its interpretation of the language of the provision and its review of decisions reached by other courts.

The Bankruptcy Court noted that some courts found that the language of 1104(c)(2) mandates an examiner be appointed when the debt threshold is met, regardless of whether the examiner was needed to perform any tasks or functions. In fact, some courts had gone so far as to appoint an examiner without assigning any duties to the examiner. Those courts reasoned that the statute required appointment, but that the phrase, "as is appropriate," gave the court discretion to assign – or not assign - duties to the examiner as it deemed fit. Other courts, however, decided that since bankruptcy courts have considerable discretion in dealing with examiner issues, and since the provision contains the phrase, "as is appropriate," a court could decide not to appoint an examiner in appropriate circumstances.

Appointment Neither Mandatory Nor Warranted

Here, the Bankruptcy Court focused its analysis on the phrase "as is appropriate," and reviewed other decisions in which the courts found that the appointment of an examiner was not mandatory. In particular, the Bankruptcy Court cited *In re Winston Indus., Inc.,* 35 B.R. 304 (Bankr. N.D. Ohio 1983), which found that appointment of an examiner was not required in instances where such an appointment is "needless, costly and non-productive and would impose a grave injustice on all parties herein."

Ultimately, the Bankruptcy Court found that the record before it did not contain sufficient evidence of "conduct that would make an investigation of the Debtors appropriate, but rather reveals deep heated differences of opinion about the value of the Debtors' companies." All parties had been vigorously represented and had conducted extensive discovery, and the court found no fraud or misconduct in the valuation methodologies. Based on these findings, the Bankruptcy Court found that no investigation was appropriate, and denied the motion to appoint an examiner, on the basis that an examiner in this case would not have substantive duties and would be wasteful. The *ad hoc* committee's allegation that Spansion's rejection of its alternative equity financing constituted misconduct was merely a "classic confirmation dispute," rather than grounds for the appointment of an examiner. As such, the court denied the *ad hoc* committee's motion.

PRACTICAL CONSIDERATIONS

The court in *Spansion* found that 1104(c)(2) does not require a court to appoint an examiner if the debtor has assets in excess of $5 million, unless there is evidence that there is an appropriate and sufficient basis to warrant an investigation by an examiner. In contrast, other courts view 1104(c)(2) as requiring the appointment of an examiner, regardless of the circumstances of the case. While there is no definitive standard, the Delaware Bankruptcy Court in *Spansion* indicated that it was appropriate for courts to perform an analysis of the facts of each case when considering the appointment of an examiner under 1104(c)(2). Furthermore, where the parties have already conducted extensive discovery, and there has not been a clear showing of fraud, a court may well conclude that appointment of an examiner would serve no useful purpose, and refuse to appoint an examiner under section 1104(c)(2).

THE THIRD CIRCUIT OVERRULES A LONG-STANDING CASE, CHANGING THE ABILITY OF PERSONAL INJURY PLAINTIFFS TO BRING SUIT AGAINST DEBTORS

JELD-WEN, Inc. v. Van Brunt (In re Grossman's Inc.), **(3d Cir. No. 09-1563, June 2, 2010)**

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CASE SNAPSHOT

The rules have changed in the Third Circuit for personal injury plaintiffs seeking recovery from bankrupt and reorganized debtors. After more than 25 years, the Third Circuit Court of Appeals recently overturned *Avellino & Bienes v. M. Frenville Co. (Frenville),* which long stood for the proposition that a "claim," as defined in the Bankruptcy Code, arises when the underlying cause of action accrues, as determined by state law. In *Grossman's*, the Third Circuit held that a bankruptcy "claim" arises when a person is exposed to a product or conduct prior to the filing of a debtor's bankruptcy petition, and such product or conduct gives rise to an injury underlying a right to payment under the Bankruptcy Code. Consequently, latent products-liability injuries that arise after a Third Circuit debtor's reorganization are now more likely to fall within the Bankruptcy Code's broad definition of "claim," rendering them capable of being discharged through a debtor's plan of reorganization. The court cautioned, however, that the dischargeability of such a claim depends upon satisfaction of the claimant's fundamental due process rights, including adequate notice of the bankruptcy case and key deadlines therein.

FACTUAL BACKGROUND

In 1977, Gloria Van Brunt purchased asbestos-containing products from a retail company called Grossman's. Grossman's filed for bankruptcy in April 1997. Ms. Van Brunt first manifested symptoms of mesothelioma (a cancer caused by asbestos exposure) in 2006 and was diagnosed in 2007. Grossman's provided notice by publication of the deadline to file proofs of claim in its bankruptcy case; Ms. Van Brunt did not file a proof of claim. Grossman's plan of reorganization, which was confirmed by the Bankruptcy Court in December 1997, purported to discharge all claims that arose prior to the plan's effective date.

Soon after her diagnosis, Ms. Van Brunt filed suit in New York state court against JELD-WEN, Grossman's successor-in-interest. JELD-WEN moved to reopen Grossman's bankruptcy case, seeking a determination that Ms. Van Brunt's claims had been discharged by the plan of reorganization confirmed 10 years earlier.

In determining whether Ms. Van Brunt's claims were discharged by Grossman's plan of reorganization, both the bankruptcy and district courts followed the Third Circuit Court of Appeals' holding in *Frenville*—a claim arises when a cause of action accrues under state law. Under New York law, a cause of action for asbestos-related injury accrues when the injury manifests itself. Since Ms. Van Brunt did not experience symptoms until nearly 10 years after confirmation of Grossman's reorganization plan, both the bankruptcy and district courts concluded that Ms. Van Brunt did not have a "claim" against Grossman's within the meaning of the Bankruptcy Code. Therefore, Ms. Van Brunt's products-liability claims were not discharged by Grossman's plan of reorganization. JELD-WEN appealed from the district court's holding.

THE COURT ADOPTS A NEW TEST

The Court of Appeals acknowledged that the bankruptcy and district courts correctly applied *Frenville's* "accrual test" in holding that Ms. Van Brunt did not have a "claim" capable of being discharged by Grossman's bankruptcy plan. Being aware of significant contrary authority, however, the Third Circuit Court of Appeals elected to consider whether *Frenville* should be overruled. In this case, the Third Circuit Court of Appeals found that the accrual test imposes too narrow an interpretation of the term "claim," and overruled *Frenville*.

In considering whether to overrule *Frenville*, the court recognized the refusal of other courts, including various circuit courts, to follow the accrual test because it results in a more narrow interpretation of the term "claim" than the Bankruptcy Code's definition requires. Section 105(8) of the Bankruptcy Code defines "claim" as "[a] right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, mature, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured . . . ." Overruling *Frenville* thus enabled the Third Circuit to reconcile the inherent conflict between the accrual test and the Bankruptcy Code's broad definition of "claim," which enables bankruptcy courts to address all of a debtor's legal obligations, including those that are remote or contingent.

In establishing the new test, the court considered the approach of its sister courts in various circuits that had declined to adopt *Frenville* in deciding the issue of when a "claim" arises. Although these specific tests vary, the Third Circuit noted a commonality that it described as "approaching consensus . . . that a prerequisite for recognizing a 'claim' is that the claimant's exposure to a product giving rise to the 'claim' occurred pre-petition, even though the injury manifested after the reorganization."

After extensively considering the existing case law in the various circuits, the court overruled *Frenville* in favor of a new test that provides "that a 'claim' arises when an individual is exposed pre-petition to a product or other conduct giving rise to an injury, which underlies a 'right to payment' under the Bankruptcy Code."

APPLICATION OF THE NEW TEST TO MS. VAN BRUNT

The Third Circuit went on to apply this test to Ms. Van Brunt. Under the newly established test, the court found that Ms. Van Brunt's claims arose in 1977 when she was exposed to the asbestos-containing products. The court noted that this did not necessarily mean that Ms. Van Brunt's claim had been discharged, however.

The Court of Appeals remanded this case to the District Court, instructing the lower court to determine whether Ms. Van Brunt's claims were discharged by Grossman's plan of reorganization. The Third Circuit instructed that whether Ms. Van Brunt's claim was discharged through Grossman's plan of reorganization

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The Third Circuit Overrules a Long-Standing Case, Changing the Ability of Personal Injury Plaintiffs to Bring Suit Against Debtors —continued from page 9

would depend upon satisfaction by Grossman's of her due process rights, including receipt of adequate notice of the bankruptcy case sufficient to protect her claim.

The Third Circuit then enumerated several factors that the lower courts may consider when evaluating the adequacy of the notice provided claimants, including Ms. Van Brunt. These factors include: the circumstances of the initial exposure to asbestos; whether and/or when the claimants were aware of their vulnerability to asbestos; whether the notice of the claims bar date of the debtor came to the claimants' attention; whether the claimants were known or unknown creditors; whether the claimants had a plausible claim at the time of the bar date; and other circumstances specific to the parties, including whether it was reasonable or possible for the debtor to establish a trust under section 524(g) of the Bankruptcy Code for future claimants. (Section 524(g) was enacted specifically to establish procedures for asbestos claims, such as the one in this case.)

PRACTICAL CONSIDERATIONS

Products-liability cases illustrate the inherent tension between a debtor's ability to achieve a fresh start through the bankruptcy process, and an injured party's ability to recover damages from a debtor when such injuries do not manifest themselves for many years. By overruling *Frenville*, the court affords debtors in the Third Circuit with comfort that latent injuries arising post-reorganization constitute a "claim" within the meaning of the Bankruptcy Code, if the exposure or conduct giving rise to such injuries occurred prior to the inception of a debtor's bankruptcy case.

Notwithstanding the Third Circuit's holding in *Grossman's*, however, debtors are cautioned that whether a discharge of such claims will occur through a plan of reorganization must be determined on a case-by-case basis. Accordingly, to maximize the likelihood of obtaining a discharge of claims that result from products-liability injuries that are asymptomatic at the time of reorganization, debtors who anticipate such claims are cautioned to carefully consider whether their actions during the bankruptcy case are capable of satisfying a potential claimant's constitutional due process rights, which include providing adequate notice of the bankruptcy case and key deadlines.

DEFENSE OF IMPUTATION OF AN AGENT'S BAD CONDUCT TO ITS PRINCIPAL CLARIFIED IN PENNSYLVANIA; INDEPENDENT AUDITOR AT RISK FOR $1 BILLION IN DAMAGES

Official Committee of Unsecured Creditors of Allegheny Health, Education and Research Foundation v. PricewaterhouseCoopers, LLP **(3d. Cir. No. 07-1397, May 28, 2010)**

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CASE SNAPSHOT

An independent auditor was sued by a nonprofit corporation's official committee of unsecured creditors, for breach of contract, professional negligence, and aiding and abetting a breach of fiduciary duty. The committee claimed damages in excess of $1 billion resulting from the auditor's alleged collusion with the corporation's officers to fraudulently misstate the corporation's finances. At the lower court level, the auditor prevailed on its argument that the fraud of the officers should be imputed to the corporation, thus preventing the corporation—and the committee standing in its stead—from collecting against the auditor because the corporation was as much at fault as the auditor. After obtaining an advisory opinion from the Pennsylvania Supreme Court, the Court of Appeals vacated the District Court's judgment and remanded the case to the District Court for further findings of fact.

FACTUAL BACKGROUND

The debtor is the Allegheny Health, Education and Research Foundation (AHERF), a nonprofit corporation that provided health care services through 14 hospitals, two medical schools and hundreds of physicians' practices. Throughout the 1980s, AHERF grew through a program of acquisitions. Unfortunately, AHERF was unable to deliver cost savings and efficiency gains as envisioned, and by 1996, AHERF was suffering substantial operating losses. During this time, independent auditing services were provided by PricewaterhouseCoopers (PWC).

A group of AHERF officers, led by the chief financial officer and operating with the approval of the president and chief executive officer, was alleged to have knowingly misstated AHERF's finances in the figures they provided to PWC for the 1996 audit. These misstatements were intended to show AHERF as enjoying positive financial conditions, rather than the dire conditions the company was suffering. PWC's audit failed to reveal the misstatements, and so PWC issued a clean opinion to the Board of Directors of AHERF as to the financial condition of the company. These same circumstances were allegedly repeated in 1997.

By early 1998, the poor financial condition of AHERF became widely known, as suppliers complained directly to board members, and doctors threatened to quit because of a lack of hospital resources. The financial damage was too deep, and in July 1998, AHERF filed a chapter 11 petition for bankruptcy.

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Defense of Imputation of an Agent's Bad Conduct to its Principal Clarified in Pennsylvania; Independent Auditor at Risk for $1 Billion in Damages—continued from page 10

In an adversary proceeding, the Official Committee of Unsecured Creditors of AHERF asserted three causes of action against PWC: (1) breach of contract; (2) professional negligence; and (3) aiding and abetting a breach of fiduciary duty. PWC moved for summary judgment, raising seven arguments in its defense. The District Court granted PWC's motion on the sole ground that the doctrine of *in pari delicto*—a doctrine that prevents courts from finding for a plaintiff when that plaintiff is as equally at fault as the defendant for the damages incurred—barred the Committee's claims. Specifically, applying principles of agency law, the District Court found that the wrongdoing of AHERF's senior management could be imputed to AHERF, and that, because AHERF was also at fault for the misstated financial statements, the doctrine of *in pari delicto* barred the Committee's claims. The Committee appealed to the Circuit Court.

Because questions were raised concerning the interaction between the doctrine of *in pari delicto* and the imputation of an agent's fraud to his principal under Pennsylvania law, the Circuit Court certified two questions to the state Supreme Court. This case discusses the findings of the Pennsylvania Supreme Court, and the Circuit Court's decision in light of those findings.

IMPUTING THE OFFICERS' WRONGDOING TO AHERF

The first question certified to the Supreme Court of Pennsylvania was: "[w]hat is the proper test under Pennsylvania law for determining whether an agent's fraud should be imputed to the principal when it is an allegedly non-innocent third-party that seeks to invoke the law of imputation in order to shield itself from liability?"

The Pennsylvania Supreme Court responded that the key was whether the defendant dealt with the principal in good faith. The Pennsylvania Supreme Court noted, however, that this underlying principle had different applications depending on whether the plaintiff was proceeding against the auditor under a theory of negligence or collusion.

In the negligence context, the Pennsylvania Supreme Court declared that a third party would generally be able to impute an agent's bad faith to the principal if that conduct benefitted the principal, but would not be able to impute the agent's conduct to the principal if the bad acts were only in the agent's self-interest.

In the collusion context, the Pennsylvania Supreme Court declared that if the auditor knew of the agent's bad or unsanctioned acts, the auditor cannot claim to have justifiably relied on the agent's statements, and no conduct can be imputed to the principal.

In reaching these holdings, the Pennsylvania Supreme Court expressly rejected the auditor's assertion that secretive falsification of corporate financial information by rogue officers can be regarded as a benefit to the corporation, instead finding that it is in the best interests of a corporation for the governing structure to have accurate (or at the very least honest) financial information.

Based on the foregoing, the Court of Appeals rejected the District Court's holding that "any benefit" received by AHERF as a result of the officer's conduct would result in imputation of that conduct to AHERF. Instead, the Court of Appeals held that, under the new directives provided by the Pennsylvania Supreme Court: (i) "a peppercorn of benefit cannot provide total dispensation to defendants knowingly and substantially assisting insider misconduct that is overwhelmingly adverse to the corporation," and (ii) as a matter of law, "a knowing, secretive, fraudulent misstatement of corporate financial information is not of benefit to a company."

IN PARI DELICTO

The second question asked of the Supreme Court was, "does the doctrine of *in pari delicto* prevent a corporation from recovering against its accountants for breach of contract, professional negligence, or aiding and abetting a breach of fiduciary duty, if those accountants conspired with officers of the corporation to misstate the corporation's finances to the corporation's detriment?" The court replied that, as a general matter, the defense is available to auditors. The court pointed out, however, that since imputation is not available as a defense to an auditor that has not dealt in good faith with the principal, collusion between the auditor and corporate officers effectively forecloses the defense of *in pari delicto*.

CIRCUIT COURT REMANDS THE CASE

In accord with the guidance from the Pennsylvania Supreme Court, the Circuit Court vacated the grant of summary judgment, and remanded the case to the District Court for further proceedings. Specifically, the Circuit Court instructed that the District Court determine whether the auditor dealt with AHERF in good faith. Furthermore, the District Court was instructed to re-examine the extent of benefit the agents' conduct conferred to AHERF, and to re-examine the benefit question in light of the Pennsylvania Supreme Court's holding that secretive, fraudulent misstatements are not a benefit at all to a principal.

PRACTICAL CONSIDERATIONS

By holding that knowing and fraudulent misstatements of corporate financial information by a corporation's officers do not, as a matter of law, provide a benefit to the corporation, the Pennsylvania Supreme Court has curtailed the circumstances in which those fraudulent misstatements can be imputed to the corporation. This holding thereby increases the likelihood that the corporation itself, or another party standing in its stead, can recover damages from accountants or other professionals for the damages resulting from those misstated financial records.

SANCTIONS AWARDED UNDER THE BANKRUPTCY COURT'S 'INHERENT AUTHORITY'

***In re 15375 Memorial Corporation, et al.,* 430 B.R. 142 (Bankr. D. Del. May 17, 2010)**

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CASE SNAPSHOT

The Bankruptcy Court sanctioned the indirect parent corporation of the chapter 11 debtors and the indirect parent corporation's counsel under its "inherent authority" and 28 U.S.C. section 1927 – but not Rule 9011 – after finding that the parent corporation abused the bankruptcy process by causing two of its subsidiaries to file bankruptcy petitions as a litigation tactic to shield itself from a $189 million liability in an environmental damage case.

FACTUAL BACKGROUND

This case concerned several corporate parties, all involved in oil and gas exploration. Bass Enterprises Production Company (Bass) and Santa Fe Minerals, Inc. (Santa Fe) were each in the chain of title for a mineral lease of land that was later found to be contaminated. 15375 Memorial Corporation (Memorial) was a holding company and immediate parent of Santa Fe. Entities Holdings, Inc. (EHI) was a holding company and the sole shareholder of Memorial. GlobalSantaFe Corporation (GSF) was the direct parent of EHI, and the indirect owner of both Memorial and Santa Fe. Bass was not affiliated with Santa Fe, Memorial, EHI, GSF, or any other party in this case.

Individuals affected by the contamination of the real property filed a state court complaint against Bass and Santa Fe. During discovery in this suit, the parties learned that Santa Fe, not Bass, was responsible for the contamination, and that it would take $189 million to remediate the property. Further, the individual plaintiffs made it known that if any defendant filed for bankruptcy, that defendant would be dismissed from the suit. In addition, as part of the state court suit, Bass asserted third-party claims against Santa Fe for damages done to the property, and asserted alter-ego claims against GSF.

In August 2006, EHI issued a demand note to Memorial, pursuant to which EHI provided a revolving line of credit to Memorial in exchange for Memorial's: (i) acceptance of all liabilities; and (ii) agreement to defend and indemnify GSF from all claims relating to Santa Fe's operations, regardless of whether those claims were based on alter-ego theories or other principles. Thereafter, Memorial and Santa Fe filed chapter 11 petitions, and the individuals' claims against them in the state court suit were dismissed.

Ultimately, Bass settled the claims against it in the state court suit for more than $20 million. As part of this settlement, Bass was assigned the state court plaintiffs' claims and rights against Santa Fe and GSF. Bass then filed proofs of claim against Santa Fe for assignment, contribution, indemnity and contamination of the property. Bass also sought relief from the automatic stay to pursue its alter-ego claims against GSF, but was denied this relief by the bankruptcy court on the theory that the alter-ego claims might constitute property of the bankruptcy estates.

COURT ANALYSIS

After years of litigation in the Bankruptcy Court between Bass, GSF and the debtors (with appeals up to the Third Circuit Court of Appeals, which resulted in the dismissal of the bankruptcy petitions for lack of good faith in their filing), Bass ultimately filed a motion for sanctions under Rule 9011 of the Federal Rules of Bankruptcy Procedure. The Bankruptcy Court denied this motion on the basis that the stringent standard of Rule 9011 requires "proof by the movant by clear and convincing evidence that no reasonable attorney could conclude that a debtor filed the case in good faith." Noting that: (i) it was unaware of any misrepresentations that had been made by any party; and (ii) it is not a *per se* violation of Rule 9011 to file a chapter 11 petition lacking in good faith, the Bankruptcy Court found that the high bar for Rule 9011 sanctions had not been met.

This, however, did not end the court's inquiry. Although the Rule 9011 request was denied by the Bankruptcy Court, the court did grant sanctions in excess of $2 million, on a joint and several basis, against GSF, EHI and their counsel. Specifically, the court recognized that it had inherent authority to impose sanctions for abuses in bankruptcy cases. In addition, it relied upon 28 U.S.C. secition 1927, which provides that "any attorney…who so multiplies the proceeding in any case unreasonably and vexatiously may be required…to satisfy personally the excess costs, expenses and attorneys' fees reasonably incurred because of such conduct."

In imposing these sanctions, the Bankruptcy Court held that it was clear that the sanctioned entities were in complete, direct control of Memorial and Santa Fe, and were dictating the filing and course of the bankruptcy cases. Further, the Bankruptcy Court held that GSF, EHI and their counsel improperly and intentionally used the bankruptcy process to thwart Bass' efforts for relief in the bankruptcy cases, and that "at every turn [they] manipulated and side-tracked the bankruptcy process for their own benefit, as non-debtors, to keep [Bass] on the defensive." The court found that GSF and its subsidiaries (which the court referred to as the "villains in these cases") had misused the bankruptcy process, "which resulted in significant, foreseeable and intended harm to [Bass]," compelling the court to impose sanctions.

In granting the $2 million in sanctions, the court denied the requests of the sanctioned entities to take discovery from Bass' attorneys regarding the attorneys' fees and expenses incurred. Instead, the Bankruptcy Court relied on its own experience in approving attorneys' fees requests, and determined that the attorneys' fees incurred were fair, reasonable, and appropriate to the work necessary. In addition, the Bankruptcy Court noted its desire to prevent a "second major litigation" over the reasonableness of Bass' fees. It did, however, reduce the sanctions award by an amount equal to Bass' fees on the various appeals pursued by the parties, finding that sanctions related to those appeals must be heard by the courts that heard the appeals.

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Sanctions Awarded Under the Bankruptcy Court's 'Inherent Authority'—continued from page 12

PRACTICAL CONSIDERATIONS

Generally speaking, courts are averse to awarding sanctions, seeking to avoid any chilling effect sanctions may have on vigorous legal representation. Where, however, conduct is so egregious and abusive of the legal process, courts are willing to impose sanctions. Parties, and their counsel, must be aware that a court has several weapons at its disposal to award sanctions, as the Bankruptcy Court in this case imposed sanctions under a non-bankruptcy provision of federal law.

TEXAS DISTRICT COURT AFFIRMS THE CONTRACTUAL DEFAULT INTEREST RATE WHERE THE DEBTOR IS SOLVENT

***Good v. RMR Investments, Inc.*, 428 B.R. 249 (E.D. Texas, March 31, 2010)**

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CASE SNAPSHOT

A secured creditor in a chapter 11 case objected to the confirmation of the reorganization plan of the debtor, arguing that the proper "cramdown" interest rate (court-modified rate) was the pre-petition contractual default rate, rather than the significantly lower cramdown rate. After the debtor appealed, the District Court affirmed, holding that utilizing the contract rate of interest was appropriate because the debtor was solvent.

FACTUAL BACKGROUND

Legacy Capital Investments, LLC, was in the business of real estate development. RMR Investments, Inc. entered into a promissory note with Legacy, whereby RMR loaned $7.8 million to Legacy. As part of this transaction, Legacy executed a deed of trust in favor of RMR, granting a first priority security interest in certain property and mineral rights.

The interest rate under the note was the higher of the prime rate plus 2.75 percent or 11 percent per annum. In the event of a default, the interest rate would increase by 4 percent. The maturity date of the note was the earlier of one year after the date of the note or upon an event of default.

Legacy filed its chapter 11 petition in June 2008, and shortly thereafter, Legacy filed its plan of reorganization. The plan proposed that the post-confirmation interest rate be set according to the prime rate. The plan also proposed that all Legacy creditors would be paid in full at the end of four years, and that Legacy would have an equity balance of roughly $85 million at that time.

Early in 2009, the Bankruptcy Court entered an order confirming Legacy's reorganization plan, over the objections of RMR. In that order, the court held that the proper cramdown rate of interest payable to RMR was the prime rate plus 2 percent (5.25 percent at that time), and that the proper length of payments was four years from the date of confirmation.

RMR filed a motion for reconsideration, arguing that – because Legacy was solvent – the proper interest rate was the contractual default rate of 15 percent, and that the proper term of payment was no more than three years. After a hearing, the Bankruptcy Court granted RMR's motion, amending the interest rate to 15 percent and the repayment term to no more than three years. Legacy then filed its own motion for reconsideration, which the Bankruptcy Court denied. Legacy appealed to the District Court.

COURT ANALYSIS

While the Bankruptcy Code does permit courts to approve plan terms over the objections of creditors, it does not set forth any methodologies for calculating the appropriate cramdown interest rate. In the absence of statutory direction, courts have used a wide variety of methods in these calculations. While some courts require specific methods for calculation of interest rates in chapter 11 cases, the Fifth Circuit has declined to do so. The Fifth Circuit has explained that such calculations require fact-specific, case-by-case determination to establish the appropriate interest rate. Given this latitude, the bankruptcy court's determination will not be overturned, absent clear error.

Here, the Bankruptcy Court applied the "presumptive contract" method, which is sometimes used in cases where the debtor is solvent, and is based upon the presumption that the court's role is "merely to enforce the contractual rights of the parties." The court noted, however, that the Fifth Circuit has also approved usage of the presumptive contract method in cases of insolvent debtors.

The court found that Legacy was in default of the terms of the note at the time it filed its petition, and that Legacy was solvent. Further, the court noted that payment to RMR at the contractual default rate would not reduce the payment that any other creditor would receive under the plan; it would simply reduce the $85 million in equity that would be available to Legacy at the end of four years. As such, the District Court affirmed the Bankruptcy Court's ruling and held that the default rate of interest under the loan documents was the appropriate rate of interest due RMR under the plan.

PRACTICAL CONSIDERATIONS

Although full of unusual factual circumstances (i.e., payment of all creditors in full, solvent debtor, $85 million anticipated equity cushion), this opinion demonstrates that a number of factors can be taken into consideration when arguing for a higher rate of interest under a plan of reorganization. Further, although unusual, it is not unprecedented for a secured creditor to be paid its contractual default interest in the context of a chapter 11 plan of reorganization.

AN LLC MEMBER/MANAGER IS AN 'INSIDER,' SO THAT PAYMENTS ARE PREFERENTIAL TRANSFERS SUBJECT TO AVOIDANCE UP TO ONE YEAR PRIOR TO BANKRUPTCY FILING

Longview Aluminum, LLC v. Brandt (In re Longview Aluminum, LLC), **2010 WL 2635787 (N.D. Ill., June 28, 2010)**

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CASE SNAPSHOT

A member of the Board of Managers of a limited liability company settled a lawsuit against the LLC, receiving partial payment four months prior to the LLC filing its petition for chapter 11 bankruptcy. The bankruptcy trustee sought to recover the payment to the member as a preferential transfer to an "insider." The Bankruptcy Court held that, despite having been stripped of many of his membership rights prior to the payment, the member was an "insider" of the LLC within the meaning of the Bankruptcy Code, and the payment was a preferential transfer that could be avoided and recovered by the trustee.

FACTUAL BACKGROUND

Longview Aluminum was organized in Delaware as a limited liability company. It was governed by a Limited Liability Company Agreement, which listed five members comprising its Board of Managers. Among these members was Mr. Forte. The LLC Agreement provided that Longview would be managed by the Board, and that Longview was required to promptly furnish members with relevant financial data. Members were also afforded the right to inspect the company's books and records.

On several occasions, Forte requested that Longview furnish business records and allow him to review the records; all of his requests were denied. Forte eventually sued one of his fellow members of the Board, alleging that the member was using his controlling interest to exclude Forte from any management decisions and any review of records. Longview intervened in that action, and was named as an additional defendant. The other members of the Board adopted a resolution that formally took away Forte's right to access Longview's records.

Forte and the defendants reached a settlement, whereby Longview would pay Forte $400,000 plus attorney's fees and costs, in exchange for Forte's agreement to leave the Board. On November 7, 2002, Longview delivered $200,000 to Forte as an initial payment. On January 16, 2003, Longview paid $15,000 to Forte as reimbursement for his attorney's fees. On March 4, 2003, Longview filed a chapter 11 petition.

William Brandt was appointed the trustee in the bankruptcy proceedings, and he filed an adversary action against Forte, seeking to avoid the payments of $200,000 and $15,000, as preferential transfers. Since the $15,000 payment was made within three months of the bankruptcy petition, Forte conceded that it was a preferential transfer, and he returned that money to the estate. The Bankruptcy Court found that Forte was an "insider" within the meaning of the Bankruptcy Code, and ordered Forte to return the $200,000. Forte appealed that decision to the District Court.

COURT ANALYSIS

A bankruptcy trustee, under section 547(b)(4) of the Bankruptcy Code, has the power to avoid any transfer a debtor makes in the 90 days preceding the bankruptcy petition filing. Further, the trustee has the power to avoid any transfer made to an "insider" of the debtor, if the transfer occurs between 90 days and one year prior to the petition filing.

The Bankruptcy Code does not define persons deemed to be an "insider" with respect to a limited liability company. Section 101(31)(B) provides that, if the debtor is a corporation, an "insider" is deemed to include a director of the debtor, an officer of the debtor, and a person in control of the debtor.

Forte argued that he was not an "insider" of the LLC since neither the term "manager" nor "member" is included in section 101(31)(B). Forte further argued that he was not an insider because he was not a person in control of the debtor. Thus, Forte contended that since the $200,000 payment to him occurred more than 90 days prior to Longview's bankruptcy filing, the trustee should not be able to avoid the payment.

The court looked to a Seventh Circuit case for the proposition that the term "insider" encompasses anyone with a "sufficiently close relationship with the debtor that his conduct is made subject to closer scrutiny than those dealing at arm's length with the debtor." The court then looked to Delaware law, which requires that a corporation generally must be managed by a board of directors. "Thus, in referencing a director, section 101(31)(B) was intended to refer to the party that 'managed' the debtor corporation." Further, Delaware law regarding LLCs states that the management of a limited liability company shall be vested in its members. Putting all of this together, the court found that a member of an LLC is analogous to a director of a corporation under Delaware law, and that Forte was, therefore, an "insider" under bankruptcy law.

Forte argued that, as early as 2001, he was no longer effectively a managing member of Longview since he was denied access to its books and records. Further, he argued, the August 2002, Board consent effectively stripped him of his status as a member. The court substantively examined this contention. First, the settlement agreement provided that Forte would remain a member of Longview until the entire $400,000 was paid. Forte had not received full payment, so he was still formally a member of the Board. The court also examined the Board consent, and concluded that, while the consent did strip Forte of his rights to examine the books and records, it did not strip Forte of any other rights, nor did it strip Forte of his status as a member of the Board of Managers of Longview.

Therefore, the court concluded, at the time of the $200,000 payment, Forte was still a member of Longview and a member of the Board of Managers, and that he was an "insider." Because the payment had been made to an insider, and had

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An LLC Member/Manager is an 'Insider,' so that Payments Are Preferential Transfers Subject to Avoidance Up to One Year Prior to Bankruptcy Filing—continued from page 14

occurred within one year of the bankruptcy filing, the trustee could avoid the payment made to Forte.

PRACTICAL CONSIDERATIONS

A party that has a close relationship with a debtor company may be deemed to be an "insider," regardless of the name or title the party has. This case illustrates that a creditor does not have to be a "director," or another term set forth in the Bankruptcy Code, in order to be an "insider." Courts will substantively examine relationships, state laws, and other relevant facts, in order to draw inferences and reach conclusions, especially where there may be some gap in the Bankruptcy Code. A creditor or other party deemed to be an "insider" stands to lose any transfers made to it by a debtor within one year prior to bankruptcy.

BROADER ECONOMIC WOES MAY HAVE PLAYED A PART IN THE COURT'S DECISION TO DISMISS ALLEGATIONS OF LENDER OVERREACHING

American Consolidated Transportation Companies, Inc. v. RBS Citizens N.A. (In re American Consolidated Transportation Companies, Inc.), **Adversary No. 10-00154, Bankruptcy No. 09-26062 (Bankr. N.D. Ill. July 13, 2010)**

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CASE SNAPSHOT

A chapter 11 debtor sued its principal secured lender over whether the lender had engaged in overreaching behavior with the debtor before the bankruptcy filing. The suit essentially alleged that the lender had induced the debtor to enter into a loan containing provisions the lender knew the debtor could not meet, and then used a default by the debtor to take control of and attempt to sell the debtor's business in order to recoup its loan. The Bankruptcy Court dismissed all but two of the debtor's counts, primarily on the basis that the debtor failed to plausibly plead a claim. The court ultimately concluded that the lender had done nothing more than take hard steps to protect its interests.

FACTUAL BACKGROUND

American Consolidated Transportation Companies provided bus and travel services. Though aware of problems with American's business, RBS Citizens entered into a banking relationship with American and its subsidiaries, expecting that it would be able to collect substantial fees and other revenue from American by providing ancillary services, such as commercial depository account services, letters of credit services, and merchant business services.

RBS and one of the American subsidiaries executed a variable rate term note in the principal amount of $4 million. Shortly thereafter, RBS and the American subsidiary executed an interest rate swap agreement, whereby the subsidiary would pay a fixed rate of interest, rather than a variable rate. RBS and other American subsidiaries entered into a loan and security agreement, involving a $1 million term note and a $1 million revolving line of credit. These transactions closed in September and October 2006.

The transaction documents contained a number of covenants regarding default, two of which are most relevant to this case. The first covenant required American to maintain a combined tangible net worth of at least $100,000 as of December 31, 2006, with specific annual increases. The second covenant required American to maintain a minimum cash flow so that the ratio of earnings to payments on the loans was always at least 1.20 to 1.00.

In June 2008, RBS sent American a default and acceleration letter, stating that American was in default of the net worth and cash flow covenants. At the time of this letter, American was current on its loan payments and not in default of any other loan provision.

RBS and American then entered into a forbearance agreement that, among other things, required American to pledge additional assets as collateral, retain a restructuring consultant of RBS' choosing, and take an active role in selling its own business. After the forbearance period ended, American filed a petition for chapter 11 bankruptcy, and RBS filed a proof of claim for more than $6 million.

COURT ANALYSIS

American alleged, and RBS internal documents showed, that RBS knew of material business problems within American even before the loan transactions closed. American had lost a major account, reducing its annual revenues by 25 percent, and RBS internal reports called into question several assumptions RBS had made about American's ability to increase sales, reduce costs, and increase prices in order to offset the revenue loss. RBS considered American's profitability to be "consistently below average" and its liquidity "weak." Because of the lost account, American was actually in default of the cash flow covenant at the time the loan documents were executed.

The forbearance agreement required American to hire a chief restructuring consultant. The consultant was given extensive managerial responsibility in connection with American's operations and businesses, and the primary responsibility of selling those businesses. Although American wished to remain in business, the forbearance agreement required American to use its best efforts to enter into a sale or refinancing transaction that would repay RBS in full, and to deliver at least one bona fide letter of intent or similar document no later than May 29, 2009. RBS itself was actively seeking proposals to liquidate American,

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and would have engaged a liquidation company had American not filed its bankruptcy petition.

American argued that these facts supported claims for equitable subordination of the RBS loan claim (Count I), damages for violations of the Illinois Consumer Fraud and Deceptive Business Practices Act (Count II), breach of fiduciary duty (Count III), breach of duty of good faith and fair dealing (Count IV), duress (Count V), subordination of the RBS swap claim (Count VI), and the undoing of the perfection of certain of RBS' security interests (Count VII and Count VIII).

In its motion to dismiss seven of American's claims, RBS made arguments falling into three categories: challenges to the plausibility of American's pleadings; assertions that some counts represent affirmative defenses and not causes of action under state law; and RBS' assertions of its own affirmative defenses.

Plausibility of Claims/Inadequacy of Pleadings

RBS argued that American did not adequately plead four of its claims. In examining the plausibility of American's allegations, the court noted that a complaint must contain "sufficient factual matter, accepted as true, to state a claim to relief that is plausible on its face." A complaint is plausible when "the plaintiff pleads factual content that allows the court to draw the reasonable inference that the defendant is liable for the misconduct alleged." Claims set forth in a complaint must be more than "conceivable," but not necessarily "probable."

The first count in American's complaint pleaded equitable subordination. Under section 510(c) of the Bankruptcy Code, a claim may be subordinated to another claim, and any lien securing a subordinated claim may be transferred to the debtor's estate. To subordinate a claim, American must show: (1) RBS engaged in some type of inequitable conduct; (2) the misconduct either resulted in injury to other creditors or conferred an unfair advantage on RBS; and (3) subordination is consistent with other provisions of the Bankruptcy Code. Under the holdings of other bankruptcy cases, types of inequitable conduct generally include fraud, illegality, or breach of fiduciary duties.

The legal relationship between the parties is a key component in determining whether conduct was truly inequitable. If RBS was a fiduciary with respect to American, then equitable subordination would be appropriate, unless RBS could show that the contested transaction was conducted at arm's-length. If RBS was not a fiduciary, then American would have to show that RBS' conduct was egregious, "gross misconduct tantamount to fraud or overreaching."

The court cited several cases in noting that a debtor-creditor relationship does not, in and of itself, cause the creditor to be a fiduciary. The creditor must exert operating control of the debtor's business in order to establish a fiduciary relationship. "Control must be so overwhelming that there is a merger of identity or a domination of the borrower's will." The court found that RBS never exerted that high level of control over American. Even the extensive responsibilities given to the restructuring consultant did not rise to the requisite level of control, since the consultant was not empowered to make unilateral operational decisions.

Since American did not plausibly plead that RBS was a fiduciary, the court examined whether American had pleaded facts showing egregious conduct. American cited six instances of supposed egregious conduct, none of which the court accepted as tantamount to fraud. In each assertion, the court found either that American's reasoning was simply not plausible or not sufficiently pleaded in the complaint so as to permit the court to draw inferences that RBS had engaged in such misconduct.

Here, the court concluded, "the Complaint shows little more than [RBS] taking hard steps to protect itself during years when the real estate market generally was in collapse."

Illinois Consumer Fraud and Deceptive Business Practices Act

To establish violation of this Act, American must show that: RBS engaged in a deceptive act; RBS intended that American rely on its deception; the deception occurred in the course of commerce; actual damage to American occurred; and the damage was caused by RBS' deception.

American alleged that RBS used its 2008 default letter as a pretext to liquidate American and regain the bank's capital, even though RBS knew that American was in default of those covenants before the loan transactions were closed in 2006. The court stated that, "it is not plausible on the face of these sparse and conclusory pleadings that the Bank used American's default as a pretext to control American and recoup its capital."

In each instance that American offered as proof of RBS' deceptive actions, the court replied that American's pleadings were either sparse, or not plausible. The court dismissed four counts of the complaint for American's failure to sufficiently plead a cause of action.

Dismissal of Other Claims

The court also dismissed two counts, breach of the covenant of good faith and fair dealing, and duress, on the grounds that neither constitutes an independent claim under Illinois law. The court did note, however, that they may stand as defenses to any claim RBS may make against American.

Broad Economic Context Counts

More than once in its opinion, the Bankruptcy Court mentions broader economic woes. In discussing American's allegations of deceptive acts, the court states, "[t]he United States economy and real estate market suffered from a historic deep recession while the events complained of here were unfolding. Adequate pleading would have to show more than a creditor protecting itself during that period." Though the court referenced RBS' superior negotiating position with respect to the forbearance agreement and its imposition of the restructuring consultant on American, it also stated that "American seems rather to have been facing a 'Hobson's choice' between financial collapse and forbearance on the Bank's terms, a choice not unusual in the present economy." As noted above, the court found that, rather than engaging in fraudulent or overreaching conduct, RBS

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was simply "taking hard steps to protect itself during years when the real estate market generally was in collapse."

PRACTICAL CONSIDERATIONS

Overreaching and resulting lender liability are real concerns of any lender, and careful consideration should be given to all actions taken during the lender's relationship with a borrower; in particular, when the loan enters workout. This case gives lenders some assurance that liability won't be imposed on a lender for taking steps that are commonplace in the current economic climate. Nevertheless, the line between protecting interests and overreaching is one that must be carefully treaded.

RISK LOSING YOUR FIRST PRIORITY LIEN IF YOU PROVIDE SUPERFLUOUS INFORMATION IN THE UCC FINANCING STATEMENT

In re EDM Corporation, **2010 WL 1929772 (8th Cir. BAP May 14, 2010)**

J. Cory Falgowski
Associate
Wilmington

CASE SNAPSHOT

A first-in-time secured lender is moved to the end of the creditor line when a field in the financing statement filed by the lender contains too much information. The court held that adding the debtor's trade name to the registered corporate name in the "name" field of a financing statement rendered the statement "seriously misleading" and therefore ineffective. To avoid this pitfall, a financing statement filed against a registered organization should only provide "the name of the debtor indicated on the public record of the debtor's jurisdiction of organization – nothing more and nothing less."

FACTUAL BACKGROUND

The case involved three lenders with liens against common collateral of the debtor, EDM Corporation. The debtor's official name registered with its state of incorporation (Nebraska) was "EDM Corporation," although it used "EDM Equipment" as a trade name. (EDM had never registered its trade name). The first-in-time lender, Hastings State Bank, filed a financing statement identifying the debtor as "EDM Corporation d/b/a EDM Equipment."

Subsequently, the debtor granted liens in the same collateral to TierOne Bank. TierOne ran UCC searches, using the Nebraska standard search logic, under the debtor name "EDM Corporation." However, none of the searches revealed Hastings' prior financing statement. TierOne filed a financing statement to perfect its perceived first priority lien. EDM subsequently granted liens in the same collateral to Huntington National Bank. Huntington ran the same UCC search as TierOne had, using the Nebraska standard search logic; this search did not reveal Hastings' financing statement, although it did reveal TierOne's financing statement.

EDM then filed a voluntary chapter 7 bankruptcy case, sparking a priority dispute among the three banks holding competing liens in the same collateral. The Bankruptcy Court held that Hastings' financing statement was not validly perfected, because a search for "EDM Corporation" utilizing the standard search logic did not reveal the statement identifying the debtor as "EDM Corporation d/b/a/ EDM Equipment."

COURT ANALYSIS

On appeal, the Bankruptcy Appellate Panel noted that Revised Article 9 of the Uniform Commercial Code provides that "a financing statement sufficiently provides the name of the debtor . . . if the debtor is a registered organization, only if the financing statement provides the name of the debtor indicated on the public record of the debtor's jurisdiction of organization . . . ." Revised Article 9 also provides a safe harbor provision whereby a financing statement is deemed "not seriously misleading" if a search of the records of the filing office under the debtor's correct legal name, using that office's standard search logic, would disclose the financing statement.

The court also noted the purpose of filing a financing statement: to put subsequent creditors on notice that the debtor's property is encumbered. The court stated that the "very first step of that process for creditors is *finding* the UCC statement in the first place, and the way to do that is by searching the records under the debtor's organizational name. In other words, complete accuracy is even more important with the debtor's name than it is with the description of the collateral." (Emphasis in opinion.)

The court emphasized that Revised Article 9 "evidenced an intent to shift the responsibility of getting the debtor's name right to the party filing the financing statement. This approach would enable a searcher to rely on that name and eliminate the need for multiple searches using variants of the debtor's name, all leading to commercial certainty."

The court concluded that, because Hastings' statement contained superfluous information in the particular field of the statement, it did not "sufficiently provide the name of the debtor." If the debtor is a registered organization, then a financing statement sufficiently "provides the name of the debtor" only if it provides the exact legal name of the debtor indicated on the public record of the debtor's jurisdiction of organization - nothing more and nothing less. The court stated that "it simply cannot be the rule that a financing statement should be deemed effective as long as words constituting the legal name of the debtor

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Risk Losing Your First Priority Lien if You Provide Superfluous Information in the UCC Financing Statement—continued from page 17

appeared somewhere in the string of words listed as the debtor's name, and regardless of whatever additional words are tacked on to the end."

Having determined that the debtor's name as set forth in the financing statement was insufficient, the court then considered whether the error rendered the filing "seriously misleading." Had the subsequent lenders' UCC searches disclosed Hastings' erroneous financing statement, the error would not have been seriously misleading under Revised Article 9's safe harbor provision. However, since those standard searches did not reveal Hastings' lien, the safe harbor did not apply. The court concluded that the financing statement was, therefore, seriously misleading, so that Hastings lost its priority lien, and the junior liens were elevated in priority.

PRACTICAL CONSIDERATIONS

In an apparent attempt to provide helpful information in its financing statement, the first priority secured lender here ended up at the back of the line of secured creditors. This case teaches a clear lesson - it is imperative that a creditor seek legal advice as to the specific filing requirements, including the search logic, in a particular jurisdiction, in order to protect the creditor's security interest and priority.

LANDLORD'S CORNER

Derek J. Baker
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In this edition of the Landlord's Corner, we review various cases that address the (i) rights of landlords to recover their property post-rejection, (ii) whether payments pursuant to a termination of lease agreement constitute preferential transfers and (iii) whether a lease could be retroactively rejected in the absence of a formal motion to reject.

In *In re Deli Den, LLC,* 425 B.R. 725 (Bankr. S.D. Fla. 2010), the court construed how quickly and through which judicial process the debtor was required to return property to the landlord after rejection of the lease consistent with the provisions of section 365(d)(4) of the Bankruptcy Code. Section 365(d)(4) provides protections for commercial landlords, requiring a trustee or debtor-in-possession to "immediately surrender" the premises upon rejection of the lease. If the trustee or debtor does not accept or reject a lease within 120 days of the bankruptcy petition filing, the lease will be deemed to be rejected. In *Deli Den,* the debtor had failed to act within 120 days; thus, the lease was deemed rejected. Rather than surrendering the premises, however, the debtor argued that the landlord was required to seek an unlawful detainer/recovery in state court, provided that the landlord ultimately obtained relief from the automatic stay to do so. In other words, the debtor asserted that, despite exercising the benefits of a bankruptcy case and rejecting the lease, the debtor could remain in possession until such time as the landlord otherwise sought to exercise its state law rights to recover the premises.

In response, the landlord argued that the plain language of section 365(d)(4) of the Bankruptcy Code required the debtor to "immediately surrender" the property to the landlord upon rejection of the lease. The court sided with the landlord, noting that the language of the Bankruptcy Code clearly provides for the "immediate surrender" of the property, and the landlord should not be required to resort to state courts to recover its property. Moreover, bankruptcy courts should exercise their broad equity powers in favor of granting a surrender order to a lessor who, under the terms of the Bankruptcy Code, clearly deserves one.

This case further supports landlords in their attempt to immediately recover property upon its rejection by a debtor in a bankruptcy case.

In *McHale v. Publix Supermarkets, Inc. (In re Luxury Ventures LLC),* 425 B.R. 680 (Bankr. M.D. Fla. 2010), the Bankruptcy Court considered whether payments made pursuant to a termination agreement could otherwise be excepted from the preference statute. Most landlords are aware that payments made by a debtor in the 90 days prior to the bankruptcy case can be recouped to the debtor's estate to the extent that those payments are made on account of a pre-existing indebtedness. While the statute imposes the "strict" liability to return certain pre-petition payments, those payments can be defended to the extent that the payments were made "in the ordinary course of business."

In this case, the debtor and the landlord entered into a pre-petition agreement pursuant to which the landlord agreed to allow the debtor to terminate the lease, provided that the debtor pay the upcoming monthly rental payment as and when due. In the succeeding month, the debtor made the payment as required under the lease and the termination agreement and, at the conclusion of the month, tendered the keys to the landlord, thereby terminating the lease in accordance with the termination agreement.

After the bankruptcy filing, a representative of the debtor's estate sought to recover the final payment, asserting that the payment was a preference. The landlord argued that the payment was made in the ordinary course of business and therefore was subject to that defense as a matter of law. After hearing arguments, the court concluded that the payment was made pursuant to the terms of the lease and the termination agreement. As a result, the payment was on ordinary business terms in accordance with ordinary business practices. Therefore, the payment was immune from any recovery as a statutory preference.

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This case is unique, in the sense that the termination agreement required the debtor to continue to make lease payments pursuant to the terms of the existing lease agreement for a set period of time. Therefore, in the event that landlords are negotiating with tenants about possible terminations – and seek to insert "preference protections" in such agreements – the better course may be to link the termination to the ongoing compliance with lease terms for a specific period of time, ensuring the continuity of the ordinary business practices and thereby possibly insulating the payments from a subsequent preference attack.

In *Tenucp Property, LLC v. Riley (In re GCP CT Sch. Acquis., LLC)*, No. MB 09-065, 2010 WL 2044871 (Bankr. 1st Cir. May 24, 2010), the court reviewed the authority of a bankruptcy court to permit the rejection of a lease retroactively and its effect on the claim of a landlord for post-petition, pre-rejection rent. In this case, the debtor, which operated a number of broadcasting schools, commenced the bankruptcy case after a liquidity event close to the end of a semester. Immediately upon the chapter 7 filing, the chapter 7 trustee sought authority to operate the business on an interim basis. As a result of the "teach out," the students of the schools would be permitted to finish and earn their completion certificates, and the trustee would be able to market the business for sale. As part of the motion seeking authority to operate the business on an interim basis, the trustee advised the court that the "teach out" would be for a very short period of time.

Shortly thereafter, the trustee was able to identify a potential buyer for the majority of the business; however, the buyer was not interested in assuming certain leasehold interests. The trustee filed a motion seeking authorization to conclude the sale and, as part of that motion, enumerated those leases that the buyer did not want. Thereafter, the trustee filed a motion to extend the period to assume or reject unexpired non-residential real property leases and noted that any lease not otherwise assumed as a result of the sale would be deemed rejected June 4, 2009.

The sale closed and immediately after the closing, the trustee sent an email to the landlord (Tenucp Property, LLC) advising that all of the assets at the landlord's location had been removed as of May 23, 2009. The trustee provided an accounting of the trustee's calculation of the aggregate obligations due. Thereafter, the trustee sent a letter to the landlord enclosing a payment for the occupation of the premises through May 23, 2009. The payment was alleged to be "in accord and satisfaction of all administrative rent and expenses 4/4-5/23/09." The landlord received and thereafter cashed the check June 9, 2009. The landlord subsequently filed a motion seeking payment of rent through July 13, 2009 (the statutory date the lease would be deemed rejected).

The court noted that non-residential real property leases receive special treatment under the Bankruptcy Code. A trustee is obligated to assume or reject a lease within a specified period of time. Also, the trustee is required to timely perform all the obligations under that lease – including the obligation to pay rent at the contract rate – until the lease is rejected. The court noted that the main issue concerned "the effective date of rejection," since that date determines when the obligation to pay rent ceases pursuant to the Bankruptcy Code. In reviewing other case holdings, the court noted that bankruptcy court approval is a condition precedent to the rejection of any non-residential real property lease. While noting that rejection may not take effect until judicial approval is secured, the approving court nonetheless has the equitable power to order that the rejection operate retroactively.

The landlord first argued that no rejection was obtained because no formal motion seeking rejection had been filed. The court held that a formal motion to reject the lease was not necessary. Rather, the Bankruptcy Code requires only prior notice of the trustee's intent to reject. The court reviewed the series of motions filed by the trustee – including the motion to extend the period to assume or reject leases – which the court held put the landlord on notice that the trustee intended to reject. Further, the court concluded that once the landlord had notice of the trustee's intent to sell the business, the landlord was on notice that its lease might be affected. The court concluded that while no formal rejection motion was filed, all the other motions filed in the case – all of which were served on the landlord – had the effect of providing the landlord with sufficient notice of the trustee's intent to reject the landlord's lease.

The landlord further contended that even if appropriate notice of rejection was found, the Bankruptcy Court could only allow "retroactive" rejection to take effect as of the motion "filing date" or the "order date." The court concluded that all prior precedent establishes that bankruptcy courts have the equitable power to retroactively determine the appropriate effective date of rejection. The court also concluded that there was no legal basis to limit the date that could be the appropriate effective date. Rather, the Bankruptcy Court could take into account all the facts and circumstances to determine the appropriate date, once the court had concluded that appropriate notice was given of the lease's rejection. The court concluded, however, that the Bankruptcy Court did err by selecting the date it chose for the effective rejection date, and remanded the case to "re-determine" the appropriate lease rejection date.

This case makes clear that landlords must remain vigilant in their review of their tenant's bankruptcy dockets. Landlords must monitor actions in their tenant's bankruptcy case to determine whether to make an inquiry as to any possible impact on the landlord's lease. While this case places a burden on the landlords to engage in more vigorous review and inquiry, it also makes clear that the court may not arbitrarily determine when a rejection is deemed effective. Rather, the court must take into account all the facts necessary to ensure that there has been proper notice of the rejection prior to being effective, and that the rejection will not be effective until the estate representative has appropriately evidenced intent to relinquish any rights in connection with the property, and has complied with its bankruptcy obligations of surrender.

COUNSEL'S CORNER: NEWS FROM REED SMITH

Presentations

Stephen Bobo spoke May 26 as part of a panel presentation entitled, "Leveraged Buyout Transactions Under Heightened Scrutiny in Bankruptcy: Withstanding Creditor Challenges to Fraudulent Transfer Claims."

Stephen also spoke July 28 as part of a panel presentation entitled, "Mezzanine Loan Foreclosure in Real Estate Transactions: Protecting Borrowers' and Lenders' Interests Under UCC Article 9." Both were on-line presentations.

Mark Silverschotz, Mike Venditto and **Andrea Pincus** are scheduled to present the "Lehman Update" in Santa Fe, N.M., Sept. 15, at the annual conference of the National Association of Attorneys General/States Association of Bankruptcy Attorneys. This conference is attended by several hundred governmental bankruptcy attorneys from virtually all 50 states.

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