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CAN A BANK-APPOINTED DIRECTOR BLOCK A BANKRUPTCY FILING BY A BORROWER?

Peter S. Clark, II
Firmwide Practice Group Leader, Philadelphia

The scenario is fairly typical. A loan goes into default and the bank and the borrower enter into a Forbearance Agreement. One of the conditions of the Forbearance Agreement is that the borrower amend its Operating Agreement to provide for an additional member of the board to be appointed by the bank, and to prohibit a bankruptcy or similar filing without the consent of the additional member. Thereafter, things go south and the bank starts to exercise rights and remedies. In reaction, the borrower files for bankruptcy protection, which is approved by all members of the board, except the additional member appointed by the bank. The bank then challenges the filing on the basis that it is in violation of the blocking rights of the additional member. The court was not necessarily troubled by the requirement of an additional board member appointed by the bank, but it was troubled by the provisions in the Operating Agreement that said that the additional director was entitled to consider only its own interests in exercising its rights. Since Michigan state law requires directors to discharge their duties in a fiduciary manner in the best interest of the borrower, the court held that the provision was void. The court concluded by stating that, "The essential playbook for a successful blocking director structure is this: the director must be subject to normal director fiduciary duties and therefore in some circumstances vote in favor of a bankruptcy filing, even if it is not in the best interest of the creditor that they were chosen by. [The bank's] playbook was, unfortunately, missing this page." *In re Lake Michigan Beach Pottawattamie Resort LLC*, 2016 WL 1359697 (N.D. Ill. April 5,2016).

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DECISION IN SABINE OIL & GAS BANKRUPTCY CASE WILL HAVE BROAD IMPACT ON MIDSTREAM AND EXPLORATION & PRODUCTION COMPANIES IN THE OIL & GAS INDUSTRY

Marsha A. Houston
Partner, Los Angeles

Christopher O. Rivas
Associate, Los Angeles

Paul B. Turner
Partner, Houston

Carol M. Burke
Partner, Houston

Sabine Oil & Gas Corporation
(Case No. 15-11835)

CASE SNAPSHOT

On March 8, 2016, the United States Bankruptcy Court for the Southern District of New York issued a bench ruling in the Sabine Oil & Gas Corporation bankruptcy (Case No. 15-11835) with wide-ranging implications for midstream and exploration & production companies. The New York bankruptcy judge allowed Sabine Oil & Gas to reject gathering agreements over the objections of midstream companies, initially finding on a nonbinding basis that the covenants do not run with the land. On May 3, 2016, the Bankruptcy Court granted summary judgment resolving the issue left open after the March 8 bench ruling, formally finding that the covenants contained in the agreements do not "run with the land" either as real covenants or equitable servitudes and do not "touch and concern" the minerals in the ground, only the oil and gas after they have been extracted from the ground.

FACTUAL BACKGROUND

On September 30, 2015, Sabine, an oil exploration & production company, filed a motion to reject midstream agreements with two parties: gas and condensate gathering agreements with Nordheim Eagle Ford Gathering LLC, and a production, gathering, treating and processing agreement with HPIP Gonzales Holdings LLC.

The court agreed with Sabine, finding that Sabine's rejection of the midstream agreements was in the best interests of Sabine's bankruptcy estate. The court overruled objections by Nordheim and HPIP that the covenants in the midstream agreements were not subject to termination because they ran with the land. The court found, among other things, that the midstream agreements did not touch and concern Sabine's real property, and only burdened Sabine's personal property interests in already-extracted products. The court acknowledged as a procedural matter under bankruptcy law that its ruling was binding on the issue of rejecting the midstream agreements, but was not binding on the parties on the substantive issue of whether the covenants ran with the land, which would be finally adjudicated in another proceeding, such as a claim objection.

Similar issues regarding the rights of midstream companies in bankruptcy were also front and center in the *Quicksilver Resources Inc.* case pending in the Bankruptcy Court for District of Delaware, where, after the *Sabine* decision came out, the debtor and the midstream company quickly settled their disputes before the bankruptcy court could rule.

The ruling in *Sabine* (although technically non-binding on courts in other jurisdictions) may drastically impact both exploration & production companies and midstream companies. On one hand, exploration & production companies often file bankruptcy to reorganize, and the ability of debtors to reject burdensome executory contracts and to otherwise remove encumbrances from a debtor's property are critical tools to accomplish this maneuver. Likewise, a debtor's secured lenders wish for the debtor to maximize its value by minimizing or eliminating burdensome agreements.

CONTINUED ON PAGE 3

On the other hand, rejection of such agreements raises serious risks for midstream companies, which may result in extreme financial loss both because midstream companies may lose the benefits of their bargained-for rights under their agreements, and because rejection may allow debtors in the distressed oil and gas industry to drive down prices and shop for "better deals" in a buyers' market. Additionally, these agreements often require midstream companies to incur substantial costs building infrastructure in anticipation of recouping the costs over the life of the agreement. Rejection may result in a midstream company party to an existing agreement losing any hope of recovering its costs of investment.

Turning to the specific issues of *Sabine*, the Nordheim agreements contained a take-or-pay clause that obligated Sabine to deliver minimum amounts of gas and condensate to Nordheim, or to pay annual deficiency payments if the minimums were not met. Sabine determined that rejecting the Nordheim agreements would save it $35 million over the life of the agreements. Nordheim, on the other hand, argued that it spent tens, if not hundreds, of millions of dollars in the short term to construct gathering systems in anticipation of long-term gains over the life of the contract, and in reliance on Nordheim's covenants running with the land.

The HPIP agreements required HPIP to construct and operate gathering and disposal facilities, which HPIP had ceased construction on, and required Sabine to drill at least one well per year through 2017, or, upon failing to drill, to purchase HPIP's gathering facilities. Sabine determined that rejecting the HPIP agreements would save it between $2.5 million and $80 million over the life of the agreements. HPIP argued that, although it had not completed construction, it spent at least $80 million under the contract in anticipation of long-term gains over the life of the agreement.

Sabine argued that the agreements were merely executory service agreements and were subject to rejection like any other executory agreement. Nordheim and HPIP each objected, arguing that the terms of the gathering agreements were covenants running with the land or equitable servitudes under Texas state law, and were therefore not subject to termination or avoidance. Notably, both Nordheim and HPIP 's agreements expressly provide that the contractual obligations run with the land, and both Nordheim and HPIP recorded memorandums of agreement in the real property records in the counties where Sabine's mineral interests are located, which they argued clearly evidenced the parties' mutual intent that the agreements run with the land.

COURT ANALYSIS

The Bankruptcy Court found that the language in the midstream agreements expressly stating that the covenants ran with the land was not dispositive because the covenants did not touch and concern Sabine's real property interests, although the court did acknowledge the opinion of many that labeled the "law of covenants as an 'unspeakable quagmire.'"* The court found that Sabine's conveyance of rights on oil and gas "produced and saved" by Sabine related to oil and gas that had already been extracted from the ground and did not touch and concern the minerals in the ground. The Bankruptcy Court also rejected the midstream companies' arguments that there need not be horizontal privity of estate for the covenants to run with the land, finding that although many Texas decisions ignored the horizontal privity requirement, the Bankruptcy Court did not believe the requirement had been abandoned under Texas law. Among other things, the court also found that the right to transport or gather produced gas is clearly not one of the five traditional "sticks" of real property interest provided for under Texas law, and therefore the midstream agreements did not burden real property interests.

A similar dispute arose in the *Quicksilver* bankruptcy case, where Quicksilver and a midstream company were litigating whether a midstream agreement may be rejected in bankruptcy. The matter was complicated in *Quicksilver*, however, by the fact that Quicksilver previously obtained an order permitting it to sell its assets free and clear of liens and encumbrances without any objection to such a sale being filed by the midstream company. Shortly after the *Sabine* ruling and before the court could rule on their disputes, Quicksilver and the midstream company settled and entered into new long-term replacement midstream agreements. A similar dispute remains pending in the Bankruptcy Court for the District of Delaware in the *Magnum Hunter* case.

PRACTICAL CONSIDERATIONS

Given the steep declines in the oil and gas industry, and numerous pending and imminent bankruptcies of oil and gas producers, the *Sabine* decision (although technically not binding) may have a broad impact on the oil and gas industry for both upstream oil and gas producers and midstream gathering and transportation companies. Indeed, the *Sabine* decision was likely a driving factor in the settlement of the similar midstream disputes in *Quicksilver*.

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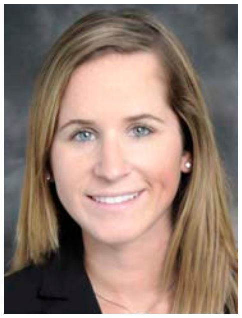
* In so holding, the Bankruptcy Court distinguished the facts in *Sabine* from the facts in *In re Energytec Inc.*, 739 F.3d 215, 221 (5th Cir. 2013), in which the Fifth Circuit held under Texas law that covenants in a pipeline agreement between the debtor and a midstream transportation company ran with the land. In *Energytec*, the original owner conveyed a pipeline to the debtor and carved out from the conveyance a transportation fee for its affiliate and the right of the affiliate to consent to further assignments of the pipeline. The Bankruptcy Court held that, unlike in *Energytec*, Sabine's real property interests were separate and apart from the covenants in the midstream agreements, and that the agreements did not restrict Sabine's use and enjoyment of the real property. The agreements were nothing more than contractual promises by Sabine related to its personal property (i.e., the oil and gas products it had extracted from the ground).

TRUSTEE RECOVERS PROPERTY MAINTENANCE EXPENSES FROM SECURED CREDITOR UNDER SECTION 506(C)



Lauren S. Zabel
Associate, Philadelphia

In the Matter of Domistyle, Inc. No. 14-41463 (5th Cir. Dec. 29, 2015)

CASE SNAPSHOT

After more than a year of attempting to sell a candle factory that was thought to be worth significantly more than the secured creditor's claim, the liquidating trustee of a bankrupt manufacturer of home goods abandoned the property to the secured creditor and attempted to charge the secured creditor for the maintenance expenses incurred while trying to sell the property. The Fifth Circuit affirmed the bankruptcy court's holding that the secured creditor should bear the costs of preserving the property.

FACTUAL BACKGROUND

Prior to filing for bankruptcy, the debtor was placed into receivership. The receiver initiated chapter 11 proceedings believing that the company had sufficient equity to reorganize. The debtor's most valuable asset was a candle factory, which, although subject to a $3.69 million mortgage lien, was appraised at approximately $6 million. Given the perceived equity cushion, a plan of liquidation was confirmed, appointing the receiver as the Liquidating Trustee, who was assigned the task of selling the factory within a particular time frame. If the Liquidating Trustee was unable to sell the factory prior to the deadline, the plan authorized the secured creditor to initiate foreclosure proceedings or obtain a deed-in-lieu of foreclosure.

Although there was a $4 million offer for the factory, the secured creditor did not consent to the sale, given that the amount would be insufficient to satisfy the secured creditor's entire claim after deducting administrative expenses. Thus, the deadline passed and the Liquidating Trustee was unable to sell the property; neither did the secured creditor exercise its rights to retake the property. Thereafter, the Liquidating Trustee informed the secured creditor that he intended to cease paying certain property preservation expenses. The secured creditor objected on the basis that such cessation would "virtually destroy any value remaining" in the property.

The Liquidating Trustee then filed a motion to abandon the property, and a separate motion to surcharge the expenses paid in maintaining the property from the estate of the bankruptcy case. The expenses at issue included insurance, security and utility service. The secured creditor objected to the requested surcharge. During an evidentiary hearing, the Liquidating Trustee and the secured creditor reached an agreement regarding expenses incurred from and after the time that the Liquidating Trustee announced his intention to abandon the property. The bankruptcy court held that the Liquidating Trustee could surcharge the expenses incurred prior to his decision to abandon the property, and the secured creditor appealed.

COURT ANALYSIS

Section 506(c) of the Bankruptcy Code contains a "narrow" and "extraordinary" exception to the general rule that administrative expenses cannot be satisfied out of collateral. Section 506(c) provides that a trustee "may recover from property securing an allowed secured claim the reasonable, necessary costs and expenses of preserving, or disposing of, such property to the extent of any benefit to the holder of such claim[.]" The secured creditor's primary argument was that section 506(c) requires the expenses to be incurred with a specific and exclusive intent to benefit the secured creditor, an argument that relied upon a prior decision by the Fifth Circuit, which stated that the claimant must incur the expenses primarily for the benefit of the secured creditor.

In this case, the Fifth Circuit held that expenses incurred primarily to preserve or dispose of encumbered property must meet the requirement of being incurred primarily for the benefit of the secured creditor, whereas expenses not incurred primarily to preserve or dispose of encumbered property cannot – a requirement that was easily met in this case. The court further explained that while an expense must be *primarily* for the secured creditor's benefit, it need not be *solely* for that creditor's benefit. "The possibility at the time the expenses were incurred that they could also benefit other creditors does not render surcharge unavailable." Even had the Liquidating Trustee been successful in selling the factory for $6 million and distributions had been made to junior and unsecured creditors, the Fifth Circuit held that the secured creditor's $3.69 million lien would have rendered preservation and selling expenses primarily for the secured creditor. Likewise, the Fifth Circuit rejected the secured creditor's argument that it actually benefited from the expenses, finding that absent the security, lawn mowing and roof repairs paid for by the Liquidating Trustee, the secured creditor would have received a building that may have been vandalized, overgrown and the subject of water damage.

PRACTICAL CONSIDERATIONS

This decision follows decisions of the Eighth and Ninth Circuits, which also require a direct and demonstrated relationship between the expenses and the trustee's preservation or disposal efforts. The inverse of these rulings is also significant – that absent such a direct relationship, expenses cannot be surcharged – which will prove helpful for secured creditors attempting to narrow the scope of surcharged expenses. Moreover, while this decision solidifies that (at least in the Fifth Circuit), expenses need not be incurred *solely* for the benefit of the secured creditor, it leaves open exactly where the line would be drawn when determining whether a secured creditor is the primary beneficiary of expenses incurred, and whether that analysis must take into account only the ultimate disposition of the asset (i.e., that the property was abandoned to the secured creditor in this case) or the attempts to dispose of the asset prior to disposition (i.e., that the parties anticipated a $6 million sale).

DE MINIMIS ACTIVITY OF FOREIGN REPRESENTATIVE INSUFFICIENT FOR RECOGNITION UNDER CHAPTER 15

Christopher A. Lynch
Associate, New York

In re Creative Finance Ltd. (In Liquidation), et al., Case No. 14-10358-REG (Bankr. S.D.N.Y. Jan. 13, 2016)

CASE SNAPSHOT

The United States Bankruptcy Court for the Southern District of New York denied recognition of debtors' British Virgin Islands (BVI) insolvency proceeding, finding that neither the criteria for a foreign main proceeding nor foreign nonmain proceeding had been met, given the foreign representative's limited activity in that venue and the debtors' lack of establishment there.

FACTUAL BACKGROUND

Creative Finance Ltd. and Coxsmorex Ltd. were foreign exchange trading companies that did most of their business in the UK, with operations out of Spain and Dubai; both debtors were organized under the laws of the BVI, which was a "letterbox" jurisdiction in which the debtors did no business. One of their creditors, Marex Financial Ltd., sued the debtors in the UK under a number of contracts governed by the laws of England and Wales, and which provided for jurisdiction in England. In July 2013, the High Court of Justice in England, Queen's Bench Division Commercial Court issued a draft ruling in favor of Marex, awarding it more than $5 million and prohibiting the parties from taking any action pending issuance of the final order. The final order issued July 26, 2013, and directed the debtors to pay the awarded amount by August 8.

Instead of paying the judgments (or appealing), the debtors proceeded to transfer the balance of their bank accounts in England ($9.5 million) to accounts in Gibraltar and Dubai. Aside from this cash, the debtors' only meaningful asset was a claim in the amount of $171 million held in the chapter 11 case of *Refco, Inc.* The proceeds of a prior $1.7 million distribution on that claim had also disappeared. Marex attempted to collect on the judgments by domesticating them in New York state (the Domesticated Judgments) and filing (but later withdrawing) a liquidation against the debtors in the BVI.

Shortly after Marex served the Domesticated Judgments on the debtors, their principal issued shareholder resolutions directing that the entities be put into liquidation in the BVI and providing for the appointment of a liquidator. The liquidator received funding that would permit him to carry out the most basic statutory duties – but no more. Indeed, despite Marex bringing the transferred funds to the attention of the liquidator, he did not seek to obtain the debtors' ledgers or journals, secure bank records, conduct investigations, bring causes of action, or even make more than a perfunctory inquiry into what happened to the $9.5 million.

In February 2014, the liquidator filed petitions under chapter 15 in the bankruptcy court and sought recognition of the BVI action so as to benefit from the automatic stay under section 362, and prevent Marex from seeking to collect on the Domesticated Judgments via the Refco claim. Marex moved under section 305 to dismiss the cases, arguing they were brought in bad faith.

COURT ANALYSIS

In *dicta*, the bankruptcy court took note of the debtors' principal's (and thus, the debtors') egregious conduct and numerous examples of bad faith, but ruled wholly apart from those findings, instead considering only whether the BVI proceeding satisfied the criteria for recognition under section 1517(a)(1). Specifically, the bankruptcy court considered whether the BVI proceeding constituted either a foreign main proceeding or foreign nonmain proceeding.

A "foreign main proceeding" is defined as a "foreign proceeding in the country where the debtor has its center of main interests [("COMI")]." The bankruptcy court noted that the debtors' pre-liquidation COMI was not in the BVI, but cited the Second Circuit's decision in *Fairfield Sentry*, 714 F.3d 127 (2d Cir. 2013), for the proposition that a letterbox jurisdiction, such as the BVI in this case, can potentially be recognized so long as estate fiduciaries in those jurisdictions do enough work to warrant that finding. Here, however, the bankruptcy court found that the liquidator did the bare minimum required under the BVI statute, and his activities, which did not include (among other things) any investigations of the transfer of substantially all of the debtors assets, "fell far short of anything that could legitimately be characterized as 'material effort.'" As such, the debtors' COMI (whether it be the UK, Spain or Dubai) did not change to the BVI and, as a result, the BVI proceeding was not a foreign main proceeding.

The foreign nonmain proceeding analysis was more succinct. A "foreign nonmain proceeding" is defined as a "foreign proceeding, pending in the country where the debtor has an establishment." "Establishment" is defined in the Bankruptcy Code as "any place of operations where the debtor carries out a nontransitory economic activity." It was undisputed that the debtors had no nontransitory business operations in this letterbox jurisdiction. Absent that, the debtors had no establishment in the jurisdiction, and the BVI proceeding could not be a foreign nonmain proceeding.

PRACTICAL CONSIDERATIONS

At the time the foreign proceeding is commenced, the debtor either has an establishment in that jurisdiction or it does not. Post-insolvency conduct by the liquidator or other fiduciary cannot change that determination. COMI, on the other hand, may be obtained post-commencement of the foreign proceeding but, to accomplish that, the fiduciary must lend legitimacy to that designation by doing more than the bare minimum. Minimal recordkeeping and holding creditors' meetings will likely not accomplish this, and the fiduciary should endeavor to act in a meaningful way for the benefit of the estate, including securing and analyzing the books, records and bank account statements of the debtor, investigating (and pursuing where warranted) causes of action, and investigating claims asserted against the estate. Doing so will increase the likelihood that the foreign proceeding is recognized by U.S. bankruptcy courts.

SEC ASSET FREEZE ORDER DOES NOT FALL WITHIN 'THE EXCEPTION TO THE EXCEPTION' TO THE AUTOMATIC STAY

Christopher A. Lynch
Associate, New York

SEC v. Miller, et al., No. 14-4261-cv (2d Cir. Dec. 18, 2015)

CASE SNAPSHOT

The Second Circuit Court of Appeals affirmed an asset freeze order entered post-petition in connection with a civil enforcement action brought by the Securities and Exchange Commission, finding that the order did not constitute an impermissible "enforcement of a money judgment," but fell within the "governmental unit" exception to the automatic stay.

FACTUAL BACKGROUND

Brothers Samuel Wyly and Charles Wyly were officers, directors, and shareholders of four publicly traded corporations. Beginning in the early 1990s, the Wylys transferred millions of stock options received from those corporations to offshore trusts and subsidiaries in the Isle of Man (IOM). Over the next dozen years, the IOM trusts exercised those options and traded in the securities while the Wyly brothers failed to disclose their beneficial ownership, returning profits to themselves of more than $550 million. In 2010, the SEC initiated a civil enforcement action against the Wyly brothers, asserting multiple claims of securities fraud.

After a jury found the Wylys liable for nine claims of securities fraud, the District Court for the Southern District of New York ordered disgorgement of approximately $300 million. According to evidence given at trial, the Wyly brothers used the IOM trusts to trade in secret, protect their assets from creditors, and avoid taxes on profits. Moreover, some of the proceeds flowed to other Wyly family members. Fearing the dissipation of gains from this fraudulent conduct, the SEC requested that the district court enter a temporary asset freeze of the Wyly brothers' assets, as well as assets possessed by Wyly family members who had allegedly received ill-gotten gains traceable to the brothers' scheme. While this application was pending, Samuel Wyly and the widow of Charles Wyly, the principal heir of Charles' estate, filed petitions for relief under chapter 11. The petitioners immediately argued that the SEC's request for an asset freeze was automatically stayed by section 362 of the Bankruptcy Code.

Shortly thereafter, the district court entered an order freezing the Wyly brothers' assets, including the assets transferred to multiple family members (together with the Wyly brothers, the Relief Defendants) that were derived or received from the IOM trusts or the Wyly brothers, subject to certain carve-outs and exceptions for living expenses. The order provided that the freeze remain in place until the assets were scheduled and clearly under the control of the bankruptcy court. In an accompanying opinion, the district court held that the SEC was "acting in its police and regulatory capacity" and, thus, the automatic stay did not preclude entry of the order. The district court also held that the freeze was warranted because the bankruptcy court had not yet established control over the Wyly brothers' assets, which were found to be at risk of transfer and dissipation.

All Relief Defendants (except for the widow of Charles Wyly, who sought relief, unsuccessfully, in the bankruptcy proceeding) appealed, asserting, among other things, that the order was issued in violation of the automatic stay.

COURT ANALYSIS

Section 362(a) of the Bankruptcy Code stays virtually all proceedings against a debtor, including "any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate." An express exception to this broad application, however, is the "governmental unit" exception, which provides the automatic stay does not apply to "the commencement or continuation of an action or proceeding by a governmental unit . . . to enforce such governmental unit's or organization's police and regulatory power, including the enforcement of a judgment other than a money judgment, obtained in an action or proceeding by the governmental unit to enforce such governmental unit's or organization's police or regulatory power." 11 U.S.C. § 362(b)(4).

All parties agreed that the SEC's enforcement action against the Wyly brothers fell within the governmental unit exception. The Relief Defendants, however, argued that the case fell under an exception to the governmental unit exception. That is, actions to enforce money judgments are subject to the automatic stay even if they were otherwise pursued by a governmental unit in furtherance of the government's police or regulatory powers. Both sides relied on the court's decision in *SEC v. Brennan*, 230 F.3d 65 (2d Cir. 2000).

The court held that the district court correctly applied *Brennan* to find that the asset freeze order fell within the governmental unit exception to the automatic stay, but not the exception to the exception. The court found that factual, procedural, and policy considerations distinguished this case from *Brennan*.

Factually, the case differed from *Brennan*, where the trial court ordered the repatriation of assets held abroad and deposit of those assets with the court's registry. Here, the district court's order was "merely an asset freeze," which maintained the status quo and neither transferred ownership nor vested control in the courts. The procedural posture of the two cases differed as well. The court held that the asset freeze order, imposed *before* entry of a final judgment as to the Wyly brothers, was distinguishable from the order in *Brennan*, which arose as part of the SEC's *post*-judgment collection procedures. As the court stated in *Brennan*: "the line between [unstayed] police or regulatory power on the one hand, and [stayed] enforcement of a money judgment on the other, [must] be drawn at entry of judgment…. [U]p to the moment when liability is definitively fixed by entry of judgment, the government is acting in its police or regulatory capacity . . . However, once liability is fixed and a money judgment has been entered, the government necessarily acts only to vindicate its own interest in collecting its judgment." As of the date of issuance of the freeze order, no judgment had yet been entered. Thus, the asset freeze order did not raise the same concerns as in *Brennan*.

Finally, the court found that the freeze order did not compromise either of the policy concerns underlying *Brennan*. Those policies were (1) the general purpose

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NINTH CIRCUIT JOINS OTHER CIRCUITS TO HOLD ABSOLUTE PRIORITY RULE APPLIES TO INDIVIDUAL CHAPTER 11 CASES

Marsha A. Houston
Partner,
Los Angeles

Christopher O. Rivas
Associate,
Los Angeles

Zachary v. Cal. Bank & Tr., No. 13-16402, 2016 BL 22570 (9th Cir. Jan. 28, 2016)

CASE SNAPSHOT

In a case of first impression in the Ninth Circuit, the court held that the absolute priority rule applies to individual chapter 11 cases.

FACTUAL BACKGROUND

In September 2011, David K. Zachary and Annmarie S. Snorsky filed a joint voluntary individual chapter 11 petition. The debtors' proposed plan of reorganization proposed to pay creditor California Bank & Trust only $5,000 of its $2 million claim. California Bank, which was an impaired creditor under the plan, objected on the basis that the plan violated the absolute priority rule of Bankruptcy Code section 1129(b)(2)(B)(ii). The bankruptcy court sustained California Bank's objection, and in so doing disagreed with the Ninth Circuit Bankruptcy Appellate Panel's decision in *In re Friedman*, 466 B.R. 471 (B.A.P. 9th Cir. 2012), which held the absolute priority rule did not apply in individual chapter 11 cases.

The debtors appealed directly to the Ninth Circuit.

COURT ANALYSIS

On appeal, the Ninth Circuit described the history of the absolute priority rule and the impact of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) on the rule in individual chapter 11 cases. The absolute priority rule requires that a debtor seeking confirmation of a chapter 11 plan of reorganization may not "cram down" the plan on dissenting creditors unless the plan pays those creditors in full before paying anything to a junior class of creditors. Typically, this means a debtor, an equity holder receiving the lowest in class priority, may not receive any estate property under the plan until the debtor has paid all creditors in full. The Ninth Circuit explained that prior to the passage of the BAPCPA, there was no question that the absolute priority rule applied in all chapter 11 cases, individual or otherwise.

That rule became far from clear when the BAPCPA introduced two changes that raised questions regarding the absolute priority rule's applicability in individual chapter 11 cases. First, section 1115 was added, which makes post-petition property obtained by individual debtors part of the bankruptcy estate (previously, only pre-petition property was part of the bankruptcy estate). Second, the absolute priority rule, codified at section 1129(b)(2)(B)(ii), was amended to provide an exception that: "in a case in which the debtor is an individual, the debtor may retain property included in the estate under section 1115, subject to the requirements of subsection (a)(14) of this section."

Although the BAPCPA clearly introduced an exception to the absolute priority rule in individual chapter 11 cases, bankruptcy courts have wrestled with the scope of that exception. The "narrow view" of the exception is that only post-petition property covered by section 1115 is excepted from the absolute priority rule and may be retained by a debtor in a plan that does not fully repay unsecured creditors. The "broad view" is that all property is excepted from the absolute priority rule (i.e., that the rule does not apply at all), and a debtor may keep estate property, whether pre-petition or post-petition, without paying unsecured creditors in full.

The Ninth Circuit acknowledged that "all of our sister circuits that have considered the issue" have adopted the narrow view that the exception under section 1115 only applies to property received post-petition. However, bankruptcy courts throughout the Ninth Circuit, as well as the Bankruptcy Appellate Panel of the Ninth Circuit, had previously adopted the broader view that the exception applied to both post-petition and pre-petition estate property, thereby making the absolute priority rule completely inapplicable to individual chapter 11 cases.

After reviewing the legislative history of the absolute priority rule, the Ninth Circuit joined the Fourth, Fifth, Sixth, and Tenth Circuits, and adopted the narrow view holding that the absolute priority rule applied in individual chapter 11 cases, with the exception only of post-petition property under section 1115. The Ninth Circuit reasoned that had Congress intended to dispose of the rule entirely, it would have done so more clearly. In so ruling, the Ninth Circuit acknowledged that adopting the narrow view "works a 'double whammy'" on individual debtors because they must commit five years of disposable income to pay unsecured creditors, but, unlike chapter 13 debtors, may not retain any pre-petition property unless they pay their creditors in full. However, the Ninth Circuit also acknowledged that the opposite holding would have been inequitable to unsecured creditors.

PRACTICAL CONSIDERATIONS

The *Zachary* ruling gives substantially more leverage to creditors in the Ninth Circuit in individual chapter 11 cases and settles a previously unsettled area of law by departing from the BAP's 2012 ruling in *In re Friedman*. This decision will effectively require debtors to either pay their creditors in full, reach consensual deals with all creditors, or to file chapter 7 cases. In other words, in most situations, a chapter 11 individual debtor will be unlikely to confirm anything other than a consensual plan, and will need to work more closely with creditors to reach an acceptable deal for all parties.

LANDLORD'S CORNER – PRE-PETITION TERMINATION OF LEASE CAN BE 'TRANSFER' FOR PREFERENCE PURPOSES

Derek J. Baker
Partner,
Philadelphia and Princeton

The Official Committee of Unsecured Creditors v. T.D. Investments I, LLP (In re Great Lakes Quick Lube, LP), No. 15-2093 (7th Cir. Mar. 11, 2016)

In a case decided March 11, 2016, the United States Court of Appeals for the Seventh Circuit ruled that a pre-petition termination of a lease by a debtor could constitute a "transfer" for preference purposes. *The Official Committee of Unsecured Creditors v. T.D Investments I, LLP (In re Great Lakes Quick Lube, LP)*, No. 15-2093. The court, addressing a direct appeal from the bankruptcy court, reversed the bankruptcy court's contrary conclusion. The court directed the bankruptcy court to determine the value of leases actually terminated and make a determination of whether the landlord had any available defenses.

The facts are not unique. The debtor, suffering from operational losses, entered into a pre-petition arrangement with the landlord of several of its locations to terminate and surrender the leases. Thereafter, the debtor filed a bankruptcy case and the appointed creditors' committee brought an action against the landlord, seeking to collect the value of the terminated leaseholds from the landlord as preferences. The bankruptcy court ruled that the pre-petition termination of leases was not a "transfer" for preference purposes. The creditors' committee appealed.

On appeal, the landlord presented its argument that a termination was not a transfer, likening the termination to an abandonment. The Court of Appeals disagreed and held that the statutory definition was broad enough to include "any disposition of any interest in property." Since a lease constituted an interest in property, the disposition of that interest – through termination – was a transfer under the statutory definition.

While the holding in the case is at a preliminary stage, it does raise concerns for landlords in their negotiations with distressed tenants. Since the act of termination can be a statutory transfer, it is incumbent on the landlord when negotiating a termination to understand the potential value of the leasehold interest being terminated; and once determined, attempt to construct an appropriate value being surrendered by the landlord (either through release of payment obligations or outright cash payments) to provide potential preference defenses.

SEC Asset Freeze Order Does Not Fall Within 'The Exception to the Exception' to the Automatic Stay—continued from page 6

of the automatic stay, which is "to allow the bankruptcy court to centralize all disputes concerning property of the debtor's estate so that reorganization can proceed efficiently, unimpeded by uncoordinated proceedings in other arenas," and (2) the general purpose of the governmental unit exception, which is "to prevent a debtor from 'frustrating necessary governmental functions by seeking refuge in bankruptcy court.'"

The court held that, because the asset freeze order excluded assets in the bankruptcy case and was to be lifted as soon as the assets were under the bankruptcy court's control, no conflict existed between the proceedings in the district court and those in the bankruptcy court. The court further held that the order was consistent with the latter policy consideration because the Wylys commenced proceedings in the bankruptcy court and invoked the automatic stay days after the SEC filed its motion for an asset freeze, noting, "The timing speaks loudly for itself."

PRACTICAL CONSIDERATIONS

Although the automatic stay is one of the most expansive provisions of the Bankruptcy Code, *Miller* reminds us that the automatic stay is not without its limitations. Further, one must look beyond labels when assessing whether the stay applies. On its face, an "asset freeze order" (or any other civil order that affects assets of a debtor in some way) would give the prudent practitioner pause, but must be looked at carefully to assess whether it rises to the level of an impermissible enforcement of a money judgment, or falls within the "governmental unit" exception of section 362.

POST-PETITION EVICTION DOES NOT VIOLATE AUTOMATIC STAY WHERE LENDER OBTAINED PRE-PETITION UNLAWFUL DETAINER JUDGMENT

Marsha A. Houston
Partner,
Los Angeles

Christopher O. Rivas
Associate,
Los Angeles

Eden Place, LLC v. Perl (In re Perl), No. 14-60039, 2016 BL 4378 (9th Cir. Jan. 08, 2016)

CASE SNAPSHOT

In welcome news to beleaguered lenders, the Ninth Circuit ruled that the automatic stay does not prevent lenders from pursuing eviction rights arising from pre-petition unlawful detainer judgments.

FACTUAL BACKGROUND

Sholem Perl and a joint tenant owned a single-family duplex in Los Angeles. Perl's lender commenced foreclosure proceedings following Perl's default under the mortgage, and sold the property to purchaser Eden Place through a non-judicial foreclosure sale. Perl refused to vacate the premises, and in response to Eden Place's filing of an unlawful detainer action against him, Perl filed a complaint to set aside the foreclosure. Eden Place successfully obtained an unlawful detainer judgment and a writ of possession against Perl, and the L.A. County sheriff posted lockout notices. Perl obtained a conditional order from the court in his unlawful foreclosure action to delay the eviction, but failed to satisfy the conditions of the order.

Instead of complying with the state court orders, Perl filed a "skeletal" chapter 13 bankruptcy petition and failed to file schedules, a statement of financial affairs, or a proposed chapter 13 plan. Seeking to further delay the eviction, Perl removed the unlawful detainer action and his own action to the bankruptcy court. Although Eden Place filed a motion for relief from the automatic stay, the L.A. County sheriff locked out Perl and evicted him prior to an order granting relief from stay being entered.

The bankruptcy court ruled that Eden Place violated the automatic stay because Perl's "bare possessory interest, coupled with the possibility of some sort of relief [from the pending litigation]" gave "the bankruptcy estate a protected interest that is subject to the automatic stay." On appeal by Eden Place, the Bankruptcy Appellate Panel affirmed, finding that although Perl had no protectable legal interest in the property following the foreclosure sale, his bare possessory interest in the property survived the unlawful detainer judgment and writ of possession, and was protected from eviction by the sheriff.

COURT ANALYSIS

The Ninth Circuit overruled, overturning not only the BAP affirmance, but also a line of cases in the Ninth Circuit holding that a debtor's bare possessory interest in foreclosed property was protected by the automatic stay. The authorities dated back to 1996, when in *In re Di Giorgio*, 200 B.R 664 (C.D. Cal. 1996), the bankruptcy court held that a lender violated the automatic stay when it sought to enforce a pre-petition unlawful detainer judgment and writ of possession through a sheriff's eviction. The court found that even though the debtors had lost all legal possessory interest in their tenancy before filing their bankruptcy petition, the debtors' mere presence in the property and their claim of a possessory interest was an interest protected by the automatic stay. The decision was followed by the bankruptcy court in *In re Butler*, 271 B.R. 867, 876-77 (Bankr. C.D. Cal. 2002), and by the Bankruptcy Appellate Panel and the Ninth Circuit (with only a limited discussion) in *In re Williams*, 323 B.R. 691, 699 (9th Cir. BAP 2005), aff'd, 204 F. App'x. 582 (9th Cir. 2006).

The Ninth Circuit expressly recognized that the BAP considered itself bound by *In re Williams* and its precedents, but the Ninth Circuit held that the line of decisions was no longer valid and that it was "not persuaded that those cases engaged in the proper analysis." The Ninth Circuit held that the BAP correctly determined that the bank's nonjudicial foreclosure divested Perl from any legal interest in the property. However, the Ninth Circuit then held that the BAP erred when it found that Perl's continued unlawful possession bestowed equitable possessory rights upon him that survived the entry of an unlawful detainer judgment and the issuance of a writ of possession.

The Ninth Circuit held that once the unlawful detainer judgment and writ of possession were entered and issued by the Superior Court pre-petition, regardless of whether the sheriff executed the writ or actually evicted Perl pre-petition, Perl no longer had any equitable interest in the property. The unlawful detainer judgment and writ of possession extinguished any possessory interest of the debtor in favor of the bank's interests in possession. Accordingly, the debtor had neither a legal nor an equitable interest in the property that could be protected by the automatic stay.

PRACTICAL CONSIDERATIONS

Lenders have become accustomed to the delay tactics of borrowers and their attorneys, who often file skeletal or "shell" bankruptcy petitions in order to stall evictions. The *Perl* decision removes one more hurdle for such lenders, who may execute writs of possession entered after an unlawful detainer judgment, so long as the judgment and writ were entered and issued before the debtor filed a bankruptcy petition. Unfortunately, the *Perl* decision does not answer the question of whether the automatic stay continues to protect debtors who filed bankruptcy petitions prior to an unlawful detainer judgment being entered, and creditors are cautioned to seek relief from the automatic stay before continuing to prosecute such judgments.

INQUIRY NOTICE OF WRONGDOING BARS LENDERS' GOOD FAITH DEFENSE IN FRAUDULENT TRANSFER CLAIM

Melissa Mickey
Associate, Chicago

In re Sentinel Management Group, Inc.,
No. 15-1039 (7th Cir. Jan. 8, 2016)

CASE SNAPSHOT

The Seventh Circuit Court of Appeals reversed the district court's decision and held that a bank employee's suspicion of wrongdoing was sufficient to give the bank inquiry notice of that wrongdoing by the borrower, barring the bank's defense of good faith against a fraudulent transfer claim. However, the Seventh Circuit ruled that the bank's claim should not be subject to equitable subordination.

FACTUAL BACKGROUND

Sentinel Management Group, Inc. was a cash-investment firm that invested cash, which had been lent by its customers, in liquid low-risk securities. Sentinel also traded on its own account, using money that it borrowed from certain banks to finance the trades. As collateral for its loans from the banks, Sentinel pledged securities that it had purchased for its customers using the customers' own money. However, federal law and the contracts between Sentinel and its customers required the securities to be held in segregated accounts separated from Sentinel's own assets. Thus, Sentinel was forbidden to pledge the assets in the segregated accounts to the banks as security for the bank's loans to Sentinel.

In August 2007, Sentinel filed for chapter 11 bankruptcy, and the bankruptcy court appointed a chapter 11 trustee. The banks filed a secured claim in the amount of $312 million. The trustee commenced an adversary proceeding against the banks, alleging that the transfer of the customers' securities to the banks constituted a fraudulent transfer pursuant to section Bankruptcy Code section 548(a)(1)(A). As a defense to the trustee's claims, the banks claimed that they acted in good faith pursuant to section 548(c). The trustee believed that officials of the banks had "inquiry notice," meaning that the banks were aware of suspicious facts that should have led them to investigate. If the banks had investigated, the trustee claimed that such an investigation would have revealed that the banks could not in good faith accept assets of Sentinel's customers as security for the bank's loans to Sentinel.

After a 17-day bench trial, the district judge found that Sentinel did not intend to defraud its creditors in violation of section 548(a)(1)(A). On appeal, the Seventh Circuit reversed, holding that Sentinel had made fraudulent transfers. The Seventh Circuit instructed the district judge to decide on remand whether the banks had been on inquiry notice in their dealings with Sentinel. However, on remand, the district court judge did not conduct an evidentiary hearing or make additional findings of fact. Instead, the district court judge issued a "supplemental opinion" intended to clarify his prior opinion and findings of fact. The trustee appealed again.

COURT ANALYSIS

The Seventh Circuit began its analysis by noting that the district court judge's supplemental opinion revealed a misunderstanding of the concept of inquiry notice. According to the Seventh Circuit, the supplemental opinion suggested that the banks, as long as they did not believe that Sentinel had pledged customers' assets to secure the loans without the customers' permission, were entitled to accept that security for the loans without any investigation. The Seventh Circuit found that this was incorrect, because inquiry notice is not actual knowledge of fraud or other wrongdoing, but merely knowledge that would lead a reasonable, law-abiding person to inquire further.

Reviewing the records, the Seventh Circuit cited to an email that a managing director at the banks sent to other employees at the banks inquiring whether Sentinel really had as much collateral as was listed on the report. In the email, the managing director suggested that perhaps the collateral was owned by a third party. The bank officer never received a direct response to his question, and he did not follow up on his inquiry. The Seventh Circuit found that the managing director's suspicion was enough to put the banks on inquiry notice since "all that is required to trigger [inquiry notice] is information that would cause a reasonable person to be suspicious enough to investigate." Because the banks failed to investigate, the Seventh Circuit avoided the banks' liens as fraudulent transfers, leaving the banks with unsecured claims.

The Seventh Circuit then considered whether the banks' claim should be equitably subordinated pursuant to section 510(c)(1) of the Bankruptcy Code. The Seventh Circuit held that for a claim to be equitably subordinated, the claimant's conduct "must be not only 'inequitable' but seriously so ('egregious,' 'tantamount to fraud,' and 'willful' are the most common terms employed) and must harm other creditors." This would require that the banks believed there was a high probability of fraud and acted deliberately to avoid confirming their suspicion. The Seventh Circuit agreed with the district court judge that the trustee had not satisfied that high standard. Here, the banks suspected wrongdoing and took no action to investigate. The Seventh Circuit held that this amounted to negligence, and negligence was not an adequate basis for imposing equitable subordination. Accordingly, the Seventh Circuit upheld the district court's decision not to equitably subordinate the banks' claim.

PRACTICAL CONSIDERATIONS

This case highlights the fact that banks have an affirmative obligation to investigate suspicious circumstances surrounding loan transactions. If a bank fails to make such an investigation, the bank may be unable to make a good faith defense to a fraudulent transfer avoidance action.

CHAPTER 11 DEBTOR MAY REJECT AND MODIFY COLLECTIVE BARGAINING AGREEMENT POST-EXPIRATION

Derek J. Baker
Partner,
Philadelphia and Princeton

In re Trump Entertainment Resorts,
No. 14-4807 (3d. Cir. Jan. 25, 2016)

CASE SNAPSHOT

In re Trump Entertainment Resorts, the United States Court of Appeals for the Third Circuit was tasked with determining whether section 1113 of the Bankruptcy Code allows a chapter 11 debtor to reject its collective bargaining agreement even after that agreement has expired. The court held that section 1113 did permit rejection of the agreement.

FACTUAL BACKGROUND

After expiration of the contract and failed negotiations, the debtor sought to reject its collective bargaining agreement with one of its unions and implement changes the debtor determined were necessary for it to reorganize. The bankruptcy court held that section 1113 of the Bankruptcy Code applied to the rejection of the expired collective bargaining agreement. After certification by the bankruptcy court, the Court of Appeals granted a direct appeal.

COURT ANALYSIS

On appeal, the union argued that only "unexpired" or "executory" collective bargaining agreements could be rejected under section 1113 of the Bankruptcy Code. The Court of Appeals held otherwise. In analyzing the question, the Third Circuit started with the language of section 1113, which on its face is not limited to the status, executory or not, of a collective bargaining agreement.

Under the National Labor Relations Act, when a collective bargaining agreement expires, the employer is required to maintain the status quo with respect to mandatory subjects of bargaining until either a new contract is entered into or bargaining to an impasse has occurred. As such, even though a collective bargaining agreement has expired, the essential terms of the expired agreement continue to control various aspects of the employer/employee relationship with bargaining unit employees. Because the NLRA mandates continuation of the collective bargaining relationship, and section 1113 of the Bankruptcy Code does not require the collective bargaining agreement to be executory, the Third Circuit held that the use of section 1113 was appropriate to modify the post-expiration terms and conditions of employment.

The union also appealed the bankruptcy court's decision to allow the debtor to implement the economic changes that the debtor sought in its last offer to the union prior to filing its motion under section 1113. As the matter was not argued in briefing, the court refused to reach that issue in this appeal.

PRACTICAL CONSIDERATIONS

This case is an important expansion on the rights of debtors with collective-bargaining arrangements with their employees. It is also important that the court conducted a very strict review of the statutory language in evaluating the rights of the parties in this case. This case exploits very specific language in a statute to achieve results not initially anticipated by the parties in a traditional understanding of the bankruptcy process.

APPELLATE COURT RULES THAT EVEN A FIRST-TIME OR SINGLE TRANSFER MAY FALL WITHIN THE ORDINARY COURSE OF BUSINESS EXCEPTION

Sarah Kam
Associate, New York

Jubber v. SMC Electrical Products, Inc., et al.
(In re C.W. Mining Co.), 798 F.3d 983 (10th Cir. 2015)

CASE SNAPSHOT

The United States Court of Appeals for the Tenth Circuit, held that a single payment made by a debtor within the 90-day preference period to a seller, with whom the debtor had never done business, may satisfy the elements to constitute a payment in the "ordinary course," and thus was not avoidable as a preferential transfer.

FACTUAL BACKGROUND

Prior to being forced into bankruptcy, the coal-mining debtor entered into a purchase contract for mining equipment, which the debtor planned to use to convert its continuous mining operation into a longwall mining system. The total amount of the purchase price was $1,064,036. The purchase contract contained a series of payment deadlines upon which a certain percentage of the purchase price would be due. Subsequent to the debtor making the first payment of $200,000 to the creditor, an involuntary bankruptcy case was commenced against the debtor. The trustee sought to recover the $200,000 as an avoidable preferential transfer because the payment was made fewer than 90 days before the petition. The bankruptcy court granted summary judgment in favor of the creditor, finding that the debt was incurred and the payment made in the ordinary course of business. The Tenth Circuit Bankruptcy Appellate Panel affirmed. The trustee appealed.

COURT ANALYSIS

The ordinary course of business exception to avoidance of a preferential transfer requires that the incurrence of the debt and the payment be in the ordinary course of business. The Tenth Circuit agreed with the Sixth, Seventh, and Ninth Circuits that a first-time transaction can qualify for the exception. Section 547(c)(2) of the Bankruptcy Code refers to the "ordinary course of business or financial affairs of the debtor and the transferee," not business between the debtor and the transferee.

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PERSONAL GUARANTIES OF A LOAN NOT IMPACTED BY A BORROWER'S CHAPTER 11 CASE

Brian M. Schenker
Associate, Philadelphia

FB Acquisition Property I, LLC v. Gentry (In re Gentry), 807 F.3d 1222 (10th Cir. 2015)

CASE SNAPSHOT

Following the approval of a chapter 11 plan that restructured a secured loan of their company, the guarantors of the secured loan filed for chapter 11 protection, seeking to confirm a plan that based their guaranties on the restructured loan, not the original loan. The bankruptcy court and district court confirmed the guarantors' plan, but the United States Court of Appeals for the Tenth Circuit reversed, finding that the guarantors were liable for the original loan – not the loan as restructured – and remanded the matter to the bankruptcy court to determine if their proposed plan of reorganization was feasible.

FACTUAL BACKGROUND

In 2005, Ball Four received a $1.9 million secured loan from FirsTier Bank to expand its sporting facilities and refinance an existing loan. The loan was personally guaranteed by Ball Four's owners, Mr. and Mrs. Gentry. After four years of struggling with construction defects, underfunding of the project, and an economic downturn, Ball Four defaulted under the loan, and Ball Four and Mr. and Mrs. Gentry each filed for chapter 11 bankruptcy protection.

In its bankruptcy case, Ball Four confirmed a plan of reorganization that provided for the outstanding principal balance of the loan, together with interest at 6 percent per annum, to be repaid over 25 years with a balloon payment in the fifth year. After that plan was confirmed, Mr. and Mrs. Gentry sought to confirm a plan of reorganization in their bankruptcy case based on the concept that they could perform their guaranties of the now restructured loan.

The Gentrys argued that they were only liable for the restructured loan, which was not currently in default, and their personal assets demonstrated that it was feasible for them to repay the restructured loan should Ball Four default. The bankruptcy court agreed and confirmed the plan. On appeal, the district court affirmed. On further appeal, the circuit court reversed and remanded.

COURT ANALYSIS

The circuit court disagreed with the lower courts for two reasons: (1) they erred in their application of bankruptcy law; and (2) they erred in their reading of the language of the personal guaranties.

On the first issue, the circuit court cited black letter bankruptcy law that the discharge of a borrower's liability for a debt in a bankruptcy does not affect a guarantor's liability for the same debt. The court drew a clear distinction between a debt and a liability for a debt. The court explained that a discharge in bankruptcy may alter a borrower's liability for a debt, but not the debt itself. Because the debt remains unaltered, a guarantor's liability for such debt remains the same. In sum, a change to the borrower's liability for a debt in a bankruptcy does not result in a change to the guarantor's liability for the same debt.

On the second issue, the court highlighted language in the personal guaranties that made clear that Mr. and Mrs. Gentry were liable for the original loan, regardless of whether or the extent to which Ball Four was liable for the original loan. In sum, by signing the guaranties, the Gentrys agreed to repay the original loan irrespective of Ball Four's liability for such loan.

On those bases, the court concluded that the lower courts had erred when they held that the guarantors were only liable for the loan, as restructured. While Ball Four's liability for the original loan was reduced to the restructured loan in its bankruptcy case, the original loan guaranteed by Mr. and Mrs. Gentry had not been changed, nor had their liability for such loan changed by reason of the change to Ball Four's liability. The foregoing was true as a matter of bankruptcy law and contract interpretation. Thus, the court remanded the matter to the bankruptcy court to determine if the guarantors' personal assets demonstrated that it was feasible for them to repay the original loan.

PRACTICAL CONSIDERATIONS

The clear takeaway from this case, if you represent debtors, is to make every effort to address personal guaranties at the time of the borrower's plan of confirmation. Otherwise, you could end up having to negotiate the same restructuring twice. From the lender's perspective, this case confirms that personal guaranties can provide important on-going leverage.

OVERSECURED CREDITOR'S 506(B) MOTION FOR ATTORNEYS' FEES SCRUTINIZED, FEE REQUEST SLASHED

Jared S. Roach
Associate, Pittsburgh

In re Bate Land & Timber, LLC, Case No. 13-4665 (Bankr. E.D.N.C. Nov. 25, 2015)

CASE SNAPSHOT

The dispute arose between the debtor and a creditor, Bate Land Company (BLC). The debtor objected to BLC's proof of claim to dispute whether, and in what amount, BLC was entitled to post-petition interest and attorneys' fees. The bankruptcy court's opinion addressed three issues arising out of the debtor's objection and concerning BLC's application for compensation: (1) the amount of reasonable attorneys' fees under section 506(b); (2) the allowance of post-petition interest at the non-default contract rate, rather than at the default rate; and (3) the equitable grounds for reducing the award of post-petition interest.

FACTUAL BACKGROUND

BLC was an oversecured creditor in the debtor's bankruptcy case. Because it was oversecured, BLC was entitled to reimbursement of post-petition attorneys' fees and interest. BLC filed for post-petition attorneys' fees and expenses in the amount of $739,723.01. The loan documents between the debtor and BLC permitted BLC to collect attorneys' fees and costs from the debtor. Notwithstanding the language in the documents, the debtor objected to BLC's fee request on reasonableness grounds. The debtor argued that BLC's fees were unnecessarily duplicative and excessive, especially compared with the fees incurred by the debtor.

BLC also sought to collect post-petition interest at the contractual default rate of interest.

COURT ANALYSIS

The bankruptcy court began its analysis by disposing of the debtor's argument that BLC was not entitled to fees or interest because there was never a default, so the provisions were never triggered. The debtor argued that because it was entitled to a 10-day cure period related to any payment default, and it filed for bankruptcy before the expiration of the 10th day, there was no default. The bankruptcy court, however, agreed with BLC's interpretation of the loan documents and stated that "a default occurs regardless of cure and regardless of a declaration of default." The bankruptcy court's interpretation negated the impact of the 10-day cure period and meant that BLC was entitled to its fees and costs.

The reasonableness requirement of Bankruptcy Code section 506(b) is designed "to prevent squandering of estate assets by oversecured creditors who fail to exercise restraint in the attorneys' fees and expenses they incur." The bankruptcy court listed 12 factors used to determine reasonableness: (1) time and labor required; (2) novelty and difficulty of the issues; (3) skill required to properly perform the service; (4) preclusion of other employment due to acceptance of the case; (5) customary fees; (6) whether the fee is fixed or contingent; (7) any time limitations imposed by the client or the circumstances; (8) amount involved and the results obtained; (9) experience, reputation and ability of the attorneys; (10) undesirability of the case; (11) nature and length of the professional relationship with the client; and (12) awards in similar cases.

In applying these factors, the bankruptcy court determined that a significant fee reduction was warranted. BLC's application contained numerous instances of duplicative billing, which, when combined with the fact that BLC's attorneys spent significantly more time on most matters than did the debtor's counsel, led the bankruptcy court to conclude that BLC had overlawyered the case. Accordingly, the bankruptcy court cut BLC's allowable fees to $325,000.

The bankruptcy court next turned to the applicable interest rate that should be charged. The court applied the following four factors to determine if it was appropriate to apply the default rate of interest (which was permissible under the loan documents): (1) the creditor faces significant risk of nonrepayment; (2) the non-default contract rate of interest is not the prevailing market rate; (3) the differential between the default and pre-default rates is reasonable; and (4) the purpose of the default rate is to compensate the creditor for losses sustained as a result of the default, and not simply a disguised penalty. Applying these factors and its own analysis, the court determined that the applicable interest rate should be the pre-default rate. The court focused extensively on the fact that BLC never faced any serious risk that it would not be repaid in full. Because repayment in full appeared almost certain, the bankruptcy court could not justify applying the higher rate of interest. The court also noted that BLC could not enumerate any reasons why the default interest rate should apply.

Finally, the bankruptcy court explained that it reduced the interest award on equitable grounds. The court felt that it would be unfair to charge the debtor significant interest for delays it could not control. For instance, scheduling and hearing delays were not within the debtor's control.

PRACTICAL CONSIDERATIONS

This case reins in a secured creditor's right to assess attorneys' fees and expenses and interest against the debtor. A secured creditor should not assume that the presence of provisions in the loan documents permitting the payment of its fees and expenses by the debtor operates as a blank check. In a bankruptcy case, the bankruptcy court has the authority to review the reasonableness of the fees and reduce them when warranted. Secured creditors should exercise restraint, even when they are not paying the bill.

ELECTRICITY IS A 'GOOD' UNDER UCC IN ADMINISTRATIVE CLAIM ACTION

Chrystal A. Puleo
Associate, New York

In re Wometco De Puerto Rico Inc. and Mantecados Wometco Inc., Case No. 15-02264 (Bankr. D. P.R. Jan. 12, 2016)

CASE SNAPSHOT

The United States Bankruptcy Court, District of Puerto Rico held that electricity is a "good" under the Uniform Commercial Code for purposes of an administrative claim under Bankruptcy Code section 503(b)(9).

FACTUAL BACKGROUND

Puerto Rico Electric Power Authority (PREPA) made an application for the allowance of administrative claim under section 503(b)(9) for electricity delivered to the debtors Wometco De Puerto Rico Inc. and Mantecados Wometco Inc. during the 20 days prior to the commencement of the debtors' bankruptcy cases. PREPA alleged that electricity is a "good" for purposes of section 503(b)(9) of the Bankruptcy Code, and therefore PREPA is entitled to an administrative expense claim for the value of the electricity sold to the debtors under section 503(b)(9). The total value of the electricity claimed was $94,932.27. The debtors filed an objection to the application and PREPA filed a reply.

COURT ANALYSIS

In their objection, the debtors argued that the current case law was split on whether electricity is a "good" under section 503(b)(9), and urged the court to follow the court's finding in *In re NE Opco, Inc.*, 501 B.R. 233 (Bankr. D. Del. 2013), which concluded that electricity is not a "good" under section 503(b)(9) and Article 2 of the UCC because there was not a meaningful period of time between which electricity is identified and consumed. The term "goods" is not defined in the Bankruptcy Code; however, bankruptcy courts have adopted the definition in Article 2 of the UCC, which defines a "good" as a thing that is "movable at the time of the identification to the contract for sale." In its analysis, the court turned to the plain meaning of section 503(b)(9), as well as the language of Article 2 of the UCC. Finally, the court was persuaded by the rationale in *In re Erving Indus., Inc.*, 435 B.R. 354 (Bankr. D. Mass. 2010) to find that electricity should be considered a "good" rather than a "service" because electricity is tangible, it can be measured and stored, and it is metered before it is consumed, thereby making it "movable at the time of identification to the contract" as required under the UCC. Upon this finding, PREPA's administrative claim was allowed.

PRACTICAL CONSIDERATIONS

Depending on the jurisdiction, debtors may be susceptible to large administrative claims for electricity delivered during the 20 days prior to the petition date.

Appellate Court Rules That Even a First-Time or Single Transfer May Fall Within the Ordinary Course of Business Exception—continued from page 11

As to the incurrence of the debt, the evidence established that the debtor incurred the debt in the ordinary course of its business. Although evidence suggested that the debtor was gambling on a risky business venture using a creditor's money, the court ultimately concluded that the trustee failed to raise such evidence and had failed to argue that the risky, unprecedented nature of the transaction was something the debtor had to disprove. The trial court was given no good reason to think that the debt was incurred outside the ordinary course of business.

As to the payment, the evidence established the payment was made in the debtor's ordinary course of business. The payment was made pursuant to the terms of the purchase contract and was made two days before the due date. No facts suggested that the creditor had engaged in collection activity prior to the debtor making the payment. Summary judgment finding the debt and the payment to be "ordinary course" under section 547(c)(2) of the Bankruptcy Code was appropriate.

PRACTICAL CONSIDERATIONS

Even a first-time or single transfer between the debtor and payee may fall within the ordinary course of business exception.

CREDITOR CANNOT USE INVOLUNTARY CHAPTER 7 CASE TO ENFORCE A JUDGMENT

Chrystal A. Puleo
Associate, New York

In re Matthew N. Murray, Case No. 14-1027 (Bankr. S.D.N.Y. Jan. 13, 2016)

CASE SNAPSHOT

The United States Bankruptcy Court, Southern District of New York held that the filing of an involuntary chapter 7 bankruptcy case by a single creditor as a means of enforcing a judgment in a two-party dispute was an inappropriate use of the bankruptcy system, and dismissed the petition.

FACTUAL BACKGROUND

Wilk Auslander LLP, a law firm (acting as both the petitioning creditor and its own counsel) filed an involuntary petition against Matthew N. Murray, seeking payment on a $10.7 million judgment. Mr. Murray had no income and his sole asset was his co op apartment, which he owned with his wife as tenants by the entirety, and where the couple lived with their two children.

Looking at the creditor's rights under both bankruptcy and non-bankruptcy law, the court found that under New York state law, Wilk Auslander, as a judgment creditor of Mr. Murray, only had a claim to Mr. Murray's interest for half the value of the apartment, and could only sell that one-half interest. In contrast, however, under federal law, a trustee would be able to sell the apartment jointly held by the debtor and his wife free and clear of the wife's interest under section 363(h) of the Bankruptcy Code, thereby likely increasing the amount that the creditor could realize upon a sale of the apartment. Under bankruptcy law, Mr. Murray's wife's only right would be one of first refusal to match the sale offer of any potential buyer and a share of the proceeds of a forced sale, but neither Mr. Murray's nor his wife's consent would be required to execute the sale. Mr. Murray had no other creditors and sought dismissal of the case for cause.

COURT ANALYSIS

The court found that: the filing arose solely from a two-party dispute; the filing was made to achieve a result unavailable under non-bankruptcy law; there were no other creditors' needs and concerns to protect; the creditor had adequate non-bankruptcy remedies; the debtor did not want or need a discharge; and, there were no other bankruptcy goals to achieve. Based on these facts and relying on the standard set in *CTC 9th Avenue Partnership v. Norton Comp. (In re C-TC 9th Avenue Partnership)*, 113 F. 3d 1304 (2d Cir. 1997) to determine whether there is cause for dismissal of a case in the Second Circuit, the court found that the case may have been filed in bad faith, and in any case, lacked a proper bankruptcy purpose, thereby supporting a dismissal. The court dismissed the involuntary filing for cause under section 707(a) of the Bankruptcy Code.

Additionally, the court seemed to find the law firm's sophisticated legal tactic to the disadvantage of the debtor's family distasteful, stating that, "'the bankruptcy court is not a collection agency,'" and "'bankruptcy is not a judgment enforcement device.'" (Citations omitted.)

PRACTICAL CONSIDERATIONS

Single creditors should think twice before filing involuntary bankruptcy petitions in the Southern District of New York solely to execute on judgments, particularly since such cases may be subject to a bad faith analysis.

BANKRUPTCY COURT DECLINES TO APPOINT INTERIM TRUSTEE DURING GAP PERIOD

Sarah K. Kam
Associate, New York

In re Diamondhead Casino Corp., 540 B.R. 459 (Bankr. D. Del. 2015)

CASE SNAPSHOT

The United States Bankruptcy Court, District of Delaware held that the petitioning creditors did not meet their burden of proof to show that an interim trustee was necessary in the "gap period" to preserve the property of the estate or to prevent loss to the estate.

FACTUAL BACKGROUND

The debtor owned 404 acres of undeveloped land in Diamondhead, Mississippi, including 50 approved for gaming operations. Over the years, the debtor had been unsuccessful in its attempts to develop the property into a resort destination centered around a casino. An involuntary chapter 7 petition was filed against the debtor. The debtor, in turn, filed a motion to dismiss, or in the alternative, convert the case to one under chapter 11. With the motion to dismiss pending, the petitioning creditors joined in the involuntary petition and filed an emergency motion to appoint an interim trustee.

COURT ANALYSIS

To avoid the appointment of an interim trustee in an involuntary case that may be dismissed, the bankruptcy court first considered whether there was a reasonable likelihood that an order for relief would be entered. Concluding that there was a reasonable likelihood that such an order would be entered, the bankruptcy court considered the merits of the motion to appoint an interim trustee.

The bankruptcy court concluded that the petitioning creditors failed to show there were grounds under Bankruptcy Code section 303(g) for appointing a trustee to manage the debtor during the "gap" period between the date the petition was filed and the date an order for relief was entered. Appointment of an interim trustee under section 303(g) is an extraordinary remedy appropriate only where it is necessary to preserve property of a debtor's bankruptcy estate or to prevent loss to a debtor's estate. The lack of trust in the debtor's management and

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FACTORED ACCOUNTS RECEIVABLE NOT PART OF DEBTOR'S ESTATE, MAY NOT BE USED AS CASH COLLATERAL

Jared S. Roach
Associate, Pittsburgh

In re Dryden Advisory Group, LLC, 534 B.R. 612 (Bankr. M.D. Pa. 2015)

CASE SNAPSHOT

The debtor filed a motion for authority to use cash collateral. Durham Commercial Capital Corp. objected to the debtor's use of cash collateral to the extent such cash consisted of proceeds of accounts receivable that the debtor had factored pre-petition. The bankruptcy court agreed with Durham that the pre-petition factor agreements were akin to a sale by the debtor of its assets, not a secured financing in which accounts receivable were used as collateral.

FACTUAL BACKGROUND

The debtor is a consulting business that assisted clients in defending tax audits and in identifying refunds or credits against assessed taxes. The debtor is paid on commission depending on the amount of the tax refund it helps the client achieve. As such, cash flow was sporadic and sometimes lagged expenses.

The debtor first obtained a loan from Beneficial Mutual Savings Bank. Part of the collateral package taken by Beneficial included a security interest in the debtor's accounts receivable. The debtor stopped making payments to Beneficial and sought additional financing. Durham agreed to factor the debtors' accounts receivable.

The debtor and Durham entered into the first factoring agreement with Beneficial's consent. Subsequently, however, the debtor and Durham entered into an amended factoring agreement for additional receivables without obtaining Beneficial's consent.

COURT ANALYSIS

The issue before the bankruptcy court was whether the amended factoring agreement was a sale of the debtor's accounts receivables or whether it constituted an extension of credit with accounts receivable as collateral. In a true sale, the receivables would not be part of the debtor's estate.

The bankruptcy court reviewed not only the language in the amended factoring agreement, but also its underlying purpose. The court concluded that the amended factoring agreement was a true sale of the debtor's receivables. First, the debtor had no right to use the proceeds of a receivable that had been factored. The proceeds were held in trust and, if received by the debtor, the debtor had to immediately pay them to Durham. Second, Durham could demand that the clients pay Durham directly, cutting the debtor out of the payment stream completely. Third, under a true sale, the factor assumed risk of nonpayment; Durham assumed the risk of nonpayment.

Because the court determined the amended factoring agreement functioned as a sale of certain of the debtor's accounts receivable, the debtor could not use cash associated with those receivables in its post-petition operations. While Durham may have purchased the receivables subject to the liens of other secured parties, the court lacked jurisdiction to make that determination.

PRACTICAL CONSIDERATIONS

A debtor should take great care to understand the nature of the agreements to which it is a party and the implications such agreements may have.

Bankruptcy Court Declines to Appoint Interim Trustee During Gap Period—continued from page 15

frustration with the lack of progress to develop the property that was worth more than debts the debtor owed, no matter how justified, did not justify appointment of an interim trustee. Accordingly, the bankruptcy court denied the petitioning creditors' request for an interim trustee.

PRACTICAL CONSIDERATIONS

Appointment of an interim trustee under section 303(g) is an extraordinary remedy and must be supported by evidence that the trustee is needed to preserve estate property or to prevent the loss of estate property.

NON-OBJECTING CREDITOR NOT DEEMED TO ACCEPT PROPOSED PLAN UNDER SECTION 1129(A)(10)

Christopher O. Rivas
Associate, Los Angeles

In re Akbari-Shahmirzadi, No. CIV 14-0982 JB/WPL, 2015 BL 403873 (D.N.M. Nov. 25, 2015)

CASE SNAPSHOT

The District Court of New Mexico held that a non-voting, non-objecting creditor may not be deemed to have accepted a plan under Bankruptcy Code section 1129(a)(10), which requires at least one class of impaired creditors to accept a plan.

FACTUAL BACKGROUND

Chapter 11 debtor and retired attorney Akbari filed a voluntary petition under chapter 7. More than a year later, the debtor successfully moved to convert the case to chapter 11, and became a debtor-in-possession. The debtor failed to timely file a chapter 11 plan and, on the last day of her exclusivity period, she moved to extend the exclusivity period so she could file a plan. The bankruptcy court denied the motion to extend exclusivity. Upon the lapse of the exclusivity period, one of the debtor's creditors filed an alternative plan of liquidation. The debtor filed a competing plan of liquidation. The debtor received no ballots voting in favor of her plan and one ballot voting to reject it. Several creditors also objected to the debtor's plan. The bankruptcy court ruled that the debtor's plan was not confirmable as a matter of law because it failed to meet the requirements of section 1129(a)(10), which requires at least one class of impaired creditors to accept a plan. Instead, the bankruptcy court found the alternative plan confirmable, and confirmed it. The debtor appealed to the district court.

The appeal was heard by a magistrate judge, who issued a Proposed Finding and Recommendation of Decision (PFRD) to the presiding district court judge, ruling against the debtor and affirming the bankruptcy court's rulings. The debtor contested the PFRD with the district court judge.

COURT ANALYSIS

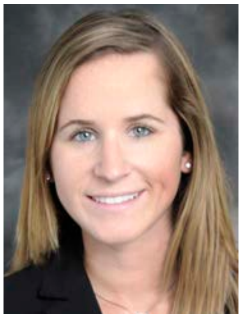
The primary issue on appeal was whether the magistrate judge correctly applied the Tenth Circuit's holding in *In re Ruti-Sweetwater, Inc.*, 836 F.2d 1263 (10th Cir. 1988). *In Ruti-Sweetwater*, the Tenth Circuit held that a creditor who failed to vote for a chapter 11 plan and failed to object to the plan was barred from later objecting that the plan was not fair and equitable. The debtor argued that, under the *Ruti-Sweetwater* holding, the non-voting and non-objecting creditors of her case should have been deemed to have accepted the plan under Bankruptcy Code section 1129(a)(10).

The district court summarily disposed of the debtor's argument, finding that *Ruti-Sweetwater* merely found that a non-objecting creditor may be deemed to accept that plan under Bankruptcy Code section 1129(a)(8), which requires that each class must either accept the plan or not be impaired under the plan. The district court held that *Ruti-Sweetwater* has no bearing on section 1129(a)(10), which states expressly that if "a class of claims is impaired under the plan, at least one class of claims that is impaired under the plan [must have] accepted the plan . . ." In other words, deemed acceptance will not satisfy section 1129(a)(10), which requires actual affirmative acceptance by an impaired class of creditors.

PRACTICAL CONSIDERATIONS

The *Akbari* decision protects non-participating impaired creditors from being deemed to have accepted a plan under section 1129(a)(10). However, creditors should not rest on their rights, and any creditor that is impaired by a chapter 11 plan should seek the advice of a bankruptcy attorney and consider timely voting against a chapter 11 plan and/or objecting to such a plan if the creditor does not approve of its treatment under the plan.

POST-PETITION CONDO ASSOCIATION ASSESSMENT NOT DISCHARGEABLE IN CHAPTER 13 CASE



Lauren S. Zabel
Associate, Philadelphia

In re Batali, Bk. No. 11-10114 (B.A.P. 9th Cir., Dec. 1, 2015)

CASE SNAPSHOT

In an unreported decision, the Ninth Circuit Bankruptcy Appellate Panel considered the issue of whether certain post-petition condominium association assessments were dischargeable pursuant to section 1328(a) of the Bankruptcy Code. The court concluded that they were not.

FACTUAL BACKGROUND

Chapter 13 debtors owned an investment condominium in Kirkland, Washington, that was subject to two mortgage liens and a lien in favor of the condominium association. The debtors' confirmed chapter 13 plan provided for the surrender of the condominium to the mortgage lender and the condominium association. After confirmation, the mortgage lender obtained relief from the automatic stay and foreclosed upon the property. The condominium association also obtained stay relief in order to pursue its state law remedies with respect to post-petition assessments. Thereafter, the debtors filed a motion seeking determination that the post-petition condominium assessments would be discharged under the debtors' confirmed plan. The bankruptcy court denied the debtors' motion, and the debtors appealed.

COURT ANALYSIS

The court first rejected the debtors' argument that the terms of their confirmed chapter 13 plan bound the condominium association and would result in the discharge of its claim for post-petition condominium assessments, finding that because the confirmed plan made no mention of discharging the debtors' post-petition liability to the condominium association, the plan could not bind the association to the dischargeability of those amounts.

The court next considered whether the post-petition condominium assessments would nevertheless be dischargeable under section 1328(a). For this issue, the court relied upon a prior decision by the Ninth Circuit Bankruptcy Appellate Panel in *In re Foster*, which held that a recorded condominium declaration runs with the land and is a property right that cannot be extinguished in a bankruptcy. By extension, the *Foster* court ruled that so long as a debtor continues to have an interest in the property at issue, the debtor cannot discharge post-petition assessments arising from that covenant running with the property. Applying these principles to the *Batali* case, the court noted that even though the debtors proposed in their confirmed plan to surrender the condominium, surrender under the plan did not effectuate a transfer of the property. Because of that, the debtors continued to be owners of the condominium until the title to that property passed to the mortgage lender through the foreclosure process. Therefore, the court held that post-petition condominium assessments accruing between the petition date and the transfer date were not discharged under section 1328(a).

PRACTICAL CONSIDERATIONS

Pursuant to section 523(a)(16) of the Bankruptcy Code, post-petition condominium assessments and other similar fees are not dischargeable in cases under chapters 7, 11 and 12 of the Bankruptcy Code (or cases under chapter 13 where a debtor obtains a discharge under section 1328(b) notwithstanding the non-completion of plan payments), so long as the debtor has a "legal, equitable, or possessory ownership interest" in the subject property. The Ninth Circuit Bankruptcy Appellate Panel's rulings in *Batali* and *Foster* effectively apply the same standard to post-petition condominium assessments in chapter 13 cases where a debtor obtains a discharge following the completion of his/her plan payments. Under these standards, whether the debtor has a legal, equitable and/or possessory interest in the subject property is key to determining whether a condominium association (or other similar organization) can pursue a debtor post-discharge for personal liability arising from post-petition homeowners association fees.

CHAPTER 7 DEBTOR'S PRE-PETITION VIATICAL SETTLEMENTS ARE RECOVERABLE AS FRAUDULENT TRANSFERS

Christopher O. Rivas
Associate, Los Angeles

Gladstone v. U.S. Bancorp, No. 13-55773, 2016 BL 4363 (9th Cir. Jan. 08, 2016)

CASE SNAPSHOT

The Ninth Circuit held that a chapter 7 debtor's life insurance policies are estate property, and that companies that pay viatical settlements or life settlement transactions to the debtor pre-petition may be pursued for fraudulent transfers based on such settlements.

FACTUAL BACKGROUND

Debtor David Green filed a chapter 7 bankruptcy petition, and died about five months later. The debtor never disclosed to the chapter 7 trustee that prior to the bankruptcy, he owned three life insurance policies with a face value of $9 million. Prior to filing his bankruptcy petition, the debtor transferred his beneficial interests in the three policies to his wife, who sold the rights to the death benefits to three entities under a viatical settlement arrangement. In a viatical settlement (or life settlement transaction), the purchaser pays a lump sum to an insured who is near the end of his life that is less than the death benefit under the policy, and the purchaser continues to make premium payments under the policies until the insured passes away, at which time the purchaser collects the death benefit.

Here, the debtor sold the $9 million in policies to the purchasers for the lump sum of approximately $500,000, but hid the transactions from the chapter 7 trustee. Two of the three policies were sold pre-petition, and one was sold shortly after the debtor filed his bankruptcy petition. About a year-and-a-half later, and a year after the debtor passed away, the chapter 7 trustee discovered the transactions purely by happenstance during a Bankruptcy Code section 341(a) meeting of creditors in an unrelated bankruptcy proceeding to which she had also been appointed.

The chapter 7 trustee filed an adversary case for fraudulent transfers against the purchasers under Bankruptcy Code section 548, and sought to extend the statute of limitations based on the delayed discovery arising out of debtor's concealment of the policies. On summary judgment, the bankruptcy court dismissed the claims without findings of fact, conclusions of law, or otherwise stating the grounds for the dismissal. The chapter 7 trustee appealed to the district court, which reversed, and determined that the chapter 7 trustee should be granted leave to amend her claims to pursue all of the policies against the purchaser defendants. The purchaser defendants appealed to the Ninth Circuit.

COURT ANALYSIS

On appeal, the purchaser defendants argued that the life insurance policies and viatical settlements were not an "interest of the debtor in property" recoverable under section 548(a)(1) (the Bankruptcy Code's fraudulent transfer statute). The Ninth Circuit held otherwise, because the legislative history of section 541(a), which defines estate property, indicates that Congress intended for section 541 to "bring anything of value that the debtors have into the estate."

The Ninth Circuit found that the debtor's interest in the policies and the life settlements would have been part of the bankruptcy estate if he had not transferred them; therefore, the policies constitute "an interest of the debtor in property" within the meaning of section 548, "except to the extent that a third party had a beneficial or equitable interest." The court found that life insurance policies were not expressly excluded from bankruptcy estates under the narrow list of exclusions in section 541(b). The court also found that the policies were not exempt property under section 522, because: (1) the debtor never claimed such an exemption; (2) the defendant purchasers lacked standing to assert such an exemption for the debtor; and, (3) the defendant purchasers did not brief the issue in the district court and therefore waived the argument.

In addition to finding that the policies were estate property and subject to avoidance as a fraudulent transfer under section 548, the Ninth Circuit found that the chapter 7 trustee should have been granted leave to amend her complaint because any statute of limitation on such claims was equitably tolled by the debtor's intentional concealment of the transfers.

PRACTICAL CONSIDERATIONS

Investors and purchasers seeking to purchase life insurance policies pursuant to viatical settlements should consider the implications of a potential bankruptcy by the insured, and whether such a bankruptcy may expose the purchaser to a fraudulent transfer action under section 548. In structuring the settlement, a purchaser should seek the advice of knowledgeable bankruptcy counsel.

LICENSEE'S SECTION 365(N) ELECTION DOES NOT PRESERVE DISTRIBUTION AND TRADEMARK RIGHTS UNDER REJECTED AGREEMENT

Christopher A. Lynch
Associate, New York

In re Tempnology, LLC, Case No. 15-11400-JMD (Bankr. D.N.H. Nov. 12, 2015)

CASE SNAPSHOT

The United States Bankruptcy Court for the District of New Hampshire held that a debtor-licensor's rejection of an agreement terminated the non-rejecting party's exclusive distribution rights and the right to use debtor's trademarks, notwithstanding its election under section 365(n) of the Bankruptcy Code, because such rights were not "a right to intellectual property" within the meaning of the Bankruptcy Code.

FACTUAL BACKGROUND

Debtor Tempnology, LLC is a materials innovation company that counted among its developments chemical-free cooling fabrics under the Coolcore brand for use in various consumer products. In 2012, the debtor and Mission Product Holding, Inc. entered into a licensing agreement whereby Mission was granted exclusive distribution rights in the United States for certain cooling material products developed by the debtor. The debtor agreed that it would not license or sell the cooling material products to anyone other than Mission for the term of the agreement. The debtor also agreed to take no actions during the term to directly or indirectly frustrate the licensee's exclusive rights thereunder. The agreement further granted Mission a non-exclusive license to use the debtor's trademark and logo for the limited purpose of performing the obligations under the agreement.

On September 1, 2015, the debtor filed a petition under chapter 11 of the Bankruptcy Code and filed a motion under section 365 of the Bankruptcy Code to reject certain executory contracts, including the licensing agreement. Mission challenged the motion, arguing the agreement was not executory and reserving its rights under section 365(n). The bankruptcy court entered an order rejecting the agreement subject to the licensee's election under 365(n). The debtor subsequently brought a motion for a determination of the licensee's rights, arguing that Mission's rights were limited to the grant of a non-exclusive license. Mission asserted that section 365(n) also protected its exclusive distribution rights and the right to use the debtor's trademarks for the remainder of the agreement. There was no dispute that the licensing rights under the agreement were preserved.

COURT ANALYSIS

In pertinent part, section 365(n) provides that if the debtor rejects an executory contract under which the debtor is a licensor of a "right to intellectual property," the licensee may elect … "to retain its rights (including the right to enforce any exclusivity provision of such contract …) under such contract … to such intellectual property (including any embodiment of such intellectual property to the extent protected by applicable nonbankruptcy law)…" 11 U.S.C. § 365(n)(1)(B). Focusing on the language of the statute, as well as its legislative history, the bankruptcy court noted that the protection afforded under 365(n) is limited to intellectual property rights, and that the right to distribute the products, even though such products are patented and subject to licensing rights granted under the agreement, is not a right to intellectual property, but merely a severable right to distribute. As a result, the court concluded that the exclusive distribution rights did not survive rejection of the agreement.

In finding that the licensee's rights to use the debtor's trademarks and logos ended with the rejection of the agreement, the court noted that the Bankruptcy Code's definition of "intellectual property" includes numerous forms of intellectual property, but does not identify among them trademarks. 11 U.S.C. § 101(35)(A). The court declined to exercise its equitable powers to include trademarks in the definition of intellectual property, as has a minority of courts, in particular the recent decision in *In re Crumbs Bake Shop, Inc.*, 522 B.R. 766 (Bankr. D.N.J. 2014). The court held that the right to use the debtor's trademarks ended with the rejection of the agreement.

Tempnology is pending on appeal before the United States Bankruptcy Appellate Panel for the First Circuit.

PRACTICAL CONSIDERATIONS

Until the Supreme Court addresses the circuit split on the interpretation of section 365(n), or Congress revises that section (or section 101(35)(A)) to expressly provide for trademarks, licensees may attempt to protect their rights through tying trademark rights together with other intellectual property rights in an integrated agreement that may fall within the purview of section 365(n). Protection may also be obtained by taking a security interest in the licensor's trademark.

APPELLATE COURT RULES THAT RES JUDICATA AND JUDICIAL ESTOPPEL DID NOT BAR USE OF TWO DIFFERENT VALUATIONS

Sarah K. Kam
Associate, New York

Gold Star Construction, Incorporated v. Cavu/ Rock Properties Project I, L.L.C., No. 15-50455, 2016 U.S. App. LEXIS 103 (5th Cir. Jan. 4, 2016) (unpublished opinion)

CASE SNAPSHOT

The United States Court of Appeal for the Fifth Circuit held that the doctrines of res judicata and judicial estoppel did not bar different valuations for the same property in different contexts.

FACTUAL BACKGROUND

The debtor asserted that certain property had a value of $8.04 million to $10.05 million at plan confirmation, and argued that the same property had a value of $2.1 million to $2.6 million in a separate adversary proceeding. The creditor argued that the bankruptcy court erred by failing to use the same property valuation for both the bankruptcy proceeding under section 1129 of the Bankruptcy Code and the adversary proceeding under section 506 of the Bankruptcy Code.

COURT ANALYSIS

The Fifth Circuit ruled that the district court correctly held that valuations under Bankruptcy Code sections 1129 and 506 are two distinct, separate valuations required for different purposes. A valuation under section 1129 is a set of projections offered in support of the plan's feasibility. A section 1129 reorganization plan provides for a debtor to retain and use collateral to generate income with which to make payments to creditors. On the other hand, the purpose of section 506 is to provide for the division of allowed claims supported by liens into secured and unsecured portions during the reorganization, and valuations under this section must be based upon realistic measures of current worth.

The feasibility projections under section 1129 were based on the debtor's estimate of monies to be realized from the sale of lots over time and anticipated continued development of the property. On the other hand, the estimate under section 506 was based on an appraisal of the current fair market value of the property. As a result, the debtor did not assume inconsistent positions by presenting two different valuations for two different purposes. The bankruptcy court's acceptance of a section 1129 feasibility plan also did not constitute a final judgment on the value of the property under section 506. The doctrines of judicial estoppel and res judicata did not apply.

PRACTICAL CONSIDERATIONS

Differing valuations may be permitted depending on the purposes of the valuations under different provisions of the Bankruptcy Code.

COUNSEL'S CORNER: NEWS FROM REED SMITH

Derek Baker presented on "Recent Bankruptcy Cases of Interest" (focused on Supreme Court and Third Circuit cases) at the Eastern District of Pennsylvania Bankruptcy conference on January 22, 2016.

Marsha Houston spoke to a group of leading entertainment executives and in-house counsel on "Recent Trends of Bankruptcy in the Entertainment Industry" at the UCLA Entertainment Symposium on March 11, at the UCLA Campus in Los Angeles.

Robert Simons presented a webinar, "Restructuring Challenges in the Coal, Oil and Gas Industries," as part of Reed Smith's ongoing Coal, Oil and Gas series, on February 24, 2016. Bob also was a presenter at the "Coal Properties & Investment Conference: Coal Investment Opportunities, Company Restructures, and Met Market Trends," March 21 - 22 in Fort Lauderdale, Florida.

REED SMITH COMMERCIAL RESTRUCTURING & BANKRUPTCY GROUP

PRACTICE LEADER
Peter S. Clark II
+1 215 851 8142
(Philadelphia)
pclark@reedsmith.com

CHICAGO
Stephen T. Bobo
+1 312 207 6480
sbobo@reedsmith.com

Aaron B. Chapin
+1 312 207 2452
achapin@reedsmith.com

Theresa Davis
+1 312 207 2777
tdavis@reedsmith.com

Timothy S. Harris
+1 312 207 2420
tharris@reedsmith.com

Ann E. Pille
+1 312 207 3870
apille@reedsmith.com

Alexander Terras
+1 312 207 2448
aterras@reedsmith.com

FALLS CHURCH
Linda S. Broyhill
+1 703 641 4328
lbroyhill@reedsmith.com

Robert M. Dilling
+1 703 641 4255
rdilling@reedsmith.com

FRANKFURT
Dr. Volker Kammel
+49 (0)69 222289 825
vkammel@reedsmith.com

HONG KONG
Desmond Liaw
+ 852 2507 9834
desmond.liaw@rsrbhk.com

HOUSTON
Carol Burke
+1 713 469 3880
cburke@reedsmith.com

LONDON
Helena Clarke
+44 (0)20 3116 3747
hclarke@reedsmith.com

Jeffery Drew
+44 (0)20 3116 2900
jdrew@reedsmith.com

Emma J. Flacks
+44 (0)20 3116 2922
eflacks@reedsmith.com

Monika Kuzelova
+44 (0)20 3116 3428
mkuzelova@reedsmith.com

Edward Mathison
+44 (0)20 3116 2932
emathison@reedsmith.com

Elizabeth A. McGovern
+44 (0)20 3116 3151
emcgovern@reedsmith.com

Charlotte Møller
+44 (0)20 3116 3472
cmoller@reedsmith.com

Georgia M. Quenby
+44 (0)20 3116 3689
gquenby@reedsmith.com

Victoria Thompson
+44 (0)20 3116 3509
vthompson@reedsmith.com

Estelle Victory
+44 (0)20 3116 3000
evictory@reedsmith.com

LOS ANGELES
Marsha A. Houston
+1 213 457 8067
mhouston@reedsmith.com

Christopher O. Rivas
+1 213 457 8019
crivas@reedsmith.com

MUNICH
Dr. Stefan Kugler, LL.M.
+49 (0)89 20304 131
skugler@reedsmith.com

Dr. Etienne Richthammer
+49 (0)89 20304 141
erichthammer@reedsmith.com

NEW YORK
Arnold L. Bartfeld
+1 212 205 6008
abartfeld@reedsmith.com

Aaron Z. Bourke
+1 212 231 2640
abourke@reedsmith.com

Edward J. Estrada
+1 212 549 0247
eestrada@reedsmith.com

Sarah K. Kam
+1 212 549 0284
skam@reedsmith.com

Christopher A. Lynch
+1 212 549 0208
clynch@reedsmith.com

James C. McCarroll
+1 212 549 0209
jmccarroll@reedsmith.com

Andrea J. Pincus
+1 212 205 6075
apincus@reedsmith.com

Chrystal A. Puleo
+1 212 231 2651
cpuleo@reedsmith.com

John L. Scott
+1 212 205 6099
jlscott@reedsmith.com

Michael J. Venditto
+1 212 205 6081
mvenditto@reedsmith.com

Lillian Worthley
+1 212 549 0273
lworthley@reedsmith.com

PARIS
Brice Mathieu
+33 (0)1 76 70 40 00
bmathieu@reedsmith.com

PHILADELPHIA
Derek J. Baker
+1 215 851 8148
dbaker@reedsmith.com

Scott M. Esterbrook
+1 215 851 8146
sesterbrook@reedsmith.com

Barbara K. Hager
+1 215 851 8864
bhager@reedsmith.com

Jennifer P. Knox
+1 215 851 8190
jknox@reedsmith.com

Brian M. Schenker
+1 215 241 7966
bschenker@reedsmith.com

Claudia Z. Springer
+1 215 241 7946
cspringer@reedsmith.com

Matthew E. Tashman
+1 215 241 7996
mtashman@reedsmith.com

Lauren Zabel
+1 215 851 8147
lzabel@reedsmith.com

PITTSBURGH
Jared S. Roach
+1 412 288 3277
jroach@reedsmith.com

Eric A. Schaffer
+1 412 288 4202
eschaffer@reedsmith.com

Robert P. Simons
+1 412 288 7294
rsimons@reedsmith.com

Paul M. Singer
+1 412 288 3114
psinger@reedsmith.com

Luke A. Sizemore
+1 412 288 3514
lsizemore@reedsmith.com

David Ziegler
+1 412 288 3026
dziegler@reedsmith.com

PRINCETON
Derek J. Baker
+1 609 520 6390
dbaker@reedsmith.com

RICHMOND
Alison Toepp
+1 804 344 3465
atoepp@reedsmith.com

SAN FRANCISCO
Douglas G. Boven
+1 415 659 5652
dboven@reedsmith.com

Jonathan Doolittle
+1 415 659 5902
jdoolittle@reedsmith.com

SINGAPORE
Troy Doyle
+65 6320 5359
tdoyle@reedsmith.com

Estelle Victory
+65 6320 5319
evictory@reedsmith.com

WILMINGTON
Emily K. Devan
+1 302 778 7570
edevan@reedsmith.com

J. Cory Falgowski
+1 302 778 7522
jfalgowski@reedsmith.com

Kurt F. Gwynne
+1 302 778 7550
kgwynne@reedsmith.com

Kimberly E.C. Lawson
+1 302 778 7597
klawson@reedsmith.com

Richard A. Robinson
+1 302 778 7555
rrobinson@reedsmith.com

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