CR&B Alert

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BAD BOY GUARANTIES

We all know that many large commercial real estate loan transactions include "bad boy" guaranties from the principals of the borrower which spring into action

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upon the occurrence of certain events, like the filing of a bankruptcy petition. Some borrowers do not take these guaranties seriously since they think that they are in violation of public policy and/or constitute an unenforceable penalty. The public policy argument is that the springing recourse nature of the guaranty creates a conflict of interest between the guarantor's self-interest and the fiduciary duty that the guarantor owes to the borrower's shareholders, and perhaps creditors as well, as the borrower enters the zone of insolvency. The unenforceable penalty argument is that the full recourse provision does not attempt to calculate the actual damages that may be suffered by the lender as a result of the occurrence of the "bad acts." A state court judge in New York was faced with these arguments recently and ruled that while he understood that "there are many real estate developers who now regret having exposed themselves to the loss of fortune by investing in an overheated real estate market…[the court] does not have a mandate to rewrite the rules relating to commercial real estate finance." The court upheld the enforceability of the guaranties and granted summary judgment in favor of the lenders. *UBS Commercial Mortgage Trust 2007-FL 1 v. Garrison Special Opportunities Fund LP*, No. 652412/10 (N.Y.Sup. Ct. Mar. 8, 2011); and *Bank of America, NA v. Lightstone Holdings, LLC*, No. 601853/09 (N.Y.Sup.Ct. July 14, 2011).

CR&B ALERT CASE UPDATE—SEVENTH CIRCUIT UPHOLDS LENDERS' CREDIT BIDDING RIGHTS IN *RIVER ROAD* DECISION

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The Seventh Circuit recently weighed in on the issue of whether a secured creditor has a right to credit bid at the sale of its collateral in connection with a chapter 11 plan of reorganization. In its decision in *In re River Road Hotel Partners, LLC*, Case Nos. 10-3597 & 10-3598 (7th Cir. June 28, 2011), the Seventh Circuit split with decisions of the Third and Fifth Circuit Courts of Appeal holding that secured creditors have no such right to credit bid, raising the prospect that the issue may be ripe for review by the United States Supreme Court.

The *River Road Hotel Partners* case involved two groups of related debtor entities that operated separate hotels. They each proposed chapter 11 plans that called for the sale of substantially all of their assets at auction sales. Both debtors filed motions seeking approval of bid procedures for the auction sales, including a prohibition on credit bidding. The proposed stalking horse bids for each hotel were substantially less than the amounts of the secured lenders' claims. In response to the secured lenders' objection to the proposed bid procedures, Bankruptcy Judge Bruce Black of the Northern District of Illinois ruled that the prohibition on credit bidding prevented the debtors' proposed plans from being confirmable, for the reasons stated in the dissenting opinion of Judge Thomas Ambro in *In re Philadelphia Newspapers, LLC*, 599 F.3d 298 (3d Cir. 2010), and therefore he denied both bid procedures motions.

The issue considered by the Bankruptcy Court was the construction of the portion of the Bankruptcy Code that allows confirmation of a reorganization plan over the objection of one or more classes of secured creditors. Ordinarily, acceptance of a chapter 11 plan by each class of impaired creditors is required for confirmation. However, section 1129(b)(2) provides that a plan may also be confirmed (*i.e.*, "crammed down") if rejected by one or more dissenting classes of impaired creditors if the plan is "fair and equitable" as to those creditors. Section 1129(b)(2)(A) provides that a plan is considered fair and equitable with respect to secured creditors if it either: (i) permits the dissenting secured creditor to retain its liens; (ii) proposes a sale of the secured lender's collateral free and clear of all liens with such liens to attach to the proceeds of the sale, subject to the lender's right to credit bid; or (iii) provides the secured lender with the "indubitable equivalent" of its secured claim, which phrase is not further defined or clarified in the Bankruptcy Code.

Last year, in *Philadelphia Newspapers*, the Third Circuit addressed whether a similar plan that proposed a sale prohibiting a secured lender from credit bidding would provide that secured lender with the indubitable equivalent of its lien. The Third Circuit followed the Fifth Circuit's prior decision in *In re The Pacific Lumber Co.*, 584 F.3d 299 (5th Cir. 2009), and found that the indubitable equivalent standard of the "fair and equitable" test unambiguously permitted confirmation of a plan despite a sale that prohibited credit bidding. In reaching this result, the Third Circuit defined indubitable equivalent to mean "the unquestionable value of a secured lender's secured interest in its collateral"—apparently the fair market value of the collateral. However, it was not possible to consider whether such a sale would actually provide a secured lender with the indubitable equivalent of its lien because the auction sale had not yet taken place. The Third Circuit noted that the determination of indubitable equivalent is based on the total compensation provided to a secured lender under a plan, rather than just the sale price of its collateral. Judge Ambro wrote a lengthy dissent, arguing that the Bankruptcy Code was ambiguous on this issue and concluding that the Bankruptcy Code's overall scheme and legislative history established that a plan may not use the indubitable equivalent option to prohibit credit bidding.

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CR&B Alert Case Update—Seventh Circuit Upholds Lenders' Credit Bidding Rights in *River Road* Decision—continued from page 2

The Seventh Circuit quickly accepted direct appeals of the issues in both the *River Road* case and its companion *RadLAX* case, and issued its opinion about two months after hearing oral argument. Its decision affirmed the Bankruptcy Court's ruling, relying on much of the reasoning in Judge Ambro's dissent. The Seventh Circuit found that the three alternative standards for the "fair and equitable" test under section 1129(b) of the Bankruptcy Code were ambiguous, and that the individual "indubitable equivalent" standard of the "fair and equitable" test was also ambiguous. The court then concluded that permitting a sale to proceed under the indubitable equivalent option without credit-bid protection for a secured lender was impermissible, because it rendered the rest of section 1129(b)(2)(A) superfluous and conflicted with the objectives of the Bankruptcy Code, as well as allowing a general Code provision to control over more specific provisions.

The Seventh Circuit also held that a sale of collateral could not independently satisfy the indubitable equivalent option without credit bidding. The court noted that the indubitable equivalent of an undersecured claim is the current market value of the collateral and that, under the Bankruptcy Code, current market value is determined either through judicial valuation or free-market valuation. The Seventh Circuit concluded that the debtors could not satisfy the indubitable equivalent option through a free-market valuation without preserving the secured lenders' credit-bid rights because such rights were otherwise preserved under the Bankruptcy Code, and because such a sale without the opportunity for credit bidding would present a "substantial risk that assets sold in bankruptcy auctions will be undervalued."

As an epilogue, while the appeal was pending before the Seventh Circuit, the secured lenders proposed their own chapter 11 plan in the *River Road* cases in which the lenders would receive the debtors' operating assets. Following some modifications, that plan was confirmed by the Bankruptcy Court on July 7, 2011, a little over a week after the Seventh Circuit issued its decision. However, no such plan was proposed in the companion case, *RadLAX*, thereby keeping the Seventh Circuit's decision subject to possible Supreme Court review should those debtors seek *certiorari*.

Debtors and creditors can be expected to consider these conflicting decisions when evaluating a potential bankruptcy filing. Debtors seeking to sell assets pursuant to a plan of liquidation will certainly be mindful of these opinions in connection with possible venue options. The possibility of being precluded from credit bidding may cause lenders to include the right to credit bid in bankruptcy cases in their loan documents, even though the enforceability of such provisions in bankruptcy is uncertain. Lenders and their counsel will be advised to closely review debtors' choice of venue as it relates to this issue.

SHAREHOLDERS PERMITTED TO RETAIN OWNERSHIP UNDER 'NEW VALUE EXCEPTION' TO 'ABSOLUTE PRIORITY RULE'

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In re Red Mountain Machinery Company, 448 B.R. 1 (Bankr. D. Ariz. 2011)

CASE SNAPSHOT

The creditor, holding both secured claims and unsecured deficiency claims, objected to the chapter 11 debtor's reorganization plan on a number of grounds, most notably that: (1) the creditor's unsecured claims were improperly gerrymandered from other unsecured claims merely because the claims were guaranteed by principals of the debtor and subject to equitable subordination claims in a pending adversary case; and, (2) the plan violated the absolute priority rule because the principals were receiving equity shares in the plan and had not contributed "new value."

The court denied the creditor's objections and confirmed the plan, finding that there was no impermissible gerrymandering, that there was sufficient new value to avoid violation of the absolute priority rule, and that the plan was feasible under the evidence provided.

FACTUAL BACKGROUND

The debtor, Red Mountain Machinery, an Arizona corporation founded in 1986, is in the business of renting earth-moving equipment to highway, commercial and residential builders. The only shareholders of Red Mountain are Owen and Linda Cowing. Since 2003, Red Mountain had been financed by a revolving line of credit issued by Comerica Bank, secured by Red Mountain's equipment and other assets, and personally guaranteed by the Cowings. The company had been successful, until the economic downturn hit in 2007. Declining revenues in 2008 led to non-monetary defaults of the credit line, which led to a series of forbearance agreements and workout negotiations.

At that time, Mr. Cowing was diagnosed with leukemia, and the Comerica negotiations were turned over to Red Mountain's chief financial officer. Cowing subsequently found secret e-mails between the CFO and Comerica, in which those parties allegedly planned to force Cowing into selling the business so that the CFO could purchase Red Mountain, and Comerica would finance the purchase. In June 2009, Cowing advised Comerica of his discovery of this plot, and that Red Mountain might have claims against Comerica. In August 2009, Comerica refused to approve payment of weekly expenses, including payroll, and within days, Red Mountain filed its bankruptcy petition. The alleged conspiracy

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SPLIT IN COURTS CONTINUES—PRIVATE STOCK PURCHASE PAYMENTS NOT PROTECTED BY SECTION 546 SAFE HARBOR

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Geltzer v. Mooney (In re MacMenamin's Grill Ltd.), Adv. Case. No. 09-8266, Bankr. Case No. 08-23660, 2011 WL 1549056 (Bankr. S.D.N.Y. Apr. 21, 2011)

CASE SNAPSHOT

Before filing for bankruptcy, the debtor obtained a secured loan for purposes of a leveraged buyout transaction, where the loan proceeds went directly to the bank accounts of three individual shareholders of the debtor as payment by the debtor for those individuals' stock. In the bankruptcy case, the chapter 11 trustee sought to (1) avoid the debtor's transfer of the loan proceeds, incurrence of its loan obligation to the lender, and grant of security interests to the lender, and (2) recover the transfers or the value thereof. While the transfers were avoidable as constructively fraudulent, the shareholders and lender contended that the transfers were protected by the safe harbor provisions of section 546(e) of the Bankruptcy Code, which excepts from avoidance transfers that are settlement payments by or to a financial institution, as well as payments made by or to a financial institution in connection with a securities contract.

After engaging in a thorough analysis of the legislative history and the divergent case law, the court concluded that the transfers did not involve any entity in its capacity as a securities market participant, the avoidance of the transfers did not pose any danger to the functioning of any securities market, and the incurrence of a loan obligation is not a transfer described in 546(e). The Bankruptcy Court, therefore, held that the transfers did not fall within the safe harbor provisions of section 546(e), and thus were subject to avoidance.

FACTUAL BACKGROUND

Mooney, Hantho, and Clark each owned 31 percent of the issued and outstanding stock of MacMenamin's Grill, a bar and restaurant. On August 31, 2007, pursuant to a Stock Purchase Agreement, the shareholders sold their shares to MacMenamin's. To fund the purchase, MacMenamin's entered into a Loan and Security Agreement with TD Bank, borrowing $1.15 million. As security for the loan, MacMenamin's gave the lender a security interest in substantially all of its assets. The closing of the loan and security agreement occurred on August 31, 2007, at which time the lender disbursed the loan proceeds directly to each shareholder's bank account, and the shareholders delivered the stock to MacMenamin's. The Bankruptcy Court described this as "a classic LBO, although writ small."

MacMenamin's filed a chapter 11 bankruptcy petition on November 18, 2008. In the bankruptcy case, the chapter 11 trustee sought to (1) avoid the debtor's transfer of the loan proceeds, incurrence of its loan obligation to the lender, and grant of security interests to the lender and (2) recover the transfers or the value thereof. All parties agreed that the transfers at issue were avoidable as constructively fraudulent transfers, agreeing that the debtor did not receive fair consideration or reasonably equivalent value for the payments, incurrence of the loan, or grant of the security interest, and the debtor was insolvent at the time of or became insolvent as a result of the transfers. The shareholders and lender argued, however, that section 546(e) protected the transfers from avoidance by the trustee.

COURT ANALYSIS

Section 546(e) provides: "… the trustee may not avoid a transfer that is a…settlement payment as defined in section…741 of this title, made by or to…a…financial institution…or that is a transfer made by or to…a… financial institution…in connection with a securities contract, as defined in section 741(7)…." A "settlement payment" is defined as "a preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement payment on account, a final settlement payment, or any other similar payment commonly used in the securities trade." "Securities contract" is defined as, among other things, "a contract for the purchase…of a security." "Security" is defined to include stock, without specifying whether the stock must be publicly traded.

The parties did not seriously dispute that the transfers of the loan proceeds were "settlement payments" made "by and to financial institutions" in connection with a "securities contract." The shareholders, citing favorable case law, thus argued that those transfers clearly fell within the plain language of section 546(e), both as settlement payments made by and to financial institutions, and as transfers between financial institutions in connection with a securities contract. Citing legislative history and favorable case law, the trustee argued that section 546(e) does not exempt private stock transactions like this one from avoidance as constructive fraudulent transfers, and even more so when such transfers are void *ab initio* or *per se* illegal under applicable law.

Relying heavily on the legislative history, the Bankruptcy Court found that applying the plain language of section 546(e) under the facts of this case would produce a result far removed from Congress' intent in enacting section 546(e) and, thus, concurred with the cases cited by the trustee. Those cases "note that granting a safe harbor to a constructively fraudulent private stock sale has little if anything to do with Congress' stated purpose in enacting section 546(e): reducing systemic risk to the financial markets." The court added that Congress enacted this section "to minimize the displacement caused in the commodities and securities markets in the event [of] a major bankruptcy affecting those industries" and to prevent a "ripple effect" that may occur as a result of such a bankruptcy. In other words, by enacting section 546(e), Congress sought to protect the financial industry's clearance and settlement system, and that interest was not served by applying the safe harbor to a small, private transaction like the instant transaction. Thus, following those cases, the Bankruptcy Court held that, despite the plain language of section 546(e), the safe harbor did not apply to the transfers of the loan proceeds because they did not involve a securities market

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Split in Courts Continues—Private Stock Purchase Payments Not Protected by Section 546 Safe Harbor—continued from page 4

participant, and their avoidance would not pose any danger to the functioning of a securities market. While the Bankruptcy Court also entertained the trustee's argument that transfers either void *ab initio* or *per se* illegal are also excepted from the safe harbors of section 546(e), the court held that the subject transfers were neither void *ab initio* nor *per se* illegal under New York corporate and criminal law.

Similar to the shareholders, the lender argued that section 546(e) protected the incurrence of the loan obligation and grant of security interests from avoidance. The Bankruptcy Court rejected the argument for the same reasons it rejected the shareholders' argument, and went on to hold that the incurrence of a loan obligation is not a transfer described in section 546(e). The court explained that section 546(e) uses the word "transfer" and not "incurrence of an obligation." Sections 544(a) and 548(a)(1), however, give the trustee the power to avoid any "transfer" of property by the debtor and any "obligation incurred" by the debtor. Thus, the court concluded that the lender had no basis on which to argue that the incurrence of the loan obligation was even contemplated to be protected from avoidance under the safe harbors provided by section 546(e). Thus, the trustee could, subject to certain other defenses available to the lender, reduce "dollar for dollar" the lender's claims against the estate.

The Bankruptcy Court, therefore, held that the subject transfers did not fall within the safe harbor provisions of section 546(e) and were subject to avoidance.

PRACTICAL CONSIDERATIONS

Secured lending for purposes of leveraged buyouts has long been an area where lenders must tread cautiously. This case is a reminder of that fact and calls attention to the divergent case law in this area. In many instances, lenders will benefit from the advice of counsel before financing a leveraged buyout (or any transaction that could be construed as a leveraged buyout).

Shareholders Permitted to Retain Ownership Under 'New Value Exception' to 'Absolute Priority Rule'—continued from page 3

became the subject of a still-pending adversary proceeding to equitably subordinate, disallow or offset Comerica's claims.

Following a sale of part of Comerica's collateral, the parties stipulated that Comerica's total secured class 2 claim was $15.9 million, paid at a present value of $10 million as a result of Comerica's section 1111(b) election, and Comerica's class 7 unsecured deficiency claim was $9.8 million. Notably, Comerica's class 7 claim was separated from class 8 general unsecured claims, wherein the remaining unsecured claimants were placed. The plan designated class 9 for any claims that would be subordinated as a result of the adversary proceeding.

Class 10 consisted of the equity ownership of the Cowings. The plan provided that their equity ownership would be extinguished and that on the effective date, the Cowings would contribute $480,000 cash payable on their administrative claim in exchange for 100 percent of the equity of the reorganized debtor. In addition, there was to be an exit loan facility for $1.25 million, to be funded by the Cowings. Together with the cash on hand, this would be more than enough cash to pay all administrative claims, including the Cowings' claims. The only classes rejecting the plan were 2 and 7, both Comerica classes.

The debtor sought confirmation of its plan. Comerica objected, asserting, among other things: (1) that the classification of claims amounted to impermissible gerrymandering; and, (2) that the plan did not satisfy the new value corollary to the absolute priority rule with respect to the deficiency claim. The Bankruptcy Court denied the objections, and confirmed the reorganization plan. The Bankruptcy Court also summarily disposed of Comerica's feasibility objections on the evidence provided.

COURT ANALYSIS

Gerrymandering—Section 1122 of the Bankruptcy Code provides that a plan may place a claim or interest in a class only if that claim or interest is substantially similar to the other claims and interests in that class, *i.e.*, dissimilar claims may not be in the same class. Comerica argued that its deficiency claim was placed in a class separate from all other unsecured claims in order to gerrymander the vote in favor of the plan.

The Bankruptcy Court held otherwise, because: (1) Comerica's deficiency claim was personally guaranteed by the Cowings, whereas no other unsecured claim was so guaranteed; (2) only Comerica's claim was involved in litigation that could result in the claim being equitably subordinated or offset by the debtor's own claim against the bank (thus moving the claim to class 9); and (3) there was no motivation to gerrymander the claim, in any case, because other impaired classes had voted to accept the plan. The court therefore denied this objection.

Absolute Priority Rule—The so-called "absolute priority rule" is set forth in section 1129(b)(2)(B)(ii), and it provides that if a rejecting class of unsecured claims is not paid in full, then "the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan **on account of such junior claim or interest** any property." (Emphasis added.) In this case, the rejecting class was Comerica's deficiency claim in class 7, and the junior class was the equity interest of the Cowings. Because Comerica's deficiency claim was not paid in full and it had rejected the plan, the bank argued that the Cowings could not retain their equity interests merely "on account of" the fact that they owned those interests as of the bankruptcy filing.

The court cited *Bonner Mall Partnership v. U.S. Bancorp Mortgage Co. (In re Bonner Mall Partnership)*, 2 F.3d 899 (9th Cir. 1993), for the "necessary logical corollary" to this rule—the "new value corollary" (sometimes called a "new value exception")—that equity owners may receive equity interests "on account of" something **other** than their prior equity ownership, "such as on account of a contribution of new value." In *Bonner Mall*, the Ninth Circuit enumerated five requirements that, if satisfied, would allow the former owners to participate in

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DRAFTING TIPS FOR TRADEMARK LICENSES: IS YOUR TRADEMARK AGREEMENT A TRADEMARK LICENSE, A SERVICE AGREEMENT—OR BOTH? THE ANSWER COULD AFFECT THE ABILITY OF A LICENSEE IN BANKRUPTCY TO ASSIGN RIGHTS REGARDING THE TRADEMARK.

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In re XMH Corp., Nos. 10-2596, 10-2597, 10-2598 and 10-2599 (7th Cir. July 26, 2011)

CASE SNAPSHOT

The Seventh Circuit Court of Appeals recently answered the following questions: (a) whether, under the Bankruptcy Code, a trademark license is assignable (that is, salable) without the licensor's permission, in the absence of a clause in the agreement stating that it is assignable (NO); and (b) whether a trademark license can be "implied" in an agreement that does not say it's a trademark license (NO).

FACTUAL BACKGROUND

The Contract in question was entered into between Western Glove Works (a licensee of the trademark, "Jag Jeans") and Simply Blue (a subsidiary of XMH Corp.). The Contract provided that Western (the Licensor in this arrangement), "hereby grants" to Blue, the Licensee, which "has been formed for the purpose of designing apparel, sourcing apparel (that is, arranging for the manufacture and importation of apparel), and selling apparel," a license (that is, a sublicense) "to sell women's jeanswear bearing the Trademark…[until] December 31, 2002." The Licensee agreed to pay the Licensor a license fee of 12.5 percent of Blue's net sales of the trademarked apparel during the period in which the Contract was in effect—a period of two weeks.

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Shareholders Permitted to Retain Ownership Under 'New Value Exception' to 'Absolute Priority Rule'—continued from page 5

the reorganized debtor on account of substantial, necessary, and fair new value contribution, rather than on account of prior interests. The five requirements are that the new value contribution be: new; substantial; money or money's worth; necessary for a successful reorganization; and reasonably equivalent to the value or interest received.

In a case subsequent to *Bonner Mall*, the U.S. Supreme Court addressed the new value corollary, in *Bank of America National Trust & Sav. Ass'n. v. 203 North LaSalle Street Partnership*, 526 U.S. 434, 119 S.Ct. 1411, 143 L.Ed. 2d 607 (1999). The Supreme Court expressly declined to overrule the new value corollary, and while the Court did not define what "on account of" requires, the Court did hold that new value cannot be achieved when old equity has the exclusive right to propose a plan.

First, addressing *203 North LaSalle*, the Bankruptcy Court ruled that exclusivity had expired in this case, thus paving the way for the new value corollary. The court analyzed each of the five requirements in turn. The court readily concluded that the $480,000 contribution was "new" and "money." The court then noted the undisputed evidence that the debtor did not have access to cash to pay nearly $1 million in administrative claims, and that the Cowings' personal infusion of cash was therefore "necessary to the reorganization" of the debtor. Comerica offered no evidence that the $480,000 was not substantial, so the court, looking at other cases, determined that the amount was indeed "substantial."

The court then turned to the fifth requirement, that the interest received be "reasonably equivalent" to the contribution. The court determined that "the value of the interest being retained should be determined based on either a pro forma balance sheet of the reorganized debtor or a capitalization of the reorganized debtor's projected income." Because evidence had not been presented on these questions, the court undertook its own balance sheet analysis. The court concluded that the debtor would be insolvent on a balance sheet basis on the effective date of the plan, so that the equity interests would have zero value. The new value contributions of $480,000 and the $1.2 million loan facility far exceed zero, so the new contributions "substantially exceed" the new equity value.

The court held that all five prongs of the new value corollary were satisfied, the absolute priority rule was not violated, and the reorganization plan was confirmed.

PRACTICAL CONSIDERATIONS

This decision is most notable on the issue of how claims are classified. Citing *In re Loop 76, LLC*, 442 B.R. 713 (Bankr. D. Ariz. 2010), the court held that guaranteed claims could be separately classified from other claims. The decision also may have provided debtors a roadmap to ensure that unsecured creditors that are unlikely to accept a proposed plan are separated from supporting creditors—*i.e.*, to gerrymander votes. Relying on this decision, a debtor may seek to initiate equitable subordination adversary proceedings against a creditor in advance of proposing a plan with the primary purpose of "carving" such creditors into a separate class, only to later dismiss such cases.

Similarly concerning for creditors is the fact that, with little to no evidence on the issue, the court determined that equity interests in a reorganized debtor are essentially valueless (as will often be the case under the balance sheet approach), thereby opening the door to "old equity" seeking to contribute new value in exchange for ownership and control of a reorganized debtor. Creditors objecting to such schemes should present financial evidence as to the value of future equity.

Drafting Tips for Trademark Licenses: Is Your Trademark Agreement a Trademark License, a Service Agreement—Or Both? The Answer Could Affect the Ability of a Licensee in Bankruptcy to Assign Rights Regarding the Trademark.—continued from page 6

The Contract further provided that during the year following the expiration of the trademark license, Western would once again "sell, for its own account, the Trademarked Apparel," while Blue would provide a variety of services related to that apparel, including sourcing services, marketing and sales services, merchandising services, and customer service. The Licensor would "control and…be financially responsible for all other aspects of the production and sale of the Trademarked Apparel, including, by way of example, purchasing the apparel from Licensee's sources, setting prices, approving the credit of prospective customers, importation, warehousing, shipping, distribution, invoicing, and collection of accounts." For these services, Western would pay Blue a fee equal to 30 percent of Western's "Net Sales of Trademarked Apparel."

The Licensee became a chapter 11 debtor, and sought to sell its business and assign the Contract to the purchasers. The bankruptcy judge, persuaded by the Licensor, ruled that the contract could not be assigned to Blue's purchasers because Western would not consent to the assignment. The Licensee appealed the ruling to the District Court. While this appeal was pending, the Licensee entered into a revised sale agreement with the purchasers, whereby the Licensee would retain title to the Contract but the purchasers would assume all the duties that the Licensee had owed to the Licensor under the Contract, and would receive all the fees to which the Licensee had been entitled. Despite the fact that this amended sale contract was merely an attempt to bypass the Bankruptcy Court's earlier ruling forbidding assignment, the bankruptcy judge allowed the amendment. The Licensor appealed.

While the Licensor's appeal was pending, the District Court ruled on the Licensee's appeal, and held that the bankruptcy judge's order barring assignment of the original Contract between the Licensor and Licensee was erroneous. This ruling disposed of the Licensor's appeal, precipitating its appeal to the Court of Appeals.

COURT ANALYSIS

Section 365(c)(1) of the Bankruptcy Code limits the assignment of an executory contract of the debtor if "applicable law" authorizes the other party to the contract to refuse to accept performance from an assignee "whether or not such contract…prohibits or restricts assignment." The Contract did not prohibit or otherwise restrict assignment—and if it did, the Bankruptcy Court, under section 365(f), could override the restriction unless "applicable law" entitles the other party to refuse to accept the substitution of the assignee for the assignor. *See*, *FutureSource LLC v. Reuters Ltd.*, 312 F.3d 281, 286-87 (7th Cir. 2002); *In re Midway Airlines, Inc.*, 6 F.3d 492, 495-96 (7th Cir. 1993). Here, the court noted that trademark law was the "applicable law," and that if the Contract still included a trademark sublicense when the Licensee "attempted to assign the Contract to the purchasers, it was not assignable."

The Court of Appeals stated that "it makes sense to make the rule that a trademark license is not assignable without the owner's express permission a rule of contract law—what is called a 'default' rule because it is the rule if the parties do not provide otherwise. … Often the owner of a trademark will find that the most efficient way to exploit it is to license the production of the trademarked good to another company, which may have lower costs of production or other advantages over the trademark's owner. …The rule that trademark licenses are not assignable in the absence of a provision authorizing assignment is a similarly sensible default rule."

Because the Contract did not contain a provision authorizing assignment, the Licensee could not have assigned the Contract without the Licensor's permission before the expiration of the trademark license. However, because the Contract was "explicit that after the expiration of the license to Blue to sell Jag Jeans and pay a license fee to Western the rights in the trademark revert to Western; all the trademarked apparel held by Blue has to be returned to Western; Jag Jeans would henceforth be priced and sold by Western; and the license fee would be replaced by a fee for specific services rendered by Blue. The services were extensive, but Western retained control over 'all other aspects of the production and sale of the Trademarked Apparel.'"

The Licensor argued that it retained the license and merely sublicensed it, and professed to be fearful that the "sublicensees"—the purchasers of Licensee's assets, who are the assignees of the service agreement—would not maintain the quality of the trademarked product. The court rejected Western's "implied" trademark license argument, asking, "if the service agreement is really a trademark license, why did the Contract distinguish between a trademark license and a service agreement and make the former expire in 2003? Western has been unable to answer that question. Maybe a contract regarding a trademark could be a trademark license for some purposes but not others, but this is not argued and we are reluctant to go down that dark path. There is no good reason for courts to wrestle with classification issues in contract cases when it is easy for the contracting parties to resolve the issues themselves. If the Licensor wanted to prevent the Licensee from assigning the service contract to another firm without Licensor's permission, all it had to do was get the Licensee to agree to designate the Contract as a trademark sublicense, thus triggering the default rule that we have discussed and endorsed. That would have headed off a legal dispute that courts are in a poor position to resolve. It would have been more effective than a clause forbidding assignment because it would have survived bankruptcy; anyway there was no such clause either."

The Court of Appeals thus affirmed the lower court's ruling, permitting the assignment of the trademark-now-service agreement to Blue's purchasers.

PRACTICAL CONSIDERATIONS

The contract at issue here turned out to be something less than Western probably had envisioned. While Western had the usual concerns of trademark licensors (quality degradation, for example), it failed to ensure that its contract with Blue would be regarded as a trademark license agreement in court. The court laid out the path that the licensor should have taken—getting the licensee to agree to designate the license/service agreement as a trademark sublicense.

CREDIT SWAP AGREEMENT *IPSO FACTO* CLAUSE STRUCK

Kathleen A. Murphy
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Wilmington

Lehman Brothers Special Financing, Inc. v. Ballyrock ABS-CDO 2007-1 Limited (In re Lehman Brothers Holdings, Inc.) No. 09-01032 (JMP) (Bankr. S.D.N.Y. May 12, 2011)

CASE SNAPSHOT

Lehman Brothers Special Financing and Ballyrock entered into an ISDA Master Agreement to engage in credit swaps, in connection with which Lehman's parent provided a guarantee. Ballyrock then entered into an indenture with a U.S. bank and issued several classes of notes to investors. The bankruptcy filing of any party or guarantor constituted an event of default under the Master Agreement, and default under the Master Agreement altered the defaulting party's priority status and capped its distribution. Following the bankruptcy of the Lehman entities, Ballyrock declared a default and liquidated the assets, and the indenture trustee announced a future distribution to senior noteholders of $137 million. The indenture trustee intended to distribute only $30,000 to LBSF because LBSF's bankruptcy subordinated its priority status to that of the senior noteholders and prohibited it from receiving the $137 million. LBSF filed an adversary proceeding to enjoin the $137 million distribution, arguing that the subordination of its priority status constituted an invalid forfeiture penalty and *ipso facto* clause under the Bankruptcy Code. The court denied Ballyrock's motion to dismiss, holding that the Master Agreement did include an *ipso facto* clause that may not be enforced to deprive the debtor of rights based on the bankruptcy filings.

FACTUAL BACKGROUND

In July 2007, LBSF and Ballyrock executed an ISDA Master Agreement. Lehman Brothers Holdings, Inc. issued a guarantee in connection with the Master Agreement. Ballyrock, in turn, executed an indenture, under which it issued several classes of notes to investors. The indenture established a waterfall system of distribution, pursuant to which senior noteholders must be paid in full before distributions could be made to junior noteholders. The Master Agreement and indenture established the terms that governed the contractual relationship between Ballyrock and LBSF. Under these contracts, Ballyrock sold, and LBSF purchased, loss protection with respect to collateralized debt obligations and mortgage-backed securities.

Pursuant to the Master Agreement, the bankruptcy filing of either party or guarantor constituted an event of default. Upon default, the non-defaulting party could designate an Early Termination Date with respect to all outstanding transactions under the credit swap. On this Early Termination Date, the out-of-the-money party would be required to make a termination payment to the in-the-money party, based on a standard industry calculation known as the "Second Method." Under the Second Method, it did not matter if the defaulting party was the in-the-money party—payment was still due in full. As of the Early Termination Date, Ballyrock was out-of-the-money, and LBSF, the debtor, was in-the-money. Thus, Ballyrock liquidated the assets, and the indenture trustee made an initial distribution to senior noteholders of $189 million. But for the bankruptcy, LBSF would have been paid the balance of $137 million; however, the terms of the indenture reduced LBSF from third priority down to nineteenth, and capped the debtor's distribution at $30,000. The indenture trustee announced that it would distribute the $137 million to other senior noteholders.

LBSF instituted an adversary proceeding seeking (1) a declaratory judgment that the proposed distribution was improper, and (2)) to enjoin the distribution, asserting that the change in its status under the indenture as a result of bankruptcy filing was an invalid *ipso facto* clause. Ballyrock responded with a motion to dismiss. The Bankruptcy Court denied Ballyrock's motion and held that the subject provision was an *ipso facto* clause.

COURT ANALYSIS

The issue before the court was "whether a provision in the documentation that adversely impacts a debtor's right to property upon the filing of a chapter 11 petition may constitute an unenforceable *ipso facto* clause."

Section 365(e)(1) of the Bankruptcy Code provides that "an executory contract…may not be terminated or modified, and any right or obligation under such contract…may not be terminated or modified, at any time after the commencement of the case solely because of a provision in such contract… that is conditioned on…the commencement of a case under this title…." Section 541(c)(1)(B) also invalidates *ipso facto* clauses, providing that a debtor's interest in property "becomes property of the estate…notwithstanding any provision in an agreement, transfer instrument, or applicable nonbankruptcy law…that is conditioned on…the commencement of a case under this title…and that effects or gives an option to effect a forfeiture, modification, or termination of the debtor's interest in property."

The court noted that these statutory provisions are broadly worded, and protect a debtor not only in the instance of its own bankruptcy filing, but in that of a related entity as well. This is because the statutory sections are triggered by the "commencement of a case under this title," rather than being triggered under the more narrow circumstance of a case "by or against the debtor." In the earlier case of *Lehman Bros. Special Fin. Inc. v. BNY Corporate Tr. Servs. (In re Lehman Bros. Holdings, Inc.)* 422 B.R. 407 (Bankr. S.D.N.Y. 2011), the same bankruptcy judge had analyzed a similar situation. In the earlier case, the court had held that a "flip" provision in the subject agreements was an *ipso facto* clause in violation of the Bankruptcy Code. In the instant case, the court relied on its earlier reasoning to hold that the contractual provisions of the Master Agreement and indenture also violated the Code.

Ballyrock argued that the waterfall provisions were protected by the safe harbor of section 560. This section protects a non-defaulting swap participant's right to "(i) liquidate, terminate or accelerate 'one or more swap agreements because of a condition of the kind specified in section 365(e)(1)' of the Bankruptcy Code or (ii) 'offset or net out any termination values or payment amounts arising under or in connection with the termination, liquidation, or acceleration of one or more

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Credit Swap Agreement *Ipso Facto* Clause Struck—continued from page 8

swap agreements…'" Relying on prior caselaw, the court stated that other courts had narrowly construed the language, refusing to look beyond the plain meaning of the words, "liquidate, terminate or accelerate." Because the right to liquidate, terminate or accelerate was not at issue here, Ballyrock was not entitled to protection under the safe harbor.

The court denied Ballyrock's motion to dismiss and held that the default provisions of the contracts functioned as unenforceable *ipso facto* clauses because they effectively eliminated the right to receive a termination payment due to commencement of the LBSF bankruptcy, and that Ballyrock was not entitled to safe harbor protection.

PRACTICAL CONSIDERATIONS

This decision reinforces the impermissibility of *ipso facto* clauses and provides a debtor-favorable ruling that narrows the safe harbor provision contained in section 560 of the Bankruptcy Code.

SUBROGATION TO 'CLAIMS' ENTITLES SUBROGEE TO VOTE ON BEHALF OF ITSELF AND SUBROGOR

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Avondale Gateway Center Entitlement, LLC v. National Bank of Arizona, et al. (In re Avondale Gateway Center Entitlement, LLC), 2011 WL 1376997 (D. Ariz. Apr. 12, 2011)

CASE SNAPSHOT

A junior and senior lender's respective loans were secured by the same piece of land. The lenders were parties to a subordination agreement, which contained a subrogation clause that subrogated the senior lender to the junior lender's rights, liens and interests with respect to the debtor's assets. The junior lender voted to approve the debtor's reorganization plan, and the senior lender voted on behalf of itself and on behalf of the junior lender to reject the debtor's plan. The junior lender objected, arguing that the subrogation clause did not expressly provide for the senior lender to vote in its place. The District Court held that the subrogation clause implicitly encompassed voting rights, and allowed the senior lender to vote on behalf of junior lender.

FACTUAL BACKGROUND

Avondale borrowed $30 million from the National Bank of Arizona, and $18 million from MMA Realty Capital, LLC. Each loan was secured by trustee deeds in vacant land. NBA held the senior lien, and MMA held the junior lien. Avondale, NBA and MMA entered into a subordination agreement, which included a subrogation clause. In relevant part, this clause provided: "[MMA] agrees that [NBA] shall be subrogated to [MMA] with respect to [MMA's] claims against Borrower and [MMA's] rights, liens, and security interests, if any, in any of the Borrower's assets and the proceeds thereof…" Subsequent to the execution of these documents, Avondale filed a chapter 11 petition.

MMA argued that, because there was no express grant of voting rights in the clause, NBA was not subrogated with respect to voting, and it was not entitled to cast a vote for MMA on the debtor's plan. NBA argued that subrogation clause subrogated all of MMA's claims to NBA, including MMA's voting rights.

COURT ANALYSIS

The court held that, under the Bankruptcy Code, the definition of a "claim" does not include a right to vote. The right to vote, however, is a derivative right of the holder of a claim, under section 1126(a).

Subrogation places one party (the subrogee) completely in the shoes of another party (the subrogor). Quoting an Arizona Supreme Court case, the court stated that, "[s]ubrogation is the substitution of another person in the place of a creditor, so that the person in whose favor it is exercised succeeds to the rights of the creditor in relation to the debt." The court concluded that NBA did step into MMA's shoes with respect to MMA's claims against Avondale, and since the Bankruptcy Code recognizes that voting is a derivative right of a claim holder, NBA did acquire MMA's right to vote.

The court then turned to the debtor's argument that the right to subrogation would not arise until NBA paid MMA's claims in full. The court held that this may be so under an equitable subrogation analysis, but this was not so where *contractual* subrogation became effective upon execution of the agreement. Here, NBA was subrogated to MMA's claims from the execution of the subordination agreement through the date of payment of NBA's claims.

Finally, the court rejected the debtor's argument that voting rights are not assignable in a bankruptcy case. While there was no Arizona precedent, the court found the reasoning of other decisions to be persuasive, and concluded that voting rights are assignable in a bankruptcy case. The District Court upheld the Bankruptcy Court's approval of the vote.

PRACTICAL CONSIDERATIONS

Subrogation clauses often expressly include voting rights, but even where they do not, voting rights, and potentially, other rights defined as rights derivative to a "claim" under the Bankruptcy Code, may be subrogated pursuant to a general subrogation clause. Such rights should be expressly provided for in the agreement, and if a junior creditor wishes to exclude such voting rights, it should expressly do so in any agreement containing subrogation clauses.

IN A CASE OF FIRST IMPRESSION, COURT HOLDS SEVERANCE PAY IS 'EARNED' IN FULL ON DATE OF QUALIFICATION, NOT PRO RATA THROUGHOUT EMPLOYMENT

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Matson v. Alarcon, No. 10-2352, 2011 WL 2624437 (4th Cir. July 6, 2011)

CASE SNAPSHOT

The severance plan at issue here provided payment based on a terminated employee's length of service. Within 180 days prior to its bankruptcy filing, the debtor terminated several employees who qualified for compensation under the plan, yet these employees did not receive any severance compensation. In the bankruptcy case, the terminated employees asserted priority claims for the entirety of the severance compensation owed to them. The bankruptcy trustee objected, contending that each employee "earned" severance compensation daily during the employee's tenure, so that only the pro rata portion of the severance "earned" before the employees' termination and within the 180 days before the employer's bankruptcy filing was entitled to priority treatment under section 507(a)(4) of the Bankruptcy Code. In a case of first impression in the Fourth Circuit, the Court of Appeals concluded that employees "earned" severance compensation in full on the day they first became qualified for the severance, not daily throughout the term of their employment. Therefore, the court held that the employees' claims were entitled to priority treatment, subject only to the statutory cap provided in section 507(a)(4).

FACTUAL BACKGROUND

In 2004, LandAmerica Financial Group, Inc., established a "Severance Benefits Plan," the purpose of which was to assist employees upon their termination from LandAmerica. Employees became eligible to participate in the plan when: (1) they were terminated without cause; (2) they signed a severance agreement and release; and (3) certain other exempting circumstances were not present. Once employees became participants in the plan, they were entitled to receive compensation equal to their weekly salary for a number of weeks determined by their years of employment. LandAmerica's board of directors retained the unilateral right to modify or terminate the plan.

Between August 2008 and November 2008, within the 180 days before LandAmerica filed its bankruptcy petition, LandAmerica terminated 125 employees. These employees qualified for severance benefits under the plan, but received no severance compensation from LandAmerica before it filed its bankruptcy petition. These employees filed proofs of claim asserting priority claims for the entirety of the severance compensation owed to them. The bankruptcy trustee objected, contending that each employee "earned" severance compensation daily during the employee's tenure, and that only the pro rata portion of the severance "earned" before the employees' termination and within the 180 days before the bankruptcy filing was entitled to priority treatment under section 507(a)(4) of the Code. The Bankruptcy Court denied the trustee's objection and allowed the employees' claims. The trustee appealed.

COURT ANALYSIS

Section 507 of the Bankruptcy Code sets forth the categories of expenses entitled to priority treatment. Section 507(a)(4) provides priority to "allowed unsecured claims, but only to the extent of $10,950 for each individual … *earned within 180 days* before the date of the filing of the petition … for (A) wages, salaries, or commissions, including vacation, severance, and sick leave pay *earned* by an individual." (Emphasis in opinion.)

The court's task was to "determine the method by which an individual 'earns' 'severance pay,' within the meaning of this statute, to decide whether the claimants 'earned' their full severance pay or only a pro-rated portion of that pay during the pre-petition period." Quoting *Webster's Dictionary*, the court defined "severance pay" as "an allowance usually based on length of service that is payable to an employee" upon termination without cause.

The court noted that interpreting the word "earned," as used in section 507(a)(4), was a matter of first impression for the Fourth Circuit. The statute does not define the word, so the court looked to the plain and ordinary meaning of "earned," citing *Webster's Dictionary*. The court stated that "earn" means to "receive as equitable return for work done or services rendered" or "to come to be duly worthy of or entitled."

The court rejected the trustee's argument that, because the amount of severance pay under the plan was based on length of employment, an employee earned severance pay daily throughout the length of the employee's tenure. "[E]mployees do not 'earn' 'severance pay' in exchange for services rendered as they do when they 'earn' wages, salaries and commissions." Instead, the court concluded that the employees become "entitled to" severance pay as compensation for the injury and losses resulting from the employer's decision to terminate the employment relationship, which decision and the decision to provide severance compensation in the first place are both the employer's. Thus, the debtor's employees "earned" the severance compensation in full on the day they first became qualified for the severance under the plan.

The court also relied on the fact that LandAmerica's board of directors had the right to amend or terminate the severance plan at any time to support the conclusion that the employees became entitled to the severance pay in full on a date certain rather than earning it over time. If the court were to hold that the employees had earned severance pay throughout their term of employment, an employee that worked for LandAmerica before the plan was adopted would have earned severance before the plan even existed. Moreover, if the board eliminated the plan before an employee was terminated, that employee would have earned severance but would never receive it. Thus, the court found logical flaws in the trustee's position. Finally, the court distinguished other Circuit Court decisions related to priority administrative expense claims based on section 503(b)(1)

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DIRECTOR'S MOTION TO DISMISS BREACH OF DUTY OF GOOD FAITH CLAIM DENIED

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NHB Assignments, LLC v. General Atlantic, LLC and Braden Kelly (In re PMTS Liquidating Corp., et al.) Case No. 08-11551 (BLS) (Bankr. D. Del. July 1, 2011)

CASE SNAPSHOT

The liquidating trustee appointed by the confirmed chapter 11 plan brought an adversary proceeding against a minority investor of the debtor, and a former director of the debtor, alleging that: the investor and the director had breached the fiduciary duties owed to the debtor, and the investor had defrauded the debtor. The liquidating trustee further alleged that the investor had led the debtor to believe that the investor would continue to provide financial backing, despite the investor's interest in investing in a direct competitor of the debtor's. The liquidating trustee also alleged that the former director (who was also a managing member of the minority investor), breached his fiduciary duty of good faith because the director knew of the overtures made by the investor to the debtor's competitor, and did not disclose those overtures to the debtor. The court granted the investor's motions to dismiss, but denied the director's motion to dismiss.

FACTUAL BACKGROUND

ProxyMed, a Florida corporation, provided health care transactions processing services to doctors' offices. General Atlantic, LLC, a private equity firm, invested approximately $25 million in ProxyMed and owned approximately 27 percent of the outstanding shares. Braden Kelly, a managing member of General Atlantic, had been named to the board of directors of ProxyMed following GA's initial investment in ProxyMed in 2002. GA participated in the funding of some of ProxyMed's acquisitions, including raising $24 million for the acquisition of a medical billing company.

In 2005, ProxyMed began to search for a new CEO. Kelly played a central role in that search, and focused on John Lettko. During the interview process and after his hiring, Lettko sought assurances from Kelly that GA would continue to provide, as needed, additional capital to support the success of ProxyMed. The liquidating trustee alleged that Lettko received such assurances. Kelly also played a major role in advising Lettko of important decisions, such as employee hiring and compensation, trademark issues, investor relations and press releases.

At the May 2005 board meeting, Lettko suggested that ProxyMed acquire more preferred provider organizations. The liquidating trustee alleged that, at the same meeting, Kelly stated that GA would either "lead or follow the financing" of the PPO acquisitions. Lettko pursued this strategy, and entered into serious negotiations with a specific PPO. Lettko sought Kelly's assistance with financing, and early in September 2006, the managing director of GA met with Lettko in New York to discuss the possibility of providing further financing to ProxyMed. On that same day, GA's managing director sent an email to other GA principals, stating that further investment in ProxyMed was a "long shot." A week after that, Kelly again represented to Lettko that, while GA would probably not lead the financing for the acquisition, it was "likely interested in participating on a pro rata basis."

Meanwhile, in February 2006, Emdeon Corporation, a significant competitor of ProxyMed, announced that it had received inquiries regarding the sale of some of its business units. Subsequently, Lettko suggested to Kelly that ProxyMed consider proposing a merger between itself and Emdeon. Emdeon declined the proposal, and GA began to pursue an investment in Emdeon on its own. The liquidating trustee alleged that on August 1, 2006, Emdeon raised concerns as to GA's ownership stake in ProxyMed, and sought assurances that the ownership would not constitute an impediment to GA's investment in Emdeon. Kelly met with Emdeon's CEO and provided such assurances. GA conducted a due diligence review of Emdeon over the next few months. All of this was done without the knowledge of ProxyMed, which continued to conduct PPO negotiations in the belief that GA would help with financing.

Within a week of meeting with the managing director of GA, Lettko laid out his investment strategy to GA, in the hope of obtaining financial backing to acquire the targeted PPO. A few days later, a GA managing director discussed the Emdeon investment with Kelly, who indicated that he thought the Emdeon deal represented a better opportunity than the ProxyMed deal. By the end of September, GA announced its deal with Emdeon, and informed Lettko that it would not provide any further financing to ProxyMed. ProxyMed sought financing from other sources, to no avail.

In July 2008, ProxyMed filed its chapter 11 petition, after which it conducted a successful sale under section 363 of the Bankruptcy Code. ProxyMed obtained confirmation of its plan of liquidation a year later. Under the plan, the liquidating trustee assumed control over ProxyMed's remaining assets, including causes of action. The trustee filed suit against GA and Kelly for breach of fiduciary duty, and against GA for fraud. The defendants moved to dismiss the complaint.

COURT ANALYSIS

In ruling on a motion to dismiss for failure to state a claim upon which relief can be granted, the court is required to accept all well-pleaded claims as true, and construe them in a light most favorable to the plaintiff.

Breach of Fiduciary Duty—The liquidating trustee argued that New York law governed this suit, because the agreement between ProxyMed and GA contained a choice of law provision designating New York law, and because the conduct giving rise to the breach of duty claims occurred primarily in New York. Under New York law, the trustee asserted two grounds for this count against GA—it occupied a "position of trust and confidence" with ProxyMed, and it exerted control and influence over ProxyMed. The trustee argued that Kelly concealed his conflict of interest resulting from GA's pursuit of Emdeon, misrepresented that interest when making additional investments in ProxyMed, and failed to inform ProxyMed that it should not rely on GA for further financing—all violations of his duties of loyalty and candor.

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Director's Motion to Dismiss Breach of Duty of Good Faith Claim Denied—continued from page 11

Both defendants alleged that the dispute was governed by Florida law (the state of ProxyMed's incorporation), and that Florida law looked to Delaware on issues of corporate law. GA further argued that, as a minority shareholder, it did not owe a fiduciary duty to ProxyMed, and that it did not exercise control over ProxyMed so as to fit within a narrow exception that creates a duty for a minority shareholder. GA asserted that the trustee's allegations were instances of Kelly's individual conduct in his capacity as a ProxyMed director, and that the complaint failed to allege that GA controlled Kelly's actions. Kelly argued that the complaint failed to allege facts establishing a breach of the duties of loyalty and candor because there were no allegations of financial self-dealing.

The court ruled that Florida law applied because the bankruptcy case was pending in Delaware, and Delaware's choice-of-laws principles regarding corporate governance required the court to look to the state of incorporation, which was Florida. In turn, Florida courts looked to Delaware law for corporate disputes.

Applying Delaware corporate law, the court noted that a fiduciary duty may arise with respect to a minority shareholder when a plaintiff alleges "domination by a minority shareholder through *actual control* of corporation conduct." (Emphasis in opinion.) "Actual control" requires showing more than the actions a director would normally take in his role as a governing member of a corporate board. For example, another Delaware court had found that a 43 percent shareholder had exercised actual control where the minority shareholder obtained votes in accordance with its wishes and where other directors consistently deferred to this shareholder. Here, the Bankruptcy Court found "nothing extraordinary" about Kelly's actions as a director that would demonstrate control by GA of ProxyMed. Therefore, the court dismissed this count with respect to GA.

Florida and Delaware law both clearly establish that directors and officers owe fiduciary duties of loyalty and care to the corporation. Prior Delaware caselaw held that the duty of loyalty encompasses cases where the fiduciary fails to act in good faith, and is not limited to financial or other cognizable fiduciary conflict of interest. Thus, the duty of good faith is embedded in the duty of loyalty. Prior caselaw also established that the duty of good faith is breached where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, or demonstrates a conscious disregard of his duties. Here, the trustee alleged that Kelly's meeting with the Emdeon CEO, ProxyMed's biggest competitor, to allay Emdeon's concerns about GA's investment in ProxyMed, reflected an intention by Kelly to limit ProxyMed's response to a GA/Emdeon transaction. Drawing all inferences in a light most favorable to the plaintiff, the court found that the trustee alleged facts sufficient to survive Kelly's motion to dismiss the count.

Fraud—The trustee based this claim against GA on the detrimental reliance that ProxyMed placed on alleged misrepresentations GA representatives made with respect to providing additional financing. The trustee argued that GA purposely misled ProxyMed of its intention to provide financing, and that, had ProxyMed known GA's true intentions, ProxyMed would have asked Kelly to step down from the board, and would have sought other avenues of financing. The trustee argued that New York law governed this claim, while GA argued that Delaware law controlled. The court found that, under either jurisdiction's law, the trustee's claim failed.

The court denied the trustee's claim for several reasons. First, the court held that GA's conduct constituted expressions of opinion as to probable future events, rather than fraudulent conduct. Further, the court found that there was not a special relationship of trust or confidence between GA and ProxyMed that could have elevated the expressions of opinion to the definition of fraud. Additionally, while specific affirmations may be actionable in certain circumstances, generally, predictions are not actionable. Therefore, the trustee's allegations that Kelly indicated that GA "was likely to" or was "interested in" providing further financing, did not establish fraud. No "credible or plausible allegation" that the speakers knew their statements to be false were made in the complaint. The court therefore held that the trustee's claim for fraud failed, and dismissed this count.

PRACTICAL CONSIDERATIONS

The liquidating trustee overreached in the pursuit of its claims against GA, and this case maintains the high burden of proof that must be carried by parties seeking claims against former officers, directors and other advisors. GA was not a majority shareholder at any point in its relationship with ProxyMed, and GA did not control ProxyMed or Kelly's conduct with respect to ProxyMed. Despite the seemingly disingenuous conduct, especially regarding the Emdeon transaction, the court found that this was neither a breach of fiduciary duty, nor fraud. In fact, the court also noted that the parties involved were sophisticated parties, capable of documenting any actual, enforceable commitment; yet, there was no such documentation here. Kelly was in a somewhat more tenuous position, since he was a director of ProxyMed while also a managing member of GA. It is fairly common to find such situations, and so, persons wearing these multiple hats must take extreme care to avoid liability, perhaps avoiding consideration of such delicate matters, and establishing sufficient firewalls.

PARENT COMPANY'S MOTION TO DISMISS CLAIM OF BREACH OF FIDUCIARY DUTY DENIED

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In re Tronox Incorporated, et al., 2011 WL 1815149 (Bankr. S.D.N.Y. May 11, 2011)

CASE SNAPSHOT

The spun-off subsidiary sued its parent for breach of fiduciary duty, and sued the corporation that acquired its parent shortly after the spin-off for civil conspiracy and aiding and abetting a breach of fiduciary duty. The plaintiff alleged that, in order to become an attractive acquisition target, the parent company breached fiduciary duties by creating the subsidiary to isolate millions of dollars of legacy liabilities and retiree costs in the subsidiary, leaving the subsidiary insolvent and severely undercapitalized. The court denied the parent's motion to dismiss the count alleging breach of fiduciary duty, and granted the defendant's motion to dismiss the civil conspiracy and aiding and abetting counts.

FACTUAL BACKGROUND

Kerr-McGee Corporation, a global energy and chemical company, had accrued liabilities for decades' worth of environmental cleanup and associated costs. In 2001, it initiated a program of corporate restructuring, designed to segregate its valuable oil and gas business within one entity, and leave all other assets, as well as the liabilities, within other entities. Kerr-McGee set up a holding company framework, creating "New Kerr-McGee," into which the oil and gas business was placed. It left its other assets and liabilities in "Old Kerr-McGee," which became Tronox Incorporated. Under the reorganized structure, New Kerr-McGee directly held the oil and gas operations, and was the parent of Old Kerr-McGee, which retained the other assets and the legacy liabilities. New and Old Kerr-McGee executed various agreements that provided for the assumption of the liabilities by Old Kerr-McGee, as well as the indemnification of New Kerr-McGee against any future liability related to the assets retained by Old Kerr-McGee. In May 2005, these companies entered into agreements effectuating the spin-off of Old Kerr-McGee/Tronox. On November 28, 2005, these companies entered into a Master Separation Agreement, pursuant to which Tronox incurred bank debt, issued bonds, and conducted its IPO. Tronox transferred substantially all of the IPO proceeds to New Kerr-McGee, as well as more than half a billion dollars of other financing. New Kerr-McGee remained the majority owner of Tronox until the spin-off was completed on March 31, 2006, when New Kerr-McGee distributed to its shareholders the remaining Tronox shares. Less than three months after this, Andarko Petroleum announced that it was acquiring New Kerr-McGee for $18 billion. Tronox filed its chapter 11 petition on January 12, 2009.

Tronox initiated adversary proceedings against its former parent, and against Andarko. Tronox charged that the defendants imposed 70 years of legacy liabilities, including enormous environmental remediation and retiree-related obligations, in connection with the Tronox spin-off. Tronox alleged that Andarko expressed interest in purchasing the oil and gas assets of Kerr-McGee in 2002, and that Andarko stepped back upon discovering the extent of the legacy liabilities. Tronox further alleged that Kerr-McGee and Andarko conspired to separate the valuable assets from the liabilities, and that the consummation of Andarko's acquisition less than three months after the spin-off of Tronox was the conclusion of this conspiracy, rather than an arm's-length transaction.

Tronox filed multi-count complaints against New Kerr-McGee and Andarko (and numerous affiliates). The defendants filed motions to dismiss three counts addressed in this opinion: Count IV—breach of fiduciary duties owed Tronox by New Kerr-McGee; Count V—civil conspiracy between New Kerr-McGee and Andarko; and Count VI—aiding and abetting breach of fiduciary duty against Andarko.

COURT ANALYSIS

In deciding a motion to dismiss, the court must accept as true all of the factual allegations of the complaint, draw inferences from those allegations in a light most favorable to the plaintiff, and construe the complaint liberally.

In the instant case, the plaintiff asserted three theories in support of Count IV. First, Tronox alleged that New Kerr-McGee owed it fiduciary duties as the parent company of a subsidiary that had minority shareholders between the date of the IPO and the date of the spin-off. Second, Tronox alleged that New Kerr-McGee owed Tronox and its creditors fiduciary duties as the parent of an insolvent subsidiary. Third, the plaintiff alleged that New Kerr-McGee was liable as promoter, by acting as Tronox's sponsor, obtaining initial credit facilities, soliciting investors, arranging for the IPO, and distributing its ownership interests to shareholders in the spin-off.

The court first noted that, under Delaware law, a parent does not owe a fiduciary duty to its subsidiary under normal circumstances. It is, however, settled law that the existence of minority shareholders of the subsidiary does impose fiduciary duties on the parent with respect to the subsidiary. Further, Delaware law imposes fiduciary duties on the parent of an insolvent subsidiary, and when a parent is engaged in a plan or scheme of promotion of a subsidiary, fiduciary duties may be imposed on the parent until the plan or scheme ends.

The court held that Tronox had adequately alleged a fiduciary duty was owed to Tronox, as a subsidiary with minority shareholders, and that New Kerr-McGee breached this duty. The plaintiff sufficiently pleaded that, at least from the time the reorganization process was undertaken through the date of the spin-off, New Kerr-McGee engaged in transactions that "lacked intrinsic fairness, involved gross overreaching, and caused Tronox to become insolvent in breach of fiduciary duties…." The plaintiff also alleged that the spin-off itself constituted a breach of duty, because New Kerr-McGee "knew or should have known that Tronox could never survive as an independent company."

The court held that the question of insolvency of Tronox was "a hotly contested factual one," such that this issue must survive the motion to dismiss. The court also held that Tronox's allegations that the scheme of promotion did not end until the spin-off date of March 31, 2006, were sufficient to create a factual question.

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COUNSEL'S CORNER: NEWS FROM REED SMITH

Presentations

On July 12, **Michael Venditto**, along with **Arnie Bartfeld** (Real Estate), made a CLE presentation entitled "De-constructing Special Purpose Vehicles: What Every Bankruptcy Lawyer Needs to Know."

Amy Tonti will be speaking at the 16th Annual Bankruptcy Institute in Pittsburgh October 6, addressing Hot Topics in Commercial Bankruptcy.

News

Debra Verstandig recently completed a four-month secondment at GE Capital in the Risk/Loss Mitigation Center of Excellence; the secondment was divided between New York City and Norwalk, Conn.

Parent Company's Motion to Dismiss Claim of Breach of Fiduciary Duty Denied—continued from page 13

Therefore, the court, taking the allegations made by Tronox as true, held that the complaint did set forth a claim for breach of fiduciary duties.

New Kerr-McGee did plead that the statute of limitations barred Tronox's claim. The cut-off date was January 12, 2006, so that a claim for conduct occurring before that date would be outside the statutory limit. Tronox based much of its claim under Count IV on conduct (including the spin-off itself) occurring on the date of the spin-off, March 31, 2006. New Kerr-McGee argued that the spin-off was merely an exercise of an appropriate corporate action. Tronox, however, pled that the spin-off was the culmination of the scheme to segregate the valuable assets from the legacy liabilities, leaving Tronox insolvent and undercapitalized. The court concluded that Tronox had adequately alleged "new and independent acts" after January 12, 2006.

The Bankruptcy Court therefore denied the motion to dismiss Count IV—breach of fiduciary duties.

The court did dismiss Counts V and VI, however, finding instead that "although the anticipation of a merger with Andarko provides the motive for New Kerr-McGee to maximize the net value of its enterprise by transferring out all the valuable property and leaving the legacy liabilities behind, the allegations do not provide a sufficient basis to infer an agreement between Andarko and New Kerr-McGee to commit an unlawful act, as required for an allegation of civil conspiracy, or of knowing and substantial assistance in a breach of duty, as required for liability for aiding and abetting. Counts V and VI are dismissed."

PRACTICAL CONSIDERATIONS

It is common business practice to structure organizations in such a way as to isolate assets and liabilities. Holding companies may have dozens of subsidiaries, direct and indirect, under their umbrella. The ability to establish such a structure, however, is not unrestricted. Parent companies are not entitled to so dominate the capitalization of and assignment of liabilities to their subsidiaries. Depending on the circumstances, a parent may find that it must act as a fiduciary toward its subsidiary, and like New Kerr-McGee, have to fight its progeny in federal court.

In a Case of First Impression, Court Holds Severance Pay is 'Earned' in Full on Date of Qualification, Not Pro Rata Throughout Employment—continued from page 10

(A) because those cases involve statutory language materially different from section 507(a)(4), *i.e.*, section 503(b)(1)(A) provides employees with priority claims for employee compensation for "services rendered" to the debtor post-petition rather than for employee compensation "earned" by the employees pre-petition.

Therefore, the court held that the employees' claims were entitled to priority treatment, subject only to the statutory cap provided in section 507(a)(4).

PRACTICAL CONSIDERATIONS

Implicit in the court's decision is that the employer's board of directors could have avoided the employees' entitlement to priority claims for severance compensation by simply terminating the severance plan before terminating the employees. Suffice it to say that an employer's severance and employee termination plans should be carefully reviewed and discussed prior to the employer filing for bankruptcy protection.

UNABLE TO SHOW 'INDUBITABLE EQUIVALENCE' WHERE PROPERTY APPRAISALS DIVERGE SIGNIFICANTLY

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In re Prosperity Park, LLC, 2011 WL 1878210 (Bankr. W.D.N.C. May 17, 2011)

CASE SNAPSHOT

The bank had loaned money to two affiliated borrowers. Each loan was secured by a deed of trust on real property. After the borrowers filed for bankruptcy, each party submitted appraisals of the encumbered properties. The bank's appraisals were significantly lower than the debtors' appraisals. The debtors' plan of reorganization proposed to convey one of the encumbered vacant pieces of land to the bank in full satisfaction of the unsecured portion of its claim, while proposing different treatment to the claims of similarly situated, but differently classified, unsecured creditors. The court denied the debtors' motion to approve the plan and granted the bank's motion to lift the automatic stay, finding that the plan unfairly discriminated against the bank, and, partly because of the wide divergence in the appraisals, failed to give the bank the indubitable equivalent of its claim.

FACTUAL BACKGROUND

Prosperity Park, LLC and its affiliate, 10120 Prosperity Park Drive, LLC, were each self-identified single asset real estate entities. Prosperity Park owned six building pad sites, and 10120 owned two vanilla shell condominium units. Each company had borrowed from Fifth Third Bank, and each loan was evidenced by a promissory note and secured by a duly recorded deed of trust. Both borrowers filed chapter 11 petitions on the same date. The bank held a secured claim against Prosperity Park for more than $430,000, as well as an unsecured claim for more than $650,000 for Prosperity Park's guaranty of 10120's debt.

Prosperity Park's appraisal of its sites was $226,643 for each of five sites, and $663,419 for the sixth site. The bank's appraisal was $82,000 for each of the five sites, and $260,000 for the sixth site. The debtor's appraisal of the 10120 property was $660,000, and the bank's appraisal was $540,000. Disclosure statements indicated that the debtors had less than $1,000, had no income, and no source of income other than what might be generated from selling the properties.

The proposed plan placed the bank's secured claim in Class 3, and the bank's unsecured claim in Class 5. The plan also placed the unsecured claim of Hidden Utilities, a company the court determined was an "insider" of the debtor, in Class 4. Unsecured claims of other debtor insiders were placed in Class 6. The plan proposed to convey the largest pad site to the bank in full satisfaction of its Class 3 and Class 5 claims. The bank cast its ballots against the plan, while the insider classes voted to approve the plan. No other votes were cast.

The bank filed a motion for relief from the automatic stay, and the debtors filed a motion to confirm the plan.

COURT ANALYSIS

While the court found that the plan did not impermissibly classify the unsecured claim of Hidden Utilities separate from the bank's unsecured claim, the court did conclude that the plan failed to satisfy several requirements of the Bankruptcy Code.

First, the plan could not be confirmed because the only impaired class of creditors voting to accept the plan was comprised of an insider of the debtors. Section 1129(b)(10) requires that, if there are any impaired classes of claims, at least one impaired, non-insider class must vote to approve the plan. Here, only insider impaired classes approved of the plan.

Second, the court found that the plan unfairly discriminated against the bank's claim, violating section 1129(b)(1). A rebuttable presumption arises that a plan unfairly discriminates when there is: (1) a dissenting class; (2) another class of the same priority; and (3) a difference in the plan's treatment of the two classes that results in an allocation of materially greater risk to the dissenting class. The two insider classes and the bank's unsecured claim were of equal priority. "However, the treatment of the Bank's claim under the Plan compared to the claims of Hidden Utilities and the insiders under the Plan will result in the Bank having to rely on estimations of value of the Real Property whereas the other creditors of the same priority rely on a liquidation of the Real Property. Thus the Bank is forced to bear much greater risk under the Debtor's Plan."

Finally, the court found that the plan did not satisfy section 1129(b)(2), because it failed to provide the bank with the "indubitable equivalent" of its claim. The plan proposed to convey the largest pad site to the bank as full satisfaction of both the secured and unsecured claims. The total of these claims exceeded $1 million. The appraisals of this site were $400,000 apart. The debtor bears the burden of proving that the creditor will receive the indubitable equivalence of a cash payment of its claim, and that standard of proof is akin to a clear and convincing standard. The court pointed out that any time a creditor is earmarked to receive a part of its collateral, "any such plan will be subject to extremely close scrutiny to insure that the creditor will actually receive the indubitable equivalent…." The court, relying on the holdings of other cases, concluded that it could not find indubitable equivalence where there was such a wide divergence of opinion with respect to the property appraisal. To rely solely on the debtor's appraisal would put the bank in too precarious of a position if the appraisal was wrong, and so the debtor could not show that it was providing the bank with the indubitable equivalent of its claim.

The court denied approval of the debtor's plan, and granted the bank's motion to lift the automatic stay.

PRACTICAL CONSIDERATIONS

The court did not find that one appraisal was more credible than the other; the problem was the large discrepancy between the appraisals. Debtors bear a heavy burden in proving indubitable equivalence, and because appraising real estate accurately is at best, an inexact science, courts are likely to find in favor of creditors in similar circumstances.

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