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COMMERCIAL RESTRUCTURING & BANKRUPTCY NEWS – DECEMBER 2010, ISSUE 4

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SWAPS

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We are seeing more and more challenges by borrowers to swaps. No big surprise since, with falling interest rates over the past few years, the borrowers are on the wrong end of the transactions. Although swaps are considered independent of the loans, they are often secured by the same collateral and are usually cross-defaulted with the loans, so the obligations that arise from early termination (which can be significant) become part of the collection process and are being fought vigorously by borrowers. The usual claim is that the borrower was duped into the swap contract by shady practices of the bank. These claims were made to the court in TD Bank, N.A. v. 158 Wooster Street, LLC, 2010 NY Slip Op 31869U, NY App. Div. (July 12, 2010), and rejected. In Wooster Street, the bank started a mortgage foreclosure action against the borrower and included the swap termination amount in the action. The borrower claimed that it did not understand the swap transaction and that the bank caused it to enter into "an unnecessarily complex financial transaction." The court concluded that the fact that the borrower overextended itself is not a basis for negating the swap termination obligation, especially when it was represented by an attorney at closing. We'll keep our eyes out for more cases on this issue.

DELAWARE BANKRUPTCY COURT SHEDS LIGHT ON THE COMMON INTEREST DOCTRINE PREVENTING THE WAIVER OF PRIVILEGED COMMUNICATIONS

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In re Leslie Controls, Inc., (Bankr. D. Del., Case No. 10-12199, 2010)

CASE SNAPSHOT

The Bankruptcy Court expounded on whether attorney-client and attorney work-product privileged documents remained protected from discovery under the common interest doctrine. The common interest doctrine permits counsel representing different clients with similar legal interests to share information without having to disclose that information to others. Specifically, the Bankruptcy Court addressed whether 26 communications between a Debtor and its counsel that were shared prior to the bankruptcy petition with an ad hoc committee of asbestos plaintiffs and the Debtor's proposed future claimants' representative remain protected from discovery under the common interest doctrine. The Delaware Bankruptcy Court held that all of the communications were protected from discovery.

FACTUAL BACKGROUND

In 2009, Leslie Controls, Inc. determined that a bankruptcy filing would be necessary in order to deal with liabilities arising from asbestos-related personal injury clams. In the hopes of creating a consensual reorganization plan, Leslie Controls began negotiating with an Ad Hoc Committee of asbestos plaintiffs and the likely future claims' representative (FCR).

During these negotiations, Leslie Controls' insurance coverage counsel prepared a number of documents dealing with insurance coverage issues and strategies in various bankruptcy scenarios. These documents were shared with the Ad Hoc Committee and the FCR in numerous e-mails. All of these communications were shared prior to these parties reaching agreement, and prior to the bankruptcy filing of Leslie Controls.

The insurers of the Debtor sought to obtain the subject documents as part of the discovery process. The Debtor argued that the documents were privileged, and although shared with the Ad Hoc Committee and the FCR, were protected from discovery under the common interest doctrine.

COURT ANALYSIS

The common interest doctrine expands the attorney-client privilege and attorney work-product doctrine under certain circumstances, because the sharing of such privileged communications does not constitute a waiver of the privilege. The initial question in applying the common interest doctrine is whether the underlying communications or documents are indeed privileged. If not, the common interest doctrine is not applicable. Here, the court determined, based upon a review of the documents in question, that those documents constituted privileged communications. The court held that the documents reflected "insurance coverage counsel's legal analysis and mental impressions concerning insurance issues and strategies in anticipation of possible litigations with the Insurers in a bankruptcy proceeding and/or subsequent coverage litigation."

Since the court held that the documents were indeed privileged, the next question is whether the common interest doctrine is applicable to the facts of the case. A party invoking the protection of the common interest doctrine must establish: (i) the communication was made by separate parties in the course of a matter of common interest; (ii) the communication was designed to further that effort; and (iii) the privilege has not otherwise been waived. The Insurers argued that the Debtor failed to meet that burden for two reasons.

First, the Insurers argued that the Debtor, the Ad Hoc Committee and the FCR only shared a commercial interest—not the requisite sharing of a legal interest. The court rejected this argument. The court held that the interest of the Debtor,

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Delaware Bankruptcy Court Sheds Light on the Common Interest Doctrine Preventing the Waiver of Privileged Communications —continued from page 2

the Ad Hoc Committee and the FCR at the time the documents were shared was to preserve and maximize the insurance available to pay certain asbestos claims, which the court held is "an inherently legal question." The court reasoned that the Ad Hoc Committee and the FCR were not merely third-party bystanders; rather, they were representatives of the ultimate beneficiaries of a portion of the insurance proceeds and were working with the Debtor to maximize the insurance coverage available.

Second, the Insurers argued that the Debtor, the Ad Hoc Committee and the FCR did not share a common interest because they were adversaries on the issue of the insurance coverage, and that the documents were shared pre-petition and while the parties were negotiating an agreement on the possible terms of reorganization. The Bankruptcy Court also rejected this argument, stating that the "Insurers argue, in effect, for establishment of a *per se* rule that parties engaged in negotiations can never share a common interest." The court explained that commonality must be determined on a case-by-case basis, noting, for example, that even parties in merger negotiations may share a common interest. Here, the court held that, while the Debtor, the Ad Hoc Committee and the FCR had a conflicting interest relating to the distribution of the insurance proceeds, they nevertheless shared a common interest in maximizing the asset pool, which included the insurance proceeds. The court found that this was sufficient to invoke the protections of the common interest doctrine.

PRACTICAL CONSIDERATIONS

In order to receive the protections of the common interest doctrine, it is essential for parties to ensure that they are sharing information regarding a legal, rather than a commercial, interest, and that they truly share a common interest. The protection only extends to interests that are identical; adversarial interests are not protected. Here, despite conflicting interests when it came to the separate distributions of insurance proceeds, these parties did share a common interest in maximizing the overall size of the insurance proceeds.

In sum, it is important for parties and their counsel to consider the common interest doctrine as a way of preventing the waiver of privileged documents both during and prior to litigation.

THE DONALD TRUMPS ICAHN - INTERCREDITOR AGREEMENT RESTRICTIONS ON JUNIOR LENDERS NOT CONTROLLING IN CONSIDERATION OF APPROVAL OF NONCONSENSUAL REORGANIZATION PLAN

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In the Matter of TCI 2 Holdings, LLC, 428 B.R. 117 (Bankr. D.N.J. 2010)

CASE SNAPSHOT

This is a heavyweight battle between Donald Trump in one corner and Carl Icahn in the other. The subject of the fight is three Atlantic City casinos operating under the Trump brand. These casinos (owned and/or managed by the debtors and Trump) filed for chapter 11 bankruptcy. Two plans of reorganization were proposed, one by the alliance of Trump, the debtors, and the Ad Hoc Committee of Second Lien Noteholders, and the other by the alliance of Icahn and the First Lien Lender. Each plan proponent objected to the other's plan. In particular, Icahn objected to Trump's plan on the grounds that it did not comply with section 510(a) of the Bankruptcy Code because the plan violated several provisions of the intercreditor agreement among the First Lien Lender and Second Lien Noteholders. Thus, Icahn argued Trump's plan was not confirmable under section 1129(a)(1). The Bankruptcy Court essentially found Icahn's objection irrelevant, because the plan was being confirmed as a nonconsensual plan under section 1129(b)(1). That section begins with the phrase "notwithstanding section 510(a)," which this court interpreted to mean that a plan can be confirmed under section 1129(b)(1), despite an alleged breach of the intercreditor agreement. Ultimately, the court determined that both plans were confirmable, and since the overwhelming majority of creditors had voted in favor of Trump's plan, the court confirmed that plan.

The Bankruptcy Court noted that, to its knowledge, it was the first court to ever consider the meaning of "notwithstanding section 510(a)" in this context, and its holding would be the first and only case law authority on the issue.

FACTUAL BACKGROUND

Several affiliated companies owned or managed three casinos in Atlantic City (Trump Taj Mahal, Trump Plaza, and Trump Marina). With the economy declining, these companies were unable to make an interest payment to the Second Lien Noteholders, and filed chapter 11 petitions on February 17, 2009. As of that date, the debtors owed $488 million to the First Lien Lender, Beal Bank; $1.25 billion to the Second Lien Noteholders; and $39 million to general unsecured creditors.

The debtors proposed the first plan, which was originally supported by the First Lien Lender and Trump. A few weeks later, the Ad Hoc Committee filed a plan. Trump then terminated his arrangement with the First Lien Lender and committed his support to the Committee's plan, a/k/a Trump's plan. The debtors subsequently announced their support for Trump's plan as well.

At about this same time, Beal Bank filed its own plan. Within days of this filing, Carl Icahn purchased 51 percent of the First Lien Lender's claims from Beal Bank and became a co-proponent of the Bank's plan, a/k/a Icahn's plan.

Trump's plan proposed to contribute $225 million in new equity capital from a rights offering representing 70 percent of the new common stock, backstopped

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The Donald Trumps Icahn—continued from page 3

by certain Second Lien Noteholders who would receive 20 percent of the new common stock as consideration for the backstopping. This plan also proposed to pay Icahn and the First Lien Lender $125 million in cash and to issue a new term note in the amount equal to the debtors' enterprise valuation ($459 million), less the $125 million cash payment, with interest payable at a market rate (proposed to be 11 percent). The Second Lien Noteholders would receive an equity distribution equal to their pro rata share of 5 percent of the new common stock. The plan also proposed certain injunctions, releases, and the reimbursement of certain professional fees.

Icahn's plan was premised on a complete deleveraging of the debtors, proposing the conversion of the entire amount of First Lien Debt into equity, with no distribution to the Second Lien Noteholders and general unsecured creditors. This plan also proposed a $45 million DIP loan to bridge the gap between confirmation and the effective date of the plan, which would convert to equity on the effective date. This plan further provided for certain releases, injunctions, and indemnifications.

COURT ANALYSIS

The Bankruptcy Court began by stating that a plan must satisfy the requirements of section 1129 of the Bankruptcy Code in order to be confirmed. Each plan proponent objected to the other's plan, specifying different subsections of 1129 in support of their objections. The Bankruptcy Court carefully discussed each objection raised. In each instance, the Bankruptcy Court either found that the plan provision alleged to violate section 1129 did not, or that modification or deletion of the contested provision would satisfy section 1129.

Intercreditor Agreement

Of significant interest is the Bankruptcy Court's discussion of the intercreditor agreement (IA). The First Lien Lender and the Second Lien Noteholders had entered into the IA more than a year before the chapter 11 filings. Icahn and the First Lien Lender pointed to multiple provisions of the IA in their objection. The relevant portions of the IA provided that: until First Lien Obligations had been paid in full, no proceeds of shared collateral could be distributed to the Second Lien Noteholders; the Second Lien Noteholders could not propose their own reorganization plan; and the Second Lien Noteholders were prohibited from objecting to or contesting the payment of any adequate protection payment to the First Lien Lender, or contesting the status of its secured claims. Icahn and the First Lien Lender asserted that these alleged IA breaches violated section 510(a) of the Bankruptcy Code.

Section 510(a) provides that "a subordination agreement is enforceable in a case under this title to the same extent that such agreement is enforceable under applicable nonbankruptcy law." The Second Lien Noteholders offered several defenses to the claim that the plan breached the IA. The Bankruptcy Court, however, declined to address whether the IA was breached. Instead, the Bankruptcy Court discussed section 1129(b)(1) of the Bankruptcy Code. Section 1129(b)(1) provides, in relevant part, "Notwithstanding section 510(a) … if all of the applicable requirements … are met with respect to a plan, the court, on request of the proponent of the plan, shall confirm the plan … if the plan does not discriminate unfairly, and is fair and equitable…."

The Bankruptcy Court stated, "[t]he only logical reading of the term 'notwithstanding' in section 1129(b)(1) seems to be: 'Even though section 510(a) requires the enforceability of a subordination agreement in a bankruptcy case to the same extent that the agreement is enforceable under nonbankruptcy law, if a nonconsensual plan meets all of the section 1129(a) and (b) requirements, the court 'shall confirm the plan.' The phrase 'notwithstanding section 510(a) of this title' *removes section 510(a) from the scope of 1129(a)(1),* which requires compliance with 'the applicable provisions of this title.'" (Emphasis added.)

In essence, then, the Bankruptcy Court concluded that section 1129(b)(1), which governs the confirmation requirements of nonconsensual plans, removed section 510(a) from the confirmation equation.

On this issue, the Bankruptcy Court concluded that, even if the Second Lien Noteholders did breach the IA, "it would not impede the confirmation of the AHC/Debtor Plan as proposed." The Bankruptcy Court therefore overruled Icahn's and the First Lien Lender's objections.

The Court Chooses a Plan

After thoroughly addressing all objections raised by the plans' proponents, the Bankruptcy Court determined that, with certain modifications, each plan satisfied section 1129 and was thus confirmable. Section 1129(c) instructs a court considering multiple confirmable plans to "consider the preferences of creditors and equity security holders." In addition, the case law compelled the Bankruptcy Court to consider: the type of plan, the treatment of creditors and equity security holders, and the feasibility of the plan.

Both plans provided full recovery to Icahn and the First Lien Lender (Icahn's plan provided immediate recovery and Trump's plan provided partial immediate recovery with the balance to be paid on a deferred basis). The plans treated all other creditors very differently, however. Icahn's plan provided nothing to Second Lien Noteholders and general unsecured creditors. Trump's plan provided a nominal amount of cash and subscription rights to the Second Lien Noteholders and other creditors. More significantly though, Trump's plan provided, to more than 60 percent of the Second Lien Noteholders, "the opportunity to receive the only value that is left in the case after satisfaction of the First Lien Lenders' Claims. That value is the potential future benefit of the reorganization, if the reorganization succeeds." In addition, Trump's plan would immediately contribute $225 million to the debtors. "The treatment of creditors favors the AHC/Debtor Plan in this regard."

The Bankruptcy Court did find that Trump's plan was feasible but that the feasibility consideration favored Icahn's plan since it completely deleveraged the debtors.

"The most significant element in choosing between two confirmable plans is the statutory direction to the court to 'consider the preferences of the creditors and the equity security holders in determining which plan to confirm.'" The Bankruptcy Court examined the plan voting results and found that an

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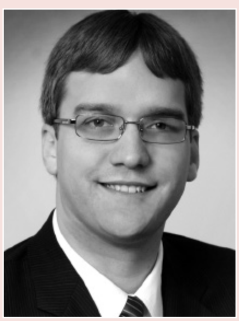
The Donald Trumps Icahn—continued from page 4

overwhelming number of creditors voted for Trump's plan and against Icahn's plan. Therefore, "the significant support for the AHC/Debtor Plan by the largest creditor constituency, coupled with the treatment of creditors and the feasibility considerations noted above, compels the conclusion that the AHC/Debtor Plan, as modified, should be confirmed. Confirmation of the AHC/Debtor Plan will allow the debtor to shed approximately $1.4 billion in secured debt, to pay the First Lien Lenders in full, and to offer to creditors the opportunity to participate in the upside potential of the debtors."

PRACTICAL CONSIDERATIONS

As one might imagine, this decision is on appeal and its impact is yet to be determined. With respect to intercreditor agreements, in other cases, courts have upheld some contractual limitations on junior creditors' rights, and courts have struck down other limitations. The Bankruptcy Court, however, stated that, "[w]e have not found cases analyzing the import of this phrase ["notwithstanding section 510(a)"] upon a cramdown plan which arguably subverts a pre-petition subordination agreement between creditors." Therefore, the Bankruptcy Court's opinion here is the first on the issue. If the Bankruptcy Court's decision is upheld on appeal, it will significantly impact the enforceability of (not to mention the comfort level of senior lien holders with) intercreditor agreements. The best advice at this point is to keep a sharp eye out for the appellate decision. It is also worth noting that nothing in the Bankruptcy Court's decision prevents Icahn and/or the First Lien Lender from pursuing non-bankruptcy breach-of-contract claims against the Second Lien Noteholders with respect to the intercreditor agreement.

CREDITORS OF INSOLVENT SUBSIDIARIES MAY BRING DERIVATIVE ACTIONS AGAINST PARENT COMPANY'S OFFICERS AND DIRECTORS FOR BREACH OF FIDUCIARY DUTIES



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Official Committee of Unsecured Creditors of TOUSA, Inc. v. Technical Olympic, S.A. (In re TOUSA, Inc.), 2010 WL 3835829 (Bankr. S.D. Fla. 2010)

CASE SNAPSHOT

The official committee of unsecured creditors filed complaints against the officers and directors of a parent company and its subsidiaries, alleging that the defendants breached their fiduciary duties by directing their respective companies to engage in a loan transaction while insolvent. The parent company had borrowed $500 million to settle litigation against the parent company, and the subsidiaries pledged their assets as security for the debt. The Bankruptcy Court found that creditors of an insolvent company take the place of shareholders as the stakeholders owed fiduciary duties, and therefore have standing to bring shareholder derivative claims. The court also found that the officers and directors of an insolvent subsidiary are obligated to manage the affairs of the subsidiary, not in the best interests of the parent company, but the subsidiary's creditors, and cannot permit the subsidiary's assets to be used for the sole benefit of the parent company. In addition, the court found that, by directing insolvent subsidiaries to use their assets for the sole benefit of the parent company, officers and directors of the parent company can be found to have both (i) breached fiduciary duties owed by them to the subsidiaries and their creditors and (ii) aided and abetted the breaches of fiduciary duties by the officers and directors of the subsidiaries. The Bankruptcy Court concluded that the committee had sufficiently pleaded causes of action for breaches of fiduciary duties and aiding and abetting such breaches, and denied the defendants' motions to dismiss.

FACTUAL BACKGROUND

TOUSA was a prominent homebuilding company, with much of its business in Florida and the Southeast. It owned several subsidiary companies. In settlement of litigation involving TOUSA, it borrowed $500 million and, as security for the loan, caused its subsidiaries to grant the lenders liens on and security interests in substantially all of the subsidiaries' assets. When the housing crisis hit the following year, TOUSA and its subsidiaries filed for chapter 11 bankruptcy protection.

The Official Committee of Unsecured Creditors of TOUSA and its nine subsidiaries filed suits against the officers and directors of the companies. Count I alleged that the officers and directors of TOUSA breached fiduciary duties owed to the stakeholders (including the creditors) of the insolvent subsidiaries. Count II alleged that the same defendants aided and abetted breaches of fiduciary duties by the officers and directors of the subsidiaries. Count III alleged breaches of fiduciary duties by the officers and directors of the subsidiary companies. Count IV alleged breaches of fiduciary duties by a member of the TOUSA board who had abstained from the decision to proceed with the loan transaction. Count V alleged that Technical Olympic, S.A., a Greece-based construction company that owned 67 percent of TOUSA's stock at the time of the loan transaction, aided and abetted the breaches of fiduciary duties by the various officers and directors of the companies.

The defendants filed motions to dismiss, making several common arguments in support of their motions: the committee was making impermissible direct creditor claims, rather than derivative claims; the committee had failed to sufficiently plead any cause of action, in part because the TOUSA defendants owed no fiduciary duties to the nine subsidiaries; and, the business judgment rule and other exculpatory concepts protected the defendants' actions, including the concept that stakeholders are not permitted to bring claims against officers and directors for causing a deepening of a company's insolvency.

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Creditors of Insolvent Subsidiaries May Bring Derivative Actions Against Parent Company's Officers and Directors for Breach of Fiduciary Duties—continued from page 5

COURT ANALYSIS

The Bankruptcy Court noted initially that for a complaint to withstand a motion to dismiss, it must state a claim for relief that is plausible on its face when the facts alleged are taken as true. The court then proceeded with its analysis of applicable Delaware law.

The Bankruptcy Court first addressed the defendants' argument that the committee was bringing direct creditor claims masquerading as derivative claims. The court found that the proper question to ask when attempting to distinguish between direct and derivative claims was "who suffered the alleged harm – the corporation or the suing stockholder individually – and who would receive the benefit of the recovery or other remedy?" The court concluded that the answer here in both instances was the companies. In the first instance, the committee's complaint alleged that the subsidiaries were the victims of a massive fraudulent transfer whereby they pledged substantially all of their assets while insolvent as collateral for a loan for which they received no benefit. In the second instance, the Bankruptcy Court had already entered an order directing that any recovery obtained by the committee on these exact claims would become property of the debtors' bankruptcy estates.

The court then noted that, when a company is insolvent, its creditors take the place of the shareholders as the stakeholders owed fiduciary duties by the officers and directors of the company and, therefore, have standing to bring shareholder derivative claims. Thus, because the Bankruptcy Court had already determined the insolvency of the debtors at a prior hearing, the committee had standing to bring derivative claims.

The court then addressed the defendants' arguments that the TOUSA defendants owed no fiduciary duties to the nine subsidiaries. The Bankruptcy Court found that, when a subsidiary is insolvent, the officers and directors of the subsidiary cannot permit the subsidiary's assets to be used for the sole benefit of the parent company. They then are instead obligated to manage the affairs of the subsidiary in the best interests of the creditors, not in the best interests of the parent company. In addition, the court found that, by directing insolvent subsidiaries to use their assets for the sole benefit of the parent company, officers and directors of the parent company can be found to have both (i) breached fiduciary duties owed by them to the subsidiaries and their creditors (e.g., a duty not to use the parent company's control of the insolvent subsidiary's assets to the benefit of the parent company and detriment of the insolvent subsidiary company and its creditors), and (ii) aided and abetted the breaches of fiduciary duties by the officers and directors of the subsidiaries.

Thus, the Bankruptcy Court concluded that the committee had sufficiently pleaded causes of action for breaches of fiduciary duties, and aiding and abetting such breaches, because the committee had alleged that the loan transaction was nothing more than the use of subsidiary assets for the sole benefit of the parent company at the expense of subsidiary creditors at a time when the subsidiaries were insolvent.

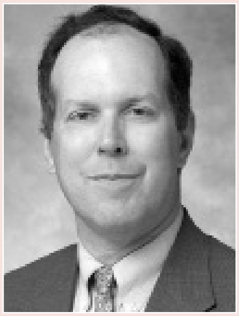
The court finally addressed the defendants' arguments that the business judgment rule and other exculpatory concepts protected the defendants' actions, including the concept that stakeholders are not permitted to bring claims against officers and directors for causing a deepening of a company's insolvency. The court found that the defendants' assertions of these affirmative defenses in their motions to dismiss were premature, e.g., "The business judgment rule does not protect the defendants at this early pleading stage because the Committee has properly alleged breaches of the duties of loyalty, good faith, and due care. A director who breached any one of those duties loses the protection of the business judgment rule under Delaware law. . . . Further, the defendants' arguments that this breach of fiduciary duty action is merely a disguised deepening insolvency claim are unpersuasive. This is not a matter in which the defendants 'cho[se] to continue the firm's operations in the hope that they [could] expand inadequate pie.' The Committee alleges that the defendants used insolvent subsidiary debtors' assets to expand the parents' pie at the expense of the subsidiaries' non-parent stakeholders."

For the above reasons, the Bankruptcy Court denied the defendants' motions to dismiss.

PRACTICAL CONSIDERATIONS

The law in the area of fiduciary duties of officers and directors of insolvent companies is still developing. It is yet to be seen whether other courts, in particular the courts in Delaware, will follow the Bankruptcy Court's decision as good authority. Certainly, the concept that a wholly owned subsidiary must at some point stop serving the best interests of its parent company, runs counter to common business practices for many companies. For those companies, the notion that the corporate family must become splintered and self-interested upon insolvency may be a shocking result. It begs the question of whether, in the majority of cases, this result would truly serve the best interests of the companies' various creditors. Given the current state of the law in this area, officers and directors of companies that may have insolvency issues should seek the advice of counsel to limit exposure to liability for breaches of fiduciary duties. On the flip side, for creditors, the Bankruptcy Court's decision may result in additional front-end protections and another means of back-end recovery.

CREDIT BIDDING CANNOT BE PROHIBITED – THE RECENT DECISION IN *RIVER ROAD HOTEL PARTNERS*



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In re River Road Hotel Partners, LLC, et al., Case No. 09-B-30029 (Bankr. N.D. Ill. 2010)

CASE SNAPSHOT

In the River Road Hotel Partners, LLC chapter 11 proceeding, a bankruptcy judge in the Northern District of Illinois rejected an attempt to restrict the secured lender's ability to credit bid at a sale of the debtors' assets. In a decision issued October 5, 2010, Bankruptcy Judge Bruce Black denied the debtors' motion to approve procedures for the sale of substantially all of their assets in connection with a proposed plan of reorganization. The motion had sought to preclude credit bidding both as a matter of law and also "for cause," based on the facts and circumstances of the case.

FACTUAL BACKGROUND

River Road Hotel Partners, LLC and its affiliates own and operate the InterContinental Hotel Chicago O'Hare, which is a full-service hotel with 556 rooms that opened in September 2008. The hotel was significantly affected by the financial crisis of 2008 and early 2009, with the result that the Debtors were forced to file for chapter 11 in August 2009. The Debtors had constructed their hotel and adjacent conference facilities with financing in excess of $135 million. This debt was secured by, among other things, a first mortgage upon the hotel property.

However, four months after the opening of the hotel, the lender had refused to advance funds to permit the Debtors to make final payments to contractors and suppliers for the construction of the hotel. This allegedly halted the completion of both the restaurant inside the hotel and the installation of furnishings, fixtures and equipment in certain of the guestrooms. As a result, the hotel is in default under its franchise license agreement and is subject to mechanics lien claims totaling nearly $10 million for unpaid construction costs.

Following the chapter 11 filing, the Debtors marketed the hotel and negotiated an agreement for the sale of the property in connection with a plan of reorganization for a proposed stalking horse price of $42 million, subject to any higher or better offers received. The terms of the offer specified that the sale would be conducted under Sections 1123(a) and (b) and 1129(b)(2)(A)(iii) of the Bankruptcy Code, and not Section 363(k) of the Bankruptcy Code; therefore, no holder of a lien on any of the assets to be sold would be permitted to credit bid at the sale.

COURT ANALYSIS

The Debtors' motion to approve the sale procedures followed the same procedure employed in *Philadelphia Newspapers, LLC,* 599 F.3d 298 (3d Cir. 2010), where the court held that there is no absolute right to credit bid at a sale of assets in connection with a plan. In addition to the decision in that case, the Debtors relied on *In re The Pacific Lumber Co.,* 584 F.3d 229 (5th Cir. 2009) and *In re CRIIMI MAE, Inc.,* 251 B.R. 796 (Bankr. D. Md. 2005) in support of their argument that the lender could be precluded from credit bidding at a sale of the Debtors' assets pursuant to a plan of reorganization confirmed under Section 1129(b)(2)(A)(iii).

The lender objected to the motion, arguing that Section 1129(b)(2)(A)(ii) is the exclusive means of selling assets free and clear of liens under Section 1129(b)(2)(A), and therefore the court could only deny the right to credit bid for cause. The court agreed, relying on what it described as the "well-reasoned dissent" of Judge Ambro in the *Philadelphia Newspapers* decision.

The court also rejected the Debtors' attempt to prohibit credit bidding for cause. The Debtors relied on three primary factual arguments: that the lender's failures to advance sufficient funds to finish the hotel construction and furnishings injured the Debtors, the hotel property, other creditors and the lenders themselves; that allowing credit bidding would chill the bidding at a sale; and the $10 million in mechanics lien claims were still being litigated in state court (and would likely be senior to the lender's secured claims under state law to the extent allowed).

After an evidentiary hearing, the court held that none of the circumstances alleged by the Debtors constitutes "cause" sufficient to justify denying the lender the right to credit bid at a sale.

The Debtors had not shown that the lender had either breached contractual obligations to the Debtors or acted with the intent to harm the Debtors. The actions taken by the lender were efforts to protect its own interests and do not constitute cause to deny credit bidding, even if they had the effect of accelerating the Debtors' failures.

The Debtors also failed to persuade the court that the potential to chill other bids at a sale is a reason to deny credit bidding. The evidence did not demonstrate that credit bidding would in fact chill bidding in this case. Therefore, this contention did not demonstrate cause to deny credit bidding.

The pendency of unresolved mechanics liens against the hotel property was also not a reason to deny credit bidding. The court indicated that it could condition a secured creditor's right to credit bid by requiring it to place cash in escrow, pay a portion of the bid in cash, or furnish a letter of credit for the amount of the alleged senior liens.

The Debtors had also suggested that the existence of an FDIC loan-loss guarantee resulting from the FDIC's takeover of one of the loan participants and subsequent sale to another bank, was also a factor supporting cause to prohibit credit bidding. However, the court appeared to have assigned no weight to this argument since it was not even mentioned in the October 5 decision. None of these factors, either individually or collectively, provided a basis for denying the right to credit bid to a secured creditor.

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Credit Bidding Cannot Be Prohibited – The Recent Decision in *River Road Hotel Partners*—continued from page 7

PRACTICAL CONSIDERATIONS

Credit bidding is an important right of secured lenders to ensure that they receive what they perceive to be fair value if their collateral is sold. Reorganizing debtors, however, are more frequently attempting to restrict credit bidding, and more courts are addressing this conflict. Clearly, this is a developing area of the law. It is no surprise, then, that the Debtors have filed a notice of appeal with respect to this decision, and the legal issue has been certified by Bankruptcy Judge Black for a direct appeal to the Court of Appeals for the Seventh Circuit.

CONSIDERATION OF A TRAC CLAUSE UNDER THE UCC AND ECONOMIC REALITIES REQUIRED TO DETERMINE IF EQUIPMENT LEASES ARE TRUE LEASES OR DISGUISED FINANCING

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Hitchin Post Steak Co. v. General Electric Capital Corporation (In re HP Distribution, LLP), 436 B.R. 679 (Bankr. D. Kan. 2010)

CASE SNAPSHOT

The United States Bankruptcy Court for the District of Kansas considered whether commercial vehicle leases that contained Terminal Rental Adjustment Clauses (or TRAC provisions) were true leases under Section 365 of the Bankruptcy Code or, instead, disguised financing transactions. The court held that the TRAC leases were true leases that must be either assumed or assigned pursuant to the terms of Section 365.

FACTUAL BACKGROUND

Hitchin Post Steak Co. filed for bankruptcy protection in July 2009. At that time, it was party to seven equipment leases with General Electric Capital Corporation, each of which contained a TRAC provision. Pursuant to the terms of the leases, the Debtor was obligated, at the end of the original lease term, to return the leased equipment – in this case tractors and trailers – and GE Capital was obligated to sell the returned equipment and liquidate its value. In the event that the equipment sold for more than the pre-negotiated residual value, the excess proceeds would be returned to the Debtor. In the event the equipment sold for less than the negotiated residual, the Debtor was obligated to compensate GE Capital for the shortfall. In all but one of the leases at issue before the Bankruptcy Court, the residual value of the equipment – negotiated at the outset of the leases – was approximately 20 percent of the original equipment costs; for the seventh lease, the residual value was equal to approximately 12 percent of the original equipment costs. Both the Debtor and GE Capital agreed that the average useful life of the equipment was greater than the original lease term, and that the value of the equipment at the end of the least term was not nominal.

Because it could not afford to pay the monthly lease payments – required to be paid under Section 365(d)(5) of the Bankruptcy Code – the Debtor filed an adversary action seeking to recharacterize the leases as disguised financing transactions. If successful, the Debtor would be obligated to compensate GE Capital only for the depreciation of the equipment prior to plan confirmation, and could subject GE Capital to a "cramdown" on the value of the equipment following confirmation of the plan. As such, the recharacterization of the leases might have had a substantial economic benefit to the Debtor both during the pendency of its bankruptcy case, and following confirmation.

COURT ANALYSIS

In its purest form, a lease has two distinguishing attributes: (i) the lessor retains an "entrepreneurial stake" in the leased property, and (ii) keeps a valuable "reversionary" interest. In contrast, a security interest involves a lender who lends money to a purchaser and retains a lien on the purchased goods to secure the repayment of the loan. With a loan, the lender has an interest in making sure the value of the collateral does not decline below the loan balance, but this is the extent of the entrepreneurial interest in the property. A TRAC lease, however, represents a non-traditional mix of these two archetypal forms.

In the GE Capital TRAC leases before the Bankruptcy Court, as is typical of many TRAC leases, GE Capital was entitled to the return of the leased equipment once the lease term had ended, but GE Capital was then required to sell the equipment. If the equipment sold for more than the pre-negotiated "residual" amount, the excess would go to the lessee. If it sold for less, the lessee was required to compensate GE Capital for the difference. This "true up" provision, the lessee argued, meant that GE Capital retained no entrepreneurial stake in the equipment. The Bankruptcy Court, however, disagreed, and granted summary judgment in favor of GE Capital.

In examining the TRAC leases within the context of Section 1-203 of the Uniform Commercial Code, which distinguishes leases from security interests, the Bankruptcy Court was first obligated to determine if the TRAC leases satisfied the "bright line" test outlined in Section 1-203(b). This "bright line" test involves a two-step analysis, namely: (i) a determination as to whether the leases were terminable by the lessee; and (ii) the consideration of certain enumerated factors indicative of a disguised financing transaction (e.g., the original term of the leases are equal to or longer than the useful life of the equipment, the lessee can purchase the leased goods for nominal consideration at the end of the lease term, etc.). Had the court found that the bright line test was satisfied, recharacterization of the leases would have been mandatory. In the instant case, however, the court declined to make such a finding.

First, the Bankruptcy Court determined that the leases expressly provided for early termination by the lessee, and that, because of the financial benefits the

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Consideration of a TRAC Clause Under the UCC and Economic Realities Required To Determine if Equipment Leases are True Leases or Disguised Financing—continued from page 8

lessee might receive upon termination, the TRAC leases were terminable, and the lessee's right to terminate was more than just illusory. Next, the court examined the leases in the context of four signposts outlined in UCC section 1-203(b) that are often indicative of a disguised financing transaction, and found them all to be lacking in this instance. Having found that the TRAC leases did not satisfy the requirements of section 1-203(b), the court determined that the TRAC leases were not financing agreements as a matter of law.

This, however, did not end the inquiry. Even if the leases did not satisfy the bright line test, the court could determine that they were financing transactions if "totality of the circumstances" supported a finding that they were not true leases. Specifically, the court considered whether the TRAC provisions in the leases left GE Capital with a meaningful residual interest. In considering this point, the court noted that many states have enacted so-called TRAC-neutral statutes that provide, in essence, that the presence of a TRAC clause has no bearing on whether a transaction is a security interest or a true lease. (See, e.g., Tex. Transp. Cod Ann. § 501.112; Kan Stat. Ann. § 84-2a-110(a).) As such, the existence of a TRAC provision was not dispositive, and the court must look beyond the TRAC provision to determine the economic realities.

The lessee argued that the TRAC provision protects GE Capital from any downside risk by assuring that, to the extent the equipment sells for less than the pre-negotiated amounts, the lessee was required to make GE Capital whole. In response, GE Capital argued that this protection is illusory unless the lessee is creditworthy, and that the existence of the TRAC provision is merely a mechanism to encourage the lessee to care for the leased equipment and protect its value.

After examining the intricacies of more than 30 years of TRAC lease jurisprudence, the court ultimately concluded that GE Capital did retain a meaningful reversionary interest in the leased equipment, and that this was consistent with the leases being characterized as true leases. Essential to this finding was the fact that the lessee had no right to renew and/or extend the term of the leases beyond their original term, and that the lessee had no rights to purchase the equipment other than those available to an independent third party to place a bid for the equipment at a public sale. Indeed, even were the debtor to be the ultimate purchaser of the equipment, it would likely have to bid the residual amount (in this case approximately 20 percent of the original equipment cost for much of the equipment) in order to acquire the goods. Finally, while GE Capital may not own the equipment after the sale, it would possess the proceeds of the equipment, which is the economic equivalent.

The Bankruptcy Court held that the leases failed to satisfy the bright line test of Section 1-203(b) of the Uniform Commercial Code. In addition, the economic reality of the leases confirmed that they should be considered true leases, and not disguised financing transactions.

PRACTICAL CONSIDERATIONS

The TRAC provisions included within many leases permit the lessor to obtain the benefits of true lessor status in bankruptcy, while, at the same time, protect the lessor from asset value risk associated with traditional leases that makes it difficult for financial institutions to book lease residuals at full value. From the practitioner's point of view, this case solidly reaches the conclusions that: (i) a lessor retains a meaningful economic interest in the lease residual even though the residual is proceeds of the asset, as opposed to the asset itself; and (ii) the fact that the asset "secures" the credit risk that the lessee will not perform the TRAC, translates into the lessor's retaining an interest in the asset even though the lessor has no economic upside or downside on disposition of the asset. Both these conclusions considerably advance the jurisprudence on this issue in the lessor's favor.

IN A CASE OF FIRST IMPRESSION, THE CIRCUIT COURT DETERMINES THAT A TRUSTEE OF A SECURITIZED INVESTMENT POOL IS A 'TRANSFEREE' IN A PREFERENCE ACTION

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Paloian v. LaSalle Bank, N.A., 619 F.3d 688 (7th Cir. 2010)

CASE SNAPSHOT

The Seventh Circuit examined the merits of a preference action filed against LaSalle Bank in its capacity as the trustee of a securitized investment pool, and determined – as a matter of first impression – that the trustee of a securitized investment pool could be a "transferee" as that term is used under Section 550(a)(1) of the Bankruptcy Code. In addition, the Seventh Circuit rejected the Bankruptcy Court's determination that the debtor was insolvent because of the Bankruptcy Court's finding that (in the context of determining the debtor's current value, and acting with 20/20 hindsight) the debtor's contingent liabilities were given 100 percent credit, but the debtor's contingent assets were valued at $0.00. As such, the Seventh Circuit remanded the case for further findings regarding the debtor's solvency, in order to resolve the ultimate merits of the fraudulent transfer claims.

FACTUAL BACKGROUND

Doctors Hospital of Hyde Park was initially founded to provide medical care as a fringe benefit for railroad workers. Between 1999 and 2000, the hospital's owner, James Desnick, paid civil penalties of approximately $18.5 million to Medicare and Medicaid for excessive billing practices. In addition, the hospital was inefficient with respect to patient care standards, and its inefficiencies created cash flow problems. In order to compensate for these problems, the hospital created a "bankruptcy remote vehicle" that took out loans from third parties and used those funds to "purchase" the hospital's accounts receivable. This bankruptcy remote entity had no office, checking account or stationery. It prepared no financial statements or tax returns. Prior the hospital's petition date, the loans to the bankruptcy remote entity were securitized, and LaSalle Bank became the trustee of the securitized asset pool.

In addition to the bankruptcy remote entity, the hospital held its real estate in a separate legal entity, HPCH, LLC. HPCH took out loans from Nomura Asset Capital Corporation and, as part of the transaction, the hospital agreed to pay HPCH additional rent. HPCH gave Nomura a security interest in the additional rent. In adversary actions not on appeal, a bankruptcy court concluded that the additional rent was actually debt service on the real estate financing.

The primary issues for adjudication by the Circuit Court included: (i) whether LaSalle Bank, in its capacity as the trustee of a securitized investment fund, was a transferee under the terms of Section 550 of the Bankruptcy Code; (ii) whether the Bankruptcy Court properly evaluated the question of the debtor's insolvency; and (iii) whether the bankruptcy remote entity was, in fact, "remote" so as to prevent recovery of the transfers made by it.

COURT ANALYSIS

The Seventh Circuit began its analysis by considering whether LaSalle Bank constituted a transferee so as to be subject to a preference action, even if it was not the ultimate beneficiary of the monies transferred. Although the Seventh Circuit expressed that it was unaware of any other appellate court that had considered the issue, it easily determined that LaSalle Bank, in its capacity as trustee of the securitized investment fund, was a "transferee" for the purposes of a preference action. In doing so, the Seventh Circuit relied on authority holding that "any entity that receives funds for use in paying down a loan, or passing money to investors in a pool, is an 'initial transferee' even though the recipient is obliged by contract to apply the funds according to a formula."

The Circuit Court next considered whether the Bankruptcy Court had properly evaluated the hospital's solvency when it determined that preference exposure existed. Specifically, it noted that the Bankruptcy Court had found that the hospital was consistently paying its creditors when due, and it had consistently positive financials and EBIDTA. The Bankruptcy Court next had considered testimony regarding the hospital's discounted cash flow analysis, which projects net cash flow into the future, and then discounts that asset stream to current-day value. In the instant case, the Bankruptcy Court subtracted from this discounted cash flow the $18.5 million it knew that the hospital would have to pay in Medicare and Medicaid reimbursements, but gave no credit to the probability that those claims were reimbursable by Mr. Desnick (in reality, Mr. Desnick reimbursed the hospital for the entire balance). As such, the Circuit Court found that the Bankruptcy Court erred in determining the present value of the hospital's business because of its failure to treat contingent assets and contingent liabilities consistently. Instead, the appellate court found that, once contingent assets were factored in, the debtor was solvent during the time that at least a portion of the alleged transfers took place. It therefore remanded the case to the Bankruptcy Court for further determinations as to when, exactly, the hospital became insolvent so as to subject its creditors to potential preference claims.

In addition, because of the scant evidence regarding whether the bankruptcy remote entity was, in fact, remote, the Seventh Circuit noted that – in the event the hospital was deemed insolvent at some point in time – the Bankruptcy Court should further evaluate the claims as to the remote status of the bankruptcy remote entity. Indeed, because there was little evidence the entity even existed – apart from the inclusion of its name on the loan documents – the appellate court challenged the Bankruptcy Court to further determine the independent status, or lack thereof, of the bankruptcy remote entity.

COURT HOLDING

There are two important holdings of the Circuit Court in this opinion: (i) a trustee of a securitized investment pool can constitute a transferee under Section 550 of the Bankruptcy Code and can, therefore, be subject to preference exposure; and (ii) when determining the value of a debtor for purposes of establishing insolvency, contingent assets and contingent liabilities must be evaluated equally.

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In a Case of First Impression, the Circuit Court Determines That a Trustee of a Securitized Investment Pool is a 'Transferee' in a Preference Action—continued from page 10

PRACTICAL CONSIDERATIONS

Although only mentioned briefly in the opinion, the court gave an important warning to parties who set up "bankruptcy remote entities" without observing the proper formalities. When considering whether to establish such an entity, parties should ensure that they have done so properly in order to provide the greatest amount of protection.

POST-CONFIRMATION CRAMDOWN INTEREST RATE: 'MARKET FORMULA' APPLIES TO OVERSECURED LOAN IN THIS DEVELOPING AREA

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In re SJT Ventures, LLC, 2010 WL 3342206 (Bankr. N.D. Texas 2010)

CASE SNAPSHOT

A chapter 11 debtor sought confirmation of its reorganization plan, over the objections of its oversecured commercial mortgage lender. The lender objected to the rate of interest proposed in the debtor's plan, arguing that it should receive the contractual rate of interest. The debtor argued that the market rate of interest was appropriate. The court agreed with the debtor, holding that, with regard to oversecured commercial loans, a "market formula" was the appropriate method for calculating the post-confirmation interest rate.

FACTUAL BACKGROUND

SJT Ventures, LLC purchased a commercial office building in Dallas. When the economy turned downward in 2008, SJT fell behind in its payments. Unable to work out an arrangement with its lender, SJT filed a chapter 11 petition.

In the six months between the petition date and the filing of its proposed plan of reorganization, the debtor experienced positive tenant growth and a somewhat better financial situation. The debtor's original plan proposed that the lender's secured claim would be paid in full over 60 months, ending with a balloon payment. The claims would be amortized over 30 years with a 5 percent interest rate per annum. At the confirmation hearing, the debtor orally amended its plan, providing for repayment of the lender's claim within five years, together with interest at 6.35 percent per annum. Except for the secured lender, all classes of creditors voted to accept the amended plan.

The secured lender objected to the feasibility of the plan, as well as to the cramdown interest rate. Specifically, the secured lender argued that since it was oversecured, it should be paid the contract interest rate of 8.69 percent.

COURT ANALYSIS

In considering the facts before it, the Bankruptcy Court examined the applicability of *In re Good*, 413 B.R. 552 (Bankr. E.D. Tex. 2009, aff'd 428 B.R. 249 (E.D. Tex. 2010) (holding that an oversecured creditor is entitled to the contractual rate when debtor is solvent and could afford the contract rate). The Bankruptcy Court, however, distinguished *Good* on the basis that the debtor in that case had sufficient assets to pay its creditors in full, while still paying its oversecured creditor at the default rate of interest specified in the contract – a circumstance not present here.

In addition, the Bankruptcy Court distinguished authority that examined pre-confirmation rates of interests, focusing instead on cases that evaluated the appropriate post-confirmation rate. In doing so, the Bankruptcy Court noted that, while the pre-confirmation contractual interest rate was the settled law in the Fifth Circuit, post-confirmation interest was still "an issue of developing bankruptcy law."

The Bankruptcy Court further explained the distinction by focusing on the unique policy concerns that distinguish pre-confirmation and post-confirmation interest rates. Prior to confirmation, a secured creditor is entitled to receive the contract rate of interest from a solvent debtor because a lesser rate "would result in a windfall to those holding the equity position." After confirmation, however, there is a new "bargain" under the cramdown provision of the Bankruptcy Code. A secured creditor need only receive the "present value" of its secured claim, and nothing in the Bankruptcy Code suggests that this value should change with the debtor's level of financial solvency.

After examining the U.S. Supreme Court decision of *Till v. SCS Credit Corp.,* 541 U.S. 465 (2005), the Bankruptcy Court rejected the notion that the contract rate is the presumptive rate of interest, and opted instead for a "formula approach." The formula approach calculation starts with the prime lending rate (appropriate for very low-risk borrowers), and builds in additional interest to compensate for the bankrupt debtor's higher degree of risk. Specifically, the Bankruptcy Court relied upon expert testimony, provided at the plan confirmation hearing, in holding that the formula usually applied by the appropriate market constituted the appropriate rate of interest.

COURT HOLDING

The Bankruptcy Court held that, with regard to oversecured commercial loans, the court will look to the formula ordinarily used by the market to derive the appropriate interest rate. This method, the court reasoned, will ensure that "secured creditors are compensated for the 'time value of their money and the risk of default' by way of an objective assessment, while at the same time employing the on-the-ground insight of an effective market, where it exists."

PRACTICAL CONSIDERATIONS

This court takes the analysis set forth in the *Good* case a step further, clearly distinguishing between pre-confirmation and post-confirmation realities. Thus, an oversecured creditor must be willing to look beyond its contractual interest rate, analyze the local market, and methodically calculate a "market" rate of interest in staking out its position before the bankruptcy court.

A PROPOSED PLAN'S VOTING STOCK ALLOCATION CAUSES AN INCURABLE CHANGE-OF-CONTROL BREACH AND IMPERMISSIBLE REINSTATEMENT OF SECURED DEBT

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In re Young Broadcasting, Inc., et al., 430 B.R. 99 (Bankr. S.D.N.Y. 2010)

CASE SNAPSHOT

The Debtor and the Official Committee of Unsecured Creditors each proposed competing plans of reorganization. Pursuant to the Committee's plan, the Debtor would reorganize and reinstate its secured debt. The Secured Lenders objected to the Committee plan on the basis that the proposed stock classification and voting rights would trigger defaults under the loan's change-of-ownership provisions, and that any alleged reinstatement would be followed by an immediate breach of the loans. The Committee argued that its proposal did not trigger the change-in-control provisions, and that, even were it true that the plan triggered these provisions, the Committee had proposed an "alternative" ownership structure – mentioned in a footnote of its disclosure statement – and that this alternative constituted a non-material modification that did not require re-solicitation of the plan. The court rejected these arguments, declining to confirm the Committee plan. The court confirmed the Debtor's plan, which provided for a sale of substantially all the Debtor's assets to a newly created entity in which the Secured Lenders held the equity.

FACTUAL BACKGROUND

Young Broadcasting, Inc. and its affiliates owned television stations in several cities around the United States. Young had two primary sources of debt: a credit agreement secured by a first priority interest in substantially all of the Debtor's assets; and senior subordinated notes, which were general unsecured obligations. As of the date of the Debtor's chapter 11 filing, approximately $338 million was due the lenders under the Credit Agreement, and approximately $484 million was due under the subordinated notes.

Both the Debtor and the Committee of Unsecured Creditors presented reorganization plans for confirmation. The plans were submitted on the same timeline, and presented to the creditors by way of a single ballot.

The Debtor's plan contemplated a sale of substantially all the Debtor's assets to a new entity, in which the Secured Lenders would receive all of the equity interests in complete satisfaction of their $338 million in secured claims. This plan also provided unsecured creditors with their pro rata share of $1 million, and provided the Unsecured Noteholders with equity warrants in the new company if they voted to accept this plan. This plan completely deleveraged the Debtor.

The Committee's plan would reinstate the $338 million owed to the Secured Lenders, which was scheduled to mature (by its terms) in late 2012, at which point a large balloon payment would come due. The Committee's plan provided that the Unsecured Noteholders would receive a pro rata share of 10 percent of common stock, and the opportunity to participate in a rights offering under which these noteholders could purchase a pro rata share of preferred stock plus 80 percent of the common stock of the company. In addition, the Debtor's founder, Mr. Young, would receive all of the Class B shares of common stock, which would convert to 10 percent of the Class A common stock of the company upon full repayment of the Secured Lenders' debt in 2012.

The Secured Lenders argued that the Committee's plan was premised upon an impermissible reinstatement of the secured debt, because the Committee's allocation of voting rights would trigger an immediate and incurable change-of-control default under the credit agreement. The Committee argued that its proposal did not trigger a default, and that even were the Bankruptcy Court to find that the proposal did trigger the default, a footnote in the Committee's plan set forth an alternative structure that conformed with the terms of the credit agreement, and that could be confirmed absent re-solicitation.

The credit agreement required that Mr. Young, his immediate family members, and certain other defined affiliates, have more than 40 percent of the voting stock by number of votes. Further, this agreement required that if any other person or group owned more than 30 percent of the total outstanding voting stock, then Mr. Young and his affiliates must own more than 30 percent, or have the right to elect or designate a majority of the board of directors.

Under the Committee plan, the board of directors and the voting stock would be divided into two groups, Class A and Class B. The proposed Class A stock would represent 90 percent of the equity interests, and Class B would represent 10 percent. Each class of stockholders would be able to vote for both classes of directors under a specific allocation. There would be six Class A directors and one Class B director. Mr. Young would have all votes for the Class B director and one vote for Class A directors. The combined total of director votes for both classes of stock would be 605,500,000, and Mr. Young could cast 500,500,000 of those votes (500,000 for Class A directors, and 500,000,000 for the Class B director). The Committee argued that this structure allocated more than 82 percent of the vote to Mr. Young and, "by number of votes," technically complied with the credit agreement.

The Bankruptcy Court disagreed, and concluded that the Committee plan did cause an incurable default to occur. In addition, it held that the "alternative" structure proposed by the Committee was infeasible, and that the Debtor's plan would be confirmed.

COURT ANALYSIS

The Secured Lenders argued that the Committee was manipulating the vote allocation, and thereby circumventing the protections the control provisions of the credit agreement afforded the lenders. While the Committee's plan allocated more than 40 percent of the votes for directors to Mr. Young, the plan prevented Mr. Young from electing 40 percent of the directors. In reality, he could elect only one of seven directors. The Secured Lenders also argued that the Committee

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A Proposed Plan's Voting Stock Allocation Causes an Incurable Change-of-Control Breach and Impermissible Reinstatement of Secured Debt—continued from page 12

plan violated the credit agreement by ceding more than 30 percent of the voting stock to a group other than Mr. Young and his affiliates. In this way, the Secured Lenders maintained that the Committee allocation did not comply with the credit agreement provision, and would trigger a change-of-control default.

While considering the Committee plan, the court noted that it must examine the competing plans by taking into account the requirements of section 1124(2) of the Bankruptcy Code, including, but not limited to, the requirement that a plan must (with certain enumerated exceptions) cure any defaults under a secured debt agreement before the agreement can be reinstated.

Looking at the credit agreement language, as well as the applicable legal authority, the Bankruptcy Court concluded that the credit agreement required that Mr. Young maintain the ability to elect at least 40 percent of the directors, and that the Committee plan only gave Mr. Young the ability to elect 15 percent of the directors. As such, the court decided, the Committee plan created an incurable default, and thus failed to satisfy the requirements of section 1124(2).

The court further found that the "alternative" equity structure disclosed in a footnote to the Committee's disclosure statement provided insufficient information to be confirmable and that, because it was not adequately disclosed, and would constitute a material modification, re-solicitation was necessary before the alternative plan could be confirmed. Finally, the Bankruptcy Court held that, even had the modification been disclosed and voted on, the Committee's plan was not feasible because the Committee failed to demonstrate that the Debtor could have either refinanced the obligations (including its proposed balloon payment), or sold its assets, prior to the maturity date of the secured debt.

Despite an objection from the Committee to the Debtor's plan, the court found that the Debtor's plan satisfied all applicable Bankruptcy Code requirements. The Bankruptcy Court, therefore, declined to confirm the Committee's plan, and instead confirmed the Debtor's plan.

PRACTICAL CONSIDERATIONS

Loan documents commonly contain change-of-control provisions. These provisions protect the lender's interests in the borrower, and courts will examine reorganization proposals for their substantive effect on debtor ownership. Secured lenders must take care to ensure that their loan documents clearly and sufficiently protect their interests.

COMPENSATION DISTRIBUTIONS TRIGGERED BY EVENTS OUTSIDE THE DEBTOR'S CONTROL ARE PROPERTY OF THE ESTATE AND SUBJECT TO AVOIDANCE

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Parks v. Dittmar (In re Dittmar), 618 F.3d 1199 (10th Cir. 2010)

CASE SNAPSHOT

Bankruptcy trustees argued that stock appreciation rights (SARs) – analogous to stock options – were property of bankruptcy estates under section 541 of the Bankruptcy Code, and, thus, belonged to the trustees rather than the debtors. The SARs were subject to numerous contingencies, including a skeletal agreement that was not finalized until after the debtors' petitions were filed. The lower courts held that the debtors' interests in the SARs were too contingent to be property of the estates. The Circuit Court overturned the lower courts, holding that even contingent agreements could be property of the bankruptcy estate under section 541, and ordered the SAR distributions to be turned over to the trustees.

FACTUAL BACKGROUND

The debtors in this case were employees subject to a skeletal collective bargaining agreement (CBA). The employer, Spirit AeroSystems, offered to create an equity participation program and to contribute SARs as part of the program, but not until certain "payment events" (e.g., an IPO) occurred. Ultimately, the SARs, which were akin to stock options, would turn out to be worth approximately $60,000 per employee after the debtors' petitions were filed.

The pre-petition CBA contained language to the effect that the parties "agree[d] to establish" the equity participation program, but the agreement did not define which employees would be eligible employees. Some terms were described in more detail in slide presentations provided to employees. The "payment events" upon which distributions would be made were all contingencies within the control of the employer.

Shortly after the ratification of this CBA, the debtors filed their respective bankruptcy petitions over a period of roughly two months. More than one year after these bankruptcy filings, the employer memorialized the equity participation program, setting forth provisions regarding eligible employees, the SARs each eligible employee would receive, and other necessary details. One month after this, a payment event (an IPO) occurred, and the employees were paid their equity participation distributions.

The trustee sought to recover the distributions as property of the bankruptcy estates under Bankruptcy Code section 541. The Bankruptcy Court granted the debtors' motions for summary judgment, finding that the SARs were not part of the estates because the CBA, by failing to define eligible employees, did not create an enforceable right in the distributions. The Bankruptcy Appellate Panel affirmed on different grounds, finding that whatever interests were created by

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Compensation Distributions Triggered by Events Outside the Debtor's Control are Property of the Estate and Subject to Avoidance—continued from page 13

the bargaining agreement were too contingent to be property of the estates. The Circuit Court reversed.

COURT ANALYSIS

The court began by noting that, for purposes of most bankruptcy matters, property interests are created and defined by state law. Under relevant Kansas law, SARs were a type of compensation, like stock options, that were generally property of bankruptcy estates under section 541 of the Bankruptcy Code.

First, the Circuit Court held that the pre-petition CBA was more than a mere "agreement to agree" and that, although skeletal, CBAs were commonly held to be enforceable under federal labor laws. Finding the CBA to be ambiguous, the Circuit Court turned to extrinsic evidence, including the slide presentations and SEC filings, which clearly showed that the eventual final post-petition agreement contained the same terms as the pre-petition CBA.

Second, the Circuit Court discussed whether stock appreciation rights could be property of the estates under Section 541 of the Bankruptcy Code. The court found that the scope of section 541 is extremely broad, and an interest may be estate property even if it is contingent. Although the Circuit Court acknowledged that the stock rights were contingent on certain events (such as an IPO) occurring, it held that the mere fact that the vesting events were entirely contingent and outside the control of the debtors did not take the property outside the scope of section 541. The Circuit Court distinguished these contingencies from bonuses that were completely within the discretion of employers, and which could be withheld at the employer's sole whim and discretion.

A dissenting opinion helpfully summed up the Circuit Court's ruling as setting up a dichotomy between (i) contingencies where the employer had discretion over the events that gave rise to the vesting interest (e.g., an IPO creating stock rights), where the interest would be property of the estate, and (ii) contingencies where the employer had discretion whether to give the interest at all (e.g., a purely discretionary bonus), where the interest would not be property of the estate.

Holding that the contingent interests were not too remote to be property of the bankruptcy estates, the Circuit Court reversed the lower court grant of the debtors' motions for summary judgment.

PRACTICAL CONSIDERATIONS

At the outside edges of Section 541, which defines property of the estate broadly, lie contingent interests. Depending on how remote the interest is, and what the contingencies are, courts will often struggle in deciding whether the property belongs to the estate or not. Here, the BAP's decision was split between majority and dissenting positions, as was the Circuit Court decision. Although it appears clear that contingent property will belong to the estate if the contingency is at least partly within the control of the debtor, it is far less certain how courts will rule where the contingencies lie exclusively in a third party's control. Here, as much as anywhere, good advocacy by experienced bankruptcy practitioners will go a long way.

TRUSTEE'S USE OF STRONG-ARM POWERS LIMITED WHERE STATE UCC GIVES PRIORITY TO THE LENDER THAT PERFECTS ITS LIEN POST-PETITION

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Sovereign Bank v. Hepner (In re Roser), 613 F.3d 1240 (10th Cir. 2010).

CASE SNAPSHOT

Prior to filing his petition for chapter 7 bankruptcy, the debtor borrowed money from a bank to purchase a car. Seven days after the petition filing, and within 20 days of the purchase, the lender filed its lien against the vehicle. The trustee sought to avoid the bank's lien, utilizing the strong-arm powers under section 544 of the Bankruptcy Code, and contending that the bank violated the automatic stay. The bank argued that the UCC gave it superior lien rights because the lien was perfected within the 20-day period under Colorado's UCC 9-317. The Bankruptcy Court held for the trustee, and the District Court affirmed. The Circuit Court overturned the lower courts, finding that the state UCC provision granted senior priority to the bank against that of any claimants (including a bankruptcy trustee) whose interest arose during the 20-day period.

FACTUAL BACKGROUND

Twelve days before filing a petition for chapter 7 bankruptcy, the debtor purchased a car. On the day of the purchase, Sovereign Bank gave the debtor a secured loan, and the debtor took possession of the car. The bank filed its lien within 20 days of the purchase, perfecting the lien as required under the Colorado Certificate of Title Act (CTA). However, the bank's lien filing occurred one week after the bankruptcy filing.

The bankruptcy trustee sought to avoid Sovereign's lien under section 544 of the Bankruptcy Code. The Bankruptcy Court found for the trustee, holding that the lien was not perfected prior to the filing of the chapter 7 petition. The Bankruptcy Court also held that the bank's post-petition perfection of its lien violated the automatic stay provisions of the Bankruptcy Code. Sovereign Bank appealed.

COURT ANALYSIS

Section 544 gives the trustee rights of a hypothetical person who acquired a judicial lien on the debtor's property at the time of the bankruptcy filing. Therefore, the trustee generally can avoid a lien that is unperfected at the time of the petition filing. Under section 546(b), however, the trustee's avoidance rights are "subject to any generally applicable law that … permits perfection of an interest in property to be effective against an entity that acquires rights in such property before the date of perfection." The term "generally applicable law" includes state UCC provisions.

Sovereign Bank argued that its compliance with the state UCC statute gave its lien priority over the trustee. The relevant UCC section provides that a financing statement filed within 20 days of delivery of the collateral takes priority over the rights of any other party that arises between the time the security interest attaches (i.e., pursuant to the vehicle purchase agreement) and the date of the financing statement filing.

The trustee argued that the CTA superseded the UCC for purposes of perfecting vehicle liens, and, thus, the bank could not rely on UCC 9-317 to take a prior interest to that of the trustee. The trustee relied on a prior Bankruptcy Appellate Panel decision, *In re O'Neill,* 370 B.R. 332 (10th Cir. BAP 2007), which, on similar facts, agreed with the trustee's position.

The Circuit Court disagreed and held that the *O'Neill* decision was wrongly decided. It found no inconsistency between the CTA and UCC 9-317. Whereas the CTA undeniably governed the perfection of vehicle liens, UCC 9-317 governed the priority of such liens – a matter on which the CTA was silent. In other words, the vehicle title code and UCC sections complemented, rather than conflicted with, one another.

The Circuit Court similarly overruled the lower court, holding that the post-petition lien perfection violated the automatic stay provisions of section 362 of the Bankruptcy Code. Bankruptcy Code section 362(b)(3) excepts from the automatic stay "any act to perfect, or to maintain or continue the perfection of, an interest in property to the extent that the trustee's rights and powers are subject to such perfection under section 546(b) of this title." The court held that UCC 9-317 clearly fell within this exception, since it permitted perfection of a purchase-money security interest to be effective against interests acquired before the date of perfection. Therefore, the court held that the perfection of the bank's interest after the date of the bankruptcy filing did not violate the automatic stay.

PRACTICAL CONSIDERATIONS

The interplay between UCC lien statutes and potentially superseding state perfection schemes – for example, state vehicle codes – is a complicated one, and the interplay varies state by state. Creditors should work with legal counsel that is proficient in the lien perfection and priority laws of a particular state before taking actions, post-bankruptcy filing, to perfect liens. Because time is of the essence when it comes to perfecting liens, creditors should seek the advice of counsel as soon as a bankruptcy petition is filed.

FUNDS 'EARMARKED' FOR BONDHOLDERS NOT PROPERTY OF THE ESTATE AND NOT SUBJECT TO AVOIDANCE

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Cooper v. Centar Investments LTD, et al. (In re Trigem America Corporation), 431 B.R. 855 (C.D. Cal. 2010)

CASE SNAPSHOT

In an attempt to avoid an inevitable put on its convertible bonds (which would have capsized Korean company TriGem Computer, Inc. (TGI) and caused it to be de-listed from the Korean Stock Exchange), TGI used its American subsidiary, TriGem America Corporation (TGA), as a conduit to transfer about $17 million cash from TGI to its bondholders as part of a purported swap agreement. TGI and TGA characterized their internal cash transfer as a payment of accounts receivable owed by TGI to TGA. The "too clever" plan failed, as did both companies, and TGA filed a chapter 11 petition months after the transfer. The bankruptcy trustee sought to avoid the conduit-transfer from TGA to the bondholders as a fraudulent conveyance. The Bankruptcy Court held that the earmarking doctrine – i.e., the funds were earmarked for another purpose and thus were never actually property of TGA's estate – prohibited the bankruptcy trustee from recovering the funds.

FACTUAL BACKGROUND

The Korean parent company, TGI, had issued zero-coupon convertible bonds to several investors in 2004. These bonds matured April 14, 2008, and had a put option, whereby the holders could present the bonds to TGI for redemption at ascending percentages of par on scheduled dates. Relevant to this case, the holders could present the bonds April 14, 2005, and receive 104.5 percent of par from TGI.

Within weeks of the imminent April 14, 2005 put, TGI's financial condition had deteriorated so substantially that the Korean Stock Exchange warned it would place TGI's stock under special supervision, and perhaps de-list the stock. Given looming deadlines by the stock exchange and the impending bond put date, TGI convinced bondholders to convert their original bonds to mandatory convertible bonds without a put option. As part of the "confirmation agreements," which were designated as "swap agreements," TGI agreed to pay the bondholders $17.85 million in immediate cash as security, in case stock prices did not climb. However, to avoid alerting the Korean Stock Exchange to its scheme and triggering mandatory waiting periods in Korea that would push the deal past critical deadlines, TGI arranged to transfer cash through its American subsidiary, TGA, which contributed a nominal $250,000 of its own cash to the deal.

TGI wired $15.6 million to TGA, and the remaining cash transfer amounts were paid to bondholders by TGA out of its own funds and from borrowing through a sister company. The $15.6 million transfer was characterized as an inter-company payment on TGA's accounts receivable (although, notably, TGA owed considerably more to TGI than vice-versa).

The swap delay tactic did not work, and within months, TGI filed for receivership protections in Korea and TGA filed a chapter 11 petition in California. The bankruptcy trustee sought to recover the $17.85 million transferred from TGA to the bondholders as fraudulent transfers, in a motion for summary judgment. The debtor and bondholders filed counter-motions for summary judgment. As to the $15.6 million inter-company transfer, the court ruled in favor of TGA and the bondholders and did not avoid that portion of the transfer.

COURT ANALYSIS

At the heart of the court's analysis was whether "'an interest of the debtor in property' . . . was transferred." The bondholders' principal defense was that the $15.6 million was not property of TGA, since it was "earmarked" by TGI for direct transfer to the bondholders. In other words, the money was never TGA's, and TGA was merely a conduit for the transfer.

First, the court indicated that neither TGI nor TGA appeared to have clean hands (particularly since TGI was seeking to hide transactions from Korean regulatory authorities). As the court noted, it "was tempted to simply disregard entirely the earmarking defense under the ancient precept that one seeking the protection of equity must come to court with clean hands." Nevertheless, the court resisted this "temptation," since it could identify no law in America or Korea that had been violated.

More importantly, the court determined that TGA's creditors had no interest or expectancy in the $15.6 million that quickly passed through TGA's bank accounts. The money clearly belonged to TGI. The mere fact that TGA accounted for the transfer as an inter-company payment of its accounts receivable was not enough to make it property of TGA, since an objective observation of the facts revealed that TGA owed far more money to TGI than vice-versa, and but for the swap transaction, TGA would never have received the money. The court looked beyond the characterization of the transfer to determine its true nature (although, again, the court noted that it is "always satisfying to see too clever actors hoisted upon their own petard").

The trustee argued that the funds were not earmarked because TGA could have done anything it wanted with the $15.6 million, but the court rejected this contention on the basis that it could apply to virtually all earmarking cases. The issue is whether there was a written or oral understanding or instruction that the funds were earmarked. Here, there was such an understanding. The court also rejected the trustee's arguments that the earmarking defense did not apply to fraudulent transfer actions in the 9th Circuit. The court ruled that earmarking went to the central issue in both fraudulent transfer and preference actions, whether the transferred property was actually property of the debtor's estate.

As to the $250,000 TGA transferred to the bondholders out of TGA's own cash accounts, the court easily determined that transfer was a fraudulent transfer, irrespective of the Section 546(g) "safe harbor" provisions for swap agreements. The court ruled that the transaction was not actually a "swap" at all, since it was clearly outside the norms commonly used in the securities trade (i.e., it was used as a device to evade Korean regulators). Here, the property was clearly that of TGA's estate, and thus within the scope of section 548 (unlike the earmarked

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Funds 'Earmarked' for Bondholders Not Property of the Estate and Not Subject to Avoidance—continued from page 16

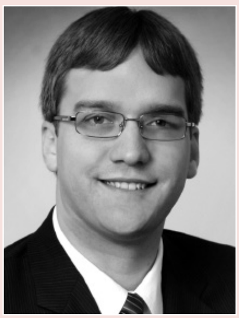
funds). Moreover, because TGA did not receive "reasonably equivalent value" for this transfer, it was avoidable as a fraudulent transfer.

Therefore, the Bankruptcy Court found that there was no triable issue of material fact. With respect to the TGI funds, the court determined they were earmarked and thus not the property of the debtor, and not avoidable as fraudulent transfers. With respect to the $250,000 owned by TGA, the court permitted the trustee to recover the funds as an avoidable fraudulent transfer.

PRACTICAL CONSIDERATIONS

Although courts will often punish parties that have appeared to act inequitably or unfairly, they will not do so when it creates an unfair windfall for creditors. Where funds are earmarked and pass through a debtor's accounts merely as a conduit, a trustee or creditors will not likely be able to benefit from the cash transfer merely because it was part of a grander, perhaps less-than-savory scheme --at least not so long as the scheme was not designed to defraud the debtor's own creditors.

'ORDINARY COURSE OF BUSINESS' ENABLES SUPPLIER TO KEEP PAYMENTS IN A PREFERENCE ACTION



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Burtch v. Detroit Forming, Inc. (In re Archway Cookies), 435 B.R. 234 (Bankr. D. Del. 2010)

CASE SNAPSHOT

A supplier thwarts the chapter 7 trustee's efforts to recover preferential payments by successfully raising the "ordinary course of business" defense. The supplier sold trays to Archway Cookies for two years prior to Archway's bankruptcy filing. Archway soon fell behind on its payments, with an average number of days between invoice and payment of 42 days and a range of 21 to 177 days (the contract terms were payment within 20 days of invoice). During the preference period, the average number of days between invoice and payment was 47 days with a range of 33 to 64 days. The Bankruptcy Court found that the small deviation during the preference period in the average number of days for payment was immaterial. The court therefore held that, although the payments were preferences, they could not be recovered by the trustee because they were protected by the statutory exception for payments made in the ordinary course of business.

FACTUAL BACKGROUND

In October 2006, Detroit Forming began selling cookie trays to Archway for use in its baking business. The terms of each sale required that Archway submit payment in 20 days, and these terms were spelled out on each invoice. About six months after they began doing business together, Detroit Forming advised Archway, in writing, that multiple payments had been received well past the 20-day term, and new product would only be shipped if Archway's accounts were kept current. Archway continued ordering from Detroit Forming, and Detroit Forming continued shipping product to Archway. On October 6, 2008, Archway filed its chapter 11 petition and, three months later, converted to chapter 7.

From the day that Archway and Detroit Forming began their relationship, until 90 days before the petition date, the average time elapsing between the invoice date and payment date was 42 days. The average time elapsing between the invoice date and payment date within the 90 days prior to Archway's bankruptcy filing (the preference period, the time during which the Bankruptcy Code permits the avoidance of preferential transfers) was 47 days.

The chapter 7 trustee sought to avoid almost $70,000 in payments that Archway had made to Detroit Forming during the 90-day preference period. Detroit Forming filed a motion for summary judgment, arguing that the transfers were protected by the "ordinary course of business" defense.

COURT ANALYSIS

To successfully avoid a payment as a preferential transfer, the payment must satisfy all the requirements of section 547(b) of the Bankruptcy Code. A payment must be:

> To or for the benefit of a creditor;
>
> For or on account of an antecedent debt owed by the debtor before such transfer was made;
>
> Made while the debtor was insolvent;
>
> Made … on or within 90 days before the date of the filing of the petition; … and
>
> One that enables such creditor to receive more than such creditor would receive if (A) the case were a case under chapter 7; (B) the transfer had not been made; and (C) such creditor received payment of such debt to the extent provided by the provisions of the Code.

Even if the transfer satisfies all of these elements, it may not be avoided if it falls within one of the safe harbor exceptions provided in section 547(c). Section 547(c)(2) sets forth the "ordinary course of business" defense. It provides that an otherwise preferential transfer can not be avoided if the transfer was in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee, and such transfer was: (1) made in the ordinary course of business or financial affairs of the debtor and the transferee; or (2) made according to ordinary business terms.

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'Ordinary Course of Business' Enables Supplier To Keep Payments in a Preference Action—continued from page 17

Courts consider the following factors when determining whether the transfer was made in the ordinary course of business or financial affairs of the debtor and the transferee:

(1) the length of time the parties engaged in the type of dealing at issue;

(2) whether the subject payments were in an amount more than usually paid;

(3) whether the payments were tendered in a manner different from previous payments;

(4) whether there appears to have been an unusual action by the debtor or creditor to collect or pay the debt; and

(5) whether the creditor did anything to gain an advantage (such as gain additional security) in light of the debtor's deteriorating financial condition.

The Bankruptcy Court held that the long history and numerous transactions between the parties established an ordinary course of business, under which the debtor incurred the debt, and in accordance with which the debtor paid the debt. The court found simply that the facts of this case showed that Archway and Detroit Forming continued their historical business dealings during the preference period, so that Detroit Forming was entitled to keep the payments under the "ordinary course of business defense" provided in section 547(c)(2).

PRACTICAL CONSIDERATIONS

This case points out that, as tempting as it may be for a creditor to change its course of dealing with a debtor the closer the debtor gets to a bankruptcy filing, the prudent action in many instances may be to stay the course to avoid preference exposure.

OMISSION OF PLAT IN A MORTGAGE RENDERS ITS RECORDING A NULLITY, PROVIDES NO NOTICE TO THE TRUSTEE AND SUBJECTS THE MORTGAGE TO AVOIDANCE

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Wells Fargo Home Mortgage, Inc. v. Richardson (In re Brandt), 434 B.R. 493 (W.D. Mich. 2010)

CASE SNAPSHOT

A chapter 7 bankruptcy trustee avoided a recorded residential mortgage utilizing the strong-arm powers of section 544 of the Bankruptcy Code. The recorded mortgage described the subject property (a platted property) only by street address and tax identification number. On its face, the mortgage complied with the Michigan recording act. The Michigan land division act, however, required that, to be recordable, a mortgage for platted property must contain the property's plat and lot number. The District Court held that the mortgage was therefore deficient, and this non-compliance caused the recorded mortgage to be a nullity. Thus, the court concluded that the trustee could avoid the recorded mortgage because, under applicable state law, the recorded mortgage had the legal status of an unrecorded mortgage of which the chapter 7 trustee was deemed to have no actual or constructive notice.

FACTUAL BACKGROUND

The home buyer, Brandt, granted Wells Fargo a mortgage on the subject property. The mortgage was recorded in the county Register of Deeds office, listed the street address, and referred to the "attached legal description." No legal description was attached, however. Several years later, Brandt filed for bankruptcy, and the trustee sought to avoid the mortgage under section 544 of the Bankruptcy Code.

COURT ANALYSIS

Section 544 sets forth the so-called "strong arm" powers of the trustee. This section allows the trustee to avoid a property lien, for example, of which a hypothetical purchaser would not have notice. Under Michigan law, a mortgage is not effective against a bona fide purchaser of real property who does not have actual or constructive notice of the mortgage. The recording of the mortgage provides constructive notice; thus, an unrecorded mortgage is not effective against a bona fide purchaser.

Section 544 empowers a trustee to avoid any mortgage that is not effective against a bona fide purchaser under applicable state law. The trustee here argued that the mortgage was improperly recorded under the land division act, so that a hypothetical purchaser would not have notice of the Wells Fargo security interest.

Wells Fargo argued that the land division act was designed to govern the relationship between property holders and public regulatory bodies, and not to determine the recording requirements for mortgages – those requirements were governed by the recording act. Thus, non-compliance with the land division act did not prevent an otherwise properly recorded mortgage from being effective or cause it to be a nullity.

The District Court disagreed with Wells Fargo, noting that one clear purpose of the land division act was to regulate conveyances of platted property between private parties, including conveyances under mortgages. "The LDA as a whole is focused on the use of plats as a means of describing and regulating rights in real property. It does not merely eliminate the use of metes and bounds descriptions of property. . . . Thus, reference in a conveyance [of platted property] to a street address or tax identification number is invalid for the same reason that reference to a metes and bounds description is invalid: it is not the 'accurate legal description' intended by the LDA. . . . Thus, while the mortgage statute sets forth requirements for mortgages, generally, the LDA can be read to make an *additional* requirement with respect to platted property. . . . The recording act itself states that its requirements are 'cumulative to the requirements imposed by any other act relating to the recording of instruments.'" (Emphasis in the opinion.)

The District Court cited several sections of the land division act in support of its position, including the provision that platted property "shall be described by the caption of the plat and lot number for *all purposes*," and the provision that an instrument "purporting to convey or mortgage" platted real property "*may not be recorded* by the register of deeds" unless it references the plat and lot number. (Emphasis in the opinion.)

The District Court concluded that, if the land division act states that a particular instrument conveying platted property "may not be recorded by the register of deeds" unless it references the plat and lot number, as required by the act, and an instrument lacking such a reference is nevertheless recorded, then "the result is the same as if the instrument was not properly recorded [under the recording act]: the recording is void, and it does not serve to provide constructive notice to a subsequent purchaser."

PRACTICAL CONSIDERATIONS

The lesson from the case is clear: all pertinent state laws and requirements regarding mortgage instruments must be carefully considered when recording mortgages and when evaluating whether recorded mortgages have created valid and perfected liens on real property. The case also highlights the importance of obtaining title insurance for mortgages. Of course, when a lender does have a problem, the question becomes what can it do before a bankruptcy filing to prevent the result in the case? One possible answer may be a 90-day forbearance agreement with the borrower; a small price to pay in many instances if it means curing the defects.

BANKRUPTCY COURT (MOSTLY) DISMISSES COMPLAINT AGAINST PRE-PETITION LENDERS BASED ON ALLEGED INEQUITABLE CONDUCT

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Official Committee of Unsecured Creditors v. Credit Suisse (In re Champion Enterprises, Inc.), 2010 WL 3522132 (Bankr. D. Del. 2010)

CASE SNAPSHOT

Unsecured creditors committee brought multiple claims, including equitable subordination, equitable subrogation, unjust enrichment, equitable estoppel, breach of contract, fraudulent transfer, and preference, against Debtors' lenders, based on conduct relating to certain pre-petition lending agreements. On the defendants' motion to dismiss, the court dismissed all claims against all defendants except for the breach-of-contract action against Credit Suisse.

FACTUAL BACKGROUND

Prior to the sale of their business, the Debtors, Champion Enterprises and its affiliates, made pre-fabricated housing and modular buildings. In 2005, the operating entity, Champion Home Builders Co. (Champion Home), obtained a senior secured credit facility from what the court referred to as the "Lending Group." As part of this credit facility, the holding company, Champion Enterprises (Champion Holding), issued certain notes that became due in 2009 (2009 Notes). The pre-petition credit facility was secured by all of the assets of Champion Home.

In 2007, the Debtors' business began to suffer. To stay afloat, the Debtors renegotiated the credit agreement with the Lending Group, amending the credit agreement and giving certain concessions to avoid defaults. One such concession included Champion Holding's issuance of new unsecured notes to third parties, the proceeds of which were used to pay down the 2009 Notes. This benefited the Lending Group, because after the 2009 secured notes were paid off, the Lending Group would alone have a priority security interest in Champion Home's assets.

In addition, in early 2009, lenders started to assign certain debt obligations of the Debtors. The credit agreement provided that the lenders could assign certain obligations to an "Eligible Assignee," which was a defined term under the agreement. The lenders needed the consent of the Debtors, unless a default had occurred. Notwithstanding that a default had not occurred, one of the banks assigned approximately $1 million in term loans and $1 million in synthetic deposits to MAK Capital Fund, L.P. (MAK Assignment).

In the end, the various concessions and amendment made to the credit facility proved insufficient to save the Debtors' business, and on November 15, 2009, the Debtors filed petitions for relief under chapter 11 of the Bankruptcy Code. At the time, $147 million remained outstanding in the credit facility.

The unsecured creditors committee, which consisted mostly of the purchasers of Champion Holding's 2007 unsecured notes, brought an adversary proceeding against the Lending Group for various forms of equitable relief and breach of contract, based on alleged pre-petition misconduct on the part of the lenders.

COURT ANALYSIS

Of 13 counts in the complaint, the Bankruptcy Court allowed only one count, breach of contract relating to the MAK Assignment, to survive the motion to dismiss. With respect to that count, the court found that the committee sufficiently pleaded that an agreement existed and that Credit Suisse, as plan administrator, breached that agreement by allowing the MAK Assignment to occur without the Debtors' consent. The court was skeptical that the committee would be able to prove damages resulting from this alleged breach, but would allow the committee to proceed to discovery on the issue.

The court, however, was not so kind to the committee on the equitable claims, which the court dismissed with varying degrees of analysis. The three claims given the most analysis – equitable subordination, equitable subrogation, and constructive fraudulent transfer – are discussed here.

To equitably subordinate the Lending Group's claims to those of the unsecured creditors, the committee needed to show: (i) inequitable conduct, (ii) resulting in injury to creditors or unfair advantage to the claimant, and (iii) an outcome that is not otherwise inconsistent with the Bankruptcy Code. To show inequitable conduct, it is necessary to show egregious action, such as fraud or overreaching. The committee would have a lower burden of proving inequitable conduct, however, if it could demonstrate that the Lending Group was an insider of the Debtors. The committee attempted to do so by arguing that the Lending Group exercised a high level of control over the Debtors because of the credit agreement. The court, however, rejected this argument, holding that the Lending Group members were traditional lenders, nothing more. While the complaint did allege that the Lending Group had access to and monitored the Debtors' financials, exerted influence in negotiating amendments to the credit agreement, and received certain concessions, none of this was sufficient to show insider status. The court also noted that nothing was unique about these lenders that would make the Debtors' economic survival dependent upon them, such as might be the case if the Debtors depended on inventory purchases from a certain vendor.

In addressing the elements of the equitable subordination claim, the court found insufficient probability of inequitable conduct. The committee had alleged that the Lending Group acted inequitably in requiring certain concessions when amending the credit agreement. The court, however, rejected this theory, stating that, "[a]lthough the Lending Group may have forcefully negotiated, the fact that one party to a contract has more leverage does not indicate that the dealings are not at arm's length. Moreover, use of that leverage does not provide a basis for the Court to find inequitable conduct." In addition, the court found that the prospectus issued in connection with the 2007 unsecured notes clearly stated that the notes would be used to pay off the 2009 Notes. The purchasers of the unsecured notes could not, then, complain that the notes were used for their stated purpose, even if that purpose benefited the secured creditors. Finally, the

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Bankruptcy Court (Mostly) Dismisses Complaint Against Pre-petition Lenders Based On Alleged Inequitable Conduct

—continued from page 20

court noted that the breach of contract claim relating to the MAK Assignment was not enough to show inequitable conduct.

Moving on to equitable subrogation, which allows one who has satisfied the debt of another to succeed to the position and rights of the satisfied creditor in certain circumstances, the committee argued that because the unsecured noteholders paid off the 2009 Notes, in essence, they should be able to take the place of the 2009 secured noteholders. The court disagreed. To prevail on an equitable subrogation claim, the committee would need to show: (i) that the payment was made by the subrogee to protect his or her own interest; (ii) the subrogee was not a volunteer; (iii) the subrogee was not primarily liable for the satisfied debt; (iv) the subrogee paid the entire debt; and (v) subrogation will not work injustice on others. In reviewing these elements, the court held that the committee's claim failed at the motion-to-dismiss stage for at least two reasons. First, the noteholders did not directly pay off the 2009 Notes, and the committee could not cite any case law to support the theory that the Debtors were acting as a mere conduit to facilitate the transaction. Second, the plaintiffs could be considered "volunteers" in that the prospectus explained exactly how the unsecured notes would be used.

As for the fraudulent transfer claim, the committee argued that the Debtors did not receive reasonably equivalent value in return for granting new security interests to the Lending Group as part of the amendments to the credit agreement, because the lenders were undersecured and the transfers did not reduce the amount of the outstanding liens. The court, however, held that the value of the collateral securing the debt and the determination of whether the lenders were undersecured are irrelevant, because the rights of secured creditors are always limited to the amount of the debt. The additional security interest did not enable lenders to receive anything more than what they had loaned, and the Debtors' liabilities were not increased as a result of the collateralization.

PRACTICAL CONSIDERATIONS

Secured lenders will find this case useful, both in its holdings and its analysis, when faced with similar complaints from creditors' committees or chapter 7 trustees. For instance, this case succinctly reaffirms the principle that the use of leverage in negotiations does not amount to inequitable conduct. In addition, insiders do not normally include third-party lenders with contractual relationships with the debtor, and this case finds no exception to that general principle – even where the lenders' conduct in monitoring the debtors' financials and aggressively negotiating with the debtors could be said to have affected or influenced the debtors' conduct.

UNDERSECURED MORTGAGE LENDERS MAY INCLUDE FEES & COSTS IN ARREARAGE CURE AMOUNT OF CHAPTER 13 DEBTOR UNDER SECTION 1322(E)

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Deutsche Bank National Trust Co. v. Tucker, No. 09-5867 (6th Cir. 2010)

CASE SNAPSHOT

In resolving a conflict within the Sixth Circuit, the Court of Appeals has held that chapter 13 debtors who propose in their plan of reorganization to cure the arrearage on their mortgage loan are required to pay all fees and costs required by the mortgage and non-bankruptcy law, even if the mortgage lender is undersecured. Put another way, mortgage lenders may include such fees and costs in their proofs of claim.

FACTUAL BACKGROUND

The debtor, Mrs. Tucker, executed a note in favor of Novelle Financial Services in August 2004. As security for the note, Mrs. Tucker and her husband gave Novelle a mortgage on their house. The note and mortgage were subsequently assigned to a trust for which Deutsche Bank National Trust Company was a trustee. In February 2008, Mrs. Tucker filed a petition for chapter 13 bankruptcy, listing the value of the home at $88,000. Deutsche Bank filed a proof of claim for $103,328.84, which included a pre-petition arrearage total of $23,286.89. The Debtor objected to the proof of claim, arguing that, of the pre-petition arrearage, fees and costs totaling $4,660.62 should be treated as unsecured under a prior case that held that, under section 1322(e) of the Bankruptcy Code, fees and costs can only be included in arrears to the extent that they are also secured amounts under section 506(b).

In her plan of reorganization, the Debtor proposed to reduce the arrearages paid to Deutsche Bank by the amount of fees and costs. The Bankruptcy Court sided with the Debtor. Deutsche Bank appealed to the United States District Court for the Eastern District of Kentucky, which certified the issue for direct appeal to the Sixth Circuit.

COURT ANALYSIS

The Circuit Court framed the issue as "what amounts are properly part of an arrearage cure under section 1322(e) when the debtor is undersecured?" To answer, the court was required to examine the interaction of sections 506(b) (which deals with secured status) and 1322(e) (which deals with cure amounts). The note permitted the lender to recover certain fees and costs in the event of default. The Debtor argued that only the amount of fees and costs that were secured could properly be included in the arrearage.

Section 1322(e) states that, "[n]otwithstanding… section 506(b)…. of this title if it is proposed in a plan to cure a default, the amount necessary to cure the default, shall be determined in accordance with the underlying agreement and applicable non-bankruptcy law." The Bankruptcy Court had determined that "notwithstanding" was ambiguous because it could mean either (i) section 506(b) has no applicability in a chapter 13 case, or (ii) the creditor must meet section 1322(e)'s requirements in addition to meeting the requirements of being fully secured under section 506(b). Because of this perceived ambiguity, the Bankruptcy Court had then turned to the legislative history and concluded that only secured creditors first meeting the requirement of section 506(b) were entitled to add interest, costs and fees to their arrearage claim under section 1322(e).

The Circuit Court disagreed with the Bankruptcy Court's approach. The Circuit Court resolved the interaction of sections 506(b) and 1322(e) utilizing strict statutory construction, and employed the rule that words in a statute should be interpreted by their ordinary meaning. Applying the ordinary meaning of "notwithstanding," the court determined that Congress expressly resolved any conflict between sections 506(b) and 1322(e) in favor of 1322(e). "By using the term 'notwithstanding' in section 1322(e), Congress expressly precluded section 506(b) from applying to a Chapter 13 cure situation where the parties have a contrary agreement." Even if the court were to look beyond the plain language of the statute and examine legislative intent, the court stated that "[i]t is hard to imagine a clearer statement of congressional intent than 'notwithstanding … section 506(b) … the amount necessary to cure the default, shall be determined in accordance with the underlying agreement and applicable nonbankruptcy law.'"

The Circuit Court therefore concluded that section 506(b) has no applicability in a situation in which the debtor is keeping the original contract in place and bringing it up to date, and that the Bankruptcy Court's conclusion conflicted with the plain language of the statute. Moreover, the Circuit Court's conclusion was in accord with the holdings of several other courts and authorities.

The Circuit Court vacated the lower court's decision, and remanded the case to the Bankruptcy Court for proceedings not inconsistent with this opinion.

PRACTICAL CONSIDERATIONS

The term "notwithstanding" is frequently used in all types of statutory language, and is thus the frequent subject of judicial construction. Parties often debate whether the word is to be applied in a supplanting or supplementing manner. The Circuit Court here held that "notwithstanding" is unambiguous in section 1322(e), and that it supplants any possible implication of 506(b). This holding agrees with the Second and Third Circuits, among others, and reaffirms that courts will first apply the plain meaning of words in a statute. This decision resolves a conflict in the Sixth Circuit and provides guidance to undersecured lenders and debtors alike.

COUNSEL'S CORNER: NEWS FROM REED SMITH

Articles

Julian Turner is the author of a feature article that appeared in a new UK publication entitled *Insolvency Today*. Julian reports that Reed Smith has been asked to write a "market watch" piece for each edition, and his in the inaugural issue is titled "Football's Financial Conundrum."

Edward Estrada has had two articles published since the last issue of the CR&B newsletter. One was "Reviews Positive on Chapter 15, Five Years Out," in the Sept. 27 issue of the *New York Law Journal*; and the second was titled, "Judicial Backlash Adds to Challenges Faced by Lenders" in the July/August publication of *The Journal of Corporate Renewal*.

Presentations

Kurt Gwynne was involved in several recent speaking engagements:

- "Valuing Assets in Chapter 11 Cases – Methodologies and Strategies in Reorganizations and Liquidations," panelist, 15th Annual PBI Bankruptcy Institute – Oct. 28 in Philadelphia
- "Non-Traditional Cram Down of Creditor Claims and Interests," panelist/prepared materials, Commercial Law League of America's Honorable Frank W. Koger Educational Program: Current Developments in Hot & Emerging Areas, National Conference of Bankruptcy Judges – Oct. 14 in New Orleans
- "Hot Ethical Issues in Bankruptcy," panelist, 15th Annual PBI Bankruptcy Institute – Sept. 29 in Pittsburgh
- **Andrea Pincus** and **Claudia Springer**, along with other Reed Smith partners, spoke at the Women's Alternative Investment Summit at New York's Pierre Hotel Nov. 5. Claudia's topic was "Maximizing Value from 363 Sales" and Andrea's was "Derivatives – Post Financial Reform." Reed Smith was a major sponsor of the event.

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