SOUTHEASTERN BANKRUPTCY LAW INSTITUTE

April 2009

CHAPTER 11 UPDATE

Margaret Howard
Law Alumni Association Professor of Law
Washington & Lee University

TABLE OF CONTENTS

Appeals—Equitable Mootness

Hilal v. Williams (In re Hilal), 534 F.3d 498 (5th Cir. 2008):

Debtor's Chapter 11 liquidating plan released the Chapter 11 Trustee and plan agent from liability for claims based on negligence and breach of fiduciary duty, and authorized compensation to the plan agent on a percentage basis. The "extraordinarily litigious" Debtor appealed and the district court dismissed the appeal on grounds of equitable mootness.

Held, an appeal is not equitably moot when no third parties would be affected if the order were reversed on appeal.

Equitable mootness is a prudential doctrine based on the practical necessities surrounding consummation of a confirmed Chapter 11 plan. A three-part test determines equitable mootness: (1) whether the confirmation order was stayed; (2) whether the plan is substantially consummated; and (3) whether the relief requested on appeal would affect the rights of parties not before the court.

Here, the first and second factors were met but the third was not because no third parties would be affected by reversal of the order on appeal. Trustee and the other professionals had been on notice of the contingent exposure since early in the confirmation process.

Both the Third and Ninth Circuits have similarly held that equitable mootness does not foreclose appeal from aspects of a Chapter 11 plan confirmation that solely affect professional compensation and releases.

On the merits, Debtor's challenges to the plan's exculpatory clause "border on frivolous." The bankruptcy court's confirmation order was affirmed.

Curreys of Nebraska, Inc. v. United Producers, Inc. (In re United Producers, Inc.), 526 F.2d 942 (6th Cir. 2008):

The bankruptcy court confirmed the Chapter 11 plan over the objections of creditors holding a substantial judgment against Debtor. The plan cancelled existing ownership interests and issued new stock, with existing management remaining in place. Creditors appealed but did not seek a stay pending appeal. Debtor moved to dismiss the appeal as equitably moot. The 6th Circuit BAP remanded the case to the bankruptcy court to determine whether the plan had been substantially consummated and the extent to which third parties had relied on the confirmed plan. The bankruptcy court found that the plan was substantially consummated and detailed the possible consequences to third parties if the plan were vacated.

Held, an appeal is equitably moot when exit financing is contingent on confirmation of this particular plan and the lack of financing would halt the debtor's operations.

Under the three-part test outlined in *Hilal*, this appeal was equitably moot.

In determining the rights of third parties, a court should decide whether the relief requested amounts to a piecemeal revision or a wholesale rewriting of the plan.

Here, funding of the exit financing was conditioned upon confirmation of this plan and Debtor would be in default if management were changed as creditors proposed. The lack of financing would bring Debtor's operations to a halt.

Debtor also engaged in a number of post-confirmation transactions that would be called into legal uncertainty, including issuance of new stock, sale of real estate and issuance of releases.

Thus, the case was equitably moot and the appeal was dismissed.

Automatic Stay

In re Bryan Road, LLC, 382 B.R. 844 (Bankr. S.D. Fla.), *reconsideration denied*, 389 B.R. 297 (Bankr. S.D. Fla. 2008):

Debtor was the developer of a boat storage facility. When Debtor defaulted on its loan obligations, Bank obtained a foreclosure judgment against the storage facility on which it held a mortgage. The parties entered into a forbearance agreement on the morning of the foreclosure sale. The agreement rescheduled the foreclosure sale for two months later, and included a waiver of the automatic stay in the event of a subsequent bankruptcy. The day before the rescheduled sale, Debtor filed Chapter 11. Bank moved for relief from stay, seeking to enforce the waiver.

Held, prepetition agreements to waive the automatic stay are enforceable when the debtor was represented by experienced counsel, the forbearance period provides sufficient consideration, and granting relief from the automatic stay would not adversely affect the rights of unsecured creditors.

The court in *In re Desai*, 282 B.R. 527 (Bankr. M.D. Ga. 2002), set out four factors relevant in deciding whether to grant relief from the automatic stay:

(1) sophistication of the debtor waiving stay;

(2) consideration that the debtor received for the waiver, including the risk to the creditor and the length of time covered by the waiver;

(3) whether other parties are affected, including junior lienholders and unsecured creditors; and

(4) feasibility of the debtor's plan.

Here, enforcement of the waiver is permissible under the *Desai* factors.

The first factor is satisfied because Debtor was represented by experienced bankruptcy counsel in negotiating the forbearance agreement.

The second factor is more problematic because the forbearance period was for only two months, but Debtor was seeking refinancing and expected to find another lender in that period of time. That was the period Debtor wanted.

The third factor appears to prevent stay relief, but it does not. Junior lienholders can protect their interests in Bank's pending foreclosure proceeding, and unsecured creditors are unlikely to receive any dividend because the value of Debtor's property does not appear to reach down to their level.

Finally, Debtor's plan is speculative at best because it is largely premised on litigation to dispute the validity of Bank's mortgage and the rights of many of the unsecured creditors.

Calyon New York Branch v. American Home Mortgage Corp. (In re American Home Mortgage, Inc.), 379 B.R. 503 (Bankr. D. Del. 2008):

Debtors' business involved the origination, servicing and sale of mortgages. Under a contract with plaintiff, as administrative agent, Debtors transferred interests in mortgage loans to Purchasers (security issuers and banks) in exchange for funds transferred from Purchasers to Debtor.

Purchasers were to return the mortgage interests to Debtors no later than 180 days after the initial transfer in exchange for the transfer of funds from Debtors to Purchasers (consisting of the original amount plus a per diem determined by the number of days Purchasers held the mortgages).

The purpose of the contract was to provide Debtors with funds for the origination of mortgages. Transfers to Purchasers were on an interim basis, pending Debtors' arrangement for their final disposition either by sale to a private investor or to a securitization trust.

As a result of the global credit crisis, Debtors experienced a significant number of margin calls resulting in their reduced ability to originate loans. Plaintiff sent Debtors notices of default and demanded that Debtors immediately repurchase all of the mortgage loans in Purchasers' possession in accordance with the terms of the parties' contract.

After Debtors filed Chapter 11, plaintiff sought a declaratory judgment that the contract was a repurchase agreement as defined in § 101(47) and, thus, that its rights under the contract were not stayed, as provided by § 559. Debtors argued that the agreement lacked indicia of a true repurchase agreement and was, in substance, secured financing.

Held, because the sale and repurchase of mortgage loans under the contract constituted a repurchase agreement as defined in § 101(47), § 559 made the automatic stay inapplicable.

The elements in the statute were clearly satisfied.

(1) the contract provided for the transfer of one or more mortgage loans.

(2) the transfer of one or more mortgage loans from Debtors to Purchasers was against the transfer of funds from Purchasers to Debtors.

(3) the contract contained a simultaneous agreement by Purchasers to transfer the mortgage loans to Debtors.

(4) the transfer of mortgage loans from Purchasers to Debtors occurred within 180 days of the initial transfers.

(5) the transfer of mortgage loans from Purchasers to Debtors was against the transfer of funds by Debtors to Purchasers.

Since the statute is clear, the model form developed by the Securities Industry and Financial Markets Association is irrelevant.

Held, because plaintiff was a "financial institution," as defined by § 101(22), and the contract was a "securities contract," as defined by § 741, the safe harbor provision of § 555 was also applicable to the sale and repurchase of mortgages.

Held, the portion of the contract providing for the servicing of mortgage loans, as opposed to the sale and repurchase of mortgages, was neither a repurchase agreement nor a securities contract. Thus, that portion of the contract was not entitled to protection under the safe harbor provisions of §§ 555 and 559.

Appointment of Examiner

***Walton v. Cornerstone Ministries Investments Inc.**,* 398 B.R. 77 (N.D. Ga. 2008):

Debtor was in the business of loaning money for real estate acquisition and development. It raised operating capital by selling bonds to the public. Debtor originally loaned money exclusively to churches and other nonprofit organizations, but later began making loans to for-profit developers of projects providing affordable housing. Because of this shift in business focus, and loans made to entities affiliated with Debtor's principals, upon Debtor's Chapter 11 filing the US Trustee sought appointment of an examiner. The bankruptcy court refused the request on the grounds that an examiner might duplicate work of the Creditors' Committee. The US Trustee appealed, arguing that § 1104(c) does not give a bankruptcy judge discretion to deny a request for appointment of an examiner when a debtor's fixed, liquidated, unsecured debts exceed $5,000,000, a trustee has not been appointed, and a plan has not been confirmed.

Held, § 1104(c) is mandatory, if its elements are established.

Every district court and most bankruptcy courts that have considered the question have held § 1104(c) mandatory on its face. The only circuit-level decision, *Morgenstern v. Revco D.S., Inc. (In re Revco, D.S., Inc.)*, 898 F.2d 498 (6th Cir. 1990), agrees.

Even a plain provision must be construed in its context, however. Seen in relationship with (c)(1), the mandatory nature of (c)(2) is even more clear.

Appellees argued that the phrase "as is appropriate" gives bankruptcy judges complete discretion over the scope—and also the existence—of the examiner's investigation. But the phrase modifies "investigation." The statute allows the court to determine the scope, length, and conduct of the investigation, but not the appointment itself.

Appointment of Trustee

In re South Star Oil Co., 2008 Bankr. LEXIS 2426 (Bankr. D. Ore. 2008):

Debtor owned or operated ten service stations, but had not been profitable since 2005. Creditor, a petroleum supplier, filed a proof of claim for $2.3 million and sought priority under §§ 507(a)(2) and 503(b)(9) for $1.5 million—the portion of inventory supplied within 20 days of Debtor's Chapter 11 petition. Several creditors, as well as the US Trustee, filed motions to dismiss or convert to Chapter 7, or for appointment of a trustee under § 1104. Creditor refused to consent to any treatment other than full payment to which it was entitled to under § 1129(a)(9)(A). Debtor did not have cash sufficient to permit payment of Creditor's claim on the effective date of the plan.

Held, although cause for dismissal or conversion is shown, a trustee may be appointed instead when a creditor holds a large 20-day claim that would be lost in a subsequently-filed bankruptcy.

"Cause" for dismissal or conversion includes, under § 1112(b)(4)(A), continuing loss to the estate coupled with the absence of a reasonable likelihood of rehabilitation. That is the situation here.

When cause for dismissal is shown, a court may, in the alternative, appoint a trustee or examiner if that is in the best interests of creditors.

Dismissal would severely prejudice Creditor, since it would not have an administrative priority in a subsequently-filed case.

Conversion to Chapter 7 would prevent the estate from obtaining the value of its properties as ongoing businesses.

Thus, the best solution is appointment of a trustee under § 1104.

Claims

Chicago Truck Drivers, Helpers and Warehouse Workers Union (Independent) Pension Fund v. El Paso CGP Co., 525 F.3d 591 (7th Cir. 2008):

In 1999, an involuntary Chapter 11 petition was filed against an employer that participated in a multi-employer pension plan. When the case was converted to Chapter 7, the pension fund viewed the bankruptcy as a withdrawal and filed a proof of claim for the employer's withdrawal liability under the Multi-employer Pension Plan Amendments Act of 1980 (MPPAA). Companies that were previously a part of that employer's "controlled group" for purposes of MPPAA did not become aware of the proof of claim until January 2002, but they took no action. In 2004, the fund sent a notice and demand to those companies and then filed suit against them to collect the withdrawal liability. The defendants disputed the demand in 2005 by requesting an informal review and then arbitration, as permitted by the MPPAA. Under the MPPAA, when notice and demand is sent "to the employer," the employer has 90 days to request an informal review by the plan of the assessment and an additional 120 days to demand arbitration. If the employer fails to demand arbitration, the assessment becomes due and owing.

Held, the fund's 1999 filing of a proof of claim in the Chapter 7 bankruptcy of a former member of defendants' controlled group constituted a statutory notice and demand, thus cutting of defendants' right to contest liability, only because defendants had actual notice of it no later than January 1, 2002.

The MPPAA is a series of amendments to ERISA that protects employees in multi-employer pension plans by requiring employers who withdraw to pay their share of "unfunded vested benefits."

Liability begins as soon as the plan sponsor sends notice and demand.

If the employer does not pay, the plan sponsor may sue the employer or any member of the "controlled group," which is jointly and severally liable.

Proofs of claim in bankruptcy may meet the MPPAA's requirements for a notice and demand if it is sent "to the employer."

Here, the proof of claim was filed in a Chapter 7 bankruptcy, not a Chapter 11.

In a Chapter 11, the debtor continues to operate the business, so a notice to the DIP is notice to the employer. In a Chapter 7, however, the trustee is neither agent nor fiduciary of the debtor, and has no duty to inform the debtor of a proof of claim.

Thus, the proof of claim filed in 1999 was insufficient notice and demand under the MPPAA.

Even if this had been a Chapter 11 proceeding, notice would not have been adequate.

This notice was delivered indirectly through the controlled group, which may constitute constructive notice. But in 1999 defendants were no longer part of the same controlled group as the debtor company.

The fund argued that the constructive notice principle was nonetheless applicable on the basis of the "evade or avoid" provision of the MPPAA. But the issue in prior cases dealing with this provision has been the validity of the transaction itself, not the adequacy of notice.

Defendants obtained actual knowledge no later than January 1, 2002, despite any deficiencies as statutory notice, thus triggering the statutory duty to arbitrate. As a result, challenges brought in 2005 were untimely.

Held, the case must be remanded on the issue of damages because the fund was not given an opportunity to be heard on the theory of damages used by the district court.

Airadigm Communications, Inc. v. FCC (In re Airadigm Communications, Inc.), 392 B.R. 392 (D. Wis. 2008):

Debtor was the successful bidder on 15 licenses auctioned by the FCC in 1996. Debtor made a down payment and the FCC retained security interests in the licenses. Debtor defaulted and filed a Chapter 11 petition in 1999. The FCC took the position that the licenses were automatically cancelled as a result of the bankruptcy filing. In 2003, the Supreme Court decided *FCC v. NextWave Personal Communications, Inc*., 537 U.S. 293 (2003), which invalidated the FCC's automatic license cancellation rule. Debtor filed a second Chapter 11 petition in 2006, to deal with the significant changes in its legal position resulting from *NextWave*. The FCC argued in the second case that an interest held by TDS, which arose from plan confirmation loans TDS made to Debtor in the first case, should be recharacterized as an equity interest because neither Debtor nor TDS expected the loans to be repaid. The bankruptcy court denied the FCC's motion to recharacterize the claim and questioned whether a bankruptcy court is ever authorized to do so.

Held, although recharacterization of a claim to an equity interest is possible under the Bankruptcy Code, such recharacterization of funds a creditor loaned to a Chapter 11 debtor to fund a prior Chapter 11 case is not appropriate despite the fact that the parties never intended that the loans would be repaid, but contemplated that the loans would be satisfied by turnover of security.

> Any recharacterization must be done within the confines of the Code, and the only possibly applicable provisions—§§ 503(b) and 502(j)—were not applicable here.
>
> The substance of a transaction, rather than the name the parties attach to it, governs its legal effect and whether recharacterization is appropriate. It is not proper in this case, however.
>
>> First, all of the parties to the first plan intended that the funding take the form of loans, and the lender had no stake in Debtor at the time the plan was negotiated. The FCC, as a sophisticated creditor, understood this but raised no objection.
>>
>> Second, TDS's status as an outsider and its subsequent behavior was consistent with that of a secured lender, not a shareholder. A lender's acquisition of an interest in a corporation does not change an earlier loan transaction into an equity investment.
>>
>> Third, the nature of confirmed Chapter 11 plans counsels against recharacterizing funding loans to equity—the plans have survived scrutiny by the court and by affected creditors, preventing unilateral mischaracterization of a claim.
>>
>> Finally, a 2006 stipulation between the FCC and TDS made clear that the parties thought of the interest as a loan. Based on each of these considerations, the loan should not be recharacterized.

In re M. Fabrikant & Sons, Inc., 385 B.R. 87 (Bankr. S.D.N.Y. 2008):

Debtors' original secured lenders transferred their rights to new lenders. The unsecured creditors' committee sued the original lenders, seeking to avoid some of the obligations and security interests that were transferred. (The committee did not sue the new lenders because the parties reached a settlement that was incorporated into the plan.) The original lenders incurred substantial expenses, which the lenders sought to recover as administrative claims, arguing that they were "reimbursement rights" retained by the original lenders under the transfer agreements. Thus, the dispute concerned whether the assignment also transferred certain reimbursement rights granted to the original lenders under the final cash collateral order. The transfer documents incorporated standard Loan Syndications and Trading Association terms, and provided that the prepetition lenders sold "any and all right, title and interest in, to and under" the loan documents, as well as any claims, including bankruptcy claims, "arising under or in connection with the" loan documents.

Held, as a matter of contract interpretation, language transferring "all claims * * *, suits, causes of action and any other right * * * that is based upon, arising out of or is related to" the transactions at issue is broad enough to include rights to indemnification for administrative expenses for attorneys' fees.

> The original lenders argued that the broad language in the agreements should be read to exclude reimbursement rights because "claims" are limited to prepetition rights to payment.
>
>> The definition of "claim" does not make such a distinction, however, and other provisions of the Code use qualifying language when the intent is to cover only prepetition claims.
>>
>> The agreements covered all claims, not just "claims" as defined in the Code.
>
> The lenders also argued that they could not have intended to transfer their reimbursement rights while leaving themselves open to a lawsuit by the committee, but that argument ignored the extent of the rights transferred.

In re Oneida, Ltd., 383 B.R. 29 (Bankr. S.D.N.Y. 2008):

Debtor and its affiliates filed Chapter 11 several weeks after passage of the Deficit Reduction Act, which amended ERISA to create an additional premium payable to the PBGC for single-employer pension plans terminated as part of an in- or out-of-court restructuring. Debtor and the PBGC negotiated pre- and post-petition over the claims and ultimately entered a stipulation requiring Debtor to issue a $3 million promissory note to the PBGC and reserving each party's rights to challenge or enforce the claims. After confirmation of its plan, Debtor sought a declaratory judgment that the DRA premiums were prepetition claims satisfied by the note and otherwise discharged by the plan. The PBGC argued that the premiums were not claims, and thus were not discharged, and in the alternative that Debtor was estopped from refusing to pay the claims in full.

Held, premiums due under the Deficit Reduction Act, for pension plans terminated as part of a restructuring, are dischargeable claims.

> Under the DRA, an employer who terminates a single-employer plan under ERISA's distress provisions, whether inside or outside of bankruptcy, is liable for a special premium. If the termination takes place in a Chapter 11 proceeding, the obligation is deemed to arise on the date of discharge, which is usually the effective date of the plan.
>
> The principal question is whether the DRA premium is a "claim."

"Claim" is broadly defined in § 101(5)(A). Under any construction of the term, a DRA claim is a classic contingent claim, even though the only real uncertainty is the number of workers who will be employed on the date for calculating the claim. The contingency results from the special rule that DRA premiums arise either at dismissal or discharge, one of which must occur in every case.

A party may have a claim even though it does not possess a cause of action on that claim. Thus, whether there is a right to payment under nonbankruptcy law does not answer the question whether there is a "claim" within the Code.

The PBGC offers no authority for the proposition that the broad definition of "claim" can be limited by a provision that the claim does not arise until after the effective date of a plan.

Private parties could not accomplish this by a contractual provision making damages payable only after a bankruptcy discharge, since that would effectively create a new priority for themselves.

Nor could a state create a liability that would come into existence on the effective date of a plan, since that would effectively circumvent the discharge.

To rule for the PBGC would require a finding that Congress amended the Bankruptcy Code and created a new nondischargeable debt by virtue of the DRA. No such intent is evident.

This claim arose prepetition, even though the liability became enforceable only after distress termination of the pension plan, which occurred post-petition in this case.

A contingent claim arises upon the happening of a future event that was within the contemplation of the parties at the time their original relationship was created.

This claim was in the contemplation of the parties prior to the petition date.

First, the DRA was passed before Debtor filed bankruptcy.

Second, Debtor undoubtedly intended to terminate its pension plans. The parties met at least twice before the filing to discuss a distress termination of Debtor's plans.

Held, Debtor is not barred from discharging the claims under the doctrine of judicial estoppel on the grounds that its CFO included payment of the premiums in its cash flow projections without suggesting that Debtor might not pay them in full.

Debtor did not take inconsistent positions, as required for judicial estoppel. Debtor's projections were made for the purpose of proving feasibility under § 1129(a)(11), and the court's finding that the plan was feasible was predicated on the premise that Debtor *could* pay the premiums, not that it *would*.

Nor was the court misled, as is also required under the doctrine of judicial estoppel. All plan confirmations involve projections and, in any event, Debtor reserved its rights to dispute the obligation.

Dugan v. Pension Benefit Guaranty Corp. (In re Rhodes, Inc.), 382 B.R. 550 (Bankr. N.D. Ga. 2008):

During Debtors' Chapter 11 bankruptcy case, Debtors and PBGC agreed to a "distress termination" of Debtors' defined benefit pension plan. Termination of the plan created a prepetition, unsecured claim in favor of PBGC pursuant to ERISA in the amount of unfunded benefit liabilities—$11,649,600. The liquidating agent objected to PBGC's claim as overstated, arguing that the inflated claim violated the equitable principles of §§ 502(b) and 1123(a)(4) that like claims be treated alike. Relying on § 502(b), the agent asked the court to recompute PBGC's claim because it involved future payments and was not properly discounted to present value. PBGC had followed its own regulations for calculating the "amount of unfunded benefit liabilities" owed to it under § 1362(b)(1)(A) of ERISA.

Held, the provision of ERISA that addresses calculation of an employer's unfunded benefit liability following termination of a defined benefit pension plan is not limited to calculation solely for purposes of ERISA, but also applies in bankruptcy.

Creditors' entitlements in bankruptcy arise in the first instance from the underlying substantive law that creates the obligation, subject to any qualifying provision in bankruptcy, *Raleigh v. Illinois Dep't of Revenue*, 530 U.S. 15 (2000). Thus, the question is whether the Bankruptcy Code contains a provision that trumps ERISA as to the calculation of PBGC's claim.

Two circuit cases have held that a bankruptcy court is empowered to adjust the amount of PBGC's claim as computed under ERISA, *In re CF & I Fabricators of Utah, Inc.*, 150 F.3d 1293 (10th Cir. 1998), *cert. denied*, 526 U.S. 1145 (1999); *In re CSC Industries, Inc.*, 232 F.3d 505 (6th Cir. 2000).

Those cases relied on § 1123(a)(4), finding that use of PBGC's discount rate would violate the policy of treating similarly situated creditors alike.

> > > Reliance on § 1123(a)(4) is misplaced, because that section has nothing to do with the computation and allowance of claims. Its primary purpose is to protect the integrity of the Chapter 11 voting process.
> > >
> > > In addition, an equitable principle derived from § 1123(a)(4) is not a statute and should not overrule ERISA.
> >
> > PBGC is authorized by law to make a binding determination of the amount of its claim, making its claim akin to a claim based on a judgment or an arbitration award. Its claim already reflects a present value that is binding on Debtors and is not subject to court determination of its amount.
>
> Section 502(b) cannot be used to collaterally attack the regulations pursuant to which PBGC's claims were computed.
>
> > The introductory clause of § 502(b) permits the bankruptcy court to restate the gross amount of a claim for future payments to the amount that reflects its value relative to claims presently due, thereby accounting for the time value of money.
> >
> > When placing claims for future payments on the same footing as claims for present payments, it is critical to determine whether the amount of the former already reflects its current value.
> >
> > The agent could not, outside of bankruptcy, successfully challenge the amount of PBGC's claim solely on the ground that it is excessive because it used an inappropriate discount rate, without obtaining a judgment invalidating PBGC's regulations.
>
> PBGC's claim is not one for future payments, however. Debtors have no liability for future payments to pension plan beneficiaries or to the PBGC. Rather, the liability for the stream of payments to be made in the future is PBGC's.

Claims—Administrative

United Mine Workers of America v. Lexington Coal Co. (In re HNRC Dissolution Co.), 396 B.R. 461 (B.A.P. 6th Cir. 2008):

> Debtors participated in a multi-employer pension plan until operations were terminated two years after their Chapter 11 filings. Termination of operations constituted a complete withdrawal from the plan, causing Debtors to incur withdrawal liability under ERISA. The plan sought administrative expense status for $36,250, which represented the portion of Debtors' withdrawal liability relating

to their post-petition operations. The bankruptcy court disallowed administrative expense status and the plan appealed.

Held, a claim for withdrawal liability is not entitled to administrative expense status.

> Calculation of withdrawal liability is a two-step process, requiring the use of factors unrelated to employees' post-petition work.
>
> > The plan's unfunded vested benefits are calculated, and then the employer's share of that amount is determined.
> >
> > Calculation of the plan's unfunded vested benefits depends on factors completely unrelated to the withdrawing employer or its covered employees: changes in negotiated benefit levels; actuarial assumptions as to employee longevity and expected retirement ages; determination of an appropriate discount rate; and the level of return on the plan's investments.
>
> Although the claim for withdrawal liability did not arise until Debtors withdrew from the plan, that does not automatically entitle the claim to administrative expense status.
>
> > A claim is entitled to priority as an administrative expense only if it is for actual, necessary costs and expenses of preserving the estate, which in turn depends on a "benefit to the estate" test.
> >
> > > Under this test, a debt obtains administrative expense status only if it (1) arose from a transaction with the bankruptcy estate and (2) directly and substantially benefited the estate.
> > >
> > > The plan's claim arose from a transaction with the estate.
> > >
> > > There was no direct and substantial benefit to the estate, however, because the withdrawal liability did not relate to work Debtors' employees performed post-petition.
> >
> > The Code recognizes that employees' work benefits the estate by giving wages and other employee benefits priority at a lower level.
>
> Arguably, claims for withdrawal liability relating to post-petition work should have administrative expense status because a debtor's post-petition minimum funding contributions to a defined benefit pension plan enjoy that priority. *PBGC v. Sunarhauserman, Inc. (In re Sunarhauserman, Inc.)*, 126 F.3d 811 (6th Cir. 1997).
>
> > Cases adopting this argument, such as *In re Pulaski Highway Express, Inc.*, 57 B.R. 502 (Bankr. M.D. Tenn. 1986), have reasoned that a

withdrawal liability claim arises from the ongoing accrual of employees' vested rights, rather than from the withdrawal itself.

That reasoning was eroded by *CPT Holdings, Inc. v. Indus. & Allied Employees Union Pension Plan*, 162 F.3d 405 (6th Cir. 1998), however, which held that a claim for withdrawal liability cannot arise before the debtor's actual withdrawal from the pension plan.

Even more important is the fact that the amount of withdrawal liability is always dependent on facts unrelated to the post-petition work of a debtor's employees—a fact that distinguishes withdrawal liability from other consideration for employees' post-petition work.

The plan argued, relying on *Reading Co. v. Brown*, 391 U.S. 471 (1968), that the "benefit to the estate" standard was inapplicable because withdrawal liability is a statutorily-imposed obligation that is incidental to operation of a debtor's business.

Reading held that a claim may have administrative expense priority, even though it does not benefit or help preserve the estate, if it was an actual and necessary cost of operating the business. The Court stressed fairness to claimholders, noting that the fire loss claimants involved in the case had had an insolvent business thrust upon them.

Courts applying *Reading* have limited it to claims sounding in tort or involving intentional misconduct by the trustee. The Sixth Circuit has granted administrative expense priority under the *Reading* exception in only one case, involving costs incurred by the state in dealing with serious environmental hazards that the debtor did nothing to remedy, *Lancaster v. Tennessee (In re Wall Tube & Metal Products Co.)*, 831 F.2d 118 (6th Circuit 1987).

The plan's claim in this case was not the type to which *Reading* applies. Withdrawal liability is not a penalty for wrongful conduct; rather, it is designed to discourage withdrawals from multi-employer pension plans and to mitigate the negative effect of such withdrawals on employees.

The special concern for public health and safety, present in *Wall Tube*, is not implicated here.

In re Diomed, Inc., 394 B.R. 260 (Bankr. D. Mass. 2008):

Under a license agreement with Creditor, Debtors had certain rights in a patent for the manufacture of products used in a medical procedure. Debtors brought prepetition infringement suits against third parties that were settled post-petition, with a permanent injunction against future infringement, but Debtors failed to share the proceeds with Creditors as required by their agreement. Debtors then moved to sell substantially all of their assets to Purchaser, one of the infringement defendants. Creditor objected to the sale on grounds that the purchase agreement was a thinly disguised attempt to transfer ownership and control of the patent without assuming and assigning the license agreement. The parties agreed to a modified purchase agreement and rejection of the license agreement. Creditor then sought allowance of an administrative expense claim, totaling $2.33 million, consisting of four components: royalties for use of the patent in products that were sold post-petition but before rejection of the license agreement; royalties for the bulk sale to Purchaser of products using the patent; its claim for a portion of the settlement proceeds; and damages resulting from Debtors' agreement to cooperate with Purchaser in having the permanent injunction released.

Held, royalty claim asserted by licensor of patent against debtor-licensee based on bulk sale by debtor of inventory that used the patent is not entitled to administrative expense priority.

> Creditor argued this claim was entitled to administrative expense status because it occurred post-petition and generated $1.5 million of the purchase price for the estates. That argument assumed that the bulk sale necessarily occurred pursuant to the license agreement, but that is factually inaccurate.
>
> Debtors argued that the claim should be denied entirely because co-owners of patents may license the patent without accounting to other co-owners for the profit.
>
> Once the license was rejected, Debtors could no longer sell inventory using the license, but under patent law its co-ownership was enough. The triggering event for the payment of royalties—actual sale of the inventory—occurred after the agreement was rejected, and pursuant to Debtor's co-ownership rights under patent law.
>
> Thus, Creditor's claim for royalties was part of its unsecured claim for damages resulting from rejection of the licensing agreement; it is not entitled to administrative expense priority.

Held, licensor is entitled to administrative expense priority for claim based on debtor's post-petition use of rights under the license agreement to obtain post-judgment settlement of infringement claims.

> Creditor asserted this claim was entitled to administrative expense priority because it arose post-petition—namely, when the court approved the settlements; before that time, the judgments could have been reversed on appeal. Debtor countered that the possibility of reversal was just a way of saying that the claim was contingent, but it arose at the latest when judgment was entered; thus, it was a prepetition, general unsecured claim.
>
> Under patent law, all co-owners of a patent are necessary parties to an infringement suit. In this case, Debtors used the provision of the license

> agreement that gave it the sole right to settle litigation and bind Creditor to the settlement. By doing so, Debtors avoided the possibility that the judgments would be overturned on appeal, and saved the estate the delay and expense of prosecuting the appeal.

Held, debtor's conduct, following rejection of license agreement, in entering agreement to sell its assets to alleged infringer and promising to use its best efforts to have injunction vacated, did not give rise to an administrative expense claim in favor of licensor.

> Creditor sought administrative expense status for this portion of its claim on the grounds that Debtor owed it a fiduciary duty. But the covenant of good faith and fair dealing, imposed by law on all contracts, does not create a fiduciary duty.
>
> Once the license agreement was rejected, as was Debtors' right, Debtors were free to grant Purchaser a license to the patent that was sufficient to permit Purchaser to use it without fear of future restriction.

Meredith Corp. v. Home Interiors & Gifts, Inc. (In re Home Interiors & Gifts, Inc.), 2008 Bankr. LEXIS 2476 (Bankr. N.D. Tex. 2008):

Debtor was in the business of selling home accessories through 100,000 independent representatives who marketed to consumers via in-home parties using monthly catalogues and newsletters. Debtor entered into a prepetition license agreement with Creditor to use its "Better Homes & Gardens" trademark in Debtor's publications and on its products. A month and a half after filing Chapter 11, Debtor rejected the agreement. Creditor asserted an administrative claim based on Debtor's post-petition use of the trademark on marketing materials. Debtor objected, arguing that the materials bearing the trademark had been approved by Creditor and published prepetition.

Held, an administrative claim is appropriate for a debtor's post-petition use of materials bearing a creditor's trademark, even though all of the materials were published prepetition, since the value of a trademark derives from its public use.

> Representatives marketed Debtor's product, post-petition, using materials bearing Creditor's trademark. Thus, Debtor continued to use the trademarks, in the contracted-for capacity, after filing and up to the date of rejection. That was the exact benefit for which Debtor contracted.
>
> There is an analogy to nonresidential lease cases decided before the 1984 amendment to § 365(d), which required that landlords be compensated for a debtor's post-petition use of the property.
>
> Because Debtor took advantage of its rights under the agreement, its post-petition sale of products bearing Creditor's trademark qualified as an actual and necessary expense of preserving the estate.

For the period between filing and rejection, calculation of the amount of the claim should presumptively start with the royalty amount set out in the contract, prorated for days of actual use. Here, that was $556,318.

For the period after rejection, contract terms are no longer binding, but are instructive.

The contract provided a two-year "sell-off" period, stating that Creditor would receive half the minimum royalty in the second year following termination of the agreement.

Creditor's claim of $568,681 was calculated as half the minimum royalty per day, which was reasonable.

Claims—§ 503(b)(9)

In re Plastech Engineered Products, Inc., 394 B.R. 147 (Bankr. E.D. Mich. 2008):

Debtor was a tier one automotive supplier, designer and maker of plastic products, with thousands of creditors. Debtor objected to certain § 503(b)(9) administrative expense claims.

Held, § 502(d) may not be used to disallow 20-day claims under § 503(b)(9).

Addition of § 503(b)(9) in 2005 converted a large number of prepetition debts to administrative expense claims, with serious consequences.

Because § 1129(a)(9)(A) requires that all administrative expense claims be paid in full on the plan's effective date, debtors now need a significant amount of cash in order to confirm a plan and exit Chapter 11. This may be an insurmountable hurdle.

It also creates significant differences in the treatment of otherwise similarly situated prepetition creditors.

It applies only to the value of *goods*, and goods received in the ordinary course, but not *services* received in the 20-day period.

Debtor argued that § 502(d) permits disallowance of any claim. Creditors argued, on the contrary, that § 502(d) only applies to pre- and post-petition claims filed under § 501 and allowed under § 502, and that allowance and payment of administrative expense claims are distinct from §§ 501 and 502.

Courts are split on the question whether § 502(d) applies to general § 503(b) administrative expenses. Debtor argued that even if it does not, it still applies to 20-day claims.

Most general administrative expenses are post-petition obligations, but § 503(b)(9) claims are necessarily prepetition obligations. According to Debtor, Congress's elevation of these claims to administrative expenses does not suggest a *sub silentio* intent to also insulate them from § 502(d). These claims are still inherently prepetition debts.

First, cases holding that the allowance of claims under § 502 is entirely separate from the allowance of administrative expenses under § 503 are correct.

> If § 502(d) applied to all post-petition claims, and not just to those governed by §§ 501 and 502, it would be unnecessary for § 502(d) to say that it applies "notwithstanding subsections (a) and (b)" of § 502.
>
> Inclusion of that phrase demonstrates that § 502(d) applies only to those pre- and post-petition claims that are governed by §§ 501 and 502 and not to administrative expenses under § 503.

Second, a § 503(b)(9) administrative expense is not the type of claim that is filed under § 501 and allowed or disallowed under § 502.

> Requests for payment of administrative expenses are filed under § 503(a) and not by a proof of claim under § 501.
>
> In addition, administrative expenses are allowed after notice and hearing, in contrast to the "deemed allowed" treatment provided by § 502(a) to proofs of claim filed under § 501. Provisions for filing, payment and allowance of administrative expenses are self-contained in § 503.

Third, adoption of Debtor's position would result in the collision of two mandatory provisions—§§ 502(d) and 503(b).

> There is no conflict between the mandatory allowance of claims under §§ 502(a) and (b) and the mandatory disallowance of claims under § 502(d) because the latter says that it applies "notwithstanding subsections (a) and (b)."
>
> But § 502(d) does not refer to § 503(b), and nothing else in the Code harmonizes the mandatory allowance of an administrative expense under § 503(b) with the mandatory disallowance of a claim under § 502(d).
>
> Creditors' position avoids this collision—the mandatory disallowance provision of § 502(d) applies only to claims governed by the claims allowance process of § 502, and the

mandatory allowance provision of § 503 applies only to administrative expenses.

Fourth, although most cases that have considered the application of § 502(d) to § 503(b) administrative expenses have done so only when the administrative expense arose as a post-petition obligation, their reasoning is sound and should apply equally to the new class of administrative expenses under § 503(b)(9).

Fifth, Debtor referred to § 503(b)(9) claims as a "special class" of prepetition claims, thus attempting to distinguish (b)(9) claims from other administrative expenses, but the Code recognizes no distinction.

Sixth, if Congress had wanted to make these claims subject to §§ 501 and 502, it could easily have done so by creating a separate priority for them under § 507.

In re Plastech Engineered Products, Inc., 2008 Bankr. LEXIS 3130 (Bankr. E.D. Mich. 2008):

Debtor was a tier one automotive supplier, designer and maker of plastic products, with thousands of creditors. One of them sold goods in the 20 days before bankruptcy in the ordinary course of Debtor's business, with invoices showing that the goods were sold to Debtor and billed to Debtor, but delivered to JCI. Creditor sought an administrative expense under § 503(b)(9), but Debtor objected on the grounds that the goods were not "received by the debtor."

Held, § 503(b)(9) only permits allowance of an administrative expense claim when the debtor has received the goods, and not just their value.

Creditor argued, first, that the goods need not be received by the debtor as long as the debtor receives their value.

The statute is plain on its face. "Received" modifies "goods," so it is goods that must be received in order for the creditor to have a claim under § 503(b)(9).

"Value" sets the amount of the allowed administrative expense.

Creditor argued, second, that the requirement is met as long as the debtor has constructive possession, even if not actual possession.

The Code does not define "received" and the only case—unreported and from another circuit—to have discussed the point did so in dictum. Thus, it was not helpful.

The record was not developed on this point, so it was reserved for later determination.

Claims--Secured

Airadigm Communications, Inc. v. FCC (In re Airadigm Communications, Inc.), 547 F.3d 763 (7th Cir. 2008):

> [See the statement of facts at page 7, *supra*.] In Debtor's second Chapter 11 case, the FCC sought interest through the date of the second filing, plus post-2006 interest, totaling $42.4 million. Debtor and TDS argued that under the 2000 plan all interest stopped accruing on the 1999 petition date. The bankruptcy court denied interest for the period from commencement of the first case to the date of confirmation of the first plan, but found that the plan implicitly entitled the FCC to post-confirmation interest for the period between confirmation of the first plan and filing of the second case. The district court affirmed as to post-confirmation interest, and reversed as to the period between commencement of the first case and confirmation of the first plan. The Seventh Circuit affirmed.
>
> Held, as to the period between confirmation of the first plan and filing of the second case, the bankruptcy court appropriately interpreted the first plan as implicitly providing interest to the FCC.
>
>> To cram down a plan as to a secured creditor, interest is necessary when payments are made over time.
>>
>> When the first plan was confirmed, the FCC was treated as an unsecured creditor and no interest was awarded. *NextWave* made it clear that, in fact, the FCC was a secured creditor, and the bankruptcy court in this case found that interest was "implicit" in the first plan.
>>
>> Now the question is whether the bankruptcy court merely interpreted the plan, or actually modified it. The answer is important because interpretations can only be overturned for abuse of discretion, but a plan cannot be modified after substantial consummation.
>>
>> On the facts, the bankruptcy court was interpreting the plan, which had left several important issues unresolved pending later determination.
>>
>> The FCC was not precluded by res judicata from now litigating the issue of its right to interest, rather than having appealed confirmation of the first plan. Under Seventh Circuit precedent, *In re Escobedo*, 28 F.3d 34 (7th Cir. 1994), res judicata does not apply to prevent a party's efforts to bring a confirmed plan into conformity with *mandatory* statutory provisions.
>
> Held, as to the period after commencement of the first case and before confirmation of the plan, the FCC was entitled to interest as an oversecured creditor and did not waive its right to bring the claim.
>
>> Under § 506(b) an oversecured creditor (as the FCC was) is entitled to post-petition, preconfirmation interest. The bankruptcy court found this portion of the FCC's claim untimely, and the district court reversed.

Debtor and TDS argued that the FCC waived this claim by not requesting interest before confirmation, objecting to an allowance order not awarding interest, or otherwise raising the issue before commencement of the second case.

Usually, failure to object to a plan provision or to appeal an order of confirmation constitutes waiver. Here, however, the first case was closed only because the parties agreed to preserve the earlier claims as part of the second case. It would be illogical to hold that the FCC had to assert its claim to interest under § 506(b) before confirmation of the first plan, in order to avoid waiver, because no one was sure at that time whether the FCC was a secured creditor.

General Electric Capital Corp. v. Future Media Productions, Inc., 536 F.3d 969 (9th Cir. 2008):

The loan agreement between Debtor and GECC provided for a default interest rate 2 points higher than the nondefault rate, and gave GECC a security interest in substantially all of Debtor's assets as well as a right to recover attorneys' fees. Debtor defaulted approximately a year before filing Chapter 11. After filing, Debtor entered into an agreement to sell its assets outside a plan, in an auction that would produce proceeds in excess of the amount it owed GECC. The Committee objected to payment of interest at the default rate. The bankruptcy court held GECC entitled only to the nondefault rate.

Held, nothing in the Code prevents an oversecured creditor from recovering interest at the default rate, pursuant to its prepetition contract with the debtor, when the debtor is not curing prepetition default by payments under a plan, but is paying the creditor's claim from the proceeds of sale of the creditor's collateral.

The bankruptcy court relied on *In re Entz-White Lumber & Supply, Inc*., 850 F.2d 1338 (9th Cir. 1988), which held that an oversecured creditor is not entitled to interest at the default rate when its claim is paid in full pursuant to a plan. Extension of that case to an asset sale outside a plan, however, was error.

The decision in *Travelers Casualty & Surety Co. v. Pacific Gas & Electric Co*., 549 U.S. 443 (2007), requires that the default rate be enforced unless something in the Code provides otherwise.

Entz-White identified § 1124(2)(A) as such a provision. Since it allows cure of default, it authorizes a plan to nullify all consequences of default, including a higher interest rate.

Here, there was no question whether Debtor needed to cure a default to render the creditor unimpaired for purposes of voting on a plan. Rather, this case involved a sale of assets under § 363, outside a plan.

On remand the bankruptcy court should apply the rule used by a majority of courts, including the Fifth Circuit, *In re Laymon*, 958 F.2d 72 (5th Cir.), *cert. denied*, 506 U.S. 917 (1992), and the Seventh Circuit, *In re Terry Ltd. Partnership*, 27 F.3d 241 (7th Cir. 1994)—namely, that a default rate is presumptively allowable as long as it is enforceable under applicable nonbankruptcy law.

General Electric Credit Equities, Inc. v. Brice Road Developments, LLC (In re Brice Road Developments, LLC)**,** 392 B.R. 274 (B.A.P. 6th Cir. 2008):

Debtor owned a partially completed apartment complex on which Creditor held the note and mortgage. Creditor's claim was $16.5 million and its interest in the property was valued at $10.2 million. Creditor elected under § 1111(b)(2) to have its claim treated as fully secured. Debtor's plan proposed to pay 6% interest on the claim, under the cramdown provisions of § 1129(b), although the contract rate was 7.75%. The claim was to be paid over a 40-year amortization, with a balloon payment of principal and interest in 2043. Creditor objected, and appealed the order of confirmation.

Held, the bankruptcy court did not err in assigning a 6% interest rate because that is within the range of rates in an efficient market for a first mortgage on multi-family real estate with a long useful life, of a size similar to this loan.

Creditor argued that a market rate must be based on terms similar to those proposed by the plan, including the debtor's particular risk profile.

The rule in the Sixth Circuit is that a market rate is applied when an efficient market exists, and the formula approach of *Till v. SCS Credit Corp.*, 541 U.S. 465 (2004), is used when an efficient market does not exist, *Bank of Montreal v. Official Committee of Unsecured Creditors (In re American HomePatient, Inc.)*, 420 F.3d 559 (6th Cir. 2005).

Creditor's expert testified that the only available financing for Debtor would be tiered financing with a blended rate of 8%, but a similar approach was rejected in *American HomePatient*. Thus, the bankruptcy court's finding was not clearly erroneous.

Held, the bankruptcy court did not err in its valuation of the property.

The income approach is appropriate, as both sides agreed. The bankruptcy court started there, and deducted various costs.

Creditor argued that the bankruptcy court did not give sufficient weight to an arms-length offer of $13.1 million for the property, but the court did consider it. The court's conclusion was not clearly erroneous.

Held, the plan did not accord Creditor its rights under § 1111(b).

Creditor argued that the plan was not fair and equitable, as required by § 1129(b)(1), because it did not recognized Creditor's rights under § 1111(b)

In order to comply with the cramdown requirements of § 1129(b)(2)(A)(i)(I), an electing creditor must (1) retain a lien equal to the total amount of its claim ($16.5 million), and receive a stream of payments with (2) a present value equal to its interest in the collateral ($10.2 million) and (3) a face amount equal to the total amount of its claim ($16.5 million).

The third requirement was problematic—that the deferred cash payments will total $16.5 million.

> Under the plan's amortization schedule, payments to Creditor will total that amount only in the 24th of its 36-year term.
>
> Plan proponents argued that the payments would total that amount even if Debtor cashed out Creditor early, because Debtor would have to pay a "§ 1111(b) premium"—*i.e.*, the difference between Creditor's total allowed claim and the outstanding principal balance remaining due, plus payments made to the present.
>
> > But no such premium obligation was evidenced either in the plan or the note.
> >
> > To insure that Creditor will receive payments totaling its allowed claim, and that the lien will remain in place until it does so, the note must be restructured in two ways—
> >
> > > to specifically provide for a § 1111(b) premium; and
> > >
> > > to provide a face amount in the amount of the allowed claim ($16.5 million), but with a below-market interest rate such that the note's present value will still only be the present value of the collateral ($10.2 million).

Claims—Subordination

In re Kreisler, 546 F.3d 863 (7th Cir. 2008):

Two individual real estate developers owned an interest in property that was subject to several mortgages, including a junior lien held by Bank. Debtors filed separate Chapter 7 cases, which were jointly administered. Debtors then formed New Corp., which purchased Bank's claim at a steep discount. When New Corp. moved for payment of the secured claim, the bankruptcy court discovered the relationship between New Corp. and Debtors. The court equitably subordinated New Corp.'s claim because of purposeful noncompliance with Rule 3001(e)(2) and because the conduct was inequitable in nature when analyzed under the heightened level of scrutiny applicable to insiders. The estates' assets were insufficient to pay unsecured creditors, so New Corp. received nothing. The district court affirmed based on New Corp.'s noncompliance with Rule 3001(e)(2)..

Held, when other creditors are not harmed, despite the underhanded quality of a debtor's conduct, equitable subordination is not appropriate under *Mobile Steel*.

Equitable subordination is a judge-made doctrine, incorporated into the Code by § 510(c).

Under *Benjamin v. Diamond (In re Mobile Steel Co.*), 563 F.2d 692, 700 (5th Cir. 1977), equitable subordination requires that the claimant engaged in some type of inequitable conduct, that the misconduct injured other creditors or conferred an unfair advantage on the claimant, and that subordination not be inconsistent with the Code.

Since there was no evidence that Debtors' scheme harmed their other creditors, exploration of the other two factors was unnecessary.

The only affected creditor was Bank, but Bank voluntarily sold its claim at a steep discount. Other creditors would be in the same position regardless of who asserted the junior lien.

Although New Corp. failed to comply with Rule 3001(e)(2), that violation did not harm other creditors. The Rule is designed to enable a seller to object before a claim is irrevocably deemed transferred, but the creditor protected by the Rule—Bank—had not objected.

In re NationsRent, Inc., 381 B.R. 83 (Bankr. D. Del. 2008):

Debtors' plan created a trust, funded with $19.37 million, for the benefit of holders of general unsecured claims (totaling $431,653,000). The Trust sought authority to make an initial distribution of $19 million, which would constitute a dividend of 4.4%. Several parties who were beneficiaries of the Trust were competing for the limited funds: (1) parties holding senior notes, aggregating $225 million, that Debtors issued prebankruptcy; (2) parties who had sold their companies to Debtors in exchange for cash, promissory notes, Debtors' stock, and deferred purchase price consideration (the "make-whole amount") to be based on the value of Debtors' common stock three years after the acquisition; and (3) the assignee of claims previously held by secured lenders that had been restated as a result of settlement agreements. The issue was whether the notes were subordinated to the assigned claims and/or the make-whole amounts.

Held, the make-whole claims were not subject to subordination, either under the indenture's subordination provisions or under the Code.

Sellers argued that the make-whole amounts were senior debt under the indenture, thus triggering the indenture's subordination provisions giving the make-whole amounts priority. But the indenture precluded shareholders from subordinating the senior notes, and sellers with make-whole amounts were shareholders.

The Trust argued that the make-whole amounts were themselves subordinated to the sellers' notes, relying on § 510(b). The make-whole amounts, however, were not damages arising from fraud, a securities violation or an obligation the debtor undertook in connection with the issuance of stock.

Held, the make-whole claims were senior to the promissory notes given to transferors in Debtor's prepetition mergers, under language in the notes. Thus, the Trustee must provide for payment in full of the make-whole amounts before payment on the sellers' notes.

Held, the assignee held only nonpriority, general unsecured claims.

The original lenders held PMSIs in Debtors' equipment.

But the assigned claims resulted from the settlement agreements, rather than from the prepetition financing, and those agreements created new rights and obligations. Under the agreements, deficiency claims became general unsecured claims.

In re Touch America Holdings, Inc., 381 B.R. 96 (Bankr. D. Del. 2008):

Debtors' former officers and directors filed proofs of claim in Debtor's liquidating Chapter 11, seeking reimbursement, indemnification, and contribution for civil actions brought against them. Trustee sought summary judgment subordinating the indemnification claims under § 510(b), arguing that they were ERISA claims by employees that arose from the purchase or sale of securities, because the employees sought damages resulting from a reduction in the value of their stock. He also argued that the reimbursement claims should be denied under § 502(e)(1)(B) because they were contingent claims of a co-debtor.

Held, indemnification claims of a debtor's former officers and directors, for liability and costs associated with an ERISA action, were based on the purchase or sale of securities within § 510(b) and were appropriately subordinated.

Claimants argued that the ERISA litigation was based on their alleged breach of fiduciary duties, rather than on the purchase or sale of securities within § 510(b)—that is, that the ERISA plaintiffs were suing as plan participants and not as shareholders.

But § 510(b) is not limited to shareholder claims.

"Purchase" is broad enough to encompass claims that officers and directors breached their fiduciary duties by using stock in Debtors' subsidiary as a matching employer contribution.

Also, the phrase "arising from" suggests that injury need not directly result from the purchase of the security, as long as there is a nexus between the claim and the sale of a security.

Thus, § 510(b) is broad enough to cover ERISA litigation.

ERISA plaintiffs took on the risk and return expectations of shareholders by participating in the plan.

Although the complaint sought damages for breach of fiduciary duty, the underlying allegations centered around the defendants' continued use of the particular stock as a matching contribution despite their knowledge that it was a high risk investment that was steadily declining in value.

Held, reimbursement claims of a debtor's former officers and directors were contingent claims that should be denied under § 502(e)(1)(B).

Claims are disallowed under § 502(e)(1)(B) if: (1) they are contingent; (2) they are for reimbursement or contribution; and (3) the debtor and claimant are co-liable.

These requirements were clearly met.

The parties did not contest whether the claims were for reimbursement or contribution.

Indemnification claims are generally contingent, and the claimants presented no evidence showing that the claims were not "typical" indemnification claims.

Finally, all of the defendants—including Debtor, but for the automatic stay—were co-liable in the underlying litigation for which the officers and directors were seeking reimbursement.

Claims—Tax

Central Valley AG Enterprises v. U.S., 531 F.3d 750 (9th Cir. 2008):

Because Debtor's wholly owned subsidiary had a 98% partnership share in a partnership, Debtor was an indirect partner within the Tax Equity and Fiscal Responsibility Act of 1982. The partnership reported heavy tax losses to the IRS, which were passed through the subsidiary and claimed by Debtor. The IRS later disallowed the partnership's losses, which left Debtor with a tax deficiency. Debtor and another partner protested the tax adjustments, but attempts to reach a settlement with the IRS Appeals Office were unsuccessful. The IRS Appeals Office sustained the tax adjustments and sent both parties the Final Partnership Administrative Adjustment (FPAA). Although TEFRA gives parties 150 days to challenge the FPAA, neither party did so. Debtor filed bankruptcy 250 days after receiving the FPAA. The IRS filed an unsecured priority claim for $13.1 million. On the government's motion, the district court withdrew the reference and then held that the opportunity for court review under TEFRA brought the IRS's adjustment determinations within the statutory res judicata provision of § 505(a)(2)(A).

Held, § 505(a) gives a bankruptcy court broad jurisdiction to determine "any tax," subject to the limitation of § 505(a)(2) that the tax has not been contested and adjudicated before bankruptcy was filed.

> Section 505(a) is a statutory embodiment of traditional res judicata principles.
>
> > If a tax claim has been litigated to final judgment before bankruptcy, the bankruptcy court lacks jurisdiction to consider the claim.
> >
> > Otherwise, the court has jurisdiction notwithstanding a default judgment or a taxpayer's failure to pursue remedies available under tax law.
> >
> > One purpose of § 505 was to protect debtors from being bound by prebankruptcy tax liability determinations that they lack financial resources to contest.
>
> Before TEFRA, treatment of partnership items at the individual partner level presented no obstacle to bankruptcy court jurisdiction under § 505.
>
> > The only question was the extent to which bankruptcy courts could determine the tax liability of nondebtor partners along with that of the debtor-partner, and courts held that jurisdiction was not available to do so.
> >
> > Enactment of TEFRA did not change this, but it did subject the tax court case to the automatic stay because all partners are deemed parties. Thus, IRS regs were issued to sever the debtor-partner, resulting in two separate proceedings— one in bankruptcy court involving the debtor-partner, and another in tax court as to the remaining partners.

Held, a debtor's failure to challenge the FPAA within the 150 days permitted by TEFRA did not give the FPAA preclusive effect.

> The FPAA did not become final when the TEFRA appeals period expired because that did not satisfy § 505(a)(2)(A)'s requirement that a tax matter be "contested before and adjudicated by a judicial or administrative tribunal."
>
> The FPAA was a final decision under TEFRA, but not for purposes of § 505(a)(2).

Claims—Unsecured

Re-Gen Capital I, Inc. v. Halperin (In re U.S. Wireless Data, Inc.), 547 F.3d 484 (2d Cir. 2008):

> Debtor was in the business of providing wireless transaction delivery and gateway services to the payments processing industry. It filed Chapter 11 in order to maximize the value of its assets through sales under § 363. Debtor proposed the assumption of its contract with Creditor, and listed the cost of cure as $11,406. The court set a bar date for "cure claims," § 365(b)(1)(A). Creditor missed the bar and filed a general unsecured claim for $71,282. The bankruptcy court expunged the claim and the district court affirmed.
>
> Held, a creditor who fails to assert a timely claim for cure of an executory contract that the debtor assumes under § 365 may not later assert a general unsecured claim.
>
>> To hold otherwise would undermine a debtor's ability to assert its rights under § 365, since it must be able to project the costs of contract assumption.
>>
>> Creditor argued that this result violated the "best interests of creditors" test, § 1129(a)(7)(A), because it allowed Debtor's shareholders to recover a portion of the estate while Creditor, the holder of an unsecured claim, remained partially unpaid. But the claim Creditor attempted to assert was satisfied, by payment of the cure cost as computed by Debtor, months before confirmation of the plan.
>>
>> It is irrelevant that the asset sale proved lucrative enough for Debtor to pay its creditors through the reorganization plan and still make some distribution to shareholders, because Creditor had no claim for prepetition arrearages at the time of plan confirmation.

Claims—Wage and Benefit

In re Tusa-Expo Holdings, Inc., 2008 Bankr. LEXIS 2852 (Bankr. N.D. Tex. 2008):

> Debtors' business—selling and distributing office furniture—was labor intensive. Debtors moved, without opposition, for authority to pay various prepetition employee obligations—wages, health insurance, workers' compensation, and accrued sick leave and holiday pay. All of these amounts were within the limits of §§ 507(a)(4) and (a)(5), and Debtors were unlikely to be able to reorganize successfully if they lost a significant number of employees.
>
> Held, a Chapter 11 debtor is authorized to pay priority prepetition employee wage and benefit claims, outside of a plan, when the debtor's business is labor-intensive and no alternative method of dealing with the employees is likely to avoid their mass exodus, to the detriment of the reorganization.

Courts considering whether a debtor may pay prepetition claims outside of a plan are primarily concerned that similarly-situated creditors be treated alike.

> But employees are not like other unsecured creditors, because of the priority granted by §§ 507(a)(4) and (a)(5).
>
> Payment of these claims in advance of those with lesser status does not diminish the debtor's estate to the detriment of creditors with general unsecured claims.
>
> Only Debtors' secured lender would be potentially disadvantaged by payment of priority employee claims.

Even if the employees' prepetition claims were not entitled to priority, they meet the test for payment set out in *In re CoServ, L.L.C.,* 273 B.R. 487 (Bankr. N.D. Tex. 2002).

> (1) Debtors' employees are creditors whose retention is necessary.
>
> (2) Unless Debtors deal with these claims, there is a risk of loss of economic value. Without competent personnel a debtor cannot operate its business, and continuity is critical in a newly-filed reorganization proceeding.
>
> (3) There is no alternative method of dealing with the claimants since, from an employee's perspective, nothing substitutes for current satisfaction of compensation and benefit claims.

Claims—WARN Act

International Union, United Automobile, Aerospace & Agricultural Implement Workers v. MRC Industrial Group, Inc., 541 F. Supp. 2d 902 (E.D. Mich. 2008):

Creditors of MRC, a manufacturer of component parts, filed an involuntary bankruptcy petition under Chapter 11. A group of Debtor's customers, after learning that Debtor would have to cease production if funding could not be obtained, entered into an agreement under which they would provide post-petition financing in exchange for being allowed to continue production at Debtor's plant until they completed their production requirements. When those requirements were met, MRC closed its plant without giving WARN Act notice to the employees. The Union brought suit against Debtor, its secured lender, and the customers. The customers moved for summary judgment on the grounds that they were not employers for purposes of the Act and, even if they were, two exceptions were applicable—the unforeseeable business circumstances exception and the good faith exception. The court denied the motion.

Held, the customers' actions exceeded conduct to protect an investment and was more like that of an employer running its assembly lines.

Movants did not hire the workers, but a creditor can become so entangled with its borrower that it has assumed overall management of the business.

The evidence, viewed in the light most favorable to plaintiffs, suggested that Movants, through a manager they hired, did more than merely monitor, understand, and report. They dictated who the company could keep as customers, created production schedules, supervised production, and authorized overtime on holidays.

Movants argued that their conduct was protected by the bankruptcy proceedings, and that finding otherwise would hurt troubled companies and employees who were able to earn more wages. Nothing in bankruptcy, however, absolves WARN Act liability.

Held, WARN Act exceptions were not applicable.

The unforeseeable business circumstances exception is decided on a case-by-case basis, but generally looks for events that were sudden, dramatic, and unexpected.

MRC closed when an anticipated sale of the business fell through, but MRC was simultaneously making plans to wind down the business.

Pitfalls associated with the sale were neither hidden nor imagined, and the fact that the sale did not occur cannot be characterized, as a matter of law, as unforeseen, unexpected, or sudden.

The good faith exception applies when an employer had reasonable grounds for believing that its act or omission was not a violation of the statute.

Movants argued that they kept the parties informed of the sale process and that no employee suffered an actual injury.

Movants presented no evidence that they consulted an attorney about WARN Act obligations, gave notice to any employees, or even considered whether they had an obligation to give notice. Rather, the facts showed that Debtor and Movants believed that giving WARN Act notice would cause employees to leave "and/or be unruly." Movants had a financial interest in keeping the employees working until the plant closed, and they were worried that notice would make the employees want to leave. That is the purpose of the WARN Act, however—to give employees a chance to leave on their own terms.

In re First Magnus Financial Corp., 390 B.R. 667 (Bankr. D. Ariz. 2008):

Debtor laid off employees without giving them 60 days' notice as required by the WARN Act, which gave the employees a claim for the equivalent of 60 days' wages.

Less than 60 days later, Debtor filed Chapter 11. The employees sought administrative expense priority pursuant to § 503(b)(1)(A) for the post-petition portion of their claims, totaling nearly $2 million.

Held, § 503(b)(1)(A)(ii), when interpreted in conjunction with the immediately preceding subsection, requires that employees asserting an administrative expense claim be actually employed post-petition.

> Before passage of the 2005 Amendments, prepetition WARN Act claims were treated as wages, rather than as a penalty, and given priority under § 507(a)(4) up to the statutory cap, with any excess treated as an unsecured claim.
>
> The language of § 503(b)(1)(A), as amended by the addition of subsection (ii) in 2005, clearly applies only to persons employed post-petition.
>
> > Subsection (i) and (ii) are joined by the conjunction "and," which suggests that both subsections must be satisfied.
> >
> > Here, the only post-petition attribute of the WARN Act claims is mathematical.

Held, § 503(b)(1)(A)(ii) contemplates an award entered by a federal court of general jurisdiction, not a bankruptcy court.

> Subsection (ii) requires that wages and benefits have been awarded in a judicial or NLRB proceeding, but no such award has been made.
>
> The WARN Act's provision of a civil action in federal district court contemplates a federal court of *general* jurisdiction. It does not contemplate a bankruptcy court, which has *limited* jurisdiction to adjudicate existing claims but not to award them in the first instance.
>
> To hold otherwise would conflict with the priority scheme set out in § 507(a).
>
> > Subsection (4) provides a cushion for certain wages, but this priority is subordinated to administrative expenses.
> >
> > Subsection (2) gives a priority for administrative expenses, which are for services related to preserving the estate. WARN Act claims for employees terminated prepetition can never be expenses of preserving an estate, since an estate is not created until bankruptcy is filed and the WARN Act claim is rooted entirely in prepetition conduct.
> >
> > Nothing suggests that Congress wanted to give employees terminated prepetition a "double-dip," getting a priority for both prepetition wages as well as for WARN Act damages that, only because of the timing of bankruptcy filing, carry into the post-petition period.

Fairness to employees is provided in two ways:

If they were not employed on or after the date of filing, they have a fourth level priority for certain wages, plus a general unsecured claim for WARN Act damages in excess of the cap; and

If they were employed post-petition, they have an administrative expense claim for their post-petition wages, plus additional WARN Act damages.

In re Powermate Holding Corp., 394 B.R. 765 (Bankr. D. Del. 2008):

Immediately before filing a voluntary Chapter 11 proceeding, Debtors discharged all of their employees without notice. One of them sued under the WARN Act on behalf of himself and other former employees, asserting administrative expense status for their damages claims. Debtors argued that if any WARN Act damages were owed (a matter under dispute), those claims should have fourth or fifth priority under §§ 507(a)(4) or (a)(5), rather than administrative expense status.

Held, any damages the former employees may recover under the WARN Act are not entitled to administrative expense priority; rather, they are entitled to fourth or fifth priority to the extent of the statutory cap, with the excess to be treated as general unsecured claims.

Of the nine types of claims entitled to administrative expense status, the most pertinent is found in § 503(b)(1)(A)(ii), which was added by the 2005 Amendments.

The only case that has considered how this new section relates to the WARN Act, *In re First Magnus Fin. Corp*., 390 B.R. 7667 (Bankr. D. Ariz. 2008), held that the conjunction "and" between §§ 503(b)(1)(A)(i) and (ii) effectively mandates that both subsections be satisfied before a claim may qualify as an administrative expense.

An alternative reading relies on the word "including," which appears before (i). Under this reading, (i) and (ii) are categories within a particular subset of allowable administrative expenses—namely, "actual, necessary costs and expenses of preserving the estate." Thus, the question is whether the new subsection independently gives administrative status to WARN Act claims.

Subsection (b)(1)(A)(ii) seems to be unclear because it describes two different times—the period to which back pay is *attributable* and the time of *occurrence* of the unlawful conduct. In addition, priority depends on whether these two times correspond with the timing of bankruptcy filing.

But closer reading reveals that the only relevant consideration is the time to which the back pay is attributable—which is when the claims vest or accrue—and how that relates to the petition date.

> If a claims vests prepetition, the back pay is attributable to the prepetition period and it is not an administrative expense. If a claim vests post-petition, the back pay is attributable to the post-petition period and it is an administrative expense. When the unlawful conduct occurred is irrelevant.

WARN Act damages are a statutory form of severance pay, akin to payment at termination in lieu of notice. Thus, WARN Act rights accrue upon termination. Because these employees were terminated prepetition, their claims are not entitled to administrative expense status.

Another reason for so holding is the lack of any indication that Congress intended to change prior law, under which WARN Act damages based on prepetition terminations only received fourth or fifth priority, in a way that would drastically cripple debtors' efforts to reorganize or liquidate equitably. If Congress intended such a monumental shift, there would be substantial legislative history to that effect.

Dismissal and Conversion

In re Products International Co., 395 B.R. 101 (Bankr. D. Ariz. 2008):

Debtor was a family-owned company that made medical identification bands. Debtor's controlling shareholder, who was president and manager, admitted transferring over $700,000 of Debtor's funds to another company he and his wife owned. He also admitted improper transfers of $120,000 of Debtor's funds to himself and his wife. Debtor failed to pay employee withholding and corporate taxes, and the IRS instituted a prepetition levy for over $500,000. After Debtor filed a voluntary Chapter 11, its minority shareholder filed numerous pleadings that opposed virtually every move Debtor sought to make. Debtor filed a motion to dismiss under § 1112(b), asserting as cause the continuing loss or diminution of the estate.

Held, dismissal under § 1112(b)(4)(A), for continuing loss or diminution of the estate, is not appropriate when a debtor company is profitable because an additional requirement is that rehabilitation be unlikely.

Debtor argued that it filed bankruptcy in order to resolve its tax liability, but its discussions with the IRS enabled it to do so outside of bankruptcy, thereby avoiding the costs and expenses of formulating and confirming a plan.

Although § 1112(b)(1), post-2005, is confusingly worded, it has been interpreted to require courts to consider three alternatives, upon the showing of cause—dismissal, conversion, or appointment of a trustee.

Before the 2005 Amendments, courts had discretion in deciding whether to dismiss or convert once cause was shown. Now, discretion is limited.

A party opposing relief is only allowed to show "unusual circumstances," but the Code does not define the phrase.

Courts do have significant discretion in determining whether unusual circumstances have been shown.

Also, "unusual circumstances" only modifies whether a case should be dismissed or converted, not whether a trustee should be appointed. That allows a court to appoint a trustee more readily than to dismiss or convert.

Subsection 1112(b)(4)(A) speaks of substantial or continuing loss *and* that rehabilitation be unlikely. Debtor failed to establish the latter, given that its figures show a company making a profit.

Held, gross mismanagement of the estate is cause for dismissal, conversion or appointment of a trustee, and appointment of a trustee was in the best interests of the creditors and the estate.

Mismanagement is cause for dismissal, conversion or other action, under § 1112(b)(4)(B).

Failure to maintain an effective management team constitutes gross mismanagement, and it was clear that Debtor's owners had an acrimonious relationship.

Inappropriate transfers by Debtor's president, and a failure to pay taxes, were also clear examples of mismanagement.

Appointment of a trustee was in the best interests of the creditors and the estate.

Debtor's majority shareholder, and president, had engaged in self-dealing, egregiously violating his fiduciary duties, and the minority shareholder had not shown himself to have the necessary business experience to run Debtor. Also, the parties were engaged in internecine warfare, leaving no one at Debtor's helm.

If the case were dismissed, the owners would continue to fight, dissipating Debtor's assets. If the case were converted, Debtor's viable operations would be destroyed.

Even though unusual circumstances may have been present, which would dictate that the case be neither dismissed nor converted, preservation of the status quo was untenable.

This Debtor needed to be allowed to operate, under court control. Appointment of a trustee would allow Debtor to recover prepetition transfers and focus on a plan of reorganization that would pay tax obligations.

In re Orbit Petroleum, Inc., 395 B.R. 145 (Bankr. D.N.M. 2008):

A motion to dismiss or convert Debtor's Chapter 11 case was brought. The court found cause under § 1112(b), because Debtor was losing money and its plan did not propose rehabilitation and continued operation. Rather, the plan proposed recapitalization in order to pay existing creditors in full, cancellation of all shares, and reversion of remaining assets to its parent company.

Held, unusual circumstances sufficient to permit a bankruptcy court to deny a motion to convert or dismiss are found in the prospect of full payment to creditors, despite the presence of "cause" for dismissal or conversion.

The 2005 Amendments to § 1112(b) restricted a bankruptcy court's discretion to deny a request to dismiss or convert, but did not entirely remove it.

Once "cause" is found, the court must convert or dismiss in the absence of "unusual circumstances." The Code does not define that phrase, but the focus is on whether the purposes of Chapter 11 are better served by maintaining the case.

A full-payout plan is such an unusual circumstance.

Equitable Liens

Barnhill's Buffets, Inc. v. SCS General Contractors, Inc. (In re Barnhill's Buffets, Inc.), 397 B.R. 51 (Bankr. M.D. Tenn. 2008):

Debtor operated 29 buffet-style restaurants in six states with financing from Bank, which held a security interest in all assets other than Debtor's leaseholds. Debtor hired SCS to renovate several of its restaurants, but failed to make full payment. SCS filed suit, but its suit was stayed when Debtor filed Chapter 11. Bank also provided post-petition financing under an order giving it a super-priority lien in the leaseholds. The bankruptcy court approved sale of the restaurants over SCS's objection, with funds to be placed in escrow pending resolution of SCS's claims. Debtor's case was converted to Chapter 7. Debtor then sought declaratory relief against, *inter alia*, SCS and Bank. SCS counterclaimed, seeking to assert an equitable lien against Debtor's leasehold interests, now in the form of the escrowed funds. The bankruptcy court granted motions by Bank and the management company for summary judgment against SCS.

Held, even if an equitable lien arose prepetition, it was rendered irrelevant by the bankruptcy filing because § 544(a)(3) put the DIP in the position of a BFP without notice of the claim.

> The Sixth Circuit held in *In re Omegas*, 16 F.3d 1443 (6th Cir. 1994), that a creditor with an equitable lien recognized under state law does not necessarily get to retain it upon the filing of bankruptcy.
>
> *Omegas* is not distinguishable on the grounds that Debtor in this case had notice of SCS's claim at the time of filing, since § 544(a)(3) contemplates that a trustee has the knowledge that would be gleaned from an examination of title, and there was no lien on record.
>
> Thus, when the leaseholds were sold, Bank received the proceeds from Debtor, a hypothetical BFP, free of any equitable lien claimed by SCS.

Executory Contracts and Unexpired Leases

COR Route 5 Co. v. Penn Traffic Co. (In re Penn Traffic Co.), 524 F.3d 373 (2d Cir. 2008):

Debtor, a leading food retailer, needed contiguous land owned by Creditor in order to develop one of its locations into a modern supermarket. The parties entered into an agreement for the exchange of certain parcels, site preparation and construction, and a sale by Debtor to Creditor of the supermarket site, with lease-back. When Debtor filed Chapter 11, it had not yet conveyed the supermarket parcel to Creditor. Creditor had performed all of its obligations except for reimbursement of construction costs (approximate $3.5 million) and tender of a lease to Debtor. Creditor tendered both, in a letter sent post-petition. Debtor rejected the tender and moved to reject the agreement. Creditor argued that the contract was not executory, and the bankruptcy court agreed. Debtor appealed and the district court reversed. On remand, the bankruptcy court approved the rejection. Creditor appealed.

Held, the nondebtor party to a contract that was executory at the time of bankruptcy filing cannot, by post-petition tender of its own outstanding performance, deprive the debtor of its rights under § 365.

> The famous Countryman definition of an executory contract—one "under which the obligation of both the debtor and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing performance of the other"—governs the question.
>
> Executoriness is normally determined as of the petition date, and both sides had substantial unperformed obligations at that time.
>
> Some courts have looked to post-petition events such as expiration of a contract by its own terms or actions by the debtor that have affected the

existence of outstanding performance obligations. Here, however, the contract had not expired and Debtor had not taken any such actions.

The notion that a nondebtor's post-petition performance could prevent a debtor's exercise of its § 365 rights is inconsistent with the language and policy of the Bankruptcy Code.

The Code does not condition the debtor's rights under § 365 on lack of prejudice to the nondebtor, and satisfaction of claims at less than their nonbankruptcy value is common.

Bankruptcy policy gives a debtor power to reject in order to relieve the estate of burdensome obligations, no matter how onerous the dilemmas faced by the nondebtor pending the debtor's decision.

Giant Eagle, Inc. v. Phar-Mor, Inc., 528 F.3d 455 (6th Cir. 2008):

Debtor entered two 160-month leases for the use of warehouse equipment. Debtor filed Chapter 11 on 9/24/01 and continued using the equipment under 7/17/02. The next day, the court entered an order authorizing sale of substantially all of Debtor's assets. Debtor formally rejected the leases on 9/30/02, with 71 months remaining in the lease terms. On 10/31/02, Lessor mitigated by signing leases with New Lessee covering the same equipment at the same price, but running for 120 months. New Lessee filed bankruptcy and formally rejected the leases on 11/30/03. New Lessee paid overdue rent to November 2003 as administrative expenses, plus a 6% dividend on Lessor's unsecured claim. Lessor, unable to re-lease the equipment, reused some, sold some, and scrapped the rest. Lessor filed an administrative expense claim in Debtor's bankruptcy, calculated in accordance with liquidated damages clauses, for the period post-filing and prerejection. Lessor also claimed liquidated damages for monthly lease payments due for the term remaining post-rejection, less amounts received through mitigation (from New Lessee and sale/salvage of the equipment).

Debtor agreed that Lessor was entitled to administrative expenses for 9/24/01 – 7/17/02, but objected to the claim for 7/18/02 – 9/30/02 on the grounds that it was then using the equipment for Lessor's benefit, to inventory merchandise ultimately sold to Lessor. Debtor also agreed that Lessor was entitled to liquidated damages from 9/30/02 – 10/31/02, but objected to claims after Lessor's agreement with New Lessee.

Held, a lessor's attempt to mitigate damages for breach of a lease of personal property, by entering a substitute lease, does not diminish the debtor's obligation as original lessee to pay unmitigated post-rejection damages to the lessor, as a general unsecured claim.

The bankruptcy court held to the contrary, concluding that a debtor's lease obligations cannot be revived after they are mitigated and supplanted by a new lease. The court predicted four dire consequences otherwise:

(1) It would force a debtor to "wait anxiously" for the duration of the original lease term, because the debtor might owe damages if the mitigating lease were to fail.

This is a good argument for shortening the statute of limitations, but that argument should be addressed to the state legislature.

Everything in the case happened within the four-year statute of limitations. Lessor's claim had not been decided when New Lessee breached, but even if it had, § 502(j) permits reconsideration of a claim for cause.

(2) It would force a lessor to sue the original lessee, even after mitigation, to protect itself from the chance of failure of the mitigating lease and from expiration of the statute of limitations. Again, this is an irrelevant argument addressing the statute of limitations, but now in favor of extending it.

(3) It would make a breaching lessee a guarantor of, or co-debtor with, the mitigating lessee

That is simply incorrect. Debtor, who became liable upon breach, is not any less liable just because Lessor partially mitigated.

Debtor remained just as liable, albeit for a lesser amount.

(4) It would put the lessor in a better position than under the original lease, by allowing recovery from both the original and the mitigating lease. But the lessor can recover no more than its damages, no matter how many parties it seeks to recover from

Debtor argued that Lessor should have to "suffer the consequences" of its effort to mitigate, but the court was unpersuaded: "It is difficult to do much with this contention, other than express dismay. Let us be very clear: there is no proposition in law or equity that an injured party who attempts to mitigate the damage that results from another party's misconduct must 'suffer the consequences' of its attempting to mitigate."

Held, § 365(d)(5) plainly requires a debtor to pay until rejection, and there was no basis "in equity" for finding that Debtor did not owe rent for the period from 7/18 – 9/30, given that Debtor indisputably benefited, at least a little, from use of the equipment during this time.

In re Buffets Holdings, Inc., 387 B.R. 115 (Bankr. D. Del. 2008):

Debtors comprised the nation's largest steak-buffet restaurant chain. Several years before filing Chapter 11, they sought to recapitalize and remove secured debt from their balance sheets. They sold 29 restaurant buildings they owned, which were sitting on land they did not own, assigned the ground leases and leased them back pursuant to four master leases. After filing bankruptcy, Debtors moved to assume one lease and reject three others, all of which were in different states. Lessor objected on the grounds that the leases were integrated into master leases that had to be assumed or rejected *in toto*.

Held, because the leases Debtor sought to assume or reject were part of master leases, they could not be dealt with individually.

> Whether a specific lease is an indivisible agreement is determined by state law, which looks to the parties' intent.
>
> The two master leases at issue here covered ten and eleven properties, in four and eight states respectively.
>
>> Each property was operated independently and provides financial reports separately. Rent was paid in a lump sum, but allocated among the underlying restaurants. Debtors argued that rental allocation was critical in mandating a finding that the master leases were separable, but this factor was not conclusive.
>>
>> Debtors also pointed to other factors: Lessor could divide and consolidate individual leases and create new master leases; Lessor had the right to sell individual properties, thereby severing them from the master lease; and individual leases could be substituted for another. The fact that master leases could be severed does not show that the parties intended them to be separate agreements; rather, it shows the opposite.
>>
>> Other factors also pointed to indivisibility: the rental obligation was joint and severable; rent remained due even if Debtors were unable to use one or more properties; upon expiration, master leases could only be extended if all the ground leases were extended; and upon default of an individual lease, Lessor had the right to declare the entire master lease in default.
>
> The individual leases were economically interdependent. They were originally independent agreements, but became consolidated upon execution of the master leases.
>
> The fact that nonseverability would make reorganization more difficult was irrelevant. Nothing in bankruptcy policy requires severance of a lease merely because it makes reorganization more feasible.
>
> The parties' course of dealing also indicated that the leases were intended to be indivisible. Lessor insisted on the master lease structure and Debtors agreed to it in order to obtain favorable terms.

Fiduciary Duties

Hedback v. Tenney (In re Security Asset Capital Corp.), 396 B.R. 35 (Bankr. D. Minn. 2008):

> Debtor had been in the business of managing debt receivable portfolios. The corporation's officers and directors continued operations after the sudden death of Debtor's CEO and board chairman, using proceeds of a key person life insurance policy to pay consulting fees and compensation to themselves. After the SEC brought suit for violations of securities laws, Debtor filed a Chapter 11 petition. Trustee sued Debtor's prepetition officers and directors, alleging, *inter alia*, breach of fiduciary duties.
>
> Held, officers and directors of a corporation have no fiduciary duty to file Chapter 7 proceedings as soon as the corporation becomes insolvent.
>
>> Once a corporation is in the "zone of insolvency," fiduciary duties owed by officers and directors expand to include creditors as well as shareholders.
>>
>>> Nevertheless, those duties are still owed to the corporation and not to any specific group of beneficiaries.
>>>
>>> Thus, officers and directors of an insolvent corporation are not obligated to liquidate the company for the benefit of unsecured creditors. Rather, they can pursue risky restructuring efforts in a good faith attempt to regain solvency.
>>>
>>> The business judgment rule's protection is not lost in insolvency.
>>
>> Trustee's theory is that Defendants kept a hopelessly insolvent company operating in order to enrich themselves with life insurance proceeds and to use corporate assets to defend against the SEC action potentially targeted against them personally.
>>
>>> But the evidence on the whole showed that Defendants operated Debtor responsibly, seeking and relying on the advice of counsel.
>>>
>>> Nothing showed that Defendants' compensation was inappropriate.
>>
>> The driving force behind Trustee's action—the premise that Defendants owed a fiduciary duty exclusively to the insolvent debtor's unsecured creditors—is not the law.

Bridgeport Holdings, Inc. v. Boyer (In re Bridgeport Holdings, Inc.), 388 B.R. 548 (Bankr. D. Del. 2008):

> Debtors, who traded as "Micro Warehouse," encountered severe financial problems when the dot-com bubble burst a year after an LBO. Debtors' officers and directors

the "D&O Defendants") were slow to react and did nothing until Debtors were in default on EBITDA covenants and key vendors began to restrict lines of credit. The D&O Defendants ignored calls by secured lenders for retention of a turnaround specialist and, meanwhile, decided that sale of the company was best. Rather than commence a competitive bidding process, they contacted an acquaintance of one of the Defendants, who was the CEO of CDW, to explore a possible sale. A turnaround specialist was finally hired, shortly before closing of the sale to CDW. He decided to sell the assets within 72 hours of commencing work. Sale was consummated quickly, without giving other possible buyers a chance, and for $25 million—much less than Debtors' value. The liquidating trust brought an adversary proceeding against the D&O Defendants and the turnaround specialist, alleging they breached fiduciary duties. The trust also alleged that the D&O Defendants abdicated crucial decisionmaking authority to the turnaround specialist, and failed to engage in adequate supervision. Defendants moved to dismiss.

Held, running of the state statute of limitations is not avoided by arguing that Defendants' challenged actions culminated in an ultimate wrongful act—sale of the business for less than its value—occurring within the statutory period.

Held, breach of the duty of loyalty does not require that a defendant acted out of self-interest or lacked independence; such a claim may be premised on a fiduciary's failure to act in good faith.

Held, an exculpatory provision in the certificate of incorporation does not require dismissal of a claim for breach of the duty of due care when the complaint adequately states a claim based on the duty of loyalty.

> Delaware law permits corporations to limit the liability of their directors, and Debtor's certificate of incorporation contained an exculpatory clause tracking the state statute.
>
> The Delaware Supreme Court has described two contexts in which liability for breach of the duty of care can arise: a board decision that was ill-advised or negligent; and a board's failure to act when due attention would have prevented a loss.
>
> > The business judgment rule applies in the former context, and the protection of the rule is lost if directors fail to inform themselves.
> >
> > Here, it was hard to see how the D&O Defendants could have decided to proceed with the sale to CDW without knowing what price other buyers might have paid.
> >
> > A board's failure to obtain a valuation of the company's assets constitutes breach of the duty of care.
>
> Delaware precedents, properly interpreted, hold that dismissal based on an exculpatory clause is inappropriate when breach of the duty of due care is not the exclusive claim.

> Here, because the duty of loyalty claim remained, the due care claim was not defeated by state statute, by the exculpatory clause, or by the business judgment rule.

Held, a claim for breach of fiduciary duty was adequately stated against the turnaround specialist. The claim was not defeated by lack of proximate cause—that sale was approved by the board rather than being caused by the specialist—when the allegation is that the board abdicated in favor of the specialist.

Fraudulent Conveyances

Baldi v. Samuel Son & Co., 548 F.3d 579 (7th Cir. 2008):

Debtor was a start-up, formed to purchase an aluminum manufacturing plant using $226 million obtained from the power company in exchange for Debtor's agreement not to buy electricity for a 16-month "curtailment period." Debtor did not begin production at the end of that period because falling aluminum prices and rising electricity prices made production uneconomical. Debtor declared bankruptcy and its plant was dismantled. Trustee sought to recover allegedly fraudulent conveyances made by Debtor during a 34-day period. Trustee attempted to prove that Debtor was insolvent by using the "rule of retrojection"—that is, by proving insolvency at beginning of the period and at the end, thus raising a presumption that Debtor must have been insolvent on the dates of the transfers. The first day was the day Debtor was formed.

Held, the "rule of retrojection" is appropriate for showing insolvency, but the trustee failed to establish insolvency on the first day.

> To presume a start-up insolvent from the date of its formation would require an assumption that experienced businessmen would pay many millions of dollars for a firm with negative value. Many start-ups fail, but if a significant probability of failure were enough for a finding of insolvency no start-up could finance its operations. Lack of operating income is not the "killer point" Trustee thought because no start-up starts with an income flow.
>
> Trustee's valuation expert jacked up Debtor's liabilities by adding contingent liabilities (for pensions, post-retirement benefits, severance pay, and the penalty provision in a take-or-pay contract) as certainties. But valuation of contingent liabilities requires discounting by the probability the contingency will occur. The expert's failure to do so invalidated his expert opinion.
>
> Also unconvincing was Trustee's alternative ground for avoidance—that Debtor was undercapitalized. "Undercapitalization is not a synonym for insolvency."

Barclay v. Mackenzie (In re AFI Holding, Inc.), 525 F.3d 700 (9th Cir. 2008):

> Defendant invested $73,400 in Debtor, which was operated as a Ponzi scheme. He received payments totaling $89,824 when he withdraw shortly before bankruptcy. Of that, approximated $16,424 was a fictitious gain on his principal investment. Trustee commenced an adversary proceeding against 170 of Debtor's investors, including Defendant, seeking recovery on fraudulent conveyance grounds. The bankruptcy court granted summary judgment to Trustee. The district court reversed as to the amount initially invested, and remanded for a determination of Defendant's good faith. Trustee appealed, arguing that the estate was entitled to the entire amount, principal as well as fictitious gain, along with interest. Defendant cross-appealed, arguing that he was entitled to retain the entire amount.
>
> Held, an investor in a Ponzi scheme is not barred from using the good-faith defense in a fraudulent transfer action.
>
>> Defendant argued that there were genuine issues of material fact as to whether Debtor transferred the $89,824 with actual intent to defraud, but the mere existence of a Ponzi scheme is sufficient to establish actual intent. Thus, Defendant's cross-appeal was without merit.
>>
>> This court has twice addressed the phrase "reasonably equivalent value" in the context of a Ponzi scheme.
>>
>>> *Hayes v. Palm Seedlings Partners-A (In re Agric. Research & Tech. Group, Inc.)*, 916 F.2d 528 (9th Cir. 1990) ("*Agretech*"), held that a distribution on account of a partnership interest relative to an investor's capital contribution was not "reasonably equivalent value."
>>>
>>>> The initial transferee in *Agretech* did not take in good faith.
>>>>
>>>> The funds, however, had been passed to the transferee's limited partners relative to their capital contributions, and the court held the good faith exception inapplicable because limited partnership interests are "equity securities" rather than "value."
>>>
>>> *Wyle v. C.H. Rider & Family (In re United Energy Corp.)*, 944 F.2d 589 (9th Cir. 1991), held that a transfer in exchange for a proportionally reduced restitution claim was "reasonably equivalent value."
>>>
>>>> Debtor offered purchasers of its solar modules contracts to sell power generated by the modules to a corporation owned by the same person who owned Debtor. The companies fabricated the amount of power the modules produced, in order to attract more purchasers, and paid them for the phony production.
>>>>
>>>> The court did not permit the trustee to avoid the fictitious power payments. The court held that purchasers had claims

> > for rescission and restitution, because they were duped into buying the modules, and deemed the power payments to have been made in partial satisfaction of those claims.

> *United Energy*, rather than *Agretech*, controls this case.

> > The parties did not expressly exchange Defendant's restitution claim for the payment of $89,824, but one should look beyond form to the substance of the transaction.
> >
> > Defendant acquired a restitution claim when he bought into the Ponzi scheme, just like purchasers of the solar modules in *United Energy*. That claim was exchanged, *in toto*, when Debtor returned his principal amount.
> >
> > Even if Defendant did not acquire a restitution claim, he still exchanged reasonably equivalent value for return of his principal investment. He was ending his interest, which created something more than a simple equity payment in proportion to a capital contribution.

> Thus, the good faith defense is not barred as a matter of law. If the court on remand finds that Defendant took the transfer in good faith, then he can keep the amount he initially provided to Debtor.
>
> The fictitious gain, however, was in excess of the restitution claim, and was not returned on account of Defendant's withdrawal from the partnership. Trustee was entitled to have that amount avoided.

In re M. Fabrikant & Sons, Inc., 394 B.R. 721 (Bankr. S.D.N.Y. 2008):

> Debtors were among the world's largest diamond and jewelry wholesalers, and had been in business for over 100 years. The individuals who owned most of Debtors' stock, the Fortgangs, also owned a group of 47 other companies (the "Fortgang Affiliates") engaged in the diamond and jewelry business. Debtors borrowed almost $130 million from several banks and transferred the funds to the Fortgang Affiliates. The loans were originally unsecured; later, the banks took security interests in all of Debtors' assets. After filing Chapter 11, Debtors sought to avoid the obligations incurred to the banks, as well as liens securing those obligations, as both actually and constructively fraudulent conveyances. Debtors relied on the doctrine of collapsing, under which multiple transactions are treated as one, for purposes of fraudulent conveyances analysis.
>
> Held, although the doctrine of collapsing may apply, Debtors failed to plead with the specificity required for allegations of actual fraud, and its allegations of constructive fraud did not make a plausible claim.

The doctrine of collapsing is usually applied to leveraged buyouts, but it can apply to a more general fact pattern.

> The paradigmatic scheme to which collapsing applies is one in which a transferee gives fair value for the debtor's property, but the debtor then gratuitously transfers the proceeds to a second transferee.
>
> Collapsing requires proof of two elements: that consideration received from the first transferee was reconveyed by the debtor for less than fair consideration or with actual intent to defraud; and that the initial transferee had actual or constructive knowledge of the entire scheme.

The first element—as to actual fraud—requires pleading with specificity, which Debtors failed to do. Constructive fraud may be pleaded more generally, and Debtors' complaint made factual allegations sufficient to provide notice of what it intended to prove.

For the second element—knowledge—Debtors relied primarily on a report drawn up by one of the banks to assist in its lending decision.

> The report indicated that Debtors and the Fortgang Affiliates made intercompany transfers routinely, and relied on each other to conduct their respective businesses. It showed that Debtors owed substantially more to the Fortgang Affiliates than they owed to Debtors.
>
> This information undercut an inference of knowledge, actual or constructive, that the transfers were part of a fraudulent scheme.

Thus, the complaint did not set forth a plausible claim that the banks knew or should have known that Debtors were engaged in a multi-year scheme of making fraudulent transfers of loan proceeds to the Fortgang Affiliates.

Held, initial transferees are not necessary parties for a recovery, under § 550, against subsequent transferees.

Debtors alleged that they paid substantial sums to the Fortgang Affiliates, which passed them to the banks to pay down their own obligations. Debtors, however, did not join the Affiliates as defendants; rather, Debtors proceeded directly against the banks as subsequent transferees.

The Code separates the concepts of avoidance and recovery, and the question is whether a trustee must first avoid a transfer as between the initial transferor and transferee before recovering from a subsequent transferee.

> Cases divide on the question, with both sides looking at § 550's language permitting recovery "to the extent that a transfer is avoided."

But the Code does not identify necessary or indispensable parties; the Federal Rules of Civil Procedure do. Under those rules, the Affiliates were not necessary parties.

Held, leave to amend granted, so that Debtors could attempt to provide the specificity missing in their pleadings.

In Pari Delicto

Gray v. Evercore Restructuring, LLC, 544 F.3d 320 (1st Cir. 2008):

Debtor, its financial advisor, and its legal counsel submitted a restructuring plan that all three knew depended upon inaccurate financial information. The plan was confirmed, but proved not to be feasible. Six months later, Debtor filed another Chapter 11 proceeding. The court appointed a trustee, who filed a liquidating plan. Trustee also sued Debtor's professionals for gross negligence and breach of fiduciary duty for promoting an unworkable plan. Defendants' motions to dismiss and for judgment on the pleadings were granted. Trustee appealed.

Held, the *in pari delicto* defense may be asserted at the motion to dismiss/judgment on the pleadings stage, as long as the facts establishing the defense are definitively ascertainable from the pleadings and other allowable sources of information.

Held, the "adverse interest" exception to the *in pari delicto* defense was inapplicable.

Trustee argued that Debtor's management sought to confirm the plan in order to collect bonuses contingent on confirmation, rather than to benefit the company.

But that was not a supportable characterization of the complaint. It contained evidence sufficient to show that management had not totally abandoned Debtor's interests while pursuing their own.

Public policy arguments—that dismissal would pardon professionals who betrayed their obligations, and make it difficult to hold professionals accountable in the future—were unpersuasive.

CBI Holding Co. v. Ernst & Young (In re CBI Holding Co.), 529 F.3d 432 (2d Cir. 2008):

Debtor, a large wholesale distributor of pharmaceutical products, filed Chapter 11 following various fraudulent schemes undertaken by Debtor's president and chairman with the intent to deceive creditors as to Debtor's true financial condition. The plan's disbursing agent brought suit against Debtor's former accountant, alleging that the firm had failed to conduct audits in accordance with generally accepted auditing standards, thereby necessitating bankruptcy.

Held, a disbursing agent has standing to assert a debtor's claims against its former accounting firm under the "adverse interest" exception to the usual rule that the knowledge of corporate officers who are involved in fraud is imputed to the company itself, when the facts show that the officers involved in the fraud had totally abandoned the debtor's interest.

The "total abandonment" necessary to satisfy the "adverse interest" exception looks principally to the intent of the individuals involved in the fraudulent scheme. The exception is not negated by incidental benefit flowing to the corporate debtor.

Here, the fraudulent scheme benefited the manager in several ways:

by enabling him to maintain control even after Debtor's financial condition would have allowed its creditors to accelerate its notes or take control;

by avoiding defaults that would have required him to relinquish control; and

by allowing him to collect bonuses greater than he otherwise could have gotten.

Since the guilty manager's acts and knowledge are not imputed to Debtor, Debtor's agent has standing to press Debtor's claims against its former accountant.

Jurisdiction

Johns-Manville Corp. v. Chubb Indemnity Insurance Co. (In re Johns-Manville Corp.), 517 F.3d 52 (2008), *cert. granted sub nom. Travelers Indemnity Co. v. Bailey*, 2008 U.S. LEXIS 9124 & 9125 (2008):

Numerous plaintiffs brought direct action suits against Travelers and other insurance companies that had provided coverage for Johns-Manville Corp. The statutory and common law theories asserted were essentially alike—that the insurers knew about the dangers of asbestos as early as the 1950s, but intentionally followed a fraudulent "state-of-the-art" defense designed to frustrate plaintiffs' recoveries. Travelers settled with three groups of plaintiffs and, in conjunction with the settlements, sought a "clarifying order" to the effect that the 1986 injunction issued as part of Manville's reorganization barred all direct action claims against Travelers. That injunction, embodied in the confirmation order approved in *MacArthur Co. v. Johns-Manville Corp.*, 837 F.2d 89 (2d Cir. 1988), was part of the settlement of Manville's insurance claims for $850 million.

Held, the bankruptcy court lacked jurisdiction to enjoin suits directed at nondebtor insurers, to recover for their own misconduct.

Plaintiffs argued that the bankruptcy court, by issuing the clarifying order, failed to distinguish between suits seeking to recover directly from Travelers for its separate acts, and true direct action suits seeking to recover from an insurer contractually obligated to indemnify Manville for its misconduct. Travelers argued that the bankruptcy court was merely enforcing its prior order. A court undoubtedly has jurisdiction to clarify its prior orders, but clarification cannot be used as a predicate to enjoin claims over which the court had no jurisdiction.

The lower courts viewed the jurisdictional inquiry as factual: if the direct actions "arose out of" or were "related to" the Manville-Travelers relationship, then the court had jurisdiction. But the extent of Travelers' duty to the plaintiffs is a function of state law, and the lower courts did not determine whether Travelers had an independent legal duty to the plaintiffs notwithstanding the factual background in which the duty arose.

The bankruptcy court was attempting to provide global finality for Travelers, but global finality is only as global as the court's jurisdiction.

The lower courts lacked subject matter jurisdiction to enjoin claims that were predicated, under state law, on Travelers' own alleged misconduct. Those claims were unrelated to Manville's insurance proceeds and the funds that were central to its bankruptcy.

Petitions for certiorari were filed by Travelers and by attorneys for asbestos victims.

Travelers argued that decades of bankruptcy practice were at risk, given the tens of billions of dollars committed to asbestos trusts in cases relying on the finality of Manville's bankruptcy.

The attorneys argued that the Second Circuit obscured the distinction between jurisdiction and statutory authority. They also argued that the Second Circuit's decision undermined the finality of reorganization plans in mass tort and large business cases, because contracts with nondebtor third parties, such as insurance companies, might never be finalized.

The Supreme Court granted certiorari on December 12, 2008, consolidating the cases.

In re Exide Technologies, 544 F.3d 196 (3d Cir. 2008):

PDH and its foreign subsidiaries contracted to sell their interests in a group of companies in the global automotive and industrial battery business to Exide and its foreign subsidiaries. After closing, the sellers sued the Exide entities in Illinois state court (as per the agreements' forum selection clause) for appropriating $16.6 million of cash, allegedly due to sellers under the agreements, from the target companies' accounts. Exide, but not its foreign subs, then filed Chapter 11 in Delaware and prosecution of the suit ceased as to Exide. The Exide foreign subs removed the Illinois state court action to an Illinois bankruptcy court and moved for transfer to the Delaware bankruptcy court. The PDH entities argued that removal was improper because the claims asserted against Exide's nondebtor subs did not "arise under" the Bankrupt Code or "arise in" Exide's bankruptcy case, nor were they "related to" the bankruptcy case. The PDH foreign entities filed proofs of contingent claims, asserting a right to recover from Exide only if actions against Exide's nondebtor subsidiaries were successful and the defendants proved unable to satisfy the judgments. The defendants argued that the claims were "related to" Exide's bankruptcy because Exide was the sole indemnitor under the agreements. The Delaware bankruptcy court denied remand and abstention, and the district court affirmed. The Third Circuit vacated and remanded.

Held, filing of contingent proofs of claim against a debtor does not render state law claims against related nondebtor entities core proceedings, nor are noncore claims rendered core because of a close business relationship between the debtor and nondebtor entities.

> Whether claims are core or noncore dictates the bankruptcy court's role as well as the availability of mandatory abstention. If the PDH entities' claims are merely "related to" Exide's bankruptcy, then abstention and enforcement of the forum selection clause are appropriate.
>
> The bankruptcy court had alternative theories for finding these claims core proceedings: (1) the PDH entities' claims against the Exide nondebtor subs were really claims directly against Exide because, under the agreements, Exide was sole indemnitor; and (2) the PDH entities voluntarily submitted to the bankruptcy court's jurisdiction by filing proofs of claim.
>
> The "sole indemnitor" theory did not makes this a core proceeding because the lower courts erred in finding the underlying agreement unambiguous. But the record on this question was not fully developed below, so remand was necessary.
>
> The "proofs of claim" theory did not make this a core proceeding.
>
>> This theory might succeed if Exide were the only proper party to the PDH entities' claims, since the subject matter of the proofs of claim would then be the same as that of the state law action.
>>
>> The bankruptcy court suggested, however, that the mere filing of a proof of claim makes a core proceeding out of whatever claims are referenced therein.
>>
>> The proofs of claim were for contribution or indemnification and, while they submitted the claimants to jurisdiction of the bankruptcy court as to claims against Exide itself, the proofs of claim did not make the claims against the nondebtor Exide defendants "core."

> > Filing of a proof of claim may cause claims against nondebtors to be deemed "related to," but it will not make them "core."
> >
> > The district court relied on *Pacor v. Higgins*, 743 F.2d 984 (3d Cir. 1984), for the proposition that a debtor's agreement to indemnify a third party gives rise to jurisdiction over nonbankruptcy controversies between that third party and nondebtors, when the third party has filed a claim against the debtor. But *Pacor* did not so hold; rather, it stated that an indemnification obligation might give rise to "related to" jurisdiction, not core.
> >
> > If, after remand, the bankruptcy court decides that Exide is the only proper party defendant, then the PDH entities' claims will be "core." If not, then the claims will be noncore and subject to mandatory abstention and enforcement of the forum selection clause.
>
> Exide also argued that the bankruptcy court had "core" matter jurisdiction, even if the claimants had independent claims against the nondebtor defendants, because of the close indemnitor-sub relationship and intertwinement of claims.
>
> > That argument was legally unsound. Courts must engage in a claim-by-claim analysis to decide if a proceeding is core; noncore claims do not become core simply because of intertwinement.
> >
> > To hold otherwise would turn every claim contained in an action in which a debtor is a defendant, and which is later removed to bankruptcy court, into a core proceeding.

Notice

Arch Wireless, Inc. v. Nationwide Paging, Inc. (In re Arch Wireless, Inc.), 534 F.3d 76 (1st Cir. 2008):

> Debtor sold paging network airtime and pagers to Nationwide, which used the pagers to supply services to customers, including AT&T. AT&T complained of defects in the pagers and Nationwide turned to Debtor to correct the problems. Nationwide also began finding billing errors in Debtor's invoices. Before resolution of the disputes, Debtor filed a Chapter 11 petition. Its schedules did not list Nationwide as a creditor, and Nationwide neither received notices as to the bankruptcy nor filed an appearance. Debtor's reorganization plan was confirmed. The next month, Debtor began terminating Nationwide's airtime service for nonpayment and Nationwide brought suit in state court. Debtor sent Nationwide a copy of the confirmation order, discharging preconfirmation debts, but Nationwide refused to withdraw its suit. Debtor moved for contempt in the bankruptcy court, which denied the motion. The district court affirmed.

Held, a known creditor with no more than general awareness of a debtor's bankruptcy filing, who does not receive formal notice of bankruptcy, is not bound by the discharge injunction.

> Although publication notice is sufficient for unknown creditors, known creditors are entitled to receive direct notice.
>
> > A known creditor is one with a reasonably ascertainable claim, which requires that the debtor have specific information reasonably suggesting both the claim for which the debtor may be liable and the entity to whom that liability is owed.
> >
> > It is not necessary that the debtor have information as to the financial magnitude of the claim.
>
> Nationwide was a known creditor, because at the time of bankruptcy filing Debtor was in possession of correspondence in which Nationwide clearly stated its belief that Debtor was liable for affirmative compensation and setoffs.
>
> Debtor argued that, even if Nationwide was a known creditor, the discharge injunction should bar Nationwide's claims because it had actual knowledge of Debtor's bankruptcy.
>
> > The bankruptcy court found no evidence of actual knowledge of the bar date, the confirmation hearing, or the plan's contents, although it assumed that Nationwide's president was generally aware of Debtor's filing.
> >
> > Although the Code does not specify the consequence for failure to comply with notice rules, the discharge injunction could not abolish the property rights of creditors, regardless of notice, without running afoul of due process.
> >
> > Debtor argued that Nationwide's actual knowledge of the filing put Nationwide on inquiry notice of the bar date. But prior cases hold that a creditor, even though generally aware of bankruptcy, is entitled to assume that proper notice will be provided before its claims are forever barred.
> >
> > Actual knowledge of the creditors' meeting has been deemed relevant in Chapter 7 and 13 cases, but differences in claims procedures justify a different rule for Chapter 11.
> >
> > Debtor relied on § 523(a)(3) for the proposition that due process requires nothing more than general knowledge of a bankruptcy case, but that argument is flawed. The statute frames the contours of due process, and creditors of individual debtors do not have reason to assume that proper notice will be given before their claims are barred,

because the statute warns that actual knowledge will suffice. The rule is different for creditors of corporate debtors.

Plans—Confirmation Orders

Varde Investment Partners, L.P. v. Comair, Inc. (In re Delta Air Lines, Inc.), 386 B.R. 518 (Bankr. S.D.N.Y. 2008):

Debtor airlines' confirmed plan provided for a fixed total distribution to general unsecured creditors, allocated pro rata based on the total amount of allowed unsecured claims. The disclosure statement estimated the amount of the ultimate distribution—a range of 76% to 100%, with a mid-point of 91%—with full disclosure that the actual recovery would depend upon the variance of claims from the estimate of $800 million, and that the plan proponents did not undertake any duty to update the financial projections. Two months after confirmation, the estimate of claims was revised to $1.05 billion. Purchasers, post-confirmation, of $125 million in claims ("speculators") sought to revoke confirmation on the grounds that it was procured by fraud. They filed their action on the last day of the 180-day period provided under § 1144, and 131 days after learning of the facts underlying their allegations of fraud.

Held, the doctrine of equitable mootness applies to bar revocation of a confirmation order when the moving parties failed to act as soon as practicable after learning the facts and, as a result, it is impossible to craft a revocation order that protects innocent parties.

The only means by which a court can revoke an order of confirmation is § 1144.

Its use of "may" indicates that the decision whether to revoke rests in the sound discretion of the court; its use of "shall," in reference to contents of any revocation order, indicates that innocent parties must be protected.

The section bars revocation of confirmation in this case because an order satisfying the mandatory statutory predicate cannot be drafted.

The section also gives a short time frame, which serves the policy of finality. Although movants complied with the letter of the law, they failed to comply with its spirit. During the 131 days that they sat back, numerous parties in this extraordinarily complex case acted in reliance on the plan.

The doctrine of equitable mootness primarily looks to whether the plan has been substantially consummated. Here, revocation of the plan would knock the props out from under every transaction that has taken place and create an unmanageable and uncontrollable situation.

Plans—Taxes

Florida Dep't of Revenue v. Piccadilly Cafeterias, Inc., ___ U.S. ___, 128 S. Ct. 2326 (2008):

Section 1146(a) of the Bankruptcy Code provides that the transfer of an asset "under a plan confirmed under section 1129 . . . may not be taxed under any law imposing a stamp tax or similar tax." In Piccadilly, the United States Supreme Court resolves a split among the circuit courts by holding that the stamp tax exclusion of section 1146(a) of the Bankruptcy Code does not apply to transfers made before a plan is confirmed. Instead, the Court held that section 1146(a) of the Bankruptcy Code only applies to transfers made pursuant to a Chapter 11 plan that has been confirmed.

Post-petition Transfers

Aalfs v. Wirum (In re Straightline Investments, Inc.), 525 F.3d 870 (9th Cir. 2008):

Debtor had been in the business of leasing commercial real estate, but began custom milling of lumber a few months before filing Chapter 11. The next day, Debtor's president personally guaranteed Creditor against all losses stemming from its lending to Debtor. Debtor then moved the court for permission to borrow up to $500,000 from Creditor. The court authorized Debtor to borrow only up to $100,000, to be secured only by liens against equipment and inventory. Despite that order, Creditor made loans to Debtor in exchange for accounts receivable. Creditor paid $186,455 for accounts with a face value of $200,600, but collected only $163,007. A Chapter 11 trustee was appointed and the case converted to Chapter 7. Trustee sought to avoid the post-petition transfers of the accounts under § 549.

Held, a post-petition transfer of a debtor's accounts receivable, made in violation of a court order, is avoidable under § 549.

Creditor argued that the transfer was not of estate property because Debtor had no control over the money collected from the account debtors, but that argument failed to distinguish between the accounts themselves and the funds paid by the account debtors.

Creditor argued that the transfers were not avoidable under § 549 because they did not result in a diminution of the estate.

The diminution of the estate doctrine, applicable under §§ 547 and 548, should not be extended to § 549 to defeat recovery of a transfer that meets every statutory requirement.

In any event, Trustee may have established such diminution, since only $186,455 was paid for accounts with a face value of $200,600. Although Creditor only recovered $163,007, a greater amount might have been recovered by Debtor.

Creditor argued that the transfer was within the ordinary course of business, under § 363(c)(1).

> Two tests have emerged for determining whether a transaction is in the ordinary course, *Burlington N.R.R. Co. v. Dant & Russell, Inc. (In re Dant & Russell, Inc.)*, 853 F.2d 700 (9th Cir. 1988). If both tests are satisfied, a transfer is within the ordinary course, but it is unclear under *Dant & Russell* whether both must be.
>
> > The vertical test inquires whether the transaction subjects a creditor to economic risks different from those the creditor accepted when the decision to extend credit was made.
> >
> > > Courts usually look to the debtor's prepetition practices, which are compared to post-petition business activities.
> > >
> > > That's difficult here, since Debtor only began the custom milling business a few months before bankruptcy. Before that, Debtor had no accounts receivable.
> > >
> > > The bankruptcy court's finding that the transfers were not in the ordinary course—because creditors would have expected notice and a hearing, given the court's earlier denial of the request to use accounts as collateral—was not clearly erroneous.
> >
> > The horizontal test looks to whether the transaction is one in which similar businesses would engage.
> >
> > > Debtor's predecessor in the custom milling business obtained a line of credit secured by receivables, rather than selling its receivables outright.
> > >
> > > Also, Creditor's own witness said that companies who enter into factoring agreements are usually in financial difficulty.

Creditor argued earmarking as a defense, but there was no agreement that the money Creditor paid would be used to satisfy a specific debt.

Creditor argued that Trustee's recovery should be subject to Creditor's right to recoup the amount he paid for the accounts ($186,455).

> But recoupment is an equitable remedy, unavailable to one who has acted inequitably.
>
> Here, Creditor and Debtor's president transferred Debtor's accounts despite a court order prohibiting such a transfer.

The remedy ordered by the bankruptcy court was appropriate.

The bankruptcy court entered judgment for the amount Creditor collected on the accounts ($163,007) plus interest, costs, and return of the uncollected accounts. That created a windfall, according to Creditor, because Debtor had already received $186,455, and the recovery should be limited to the difference between the face amount of the accounts and the amount Debtor received from Creditor ($200,600 – 186,455 = $14,145).

Creditor's view is supported by *Dobin v. Presidential Finance Corp. (In re Cybridge Corp.)*, 312 B.R. 262 (D.N.J. 2004), which relied on § 550(d)'s limitation of recovery to a "single satisfaction."

But *Cybridge* was concerned with protecting innocent transferees, without knowledge of a bankruptcy filing.

Here, Creditor was aware of bankruptcy and that the court had denied Debtor's request to use accounts as collateral.

Creditor was attempting to set off the amount he paid for avoidably transferred property against the value of the property, but the only exceptions to recovery under § 550(a) were inapplicable. The estate had a greater claim to the proceeds of the accounts than did Creditor, based on his inequitable conduct.

Property of the Estate

Callaway v. MEMO Money Order Co., 381 B.R. 650 (E.D.N.C. 2008):

Davises were sole shareholders of Debtor, an IGA grocery store. Under a prepetition contract, Debtor sold money orders through Creditor and held the proceeds in a separate money order account that Creditor electronically swept each week. Davises began routinely putting the proceeds in the general operating account, transferring funds to the money order account immediately before the sweep. Eventually, insufficient funds were transferred and Creditor was unable to collect the funds it was owed. Both Debtor and Davises filed bankruptcy under Chapter 7.

Debtor's Trustee asserted that the $39,500 in the money order account belonged to the estate, having lost its trust character when the funds were first deposited into the general operating account. Creditor argued that it was entitled to the funds under a state statute impressing a trust on commingled funds. The bankruptcy court granted summary judgment to Creditor, analogizing the state statute to the Perishable Agricultural Commodities Act, which creates a floating trust in commingled produce.

Held, state law's floating trust provision does not apply in bankruptcy, to eliminate the need to trace funds under the intermediate balance rule.

Tracing is an issue of federal, not state, law. If state law creates a floating trust, it conflicts with federal law and is preempted.

Nor can the floating nature of the trust overcome federal law's tracing requirement under the guise of being a definition of property. State law only supplies a definition of property absent a countervailing federal interest, and the federal tracing requirement is such an interest.

On remand, the bankruptcy court should address tracing and estoppel issues.

Releases

Airadigm Communications, Inc. v. FCC (In re Airadigm Communications, Inc.), 519 F.3d 640 (7th Cir. 2008):

[See the statement of facts at page 7, *supra*.] Debtor's plan of reorganization in its second bankruptcy case provided, *inter alia*, that Debtor's third-party financer, TDS, would be released from liability "for any act or omission arising out of or in connection with the . . . confirmation of this Plan . . . except for willful misconduct." Debtor owed TDS over $188 million in secured claims that Debtor would have to refinance if TDS were not involved in the reorganization, and TDS refused to go forward without the release.

Held, a provision in a plan of reorganization that releases a third party's liability to a debtor's nonconsenting creditor is permissible when the release is necessary for the reorganization and is appropriately tailored.

The circuit courts have divided on the question whether a bankruptcy court can release a third party from liability to the debtor's creditors.

Some circuits hold that such releases violate the Code and are, therefore, beyond the power of the bankruptcy court.

Others permit releases, but do not agree on the governing standard.

The circuits' disagreement deals with two interrelated questions.

First, whether § 524(e) bars such a release.

The natural reading of § 524(e) does not foreclose a third-party release. It is a savings clause that limits the operation of other parts of the Code and preserves rights that might otherwise be lost after reorganization.

It does not purport to limit the bankruptcy court's power to release a nondebtor from a creditor's claims. If Congress had meant to do so, different language would have been used.

Thus, § 524(e) does not bar a third-party release.

Second, whether bankruptcy courts have the power to approve such releases, even if § 524(e) does not expressly bar them. A bankruptcy court has broad equitable powers, codified in § 105. These powers may be exercised within the plan itself, under § 1123(b)(6), which permits a court to include appropriate provisions not inconsistent with other sections of the Code.

Thus, a bankruptcy court has "residual authority" to approve such a release, as long as it is appropriate and not inconsistent with other provisions.

Whether a release is "appropriate" is a fact intensive question. This release was narrow—it applied only to claims related to the reorganization and excepted willful misconduct. It was not blanket immunity for all times, all transgressions and all omissions; and it did not affect matters beyond the jurisdiction of the court or unrelated to the reorganization.

The limitation was subject to other plan provisions, including one that expressly preserved the FCC's regulatory powers respecting the licenses.

TDS required the release before it would provide financing that was essential to the reorganization.

Given how narrow the limitation was and how essential TDS was to the reorganization, the release was "appropriate" and therefore within the power of the court.

In re Federal-Mogul Global, Inc., 2008 Bankr. LEXIS 3517 (Bankr. D. Del. 2008):

Debtors, the asbestos claimants' committee and the representative for future asbestos claimants, on the one hand, and Pneumo Abex and Cooper Industries (the "protected parties"), on the other, negotiated alternative settlements. Under Plan A, the protected parties would contribute $756 million to a subfund of the personal injury trust, withdrawing their claims against Debtors. In return, they would receive the benefit of a third-party injunction under § 524(g)(4)(A)(ii) that would channel claims to the trust. Plan B would resolve the protected parties' claims against Debtors, in return for payment of $140 million to them from the trust. The parties sought court approval of Plan A, which all of them preferred.

Held, a former unincorporated division cannot serve as a predecessor in interest for purposes of § 524(g)(4)(A)(ii).

A third party may receive the benefits of an injunction under§ 524(g) when that third party is directly or indirectly liable for claims against a debtor.

That is permissible, however, only when the third party's liability arises from one of several relationships listed in § 524(g)(4)(A)(ii)(I) – (IV). The plan's supporters argued three possibilities—

(I) that there was a third party's ownership of a predecessor in interest of the debtor;

(II) that there was a third party's involvement in management of a predecessor in interest of the debtor; and

(IV) that there was a third party's involvement in a transaction changing the corporate structure of a predecessor in interest of the debtor.

But the third party entity upon which the proponents relied could not be a predecessor in interest for purposes of § 524(g)(4)(A)(ii) because it was a former unincorporated division of Pneumo Abex.

In re Berwick Black Cattle Co., 394 B.R. 448 (Bankr. C.D. Ill. 2008):

Debtors proposed a Chapter 11 plan containing three separate third-party releases: ¶ 6.7 released Debtors, the Creditors' Committee and entities who were funding the plan (the "Ward Entities") from liability related to the bankruptcy case, with an exception for gross negligence or willful misconduct; ¶ 4.2.13 released the Ward Entities and the Creditors' Committee from any claims, brought by a party-in-interest, that existed on the effective date of the plan; and ¶ 8.3, which enjoined actions against Debtors, the Ward Entities and the liquidating trust except as authorized by the bankruptcy court. Debtors argued that release of the Ward Entities was justified by the consideration they were providing in connection with the plan, including purchase of $1 million in notes, payment of certain administrative and priority claims, and financing of the reorganized debtor. No party objected, but Debtors asked the court to consider the appropriateness of the third-party releases.

Held, releases giving blanket immunity, as in ¶¶ 4.2.13 and 8.3, go beyond the limits that have been approved by circuit-level precedent and, therefore, exceed the authority of the bankruptcy court.

Controlling precedent is *In re Airadigm Communications, Inc.*, 519 F.3d 640 (7th Cir. 2008), which held that § 524(e) does not limit a bankruptcy court's power to release nondebtors, and that § 105 carries residual authority to do so when necessary for the reorganization.

Releases similar to ¶ 6.7 have become *de rigueur* in cases filed in New York and Delaware.

Such releases have been approved when they exculpate only negligent conduct related to the bankruptcy case that occurs during the case.

Airadigm was simply approving the kind of narrowly tailored releases customarily used, and nothing in the opinion indicated an intent either to go beyond that, or to reject the limits on third-party releases established by other circuits.

Broad releases are not supported by the case law from other circuits.

The Ninth and Tenth Circuits do not permit any third-party releases.

The Third Circuit, in *In re Continental Airlines*, 203 F.3d 203 (3d Cir. 2000), rejected the idea that an "identity of interest" between the debtor and the third-party warranted such releases.

In *In re A.H. Robins, Inc.* 880 F.2d 694 (4th Cir. 1989), the Fourth Circuit allowed a broad release, but the affected creditors were to be paid in full under the plan.

The Sixth Circuit characterized third-party releases as "dramatic measures to be used cautiously in unusual circumstances," *In re Dow Corning Corp.*, 280 F.3d 648 (6th Cir. 2002).

Thus, a bankruptcy court lacks jurisdiction to release a nondebtor's claims against another nondebtor. The releases in ¶¶ 4.2.13 and 8.3 exceeded the authority of the court.

Sale of Estate Property

Clear Channel Outdoor, Inc. v. Knupfer (In re PW, LLC), 391 B.R. 25 (B.A.P. 9th Cir. 2008):

Debtor owned prime real estate in Burbank, California, which it tried to develop. When development efforts failed, Debtor filed Chapter 11. DB, the holder of a first-priority lien on most of Debtor's assets, moved for appointment of a Chapter 11 trustee. Trustee recognized that DB was likely to get relief from the stay under § 362(d)(3), so she began negotiations with DB for sale of Debtor's property. The parties agreed that DB would serve as a stalking horse bidder, and they agreed on a strike price, based on the amount Debtor owed DB. The court approved sale free and clear of liens, despite objections raised by a junior lienholder. When no other bidders were found, DB purchased Debtor's assets. The junior lienholder, who received nothing, appealed.

Held, § 363(f) does not permit a secured creditor to credit bid its debt and purchase estate property free and clear of valid, nonconsenting junior liens.

Subsection (f)(3):

Trustee and DB argued that § 363(f)(3)'s reference to the "aggregate value of all liens" means the economic value of the liens, rather than face value.

They relied on the variance of this wording from the Code's usual language, which refers to the value of claims secured by liens.

They also relied on cases interpreting § 506(a), under which the amount of an allowed secured claim can never exceed the value of the property securing it, to permit sale under § 363(f)(3) free and clear of out-of-the-money liens.

That reading expands (f)(3) too far and misreads the language. If the "aggregate value of all liens" means the aggregate amount of allowed secured claims, then (f)(3) could never be used in a case, like this one, in which the claims exceed the value of the collateral. In such a case, the total of allowed secured claims will equal, not exceed, the sales price, and the statute requires the price to be "greater than" the "value of all liens."

Thus, (f)(3) does not authorize sale free and clear of liens if the price is equal to or less than the aggregate amount of all claims held by creditors with liens in the property.

Subsection (f)(5):

Trustee and DB argued, and the bankruptcy court agreed, that (f)(5)'s plain meaning permits sale free and clear. That subsection is anything but plain, however.

The subsection has three elements—

(1) a proceeding exists or could be brought;

(2) in which the nondebtor could be compelled to accept a money satisfaction;

(3) of its interest.

(3) "Interest" is expansive, and includes liens such as this one.

The introductory sentence to § 363(f) refers to "any interest" and four of the following paragraphs refer to "such interest."

Subsection (f)(3), which applies only if "such interest is a lien," makes it clear that liens are a type of interest.

(2) The court must find the existence of a mechanism under which satisfaction of the lien could be compelled.

> The bankruptcy court's analysis—that (f)(5) applies whenever a claim or interest can be paid with money—was too simple. Just because a lien can be satisfied by paying the money owed, it does not follow that any sum, no matter how large or small, will suffice.
>
> > Subsection (f)(5), presumably, refers to whether the nondebtor can be compelled to take *less* than the value of its secured claim.
> >
> > That gives (f)(5) a small role, but does not write it out of the Code. A narrow view is justified as long as it complements the other four subparagraphs. Examples include a case in which specific performance might ordinarily be granted, but a liquidated damages clause allows a court to satisfy the nonbreaching party's claim in cash instead.
>
> Under the bankruptcy court's reading, (f)(5) does not work in harmony with the other subsections of (f). It would allow (f)(5) to render (f)(3) superfluous, since all liens would be covered regardless of the relationship between the value of collateral and the creditor's claim.

(1) Compelling a creditor to accept a money satisfaction cannot be the sole requirement of (f)(5); rather, there must be an available legal or equitable proceeding in which a court could so compel.

> Cramdown under § 1129(b)(2) is not such a proceeding. Use of the cramdown mechanism to allow sale free and clear under § 363(f)(5) uses circular reasoning, sanctioning the effect of cramdown without requiring any of § 1129's protections.
>
> Because the bankruptcy court did not make the necessary finding, the case was remanded.

In re TOUSA, Inc., 393 B.R. 920 (Bankr. S.D. Fla. 2008):

Debtor-developers sought entry of an emergency order permitting bulk sale of 20 residential lots in a community development for $150,000 per parcel. Debtors, however, had entered into a restrictive covenant under which, as long as the other party owned any of the lots, Debtors could not sell any lot for less than $325,000. Debtors pointed to the drastic change in the Florida real estate market and argued that enforcement of the covenant would be unreasonable.

Held, property may be sold pursuant to §§ 363(b) and (f) free of a restrictive covenant if that covenant has become an unreasonable restraint on alienation because of changes in the local market.

> Generally, a restrictive covenant creates an interest in property that prevents sale free and clear under § 363.
>
> But under state law, unreasonable restraints on alienation of property are unenforceable. Courts look primarily at duration of the covenant.
>
> This covenant gave the objector the power to indenture Debtors to indefinite ownership of the property, while permitting the objector free reign to sell his parcels at the market rate.
>
> The balance of equities under both state and bankruptcy law favored Debtors' motion.

Setoff

CDI Trust v. U.S. Electronics, Inc. (In re Communication Dynamics, Inc.), 382 B.R. 219 (Bankr. D. Del. 2008):

Four months before filing bankruptcy, Debtor and its sub (Sub-1) entered into an Asset Purchase Agreement under which ICX would acquire the sub's assets for $25 million. ICX paid $20 million in cash and gave two notes with a face amount of $5 million. A few days later, Debtor and another of its subs (Sub-2) executed a Distribution Agreement with ICX, giving Sub-2 the exclusive right to market products manufactured by ICX. The Agreement contained a minimum amount clause and gave Sub-2 a 25¢ discount for each unit it sold, with the discount to be credited against the amount ICX owed under the notes. When Debtor and several affiliates filed Chapter 11, Sub-2 had purchased fewer units than the minimum. ICX was concerned about Sub-2's ability to comply with the Distribution Agreement and the preclusive effect Sub-2's exclusive rights would have on ICX's ability to mitigate. Given ICX's concerns and a cure amount of $1.3 million, Debtor agreed to reject the Distribution Agreement and to enter a new nonexclusive manufacturer's representative agreement (NEMRA). ICX filed a secured claim for $4.835 million, representing the portion of its rejection damages subject to setoff or recoupment against sums it owed on the notes, and an unsecured claim for $10.13 million. Debtors later confirmed a plan under which assets, including the notes, were transferred to a trust, to collect and distribute to creditors. The trust filed a complaint against ICX seeking full payment of the notes, without setoff. The trust moved for summary judgment.

Held, setoff and recoupment are equitable remedies, available independent of any contractual remedy.

> The trust argued that the parties' contracts precluded setoff or recoupment because the notes were to be paid in cash. ICX countered that the notes and

Distribution Agreement, by permitting the 25¢ per unit discount, specifically permitted setoff, and that the Agreement reserved all remedies to ICX if Sub-2 breached the minimum purchase requirements.

The court agreed with ICX. Because the five-year Distribution Agreement was breached the first year, it's safe to conclude that Sub-2 did not meet the minimum purchase requirement and that ICX was entitled to damages.

Held, grounds sufficient to provide a basis in equity for denying setoff are not found in the fact that setoff would diminish other creditors' recovery.

The trust argued that permitting setoff would be inequitable because the notes represented the bulk of the trust assets; even if the trust collected on them, unsecured creditors would receive less than 2% of their claims. Equity, however, does not mandate that one creditor lose its rights under the Code and state law just because other creditors would benefit thereby.

Nor did ICX behave inequitably by not advising Debtors of ICX's setoff rights until after rejection of the Distribution Agreement. ICX had no duty to do so; Debtors were aware of the terms of the agreements and they were represented by counsel.

Held, the requirement that both claims be valid is met when the *fact* of damages is certain even though the *amount* is not.

The parties did not dispute that ICX owed over $4 million on the notes, but the trust argued that ICX failed to establish that it had a claim for rejection damages.

Rejection constituted breach immediately before the date of filing and ICX prepared a report of its damages. The trust could not obtain summary judgment on that point merely by disputing it.

The trust argued that ICX suffered no damage because Debtors entered the NEMRA at the time they rejected the Distribution Agreement, intending the former to replace the latter and to eliminate any claim to rejection damages.

That argument was belied by the NEMRA's language, however.

The amount of ICX's rejection damages claim was disputed, so summary judgment could not be granted.

Held, §§ 365(g) and 502(g) are applicable to setoff, and render a rejection damages claim a prepetition claim for purposes of § 553; thus, such a claim is subject to setoff against any prepetition debt owed by a creditor to the debtor

The trust argued, relying on *In re Delta Air Lines, Inc.*, 341 B.R. 439 (Bankr. S.D.N.Y. 2006), that rejection damages may not be treated as a prepetition claim and set off against a prepetition debt owed by Debtors.

Delta is unpersuasive, having been criticized by commentators and all other courts considering the issue.

Its premise is that § 553 unambiguously precludes any other section from "affecting" a creditor's right to setoff under state law as of the petition date. Thus, §§ 365(g) and 502(g), deeming a rejection claim a prepetition claim, cannot be considered in setoff.

That interpretation would lead to absurd results. It might elevate rejection damages to administrative expense status, under an argument that the claim arose post-petition. It might prevent a landlord from setting off a security deposit, received prepetition, against its rejection damages claim, because the latter did not arise prepetition.

Section 553 is ambiguous and must be considered together with other Code provisions—specifically §§ 101, 365(g) and 502(g).

Section 101 defines "debt" and "claim" broadly, to include those that are unmatured, contingent, disputed and unliquidated. Sections 365(g) and 502(g) provide that a rejection damages claim is to be treated as if it arose prepetition.

Thus, for purposes of § 553, a rejection damages claim is a prepetition claim subject to setoff against any prepetition debt owed by a creditor to the debtor.

Alternatively, the Code looks to state law to determine the substance of a creditor's claim, but the Code determines the effect of that claim, including when it arises. Thus, §§ 354(g) and 502(g) do not affect the substance of a rejection damages claim, only when it arises.

The trust argued that the estate's claim on the notes was a post-petition claim because payment was due post-petition.

It relied on *Avellino & Bienes v. M. Frenville Co. (In re M. Frenville, Co.*), 744 F.2d 332 (3d Cir. 1984), for the proposition that a debt arises when the cause of action underlying it accrues under state law, and thus that a debt arises only when a right to payment on that debt arises.

A claim arises when the right to payment accrues, however, not when payment is due, given § 101(5)(A)'s broad definition.

Frenville was distinguishable. It considered the effect of the automatic stay on a common law right of indemnity, and distinguished a situation—like this case—in which the parties' contract provides for indemnity.

Held, summary judgment could not be granted because the obligations might not have been mutual, having been made by separate parties; the notes were payable by ICX to Sub-1, while the Distribution Agreement was between ICX, Sub-1 and Sub-2.

Held, summary judgment is not available when it is unclear whether the obligations arose from the same transaction.

> The trust argued that the two claims did not arise from the same transaction because rejection damages arose from the Distribution Agreement (a marketing agreement) and ICX's obligations under the notes arose under the Asset Purchase Agreement (sale of a business).
>
> Some facts suggested they were an integrated transaction, but trial was necessary for determination.

In re K.D. Builders, Inc., 382 B.R. 1 (Bankr. D. Mass. 2008):

Bank loaned Debtor $1,275,000, secured by a mortgage on land that Debtor intended to develop into a subdivision. Bank and Debtor entered an agreement with the town for the construction of roads and installation of municipal services in the subdivision. To ensure Debtor's performance, funds were set aside in an account held at Bank in Debtor's name, on which two Bank officers were signatories. When Debtor abandoned the work and filed bankruptcy, $110,000 remained in the account. Debtor defaulted on three promissory notes, totaling $1,200,000—far more than the value of collateral securing them. Bank obtained relief from stay and sold the property, leaving a deficiency of $327,000. Bank then sought setoff against the funds remaining in the account after the town's completion costs were paid. [$49,500?]

Held, Bank is not entitled to relief from stay to setoff its debt against an account, created for a special purpose, as to which Bank's only obligation is to hold funds pending authorization from a third party.

> Bank argued that the obligations were mutual even though, on the date of filing, the amount of the account due to Debtor was contingent and unliquidated. Trustee argued that mutuality was lacking because the account was a special purpose account.
>
> The sole purpose of this account was to ensure Debtor's compliance with the development agreement and to ensure that funds were sufficient to make the improvements in the event of default. Bank's only obligation was to hold Debtor's funds pending authorization from the town. Bank had no real control over the account or any ability to make a demand on it. Therefore, the account was a special deposit account and ineligible for setoff rights asserted by the bank.
>
> In addition, the mutuality required by § 553 was lacking.

Bank did not hold the account in a debtor-creditor or bank-depositor relationship.

Thus, Bank's debt to Debtor was not held in the same right or capacity as Debtor's liability on the deficiency claim.

Small Business Cases

In re Save Our Springs (S.O.S.) Alliance, Inc., 393 B.R. 452 (Bankr. W.D. Tex. 2008):

Debtor's original Chapter 11 petition identified it as a "small business debtor," as defined in § 101(5D). When Debtor failed to confirm a plan within the applicable time limits, Creditor moved for dismissal. Debtor then moved for a determination that it was not, in fact, a small business debtor.

Held, a debtor may not change its status as a small business debtor late in the case.

Assuming there is no *per se* prohibition against a debtor's amendment of its status as a small business, amendment is not permissible when the facts justify estoppel.

The doctrine of judicial estoppel, which prevents a party from assuming inconsistent positions in litigation, is applicable.

The court expedited numerous aspects of this case only because it accepted Debtor's claim of small business status.

Debtor's original assertion of small business status was anything but mistaken or inadvertent.

The doctrine of equitable estoppel, which looks to the effect of a party's changing of position on opposing parties, is also applicable.

Standing

Dynasty Oil & Gas, LLC v. Citizens Bank (In re United Operating, LLC), 540 F.3d 351 (5th Cir. 2008):

At the time it filed Chapter 11, Debtor owned several oil and gas properties that had been out of production for several months. Pursuant to a motion brought by Bank, Debtor's largest creditor, the court appointed a manager to bring Debtor's properties back into production. Bank was authorized to pay the manager's fees out of the DIP account. The manager ran the operations for seven months, until the plan was confirmed. The plan authorized another creditor to purchase all of Debtor's assets for $2.5 million, with payment going to Bank. The plan specified that Debtor was not revested with title to any estate assets, although it retained limited powers to pursue certain claims on behalf of the estate. After confirmation, Debtor filed suit in state court against Bank, the manager, and officers of both, asserting common law claims for mismanagement of its properties during reorganization.

Held, a reorganized debtor that survived only as a shell corporation, after liquidation of its assets in Chapter 11, lacks standing to bring post-confirmation claims when the right to do so was not specifically preserved by the plan.

> Upon confirmation, the estate ceased to exist and a debtor's status as DIP is lost. A debtor may preserve its standing to bring certain claims, but only if the plan expressly so provides.
>
> Debtor's claims were for fraud, breach of fiduciary duty and negligence, but Debtor did not preserve its right to bring these claims post-confirmation. Neither a blanket reservation of "any and all claims" arising under the Code, nor reservation of other types of claims, is sufficient.
>
> Debtor also lacked standing to bring the misrepresentation claim.
>
> > Debtor asserted that Bank had agreed its claim against Debtor would be satisfied by the buyer's payment of $2.5 million, but Bank subsequently brought a collection action against Debtor's guarantors.
> >
> > Debtor had no standing to represent its guarantors, and had shown no injury of its own.

In re River Center Holdings, LLC, 394 B.R. 704 (Bankr. S.D.N.Y. 2008):

Debtor owned real estate in Manhattan that was taken by eminent domain. While Debtor was litigating with the state over the value of the property, Debtor's Lenders, who were secured by a mortgage on the property, sought conversion of Debtor's Chapter 11 proceeding to Chapter 7. Lenders argued that Debtor was continuing to incur losses because of its inability to pay professional fees in the condemnation action. During the hearing on the conversion motion, Debtor's principal testified that he would pay the fees. The motion to convert was denied. The property was valued in the condemnation action at an amount insufficient to pay Lenders. Neither Debtor nor Debtor's principal paid condemnation counsel, and Lenders sought an order under § 105(a) to enforce the principal's promise.

Held, lenders lack standing to enforce an in-court promise made by a debtor's principal when they are neither the promisee nor intended beneficiary of the promise.

> It is debatable whether a court can use § 105(a) to enforce an alleged promise made in court but not in a contract. Assuming it can be done, however, it can only be done in a proceeding initiated by the promisee with respect to a promise that was clear and unequivocal.

By means of § 105(a), Lenders essentially sought specific performance of the principal's promise, or damages for his failure to follow through.

But the promise was made to the estate, not to Lenders.

Lenders would only benefit indirectly, as estate creditors normally do when estate assets available to satisfy their claims are augmented or protected.

Bankruptcy courts have the power to deputize committees or individual creditors to bring actions to vindicate rights belonging to the estate, but in the Second Circuit that requires an order of court that was neither sought nor obtained in the case.

Lenders had standing, under § 1109(b), to seek case administration relief—moving for appointment of a trustee, dismissal, termination of exclusivity, or conversion—if the principal failed to honor his promise. But the right to be heard under § 1109(b) does not confer ownership of causes of action belonging to the estate.

Held, assuming that Lenders have standing to enforce in-court promises made by debtor's principal, only sufficiently unequivocal promises are enforceable. These were not.

In re Mayco Plastics, Inc., 379 B.R. 691 (Bankr. E.D. Mich. 2008):

Creditor provided post-petition financing to Debtor, a manufacturer of automobile component parts, and received a priority claim under § 364(c)(1) as well as liens under §§ 364(c)(2) and (c)(3). Debtor proposed a plan that provided a distribution to administrative claimants and to unsecured creditors, but not full payment of the indebtedness that arose under the DIP financing order. Creditor objected under § 1129(a)(9)(A), but Debtor and the Committee argued that indebtedness under the financing order was not an administrative claim; thus, Creditor did not have standing to object under § 1129(a)(9)(A). The court agreed to decide the issue as a threshold matter.

Held, a creditor who extends DIP financing does not have an administrative claim under § 507(a)(2) and, therefore, lacks standing to raise objections under § 1129(a)(9)(A).

This financing order very specifically granted Creditor the inducements enumerated in §§ 364(c)(1), (2) and (3); it did not give Creditor an administrative expense under § 364(b) or a priming lien under § 364(d).

Debt incurred under (c)(1) has priority over administrative expenses, but its other attributes are not specified.

Reading of (c)(2) and (c)(3), however, makes it clear that (c)(1) debt is unsecured.

Reference to (c)(1) debt as having "super-priority" does not make it effectively secured debt or entitled to administrative expense status.

The mandate that (c)(1) debt be paid before all administrative expenses precludes a (c)(1) claim from itself simultaneously being a type of administrative expense.

Because Creditor did not have an administrative expense claim under § 503(b), it did not have a priority claim under § 502(a)(2) (and never claimed to have a § 507(a)(3) claim). Thus, Creditor may not object to confirmation on the basis of § 1129(a)(9)(A).

Utility Cases

In re Viking Offshore, Inc., 2008 Bankr. LEXIS 831 (Bankr. S.D. Tex. 2008):

Chapter 11 Debtors sought an order determining that two utilities holding Debtors' security deposits had adequate assurance of future payment for their services. Debtors also sought to establish a procedure, under §§ 105(a) and 366, requiring utilities to request adequate assurance in writing by a certain date, and prohibiting them from discontinuing service pending a decision on motions to be filed if the parties could not otherwise agree on adequate assurance. The court refused to enter either order.

Held, a procedure requiring a debtor to provide adequate assurance to a utility for future services only upon that utility's request is not permitted under §§ 105(a) and 366.

As to the utilities with no cash deposit, Debtors proposed that they not be required to provide any adequate assurance unless a party requested it.

Under the plain language of § 366(c)(2). a Chapter 11 debtor must furnish adequate assurance of payment that is satisfactory to the utility. Debtors' proposal would reverse that statutory provision.

Held, the relief requested by Debtors' as to the utilities holding cash deposits—an advance determination that relief is adequate—would reverse the burden under § 366(c)(2), which requires that the provision of adequate protection be satisfactory to the utility.

In re Beach House Property, LLC, 2008 Bankr. LEXIS 1091 (Bankr. S.D. Fla. April 8, 2008):

Debtor moved for an order determining adequate assurance for future utility services. The utility objected, and requested a post-petition deposit of twice the average monthly bill. The court found the request reasonable and sustained the objection, although it did not agree with many of the utility's assertions.

Held, a bankruptcy court is not barred from determining the appropriate amount of adequate assurance until the debtor has paid whatever amount the utility has demanded.

> The holding to the contrary in *In re Lucre,* 333 B.R. 151 (Bankr. W.D.Mich. 2005), could lead to absurd results and cannot be what Congress intended.
>
> A court may determine the form and amount of adequate assurance if the parties cannot reach agreement, as long as assurance of payment is offered in one of the forms described in § 366(c)(1)(A).
>
> A debtor may comply with § 366 by proposing a means and amount of adequate assurance in a motion filed at the start of a case. The court may then enter a scheduling order that sets an objection deadline and hearing date allowing for resolution of any disputes before § 366(c)(2)'s 30-day deadline. A debtor who pays the court-ordered amount by the 30th day will have complied with § 366 and the utility may not discontinue service.