Trashing the Promenade, The Company Town, The Dead Debtor and Many Other Recent Anomalies and Contradictions From Bankruptcyland

2010 Southeastern
Bankruptcy Law Institute Seminar
March 18, 2010

Presented by:

Robin E. Phelan, Esq.
HAYNES AND BOONE, LLP

Written Materials Prepared By:
Robin Phelan
Eric Terry
Abigail Ottmers
Stephen Manz
Haynes and Boone, LLP
2323 Victory Avenue, Suite 700
Dallas, Texas 75219
www.haynesboone.com

TABLE OF CONTENTS

A. APPEALS

***American Safety Indemnity Co. v. Official Committee of Unsecured Creditors (In re American Safety Indemnity Co.)*, 502 F.3d 70 (2d Cir. 2007).**

The bankruptcy court granted summary judgment for the committee and dismissed the claims brought by American Safety Indemnity Co. ("ASIC"). ASIC appealed the judgment to the district court. On October 12, 2006, the district court entered a judgment affirming the bankruptcy court's order in all respects. On October 26, 2006, the district court amended the original judgment correcting a clerical mistake - the reference date of the bankruptcy court order. ASIC filed a notice of appeal on November 27, 2006, more than 30 days from the date of the district court's original judgment. The committee moved to dismiss the appeal as untimely.

The Second Circuit granted the committee's motion and ruled that the notice of appeal was untimely. The Second Circuit concluded that the time for appeal runs from the entry of the first judgment when a subsequently entered judgment does not alter the substantive rights of the first judgment. The Second Circuit found that the district court's judgments were exactly the same except for the clerical correction of the bankruptcy court order.

***In re Congoleum Corp.*, Case No. 09-1337 (D.N.J. August 17, 2009).**

This case is an appeal of the bankruptcy court's order denying confirmation of a plan, and dismissal of the bankruptcy case. At issue was a pre-packaged reorganization plan that sought to resolve personal injury claims stemming from asbestos exposure by providing for a distribution of insurance proceeds to the claimants. The court considered whether insurers in the case had standing to appeal an order of the bankruptcy court, whether prepetition payments to certain claimants violated the equality of distribution required by the Code, and whether the bankruptcy court erred in dismissing the case.

The court found that standing to appeal an order of the bankruptcy court is subject to a more restrictive, prudential limitation than is applicable for general standing to participate in the early stages of a bankruptcy proceeding. The court found the insurance carriers had standing to challenge the plan because they had a fundamental stake in the outcome of the bankruptcy proceeding.

Further, because certain claimants relinquished rights to future payments in a settlement agreement, the court found the prepetition transfers did not violate the Code.

Finally, the court considered whether the bankruptcy court erred in dismissing the chapter 11 case without first holding a hearing. The court held that a bankruptcy court has an independent duty to determine whether a plan is confirmable and may dismiss or convert a case so long as the conversion or dismissal is in the best interests of the creditors and the estate. The court held that instead of evaluating whether the dismissal would be in the best interests of the debtors' estate, the bankruptcy judge focused on prior difficulties in drafting the plan and effectively sanctioned the plan proponents for failing to produce a plan acceptable to the court. The district court determined dismissal was not in the best interest of the debtor, the creditors or the estate and reversed the order dismissing the bankruptcy case.

***Bank of New York Trust Co., NA, et al. v. Official Unsecured Creditors' Committee, et al. (In re The Pacific Lumber Co.),* Case. No. 08-40746, (5th Cir. Sept. 29, 2009).**

The Debtors were involved in the heavily regulated industry of growing and harvesting redwood timber. Their various assets included 200,000 acres of prime redwood timberland, a sawmill, a power plant, and the town of Scotia, California. In a direct appeal from the bankruptcy court, certain noteholders challenged the legality of a confirmed chapter 11 plan. Plan confirmation was not stayed during the appeal and the plan was substantially consummated before the parties had oral argument in the appellate court. The plan proponents moved to dismiss the appeal on the grounds of equitable mootness.

The Fifth Circuit first found that equitable mootness did not bar: (1) review of the treatment of the noteholders' secured claims; (2) evaluation of whether their administrative priority claims was correctly calculated; and (3) review of the plan's release clauses insulating multiple parties' from liability. Because of the substantial confirmation of the plan, over $500 million in cash was escrowed to pay the noteholders. If the Fifth Circuit reversed the bankruptcy court's decision, the cash would revert to the reorganized company for some other use. The expectations of third parties other than the plan proponent could be preserved despite a decision reinstating or re-evaluating the noteholders' lien. The plan proponent was a sophisticated investor "who opted to press the limits of bankruptcy confirmation and valuation rules." *Id.* at 22.

Equitable mootness did bar review of issues related to the treatment of impaired and unsecured classes. The noteholders' impairment and classification contentions were equitably moot. Because the plan had been substantially consummated, the unsecured creditors had received payment on their claims. Those third-party expectations could not be undone.

B. <u>BANKRUPTCY RULES</u>

***In re Washington Mutual, Inc., et al.*, 419 B.R. 271 (Bankr. D. Del. 2009).**

The bankruptcy court held that a Noteholders Group was an "entity or committee representing more than one creditor" and therefore required to comply with the disclosure requirements of Rule 2019. The issue came to the court when JPMorgan Chase Bank National Association filed its Motion to Compel the Washington Mutual, Inc., Noteholders Group to Comply with Rule 2019.

The Noteholders Group argued that Rule 2019 was not applicable. Rule 2019 requires disclosure from "every entity or committee representing more than one creditor or equity security holder." Such parties must disclose, among other things, "the amount of claims or interest owned by the entity, the members of the committee, or the indenture trustee, the amounts paid therefor, and any sales or other dispositions thereof." The Noteholders Group, however, argued that it was merely a "loose affiliation of creditors who, in the interests of efficiency are sharing the cost of advisory services in connection with the case." Counsel for the Noteholders Group pointed out that they had no ability to speak for or bind any of the individual members absent their individual consent. Therefore, they argued, they were not subject to Rule 2019.

The court disagreed. The court found that the characteristics of the group made it fit squarely within the definition of an ad hoc group or an entity representing more than one creditor, to which Rule 2019 would apply. The Noteholders Group, among other things, 1) consisted of multiple creditors holding similar claims, 2) filed pleadings and appeared in the chapter 11 cases collectively, not individually, and 3) retained counsel, which took its instructions from the Group as a whole. The court discussed the plain language of the Rule, the history of the Rule, and the recent attempts to modernize the Rule by the Advisory Committee on Bankruptcy Rules and found that all of them supported requiring the Noteholders Group to comply with the disclosure requirements.

***In re Premier International Holdings, Inc., et al.*, Case No. 09-12019 (Bankr. D. Del. Jan. 20, 2010).**

The bankruptcy court held that an "informal committee" of bondholders was not a "committee representing more than one creditor" and therefore was not required to comply with the disclosure requirements of Rule 2019. Importantly, Judge Sontchi's holding in this case stands in stark contrast to the holding of Judge Walrath only two months prior in *In re Washington Mutual, Inc., et al.*, 419 B.R. 271 (Bankr. D. Del. 2009) as well as the holding of *In re Northwest Airlines, Corp., et al.*, 363 B.R. 701 (Bankr. S.D.N.Y. 2007).

The issue came before the court when the Official Committee of Unsecured Creditors filed its Motion to Compel the SFO Noteholders Committee to Comply with Federal Rule of Bankruptcy 2019. Specifically, the Official Committee wished to compel the SFO Noteholders to disclose (a) the amount of each of their respective claims, (b) the dates those claims were acquired, (c) the amounts paid for those claims, and (d) the dates and circumstances of any subsequent disposition of those claims. These disclosures were necessary, the Official Committee argued, so that the court and the Official Committee could "evaluate the SFO Noteholders Committee's credibility and motives in these cases…."

The court denied the motion because it refused to classify the SFO Noteholders Committee as a "committee" under Rule 2019. The court stated that this holding is supported by both the plain language of Rule 2019 as well as the legislative history behind the Rule and its predecessor Rule 10-211 under Chapter X of the Bankruptcy Act. In particular, the court focused on the meaning of the words "committee" and "represent" as used in Rule 2019. The court noted: "In order for a group to constitute a committee under Rule 2019, it would need to be formed by a larger group either by consent, contract, or applicable law—not by 'self-help.'" A self-appointed subset of a larger group, the court continued, "simply does not constitute a committee under the plain meaning of the word." Further, the court felt that in order to "represent" a party, there must be an "active appointment of an agent to assert deputed rights." Thus, because the SFO Noteholders Committee did not represent any parties other than its members, either by consent or operation of law, it was not a "committee" under Rule 2019.

C. BAPCPA[1]

***Hutson v. E.I. du Pont de Nemours & Co., Inc. (In re National Gas Distributors, LLC)*, Case No. 07-2105 (4th Cir. Feb. 11, 2009).**

The Fourth Circuit reversed a decision on direct appeal from the bankruptcy court, which gave a narrow reading to the definition of a "commodity forward agreement" and remanded for a finding, in light of certain required elements found in the statutory language, of whether the contracts at issue were "commodity forward agreements" entitled to broad protections under the Bankruptcy Code.

In the year before filing for chapter 11 protection, the debtor entered into contracts to deliver natural gas in the future to three customers. The trustee sought to avoid the contracts as fraudulent transfers, alleging that the debtor sold the gas at below market prices either as part of a fraudulent scheme or in a fraudulent manner. The defendant customers argued that the contracts were "swap agreements" in that they were "commodity forward agreements" and not avoidable pursuant to section 546(g). The defendants argued that the contracts provided a hedge to manage commodity risks.

The bankruptcy court ruled that the contracts were simple supply agreements by a single end user to purchase a commodity, which were physically settled and not traded in the financial markets. As such, the contracts did not constitute swap agreements. The defendants appealed the decision directly to the Fourth Circuit.

Although the Fourth Circuit agreed that Congress sought to provide safe harbors to protect the financial markets from the destabilizing effects of a bankruptcy case, it held that (i) the term "swap agreement" was defined too narrowly by the bankruptcy court, (ii) there was no statutory requirement that a commodity forward agreement be traded on an exchange or in a market, and (iii) there was no statutory requirement that a swap agreement be settled financially. Additionally, the Fourth Circuit set out statutory guideposts to assist judges in recognizing commodity forward agreements and swap agreements. The Fourth Circuit remanded to the bankruptcy court for a determination of whether the contracts at issue were commodity forward agreements or swap agreements.

***Milavetz, Gallop & Milavetz, P.A. v. United States*, 541 F.3d 785 (8th Cir. 2008).**

The plaintiff, a bankruptcy law firm, sought a declaratory judgment that certain provisions of the BAPCPA did not apply to attorneys and/or law firms, and were otherwise unconstitutional as applied to attorneys. The plaintiff argued that section 526(a)(4) and 528(a)(4) and (b)(2) did not apply to attorneys and law firms and were otherwise unconstitutional. Section 526(a)(4) directs the activity of "debt relief agencies" while section 528(a)(4) and (b)(2) restricts the advertising conducted by debt relief agencies. The district court granted summary judgment in favor of the plaintiff declaring that attorneys/law firms in the District of Minnesota were excluded from the definition of debt relief agency and that the challenged provisions were unconstitutional as applied to attorneys in the District of Minnesota. The Eighth Circuit, however, affirmed in part and reversed in part.

[1] BAPCPA means the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.

The Eighth Circuit held that attorneys/law firms are included in the definition of debt relief agency because attorneys/law firms were not specifically excluded from the definition. The court found that section 526(a)(4) was substantially overbroad and unconstitutional as applied to attorneys. However, the court found that the restrictions on advertising by debt relief agencies were constitutional as it applied to attorneys. The court found that advertising by attorneys/law firms shall include the proscribed language "We are a debt relief agency. We help people file for bankruptcy relief under the Bankruptcy Code." The court found that the advertising disclosures required attorneys to disclose factually correct statements and this did not violate the First Amendment.

***In re Henderson*, 2008 WL 1740529 (Bankr. W.D. Tex 2008).**

A debtor filed a chapter 7 bankruptcy petition. After the filing, the debtor died. The debtor's will was probated in the state courts and the estate representative sought to waive the financial management course under section 727(a)(12). Ordinarily, the debtor must complete the financial management course or the debtor cannot obtain a discharge.

The bankruptcy court found that the debtor's death was a "disability" under section 109(h)(4) and waived completion of the course.

***In re Plastech Engineered Products, Inc.*, 397 B.R. 828 (Bankr. E.D. Mich. 2008).**

Section 503(b)(9), which was added to the Bankruptcy Code by the BAPCPA, provides an administrative expense priority to a claim for "the value of any goods received by the debtor within 20 days before" the petition date. The debtor, a tier one automotive supplier, objected to the section 503(b)(9) claims filed by four claimants, asserting that the claimants delivered services, not goods, to the debtor as required by the statute. The claimants included a company which plowed snow and applied salt and de-icer for the debtor; a company which sold thermoplastic polyolefin pellets to the debtor; a company which repaired or replaced broken parts on electric motors for the debtor; and a company which provided natural gas to the debtor.

Because the Bankruptcy Code does not define "goods," the debtor urged the court to adopt the definition of "goods" contained in the Uniform Commercial Code and to apply the "predominant purpose" test used in the UCC and other contexts to find that the claimants provided services, not goods, to the debtor.

The bankruptcy court agreed that it should apply the UCC definition of "goods" but rejected the "all or nothing" approach of the "predominant purpose" test. The plain language of section 503(b)(9) required only that the value of the goods delivered to the debtor within 20 days before the petition date be ascertained. Analyzing the proofs of claim and supporting materials offered by the four claimants, the court was able to determine the value of goods provided by each. The court concluded the claimants were entitled to a section 503(b)(9) claim for the value of such goods. The remainder of their claims, however, were for services, which were properly relegated to unsecured non-priority claim status.

***In re First Magnus Financial Corporation*, 390 B.R. 667 (Bankr. Ariz. 2008).**

In a case of first impression, the bankruptcy court denied an administrative expense claim under section 503(b)(1)(A), as amended by the BAPCPA, brought by former employees of a chapter 11 debtor for wages and benefits to which they were allegedly entitled under the Worker Adjustment and Retraining Notification Act ("WARN Act"), 29 U.S.C. section 2101.

The former employees were laid off five days before the debtor filed its chapter 11 petition, allegedly without receiving 60 days' advance written notice as required by the WARN Act. The former employees maintained that the 60-day liability period of the violation ran into the postpetition period and that the postpetition portion of their claims was an administrative expense under section 503(b)(1)(A)(ii).

The bankruptcy court denied the claim, holding that the plain language of section 503(b)(1)(A) limits recovery to those persons who are employed by the debtor postpetition. The first and second subsections of section 503(b)(1)(A) are joined by the word "and" which under statutory construction rules requires that both parts of the subsections must exist in order for a claimant to be entitled to an administrative expense. Section 503(b)(1)(A)(i) clearly requires that services be rendered "after the commencement of the case." The bankruptcy court noted this interpretation of the statute is consistent with the longstanding law that only debts that arise postpetition can be treated as administrative expenses and with the notion that a liquidating chapter 11 trustee or debtor-in-possession does not succeed to the notice obligations, and thus the liability for any noncompliance therewith, of the prepetition operating debtor. In addition, the claimants had not been awarded back pay by a court or the NLRB, and the bankruptcy court, a court of limited jurisdiction, was not granted the power to adjudicate, in the first instance, whether an award under the WARN Act was appropriate. Finally, the bankruptcy court noted that the wage priority scheme of section 507(a)(4) requires that administrative expense priority be given only to those expenses related to the actual, necessary costs and expenses of preserving the estate. A WARN Act claim of an employee terminated prepetition, by definition, can never be an expense of preserving the estate postpetition.

***Ad Hoc Group of Timber Noteholders v. The Pacific Lumber Co. (In re Scotia Pacific Co., LLC),* 508 F.3d 214 (5th Cir. 2007).**

The bankruptcy court held that the debtor was not a single asset real estate debtor because the debtor was engaged in a substantial business other than operating real property. The Fifth Circuit affirmed using a definition of single asset real estate debtor "according to an active-versus-passive criterion that inquires into the nature of revenue generation on and by the property, that is whether the revenue is the product of entrepreneurial, active labor and effort (and thus is not single asset real estate) or is simply and passively received as investment income by the debtor as the property's owner-and thus is single asset real estate." The Fifth Circuit held that section 101(51B) requires all three elements be met to be considered a single asset real estate debtor: (1) the debtor must have real property constituting a single property or project (other than residential real property with fewer than 4 residential units), (2) which generates substantially all of the gross income of the debtor, and (3) on which no substantial business is conducted other than the business of operating the real property and activities incidental thereto. The Fifth Circuit held that because there was extensive business conducted on the debtor's real property, the debtor did not qualify as a single asset real estate debtor.

D. CLAIMS

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

Two individuals owned properties in Chicago, which were fully encumbered with several mortgages held by a bank. The individuals, Kreisler and Erenberg, filed for chapter 7 bankruptcy protection. Their cases were jointly administered. The bank began negotiating with the trustee about significantly reducing one of the claims in exchange for the trustee's help in obtaining the court's approval to foreclose on the other property. The trustee and bank never reached a settlement, and in the meantime, the debtors formed a separate company (Garlin) and negotiated and ultimately purchased one of the bank's claims for $16,500. The bank assigned Garlin its claim. When Garlin moved to have the secured claim paid, the issues of Garlin's ownership and management arose. The court discovered that Garlin was a separate company owned by Kreisler's sister and a close friend of Erenberg and that neither had contributed capital to the company. Neither Kreisler nor Erenberg were officers or directors of Garlin, but Kreisler did act as its counsel, and in fact, negotiated the deal with the bank. The bankruptcy court at discovering this relationship "threw the book at them" and equitably subordinated Garlin's secured claim pursuant to section 510(c) on a finding that the debtors engaged in misconduct. The district court affirmed.

The Seventh Circuit reversed and remanded finding that "misconduct alone doesn't justify subordination of this claim." Instead, the court found that the misconduct had to have harmed other creditors in order to be equitably subordinated. The court noted that there were no creditors that were harmed in the claims buying transaction, and that the only creditor affected was the bank from whom Garlin purchased the claim – and the bank wasn't complaining. Because no creditors were harmed, the court ruled that there was no justification to equitably subordinate Garlin's secured claim.

***In re Plastech Engineered Products, Inc.*, Case no. 08-42417 (Bankr. E.D. Mich. Feb. 21, 2008).**

The debtor identified several vendors that repudiated or refused to honor their contractual obligations postpetition. These vendors refused to continue to supply goods unless and until the debtor paid all outstanding prepetition claims, agreed to onerous postpetition payment terms and agreed to price increases. The debtor argued that these repudiating vendors were making the debtor's business unstable and more likely to fail. The debtor proposed a procedure whereby the debtor would pay these repudiating vendors a provisional amount that covered a small portion of their undisputed prepetition claims in exchange for the vendor's agreement to continue or restart shipping to the debtor. The debtor would then notify the repudiating vendor and its counsel of the debtor's belief that the vendor is in violation of the Bankruptcy Code by failing to perform its contractual obligations postpetition. The debtor would then schedule a hearing before the court to determine (i) if the vendor has an enforceable contract, and (ii) if the vendor has refused to ship in violation of such contract(s) and in violation of the automatic stay. The debtor would have the burden to demonstrate the violation of the contracts and section 362. The bankruptcy court approved this procedure

***In re Winstar Communications, Inc.*, 554 F.3d 382 (3d Cir. 2009).**

This case is an appeal of an adversary proceeding brought by the debtors, Winstar Communications, Inc. ("Winstar"), and its wholly owned subsidiary Winstar Wireless, Inc. ("Wireless"), and, later, by the chapter 7 trustee, against Lucent Technologies Inc. Winstar provided local and long distance telecommunications services. In 1998, Winstar and Lucent entered into a "strategic partnership" through which Lucent agreed to help finance and construct a global broadband telecommunications network for Winstar. Wireless agreed to act as Lucent's subcontractor and build various aspects of the network for Lucent.

At the conclusion of a 21-day bench trial to the bankruptcy court, the trustee sought and the court granted (i) recovery of a $188 million preference payment made by Lucent four months prior to the petition date, (ii) breach of contract damages in the amount of $62 million against Lucent, and (iii) equitable subordination of Lucent's claims against Winstar's estate to those of other creditor's and certain equity interest holders. The court determined that what began as a strategic partnership to benefit both parties quickly degenerated into a relationship in which the much larger company Lucent "bullied and threatened" the smaller Winstar into taking actions that were designed to benefit the larger at the expense of the smaller. The court concluded that Lucent exercised control over Winstar such that Lucent used "Winstar as a mere instrumentality to inflate Lucent's own revenues." On appeal, the district court affirmed.

Lucent appealed the lower courts' holdings on the preference claim, the breach of contract award and equitable subordination.

Preference claim: The Third Circuit affirmed the bankruptcy court's holding that Lucent was a non-statutory insider for purposes of extending the time for recovery of preferential payments such that the trustee may recover a $188 million payment to Lucent made four months prior to bankruptcy as a preference. The principal issue on appeal was the legal standard for "insider" under section 101(31). Lucent asserted that in order for a creditor to constitute an "insider" as either a "person in control" or a non-statutory insider, that creditor must exercise "actual managerial control over the debtor's day-to-day operations." While the Third Circuit agreed with Lucent that actual control is necessary for a creditor to constitute an insider under section 101(31)'s "person in control" language, a finding of such control is not necessary for an entity to be a non-statutory insider. The non-statutory insider determination hinges on "whether there is a close relationship between the debtor and creditor and anything other than closeness to suggest that any transactions were not conducted at arm's length."

The Third Circuit rejected Lucent's contention that it simply used its superior bargaining position to push Winstar to purchase as much Lucent equipment as Winstar was willing to take. The bankruptcy court's "extensive findings" regarding Lucent's ability to coerce Winstar into transactions not in Winstar's interest amply demonstrated Lucent's insider status. Lucent repeatedly forced Winstar to make "massive, last minute, unneeded purchases that were arranged by Lucent as the ends of quarters approached." Winstar's purchases of Lucent equipment in end of quarter sales were on average eight times as high as Winstar purchases of Lucent equipment in months in which a quarter did not end. In one particularly egregious example, Lucent coerced Winstar into purchasing $135 million worth of "software it did not need, did not use, and had a fair market value of substantially less than the contract price." In fact, frequently, goods purchased by Winstar "never even left the Lucent warehouse." These coerced deals enabled Lucent to report more revenue and appear more profitable in its quarterly public reports than it really was. The record also demonstrated that Lucent "deliberately held up" the issuance of a refinancing notice under the Lucent credit facility in order to ensure that the Siemens loan and $270 million in private equity investments occurred and new equity was infused into the "dying Winstar." In sum, there was sufficient evidence that the parties were not dealing at arms length.

Breach of contract: The Third Circuit turned next to the bankruptcy court's holding that Lucent should be required to pay the estate $62 million for breaching a subcontract with Wireless. The court found that the breach of contract claim was within the bankruptcy court's jurisdiction as "related to" the Trustee's case under title 11. Lucent filed proofs of claim against Winstar and Wireless, supported in part by the subcontract agreement with Wireless. Therefore, in order to determine whether Lucent was entitled to recover on its proof of claims, and if so, in what amount, the bankruptcy court had to determine whether Lucent breached its obligations under the subcontract. Any amount that Lucent was entitled to recover against Winstar would be offset by any amount that Lucent failed to pay under the subcontract. Accordingly, the Trustee's breach of contract claim fell within section 157(c)(1) because resolution of that claim could have an effect on the estate being administered in bankruptcy. Although it could not enter a final judgment on the breach of contract claim, the bankruptcy court expressly entered, in the alternative, proposed findings and conclusions, and the district court upheld the bankruptcy court's resolution of the breach of contract claim after reviewing the decision under a plenary standard of review.

Equitable subordination: Finally, the Third Court affirmed the bankruptcy court's decision to equitably subordinate Lucent's claims to those of other creditors. The evidence supported a finding of inequitable conduct which caused substantial actual harm to Winstar's other creditors. However, the bankruptcy court did improperly subordinate Lucent's claims to those of equity interests, which is not consistent with section 510(c). The Third Circuit therefore modified the bankruptcy court's equitable subordination order such that Lucent's claims were subordinated only to the claims of other creditors.

***In re Vitalsigns Homecare, Inc.*, 396 B.R. 232 (Bankr. D. Mass. 2008).**

The debtor operated a home health care business prior to filing for chapter 11 bankruptcy protection. The case was converted to a chapter 7 proceeding, whereby the chapter 7 trustee sought authority to sell the debtor's Medicare provider number free and clear of all encumbrances. The federal department of Health and Human Services ("HHS"), the agency that oversees the Medicare and Medicaid programs, objected. The trustee argued that the provider number constitutes a statutory entitlement. The HHS argued that the number was assigned pursuant to a Medicare Provider Agreement which is an executory contract. The issue before the court was whether the Bankruptcy Code permits the sale of the Medicare provider number free and clear of any claims for recoupment against the successor.

The court explained the Medicare process whereby the health agency submits a claim to regional providers that review, process and pay Medicare claims. Payments to providers are made on an interim basis under a "system of prospective reimbursement." Following an audit by the regional intermediary, the health care providers may be required to reimburse HHS for overpayments. Outside of bankruptcy, when a change of ownership takes place, the new owner accepts the prior owner's previous agreements and the overpayments may be recovered from the new owner.

The chapter 7 trustee, however, was attempting to sell only the provider number and not sell to the purchaser the assets and liabilities of the debtor company, including the HHS' right to exercise recoupment. The court, persuaded by the majority of other bankruptcy courts that have held that a Medicare provider agreement is an executory contract, ultimately approved the sale of the provider number and authorized the HHS to exercise its recoupment rights in this fashion: first from any overpayments made to the debtor, then from any funds held by the trustee if generated by Medicare payments, then against any sale of proceeds generated by the sale of the provider number, and finally, against the successor of the provider number.

***In re Patriot Aviation Services, Inc.*, 396 B.R. 780 (Bankr. S.D. Fla. 2008).**

MezzCap filed a general unsecured claim in the amount of $120,000. Prepetition, MezzCap and the debtor entered into a letter of intent that contemplated the purchase by MezzCap of senior subordinated notes of the debtor for $4 million. Because MezzCap did not purchase the notes, it filed its claim for the alternative transaction fee provided for under the letter of intent. The chapter 11 trustee and the committee objected to the claim and sought to subordinate the claim pursuant to section 510(b).

The court concluded that the debt financing arrangement constituted "security" as contemplated by section 510(b). The court held that the claim was for damages that *arose from* the purchase of a security pursuant to section 510(b), and therefore mandatory subordination was appropriate. However, the court found that the appropriate subordination of MezzCap's claim, if allowed, shall be from a secured claim to a general unsecured claim. So, even though MezzCap filed an unsecured claim, the court stated that the claim filed by MezzCap was actually a claim to purchase secured debt securities.

***In re Matrix Dev. Corp.*, 2009 WL 2169717 (Bankr. D. Or. 2009).**

In this case, the court overruled the debtor's objection to the creditors' notices of election under section 1111(b)(2) (election of a secured claim). Under the debtor's plan, the debtor proposed to continue to develop retained properties, then sell the developed properties as individual units. The debtor objected to the election by the creditor and argued that the sale of the units was in the ordinary course of its business (verses under a plan).

The court held that section 1111(b)(1)(B)(ii) prohibits a recourse creditor from making an election under section 1111(b)(2) only where the creditor's collateral is sold "under section 363" or "under the plan." Further, the court held the sale exception of section 1111(b) is only applicable if the effected creditor is allowed to credit bid at the sale of its collateral. The plan must provide for an auction of the creditor's collateral or, if the sale is to be a private sale, disclose the specifics of the sale, including the name of the purchaser, the sale price, the proposed closing date, other terms of the sale, and where the proposed sale will occur substantially contemporaneously with plan confirmation.

The debtor's Plan proposed "ordinary course" sales with no right of credit bid granted to the creditors upon the sale of their collateral. Further, the Plan contained no specifics as to the terms of those sales or even when the sales were to occur. The court held the "ordinary course" sales proposed by the debtor were not sales "under the plan" within the meaning of section 1111(b). Thus, the debtor's objection to the creditors' section 1111(b)(2) election was overruled.

***In re SNTL Corp.*, 571 F.3d 826 (9th Cir. 2009).**

The Ninth Circuit considered the issue of whether an unsecured creditor may include attorneys' fees incurred postpetition but arising from a prepetition contract as part of its unsecured claim, a question left unanswered by the Supreme Court in *United Savings Ass'n of Texas v. Timbers of Inwood Forest*

Assocs., Ltd., 484 U.S. 365 (1988). The Ninth Circuit rejected the argument that section 506(b) preempts postpetition attorneys' fees for all except over-secured creditors.

The Ninth Circuit held that the parties' execution of a prepetition agreement containing a provision for attorneys' fees gave rise to a contingent, unliquidated attorneys' fee claim. The court allowed the creditors to assert unsecured claims for fees and costs arising under their contracts with the debtor, because even though the creditors' claims were not allowed secured claims under section 506(b), section 502(b), (which applies to claims generally), does not specifically disallow attorneys' fees to creditors. The court reasoned that so long as the right to collect the fees existed prepetition, the fact that the fees were actually incurred during the postpetition period is not relevant to the determination of whether the creditor has an allowable prepetition claim for the fees. Because the creditors were entitled to claim postpetition attorneys' fees as part of their unsecured claims under section 502, the court remanded the case to the bankruptcy court to determine whether the creditors satisfied the requisites for allowance of that portion of their claims under the relevant contract and state law.

***SeaQuest General Holdings, LLC v. S&J Diving, Inc. (In re SeaQuest Diving, L.P.),* 2009 WL 2450680 (5th Cir. Aug. 12, 2009).**

The Fifth Circuit considered whether a former partner's claims should be equitably subordinated under section 510(b). Section 510(b) orders subordination of claims "arising from rescission of a purchase or sale of a security of the debtor." In this case, the debtor was a limited partnership and its general partner a limited liability company. Shortly after the partnership was formed, conflicts arose and lawsuits were filed. The parties eventually entered into an agreement; however, when it was not consummated, one lawsuit proceeded resulting in a state court judgment in favor of one of the partners. The debtor filed for bankruptcy protection shortly after entry of the judgment, and listed the judgment as an unsecured debt on schedule F. Two of the debtor's creditors sought equitable subordination of the debt pursuant to section 510(b) claiming the judgment was based on an equity interest and was not a claim. The bankruptcy court concluded that the claim was the result of a rescission of the limited partnership and LLC agreements and related obligations to merge businesses and acquire assets and, therefore subordinated the claim pursuant to section 510(b). The appeal was certified directly to the Fifth Circuit, which affirmed the bankruptcy court's ruling finding that the judgment was a rescission of a securities agreement. The Fifth Circuit reasoned that subordination would prevent the partner from relying on the state court judgment to elevate its claim from a preferred equity interest to an unsecured position in contravention of the absolute priority rule.

***Ogle v. Fidelity & Deposit Company of Maryland,* Case No. 09-0691 (2d Cir. Nov. 9, 2009).**

The Second Circuit held that the Bankruptcy Code does not prohibit an unsecured creditor from collecting post-petition attorneys' fees pursuant to an otherwise enforceable pre-petition contract of indemnity. Fidelity & Deposit Company of Maryland entered into several agreements with Agway, Inc., which required Agway to indemnify Fidelity for attorneys' fees that it might incur to enforce the agreements against Agway. After Agway filed for bankruptcy under chapter 11, Fidelity made payments to Agway's creditors, unsuccessfully demanded indemnity from Agway, and incurred attorneys' fees in litigation to collect from Agway. Those attorneys' fees were the subject of the appeal. The bankruptcy court held that Fidelity was entitled to the attorneys' fees, and the district court affirmed. The Second Circuit affirmed as well.

The court discussed its prior holding in the case of *United Merchants & Manufacturers, Inc. v. Equitable Life Assurance Society of the United States*, 674 F.2d 134 (2d Cir. 1982), which found that an unsecured creditor could collect attorneys' fees in a situation such as this pursuant to the Bankruptcy Act. The issue before the court was whether *Travelers Casualty & Surety Co. of America v. Pacific Gas & Electric Co.*, 549 U.S. 433 (2007) or the statutory changes since *United Merchants* affected the court's prior decision. After examining the effect of sections 502(b) and 506(b) on the issue, the court held that neither statutory revisions nor *Travelers* impaired *United Merchants*.

E. EMPLOYMENT ISSUES

***In re Energy Partners, Ltd., et al.*, Case No. 09-32957-H4-11 (Bankr. S.D. Tex. August 10, 2009).**

In *Energy Partners*, Judge Bohm wrote a scathing opinion denying the applications of Tudor Pickering Holt & Co. Securities ("Tudor Pickering") to serve as valuation consultant for the Official Committee of Equity Security Holders ("Equity Committee") and Houlihan Lokey Howard & Zukin Capital, Inc. ("Houlihan Lokey") to serve as financial advisors to the Official Committee of Noteholders ("Noteholder Committee"). The court described their requested employment terms as "outrageous" and referred to Tudor Pickering and Houlihan Lokey as "greedy," "arrogant," and "hogs." In addition, the court characterized the testimony of the three witnesses as "conclusory, scant, and self-serving on certain key points."

The Tudor Pickering application proposed: (1) a nonrefundable advisory fee of $500,000; (2) a nonrefundable expert witness fee of $25,000 per day for each day of deposition or testimony; (3) a nonrefundable extended assignment fee of $100,000 per month; and (d) out-of-pocket expenses. The Houlihan Lokey application sought: (1) a non-refundable initial fee of $500,000; (2) a nonrefundable additional fee of $100,000 for August 1, 2009 through August 15, 2009; (3) a nonrefundable additional fee of $100,000 for August 16, 2009 through August 31, 2009; and any out-of-pocket expenses. Both the Equity Committee and the Noteholder Committee wanted their respective professionals to, among other tasks, provide an enterprise valuation of the debtors.

The court described its role as the "gatekeeper" to ensure that the employment of these professionals was in the best interests of the estate. The court first considered whether Houlihan Lokey and Tudor Pickering should be retained, as requested, under 11 U.S.C. section 328(a), a determination that the court did not take "lightly" because, once approved, the terms and conditions cannot be modified without a finding that they were improvident. Applying the factors set forth in *Insilco Technologies, Inc.*, 291 B.R. 628, 633 (Bankr. D. Del. 2003), the court stated that the movants did not put forth sufficient evidence that the terms of the engagement agreements reflected the normal business terms in the marketplace. The debtors' investment banking firm (Parkman Whaling) had agreed to provide similar services for only $75,000 a month (plus transaction fees payable upon certain contingencies occurring). There was nothing in the record to show that Houlihan Lokey and Tudor Pickering would provide services superior to that of Parkman Whaling. The court also found a lack of evidence of arms' length negotiation. Calling the Noteholder Committee's witness's testimony too generalized and conclusory, the court found it lacked specifics as to who conducted the negotiations, where they took place, for how long, and if proposals were made and reduced to writing. The court further found the retention was not in the best interests of the estates, there was creditor opposition to the retention and retainer provisions, and the amount of the compensation was unreasonable.

In addition, the court found the proposed valuation work to be duplicative. The court had previously approved the debtors' Second Amended Disclosure Statement, which had referenced two valuation reports for the debtors' assets: the Parkman Whaling report that valued the debtors' equity at zero and the Birch Run report that valued the debtors' equity at in excess of $212,000,000. The court determined that the Noteholder Committee request that the estate transfer $500,000 to Houlihan Hokey "so that yet another valuation report can be generated showing no equity value" was "extravagant."

The court cautioned parties that "if the parties themselves give in to these investment bankers, then the bankruptcy courts themselves must call the bluff of these financial advisors and challenge them to accept reasonable fee arrangements."

Houlihan Lokey and the Noteholder Committee filed a joint motion to amend the court's opinion and correct the court's "unwarranted attack." The court denied the motion to reconsider.

***Official Comm. of Unsecured Creditors v. Perseus Partners VII, L.P. (In re Distributed Energy Sys. Corp.),* Case No. 09-11101 (Bankr. D. Del. May 18, 2009).**

Prior to filing for bankruptcy, the debtors received a cash infusion from a third party investment fund evidenced by a securities purchase agreement. The fund maintained that the cash infusion was a secured loan. After the case was filed, the court granted the creditors committee standing to sue the fund on behalf of the debtor's estate, seeking to recharacterize the loan as an equity investment, or to equitably subordinate the loan. The committee and the fund settled the dispute. The debtors also engaged a financial advisor that was to be paid a monthly fee and transaction fees based on the sales of two affiliates of the debtor. Pursuant to its engagement letter, the transactions fees were conditioned on the fund receiving payment in full.

On the objection of the committee, the bankruptcy court denied payment of the transaction fees to the advisor on the grounds that the fund was not paid in full, notwithstanding language in the settlement agreement stating that the fund's claims were deemed satisfied in full. The court went on to hold that if it were necessary to decide, the distress of the current economy is the type of "changed circumstances" that would necessitate disallowing the transaction fees under section 328(a). The economic crisis clearly diminished the value of the sold entities, therefore, payment of the transaction fees would be "highly inequitable and improper."

The court approved the settlement agreement between the debtor, the committee and the fund over the objection of certain creditors. Under the settlement agreement, the fund agreed to distribute proceeds to the general unsecured creditors. Certain higher priority creditors objected on the basis of the absolute priority rule. The court overruled the objections on the grounds that the unsecured creditors were receiving proceeds from the sale of collateral of the fund, and not property of the estate. The absolute priority rule, therefore, was not implicated.

F. <u>INTEREST RATES</u>

***Drive Fin. Servs., L.P. v. Jordan,* 521 F.3d 343 (5th Cir. March 12, 2008).**

In a direct appeal from the bankruptcy court, the Fifth Circuit determined whether the prime-plus interest rate described in the Supreme Court's plurality opinion of *Till* was appropriate for a chapter 13 secured claim. Prepetition, the debtor purchased a motor vehicle with an interest rate of 17.95%.

After filing for bankruptcy protection, the debtor proposed to pay the secured creditor over time with an interest rate of 6%. The secured creditor objected.

The bankruptcy court ruled that *Till*'s ruling was binding and applied the "prime-plus" approach to the plan. The Fifth Circuit, after reviewing the Supreme Court's plurality opinion ruled that the prime-plus interest rate was the appropriate rate and rejected the application of the "narrowest grounds test" if it would yield an interest rate higher than the prime-plus approach.

G. <u>LANDLORD/TENANT</u>

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

Debtor was a large national restaurant chain. At the time of filing, the debtor had more than 600 company-operated restaurants and 16 franchise locations. Prior to the bankruptcy filing and in order to recapitalize, the debtors restructured by entering into certain sale/leaseback transactions with an entity referred to as FP.

After filing for bankruptcy protection, the debtor sought to reject two locations and assume and assign one location. FP objected arguing that the individual leases were not severable from the master leases and could not be assumed or rejected separately. The bankruptcy court looked to Illinois state law to determine whether a specific contract or lease is an indivisible agreement. Based on Illinois law, the test for severability is intent of the parties, and whether the parties intended a single contract or separate contracts. The bankruptcy court concluded that the agreements were not severable. The court found that the parties intended each master lease to be an integrated agreement because: the parties' conduct was that the master lease was integrated; the obligation to pay rent was joint and severable; the renewal terms were joint and severable; and the master lease was cross-defaulted. Moreover, the court found that FP's interest was only in the total package and it had no interest in individual leases. The court further relied on the contract negotiations of the parties when entering into the master leases, and found that FP's insistence that the contracts be integrated in master leases was consistent with the intent of the parties that the contracts not be severable.

***In re MD Promenade, Inc.*, 2009 WL 80203 (Bankr. N.D. Tex. Jan. 8, 2009).**

The debtor, a company operating a restaurant in leased space in Dallas, Texas, fell on hard times and agreed to vacate and relinquish possession of the premises to the landlord. Prior to the agreed upon vacation date, the debtor filed a voluntary chapter 11 petition, allegedly to attempt a quick sale of the restaurant.

After the sale fell through, debtor's principals (two brothers), with the assistance of a company owned by their parents, another entity owned by the debtor's principal's "girlfriend's father's friend," and various day laborers hired from a Sam's Club parking lot, "pilfered and ransacked" and "trashed" the premises, removing all personal property such as kitchen equipment, restaurant furniture, furnishings, and alcohol inventory and all fixtures such doors, frames and hardware, windows and their frames, hardware, restroom mirrors, sinks, toilets and urinals, indoor and outdoor light fixtures, kitchen ceiling tiles, kitchen equipment and stainless steel countertops, mop sinks, ceiling fans, a walk-in cooler door and condenser and the HVAC units and condensers (the latter, by crane, from the rooftop). The removal occurred without notice to any party in the bankruptcy case and without court permission.

Based on the debtor's conduct, the bankruptcy court entered orders compelling the immediate rejection of the lease and the turnover of items removed from the premises. When the principals and their cohorts failed to return the removed items or returned them with damage, such that the items were unusable, the landlord requested section 362(k) damages for willful violation of the automatic stay.

In its order resolving the landlord's request, the bankruptcy court noted the "paradoxical arguments" being made by the parties regarding the imposition of section 362(k) damages. The landlord argued that the removed items were permanent fixtures, such that they were the landlord's property by virtue of the lease with the debtor. If the landlord were correct that the removed items were its property, however, they were not property of the estate, such that no stay violation occurred. On the other hand, if the debtor's principals were correct that the removed items were the property of the debtor, then the principals and their cohorts had exercised control over property of the estate in violation of the automatic stay.

Ultimately, the bankruptcy court concluded that the answer "lies in the middle." Part of the removed items were fixtures belonging to the landlord and part were property of the estate. In both cases, the court found that contempt sanctions were appropriate pursuant to its equitable authority under section 105(a). With respect to the removed property of the estate, the debtor's principals and their parents' company contemptuously violated the automatic stay by willfully and recklessly exercising control over property of the estate for their own benefit. The court therefore concluded that the estate was entitled to an award of $250,000 in contempt sanctions. With respect to the landlord's property, the court further concluded that sanctions were available, based on the willful and knowing violation of the first turnover order entered in the case. The court therefore awarded to the landlord $150,000 in contempt sanctions.

***In re Four Bucks, LLC*, 2009 WL 1857432 (Bankr. N.D. Tex. 2009).**

The debtor operated an apartment complex. Pre-petition, the debtor entered into a financing agreement with its lender. The agreement included an assignment of lease and rents, along with a deed of trust and promissory note. Pre-petition, the debtor defaulted on the note and the lender accelerated the debt. Once in bankruptcy, the debtor requested the authority to use the rents collected as cash collateral. The lender objected citing that the pre-petition assignment of rents was absolute and that the debtor had no interest in the rents. The bankruptcy court determined that because the debtor defaulted pre-petition, the absolute assignment of rents was effectuated, and therefore on the petition date, the debtor had no interests in the rents. The court denied the debtor's use of the rent to be used as cash collateral.

***In re Empire Equities Capital Corp.*, 405 B.R. 687 (Bankr. S.D.N.Y. 2009).**

The bankruptcy court upheld the right of a debtor, pursuant to section 108(b), to exercise rights under an option contract that expired by its terms less than an hour after the bankruptcy petition was filed. Prepetition, the debtor entered into an option contract to purchase three loans secured by real property. The debtor paid a $100,000 deposit, which the debtor would lose if the option was not exercised. The option contract stipulated a strict deadline, but the debtors were able to extend the deadline twice for an additional down payment of $600,000. However, thirty-nine minutes before the final closing deadline, the debtor filed for bankruptcy. The counterparty to the option moved for an order granting relief from the automatic stay to terminate the contract or, in the alternative, to compel rejection.

The court began by establishing that the contract was not assumable under section 365 because the debtor's default on the option contract was both material and incurable. While there has been some disagreement in the past over the cure requirements for non-monetary defaults, the court noted that in 2005 "Congress revised the language of section 365(b)(2)(D) by including the word 'penalty' as a modifier to the word 'provision,' making it clear that most non-monetary defaults are not exempted from the cure requirements." This case presented a non-monetary default because the default was not in failing to make a payment but rather in failing to take action within the time provided for in the contract. Therefore, the court concluded, the debtor's failure to close on time was incurable, and the contract could not be assumed under section 365.

According to the court, however, section 108(b) gives a debtor broader rights than the power to cure a default. Section 108(b) also permits a debtor to "perform any other similar act…." This court joined several others in holding that this provision allows a debtor 60 days after the order for relief to take up an option that would otherwise have expired. The court was quick to point out that this ruling does not mean that every time a time-of-the-essence option contract is about to expire, the optionee can simply file for bankruptcy and get a 60 day extension. The contract counterparty could always move to dismiss a Chapter 11 petition that is filed for improper purposes.

H. <u>LIEN RIGHTS</u>

***Clear Channel Outdoor, Inc. v. Knupfer (In re PW, LLC)*, Case No. 07-1176 (9th Cir. BAP July 18, 2008).**

The debtor, PW, LLC, owned several parcels of real estate mortgaged to DW with junior liens held by Clear Channel Outdoor. Certain contractual obligations were not met by PW and DW set the parcels for foreclosure. On the eve of the foreclosure, PW filed for chapter 11 protection. In the bankruptcy, the chapter 11 trustee set the parcels for sale under section 363 of the bankruptcy code. DW was the stalking horse bidder with its credit bid, which was less than the secured claim amount. The auction failed to produce qualified bidders, and the properties were sold to DW for its credit bid amount. The bankruptcy court entered an order pursuant to section 363(f)(5) stripping the junior liens held by Clear Channel Outdoor. The bankruptcy court then confirmed the debtor's plan which stripped Clear Channel Outdoor of its liens. Clear Channel Outdoor appealed and the district court affirmed. The Bankruptcy Appellate Panel affirmed in part and reversed in part.

The BAP concluded that the doctrine of equitable mootness and section 363(m) rendered Clear Channel Outdoor's appeal of the validity of the sale to DW moot. However, the BAP held that the appeal of the lien-stripping ruling was not equitably moot because the court could fashion effective relief.

The BAP analyzed each of the five possible lien-stripping mechanisms under section 363(f), and held that the bankruptcy court applied an incorrect legal standard to strip Clear Channel Outdoor of its junior liens pursuant to section 363(f)(5). The BAP analyzed 363(f)(5) and found that the availability of cramdown under section 1129(b)(2) is not a "legal or equitable proceeding" to which section 363(f)(5) applies. The BAP remanded for the bankruptcy court to determine if there is a qualified proceeding under non-bankruptcy law that would allow the court to strip Clear Channel

Outdoor of its junior lien and allow the sale to DB to exist free and clear pursuant to section 363(f)(5).

***Kim v. Kim (In re Kim)*, 405 B.R. 179 (Bankr. N.D. Tex. 2009).**

In *Kim v. Kim*, the non-debtor spouse claimed equitable title to certain real estate held in the name of the debtor. Citing statements in two Fifth Circuit cases that "[a]s a general rule, it must be held that section 541(d) prevails over the trustee's strong arm powers," the court concluded that the claimed resulting trust should prevail over the rights of a trustee under section 544.

Several courts have come to a different conclusion and ruled that the avoidance power of section 544 is not restricted by section 541(d).[2] It is important to note that the 1984 amendment to section 541(d) deleted the phrase "under subsection (a) of this section" and replaced it with "under subsection (a)(1) or (2) of this section."[3] This amendment changed section 541(d) to exclude only property coming into the estate under section 541(a)(1) or (2), not under section 541(a)(3). Section 541(a)(3) includes in the debtor's estate any interest in property recovered by the debtor under section 550. That section allows the debtor to recover transfers avoided by the debtor under section 544. Consequently, section 541(d) does not appear to apply to property recovered by the debtor under section 544(a)(3).

The two cases cited by the court in *Kim v. Kim* do not support the ruling. In *Vineyard v. McKenzie* (*In re Quality Holstein Leasing*), 752 F.2d 1009 (5th Cir. 1985), the property in question was an airplane, and the trustee prevailed over the unrecorded interest. Because the item in question was personal property, the discussion by the court revolved around the respective rights of the beneficiary of a constructive trust and the holder of a judgment lien. In *Haber Oil Co. v. Swinehart (In re Haber Oil)*, 12 F.3d 426 (5th Cir. 1994), the court did not find a constructive trust, and it appears that the bona fide purchaser that actually bought the property was able to retain the property.

The United States Supreme Court in *Lamie v. United States Trustee*, 540 U.S. 526 (2004) said that a court should read a statute as it is written. Section 544 says that a trustee can avoid a transfer that can be avoided by a bona fide purchaser. Section 544 involves prepetition transfers that by definition involve property that is no longer property of the debtor and does not come into the estate under section 541(a)(1). However, section 550 says that if a transfer is avoided under section 544, it is recovered for the benefit of the estate. Section 541(a)(3) says that the estate includes any property recovered under section 550. Section 541(d) states that if the debtor just holds legal title, and not an equitable interest, that property becomes property of the estate under section 541(a)(1) and (a)(2) only to the extent of the legal title. Section 541(d) does not mention section 541(a)(3). It is clear from a literal reading of these sections that if an unrecorded interest in real estate does not prevail over a bona fide purchaser under the applicable state law then the unrecorded equitable interest can be avoided under section 544.

It is also worth noting that section 541(d) does not mention section 544. If Congress intended for section 541(d) to limit the reach of the trustee's strong arm powers under section 544, it could have

[2] *See, e.g.*, *Belisle v. Plunkett*, 877 F.2d 512, 516 (7th Cir. 1989); *Chbat v. Tleel (In re Tleel)*, 876 F.2d 769, 773-74 (9th Cir. 1989); *In re Ebel*, 144 B.R. 510, 515 (D. Colo. 1992); *Wilson v. Parson (In re Jones)*, 77 B.R. 541, 548-51 (Bankr. N.D. Tex. 1987); *In re Great Plains Western Ranch Co., Inc.*, 38 B.R. 899 (Bankr. C.D. Cal. 1984); *D & F Petroleum v. Cascade Oil Co., Inc. (In re Cascade Oil Co., Inc.)*, 65 B.R. 35, 40-41 (Bankr. D. Kan. 1986).

[3] Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, § 456, 98 Stat. 333, 376 (1984).

made this clear by including a reference to section 544 in section 541(d). This is precisely what Congress did in section 541(b)(4), which explicitly makes section 544(a)(3) inapplicable in the context of farmout agreements.

***Borrego Springs Bank, N.A. v. Skuna River Lumber, L.L.C. (In re Skuna River Lumber, LLC),* 564 F.3d 353 (5th Cir. 2009).**

The Fifth Circuit Court of Appeals held that a bankruptcy court may not surcharge or impose a judicial lien on property that has been sold in a section 363 sale, even if it is to secure payment of administrative expenses under section 506(c).

This case involved a sale of substantially all of the debtor's assets at auction. Equity Partners, Inc. ("EPI") was hired to facilitate this sale, but despite broad marketing to third parties, a credit bid from Borrego Springs Bank ("Borrego") won the auction. Because the amount owed to the Borrego exceeded the amount of the credit bid, the bankruptcy estate received no cash or tangible proceeds from the sale. The court entered an order approving the sale, and several months later, EPI sought reimbursement for its expenses and payment for its services. The bankruptcy court approved the application for compensation and surcharged the assets that had been sold to Borrego, securing the payment with a judicial lien on the assets.

On appeal, the district court affirmed this decision, but the court of appeals reversed, finding that the bankruptcy court had no jurisdiction over the property sold at the auction. The property had been conveyed to Borrego free and clear of liens and encumbrances nearly a month before the bankruptcy court attempted to impose a surcharge and lien. Section 506(c), which allows administrative expenses to be surcharged against a creditor's collateral, did not authorize the actions of the bankruptcy court because the property had already left the estate entirely.

The court of appeals also vacated the portion of the district court's decision that entered a personal judgment against Borrego when the debtor did not file a cross-appeal requesting that relief.

I. <u>PLAN & ASSET SALES</u>

***Moglia v. Keith (In re Manchester, Inc.),* 2009 WL 2243592 (Bankr. N.D. Tex. July 16, 2009).**

The plan trustee filed suit against multiple defendants for preferential transfers, fraudulent transfers, disallowance of claims, and subordination. Additionally, the plan trustee sued the same defendants for breach of fiduciary duty, payment of illegal dividends and negligent misrepresentation. The defendants moved to dismiss the lawsuit on the basis that the plan trustee lacked standing to assert the causes of action. The defendants argued that the plan did not contain "specific and unequivocal retention language" to preserve those claims to be pursued post-confirmation by the plan trustee. In citing *Dynasty Oil & Gas, LLC v. Citizens Bank (In re United Operating, LLC),* 540 F.3d 351 (5th Cir. 2008), the bankruptcy court ruled that in order for a cause of action to be preserved post-confirmation, the plan must specifically reserve the claims. The bankruptcy court concluded that the plan sufficiently preserved the right to pursue avoidance actions under chapter 5 of the Bankruptcy Code, but the plan did not preserve the right to pursue other causes of action such as breaches of contract, breach of fiduciary duty and negligent misrepresentation. The court reasoned that if the plan is sufficient enough to notify creditors that avoidance actions would be pursued post-conformation by plan trustee, the individual defendants of such avoidance actions did not have to be identified in the plan specifically.

***In re Bayou Group, LLC,* 564 F.3d 541 (2d Cir. 2009).**

The U.S. Trustee sought to replace a receiver that had been appointed by a pre-petition order of the district court with a court-appointed chapter 11 trustee. The Second Circuit denied the U.S. Trustee's motion, holding that the U.S. Trustee failed to meet the "very high standard" for appointing a chapter 11 trustee pursuant to section 1104 of the Code. The U.S. Trustee failed to show any "fraud, dishonesty, incompetence, or gross mismanagement" by the individual appointed by the district court, or that removal of the individual was in the interest of the creditors or the bankruptcy estates. The individual receiver had successfully recovered assets of the estate, and the creditor's committee opposed the U.S. Trustee's motion. The Second Circuit held that the district court's order effectively appointed the individual to serve as both receiver and sole managing member of the hedge fund entities, leaving no governance vacuum to fill. The Second Circuit also rejected the U.S. Trustee's argument that allowing the district court appointed receiver to prosecute the bankruptcy cases would supplant the U.S. Trustee's authority in chapter 11 cases.

***In re Estate of Larosa,* 2009 WL 1172843 (Bankr. N.D. W.Va. 2009).**

This case was filed prior to BAPCPA. Judgment creditors sought to have the chapter 11 case converted to chapter 7 under section 1112(b) on the basis that the judgment creditors were the only impaired creditors and their promised rejection of the debtors' plan made the plan incapable of being confirmed. The debtors argued that the bank, the only other creditor in this case, was impaired by the plan because the debt owed the bank by the debtors' corporation would be paid a few weeks or months early and the debtors' guarantees on letters of credit issued by the bank on behalf of the corporation would terminate. The court held that these grounds were insufficient to impair the bank's claims. The court found that the promissory note between the corporation and the bank specifically allowed for prepayment of the loan. Additionally, the court found that the debtors' personal guarantees would terminate even if such termination were not provided for in the proposed plan. Section 1141(d)(1), as it existed pre-BAPCPA, provided that the confirmation of a plan discharges the debtor from any debt or attempts to collect debt that arose before the date of such confirmation, including personal guarantees. The court held that a claim is only impaired if the "impairment results from what the plan does and not from what the statute does." Because these guarantees would be terminated as a matter of law, the plan language purporting to terminate such guarantees was insufficient to create an impairment as to the bank. The court gave the debtors 20 days to submit a plan capable of being confirmed before it converted the case to a chapter 7.

***In re Metaldyne Corp.,* 409 B.R. 661 (Bankr. S.D.N.Y. 2009).**

The original stalking horse bidder requested additional time to conduct due diligence. The debtor sought court approval extending the deadline, however, the extension was not granted prior to the deadlines set out in the APA. In the meantime, a competing bidder provided a better bid for the assets and requested to be substituted as the stalking horse bidder since the APA with the first bidder had expired and no court-approved extension was granted. Faced with two competing motions, the court determined that the first APA had expired, and despite oral agreements with the debtor to extend the due diligence deadline, the bidder's protections expired without court approval. Thereafter, the court found that the debtor exercised reasonable business judgment in selecting the second bidder as the stalking horse bidder and therefore was allowed to proceed to an auction for the assets.

***In re Philadelphia Newspapers, LLC,* 418 B.R. 548 (E.D. Pa. 2009).**

The district court held that section 1129(b) does not, standing alone, provide a right to credit bid. This case came to the district court on appeal from the bankruptcy court, which had denied approval of bid procedures for a sale of substantially all of the debtors' assets. The debtors' bid procedures explicitly stated that the senior lenders would not be allowed to credit bid because the sale was being conducted under sections 1123 and 1129 rather than section 363(k), but the bankruptcy court refused to approve the bid procedures, stating that the debtors' senior lenders had a right to credit bid under section 1129(b)(2)(A)(iii).

The opinion from the district court focused heavily on the plain meaning rule. Since the plain meaning of section 1129(b) is clear and a literal interpretation would not lead to an absurd result, the court explained, there was no need for further inquiry. In order to cram down a plan, it must comply with section 1129(b). One requirement of section 1129(b) is that the plan be "fair and equitable," and there are three independent ways listed in the statute that a plan can be found fair and equitable. The court held that in the context of a sale, the standard of section 1129(b)(2)(A) can be satisfied by either the credit bid prong (ii) or the indubitable equivalent prong (iii).

Because it would not be possible to know whether senior lenders would receive the indubitable equivalent of their claims under the plan until the confirmation hearing, the court felt that the fight over a right to credit bid was a confirmation issue. Thus, the bankruptcy court's decision to deny the bid procedures simply because the senior lenders were precluded from credit bidding was incorrect, and the district court reversed.

***In re Fontainebleau Las Vegas Holdings, LLC,* No. 09-2148-BKC-AJC (Bankr. S.D. Fla. Dec. 7, 2009).**

As noted in section 363(k), a court can, for cause, prohibit a secured creditor from credit bidding the amount of its claim. *Fontainebleau* came on the heels of *In re Philadelphia Newspapers* and *In re Pacific Lumber*.[4] In *Fontainebleau*, the court concluded that allowing the secured creditors, consisting of over 300 mechanics and materialmen lien claimants and dozens of bank mortgage lenders, to credit bid at the section 363 sale of an unfinished hotel and casino would delay the sale, deny all creditors the potential benefits of the sale process and continue the erosion of value of the property.

The court noted "[e]ven if the lien claims could be adjudicated as to validity, priority and amount, prior to the § 363 sale scheduled for January 21, 2010, there is no feasible procedure to permit five (5) different groups, plus additional unrepresented lien claimants and the dozens of bank mortgage lenders to bid as single bidders against prospective cash bidders." Section 363(k) of the Bankruptcy Code gives the court the discretion to deny credit bidding.

***In re Gulf Coast Oil Corp.,* 404 B.R. 407 (Bankr. S.D. Tex. 2009).**

The bankruptcy court denied a motion to sell substantially all of the assets of the debtor under section

[4] *In re Pacific Lumber,* No. 08-40746 (5th Cir. Sept. 29, 2009).

363 and held that there was not a substantial business reason for the section 363 sale in preference to a sale under a liquidating chapter 11 plan.

In this case, one creditor ("Laurus") held a claim that was both secured by all of the assets of the estate and substantially in excess of the value of the assets of the estate. Laurus also provided the DIP financing, and because of a default, the stay was automatically lifted and Laurus could technically foreclose on the assets at any time. Once the debtors concluded that the revenues and cash flows of the business would not support a plan of reorganization and that Laurus would not support a plan of reorganization anyway, they consulted with Laurus on how to proceed. The debtors then abandoned their chapter 11 plan and filed a motion to sell all of their assets. Despite the fact that the debtors had been marketing their assets for over six months, the only expressions of interest the debtors received were in the range of $10 to $19 million. It was agreed that Laurus would be entitled to credit bid for $75 million, so the court concluded that Laurus would be the only potential purchaser if the motion to sell the assets were approved. The financial advisors objected to the sale because it would not pay all administrative expenses of the estate. Essentially, the sale would leave the estate with no assets, and the sale would yield no proceeds because a credit bid was going to win.

After a lengthy discussion of the prevalence of section 363 sales in bankruptcy today, the court listed the ten factors that it is allowed to consider. In examining the burden of incorporating the sale into a plan rather than a motion, the court noted that it should not be substantially more difficult to write a plan and disclosure statement to sell the estate than it is to write a motion to sell the estate. This is partially true because even though parties in small cases frequently use lengthy boilerplate disclosure statements from more complex cases, it is not necessary. Ultimately though, the court denied the motion for the sale for three primary reasons. First, the court said that a showing of a business justification was required, but the debtors had only asserted that it did not matter because the secured lender would be the only beneficiary under either a plan or a sale motion. Second, the only administrative claims that would be paid were those that the purchaser had previously agreed to pay or that the purchaser subsequently decided to pay. And finally, some unsecured creditors would probably be paid while others would probably not be paid, thus providing unequal treatment of similar creditors.

***In re Silicon Graphics, Inc.*, Case No. 09-11701 (Bankr. S.D.N.Y. 2009).**

The bankruptcy court denied the debtors' motion to file certain documents under seal for the purpose of concealing the identity of third party bidders in a section 363 sale. This particular sale was an auction with a stalking horse bidder, and the court complained that "other than the conclusory assertion that disclosing the identities of interested parties will chill the bidding, the debtors have offered no factual or legal support for the requested relief permitting sealing of court documents containing the identities of interested parties."

The court went on to discuss the public interest in the transparency of bankruptcy court proceedings. The court's central message though was that while filing certain documents under seal is very important for the bankruptcy process, this court "will not provide blanket authority for sealing."

***In re Reliant Energy Channelview LP*, No. 09-2074 (3d Cir. Jan. 15, 2010).**

Debtors in the Chapter 11 case entered into an Asset Purchase Agreement ("APA") with an initial bidder, Kelson. The APA required the Debtors to seek an order approving certain "bid protections and procedures" in favor of Kelson if the Court required an auction of the plant before its sale. The bid protections and procedures provided: (1) that the Debtors could not accept a competing bid unless the bid exceeded Kelson's by $5 million; (2) that Kelson would receive a $15 million break-up fee if the Debtors accepted a competing bid; and (3) that the Debtors would pay Kelson up to $2 million as reimbursement for expenses incurred in the sale process. Before entering into the APA, the Debtors considered 11 other bids, including Fortistar's, which was contingent on Fortistar obtaining financing. Because Fortistar lost its financing, the Debtors rejected Fortistar's bid. Subsequently, the Debtors and Kelson entered into the APA.

The Debtors sought authorization to sell the plant to Kelson and approval of the bid protection measures. The Bankruptcy Court decided it would not approve the sale to Kelson without an auction for the plant. Further, Fortistar objected to the bid protection measures, indicating it would enter a higher and better bid but was deterred by the $15 million break-up fee and the $2 million expense reimbursement. At auction, Fortistar submitted the winning bid, which exceeded Kelson's bid by $32 million. Pursuant to the Bankruptcy Court's decision, the Debtors did not pay Kelson the $15 million break-up fee, but did pay for its expenses.

The Third Circuit considered whether the Bankruptcy Court abused its discretion when it concluded that an award of a break-up fee was not necessary to preserve the estate's value. The Third Circuit determined that the "the allowability of break-up fees, like that of other administrative expenses, depends upon the requesting party's ability to show that the fees were actually necessary to preserve the value of the estate." Thus, like the Bankruptcy Court, the Third Circuit focused on whether approving the bid protections would enhance or chill bidding. The Court determined that the break-up fee was not necessary to preserve the value of the estate for two reasons. First, the opportunity to obtain a break-up fee did not induce Kelson to make its bid before the Bankruptcy Court ordered the auction because the offer only required that the Debtors seek, not actually obtain, approval of the break-up fee. Second, the break-up fee was not necessary to preserve Kelson's bid because bidders who have expended money, effort and time to make a bid will not necessarily withdraw a bid absent a break-up fee. Ultimately, the Court determined that any benefits of the break-up fee did not outweigh the potential harm to the estate of deterring other bidders from entering the bidding process.

***Boyer v. Crown Stock Distribution, Inc.*, Nos. 09-1699, 09-1861 (7th Cir. Nov. 18, 2009).**

This was a fraudulent conveyance action. The debtor purchased the assets of the company from the defendants for $3.1 million in cash and a $2.9 million promissory note. The cash was borrowed from a bank at 9% interest, and the promissory note was secured by a lien on all of the assets of the debtor, junior to the bank's lien. Prior to the closing, the defendants were also allowed to transfer $590,328 from the corporate bank account to a separate bank account so that they could distribute that amount as a dividend. After the transaction, the company limped along for three and a half years before entering bankruptcy. The bankruptcy court found that the sale constituted a fraudulent conveyance because the debtor had not received reasonably equivalent value in the transaction. The court held that the cash and the interest payments had to be returned to the estate and that the promissory note could not be enforced but the $590,328 was legitimate because it was a dividend paid out of the defendant's property before the transaction. On appeal, the district court affirmed. Both parties appealed to the circuit court of appeals.

One of the major issues in this case was whether the transaction could be characterized as a leveraged buyout. If the burden of debt created by an LBO is so heavy that the buyer of the corporation has no reasonable prospect of surviving, the payment to the shareholders of the buyer is deemed a fraudulent transfer. This transaction was unlike an LBO in that the buyer purchased assets rather than stock, and the company did survive for three and a half years before filing for bankruptcy. The court felt that these two distinctions were not relevant though, and "if one has to call the overall transaction something, the something is an LBO." Further, by encumbering all of the company's assets, the sale reduced the company's ability to borrow on favorable terms. The sale almost completely drained the company of cash while at the same time saddling it with enormous interest payments on the promissory note and the loan from the bank. Thus, the court concluded that the debtor did not receive reasonably equivalent value in the transaction and affirmed the decision of the district court finding that the cash and the interest payments had to be returned to the estate and that the promissory note could not be enforced.

In addition though, the circuit court of appeals also found that the $590,328 removed from the company before the sale had to be returned as well. The sale left the debtor with "unreasonably small" assets. The term is difficult to define, but the court felt that having all of the physical assets encumbered twice over and draining the company of cash satisfied the definition of "unreasonably small" assets. The shareholders who received this cash as a dividend were not protected as good faith transferees under section 550(b)(2) because they did not give value in the transfer.

The final issue the court discussed was whether recovering all of this money would create a windfall to the estate, which had already received $3.7 million from a sale of substantially all the assets of the company pursuant to section 363. Since the court essentially undid the transaction in question, the defendants were still the actual shareholders of the company, and thus received any surplus created by the recovery that they themselves were paying.

***In re DBSD N. Am, Inc.*, No. 09-13061 (REG) (Bankr. S.D.N.Y. Oct. 26, 2009).**

In *In re DBSD North America, Inc.*, the Bankruptcy Court considered an issue of first impression: How should a bankruptcy court rule (1) when, after a plan has been proposed, a creditor purchases all class votes to defeat the proposed plan and (2) when, if that creditor's vote is designated, no other creditor remains to assent to the plan? The court ruled that when an entity's vote has been disqualified because that entity bought all the claims in a class after a plan was announced, thereby making consent by that class impossible, the entity cannot indirectly secure the benefits of a dissenting class. Thus, that class will not be counted for section 1129(a)(8) purposes.[5] The court reasoned, however, that the good faith requirement found in section 1129(a)(3) protects a designated entity by "ensur[ing] that plan proponents do not abuse the benefits of a court's designation ruling."

Under section 1126(e),[6] the court designated DISH Network's ("DISH") vote to reject the debtors' Chapter 11 plan by characterizing DISH as a "strategic investor" rather than a conventional creditor

[5] "The court shall confirm a plan only if . . . with respect to each class of claims or interests[,] such class has accepted the plan . . . ."

[6] "On request of a party in interest, and after notice and a hearing, the court may designate any entity whose acceptance or rejection of such plan was not in good faith, or was not solicited or procured in good faith or in accordance with the provisions of this title."

seeking to maximize its claim recovery. Further, section 1126(c) discusses the "effects of voting within the class of a designation order."

> A class of claims has accepted a plan if such plan has been accepted by creditors, *other than any entity designated under subsection (e) of this section*, that hold at least two-thirds in amount and more than one-half in number of the allowed claims of such class held by creditors, *other than any entity designated under subsection (e) of this section*, that have accepted or rejected such plan.[7]

The court observed that no creditors remained other than DISH, the designated entity, because DISH purchased all the other creditors' claims. Therefore, the court determined that the class must be regarded as vacant. The question then became: How does a court handle a class with no members who may vote? This court offered two solutions. First, the court should disregard the class because to hold otherwise would make the designation ruling meaningless. DISH, although disqualified from rejecting, would essentially still be allowed to reject if the court held that the class effectively rejected. Second, the class "should be regarded as an accepting class" because "the Bankruptcy Code focuses on those who vote, not the total membership of classes." The court concluded that where at least one impaired class has consented, and a class has no votes, that lack of votes in the class does not constitute a failure to satisfy section 1129(a)(8). In concluding, the court suggested that because DISH engaged in affirmative acts that precipitated its being designated, DISH's behavior strengthened the arguments that the class should be disregarded, and if not disregarded, deemed an accepting class.

***In re Blake*, No. 07-12445-FJB (Bankr. D. Mass. Nov. 30, 2009).**

In re Blake presented the Bankruptcy Court with an issue of first impression in the Circuit: For cram down purposes under section 1129(b)(2)(A)(i), in quantifying the value of property securing a claim, is the date of valuation the date on which the bankruptcy case commenced or the confirmation date? The court held that under section 1129(b)(2)(A)(i), the valuation date is the confirmation date. Similarly, the court held that in quantifying the interest rate for the "stream of deferred payments" under the plan that would ensure present value as required under section 1129(b)(2)(A)(i), a debtor should use the base rate that exists on the confirmation date.

The debtors owned four mortgaged rental properties. In their plan, the debtors proposed the following: (1) each senior mortgagee would retain the mortgage securing its claim and (2) on account of its secured claim, each mortgagee would receive a 30-year stream of equal monthly payments having a present value as of the confirmation date of an amount that the debtors contended was the fair market value of the property on the confirmation date. The creditors objected, contending that for purposes of cram down, the proper valuation date is the date on which the bankruptcy case commenced. The creditors also argued that the base rate applicable on the date the bankruptcy case commenced should determine the applicable interest rate to ensure they would receive present value for the 30-year stream of monthly payments.

The court concluded that the plan satisfied all section 1129(a) requirements except for paragraph (8). Under paragraph (8), each class must either accept the plan or be unimpaired by it. Here, each of the four secured claims were impaired and each had rejected the plan. Nevertheless, a court shall

---

[7] Emphasis added.

confirm a plan when all section 1129(a) requirements, except for paragraph (8), are met if the plan does not discriminate unfairly and is fair and equitable with respect to each class of claims or interests that is impaired under and has not accepted the plan.[8] The secured creditors argued that the plan was not fair and equitable. The court observed that section 1129(b)(2)(A) specified three requirements for fair and equitable treatment for secured claims but noted this case involved only the first requirement, which has two parts. First, a secured creditor must retain its lien, up to the allowed amount of the claim.[9] Second, a secured creditor must receive deferred cash payments that total at least the allowed amount of its claim, which must be of a value, *as of the effective date of the plan*, of at least the value of the secured creditor's interest in the estate's interest in the property.10 The secured creditors conceded that the plan satisfied clause (I), lien retention, but argued the plan failed to satisfy clause (II) because both the valuation date and determination date for the interest rate should have been the date bankruptcy commenced, not the confirmation date.

More specifically, the creditors argued that the value of each creditor's interest in the estate's interest in each property was the value of the collateral as of the date bankruptcy commenced. The court determined that the Bankruptcy Code did not specify the date on which property securing a claim must be valued for section 1129(b)(2)(A). Yet, the court did highlight two subsections that indicate congressional intent as to the date of valuation issue, and both favor valuation as of the confirmation date. First, under section 1129(b)(2)(A)(ii), a plan satisfies the fair and equitable requirement if it provides for sale of the property free and clear of liens, with the liens attaching to the sale proceeds. The court reasoned that because "the sale would necessarily occur at or after confirmation, . . . the secured claim is necessarily valued as of the date of sale, because the sale itself quantifies the claim by converting the lien from one on the original collateral to one on the proceeds." According to the court, Congress must have anticipated that section 1129(b)(2)(A), including clause (i), would require the value of a secured claim be determined as of the confirmation date.

Additionally, the court determined that the language in section 1129(b)(2)(A)(i) reinforced its conclusion that Congress intended the confirmation date to be the date for determining value. That subsection requires that payments given for an allowed secured claim have a certain present value "as of the effective date of the plan." The court remarked that this language seems to indicate an intent to ensure that a secured creditor receives the same value it would receive if the collateral (up to the value of the secured claim) were "simply handed over" to the secured creditor on the effective confirmation date. The court opined that had Congress intended to guarantee secured creditors the value of their secured claims as of case commencement, it would likely have written this clause to require that the stream of deferred payments have the required present value "as of the date of the bankruptcy petition." The court noted that Congress made adequate protection available for secured creditors to protect their interest in their collateral from deterioration beginning from the commencement of the case up to confirmation. Thus, before the confirmation date, creditors should file a motion to seek adequate protection to prevent erosion of their collateral's value. For plan confirmation, therefore, a secured claim is valued as of the confirmation date.

Likewise, the secured creditors objected to confirmation based on the five percent interest rate that the debtors used to amortize their secured claims. The creditors argued that the proposed rate was lower than the rate applicable on the commencement date. The court, agreeing with the debtors,

[8] 11 U.S.C. § 1129(b)(1).
[9] 11 U.S.C. § 1129(b)(2)(A)(i)(I).
[10] 11 U.S.C. § 1129(b)(2)(A)(ii)(II).

found that the stream of payments promised under section 1129(b)(2)(A)(i)(II) must have a certain present value "as of the effective date of the plan." Therefore, as the court noted, a cram down creates a situation similar to a "forced loan." The date on which the "loan" is made and the risk is undertaken governs because that is the date the plan becomes effective.

Thus, the court overruled the secured creditors' objections and confirmed the plan.

J. SUBSTANTIVE CONSOLIDATION

Simon v. ASIMCO Techs., Inc. (In re Am. Camshaft Specialties, Inc.) **Adv.No. 08-5622, (Bankr. E.D. Mich., Sept. 1, 2009).**

In *American Camshaft*, four related companies, a parent company (American Camshaft) and three of its wholly-owned subsidiaries (Assembled Camshaft, ACS Orland, ACS Grand Haven) filed for relief under chapter 11. American Camshaft was wholly owned by ASIMCO Technologies, Inc. ASIMCO Technologies, Inc. was wholly owned by ASIMCO Technologies Holding Limited ("ASIMCO Holding"). The court entered an order jointly administering the cases for procedural purposes only but not for substantive consolidation.

After substantially all of the debtors' assets were sold, the court converted all four bankruptcies to chapter 7 cases. The chapter 7 trustee (Simon) filed an adversary complaint against four non-debtor corporations, including ASIMCO Technologies and ASIMCO Holdings, as well as two other ASIMCO affiliates, and six individuals. The complaint alleged eight counts including, Count II for an order of substantive consolidation of the four non-debtor corporate defendants with the debtors. All of the non-debtor corporate defendants moved to dismiss the substantive consolidation claim.

The trustee alleged that section 105 provided the bankruptcy court with equitable power to order substantive consolidation, even of a non-debtor with a debtor. The court reviewed the substantive consolidation law and made the following observations: (1) a cause of action for substantive consolidation is not the same as a cause of action to pierce the corporate veil for alter ego; (2) courts have recognized an independent, judicially created cause of action for substantive consolidation; (3) although section 105 is the most frequently cited statutory authority for substantive consolidation, and the weight of the case law holds section 105 can be used to order substantive consolidation, there is no express statutory authority; (4) substantive consolidation is an extraordinary remedy that should be used sparingly; (5) as a judicially created doctrine, courts have created a "myriad of 'tests' for substantive consolidation' which have, in many cases, become a "checklist" or "factor" counting exercise; (6) "the dependence upon checklists and factors leaves the impression of an untethered, ad hoc approach in the case law which can greatly diminish predictability in the law"; (7) the absence of a clear rule combined with the premise that substantive consolidation is an equitable remedy, encourages parties to "treat the bankruptcy court as a 'roving commission to do equity'"; (8) actions to substantively consolidate non-debtor entities raise serious due process considerations; and (9) due process considerations are exacerbated by the need to determine whether substantive consolidation, if warranted, should be made on a nunc pro tunc basis.

The court determined that, until the Supreme Court or the Sixth Circuit Court of Appeals set out the standard to determine the elements of substantive consolidation, it would only substantively consolidate a non-debtor entity with a debtor when it was shown that either: "(i) the debtor and the non-debtor entity in their pre-petition conduct disregarded the separateness of their respective entities so significantly as to lead their creditors to treat them as one legal entity; or (ii) that post-petition, the assets and liabilities of the debtor and the non-debtor entity sought to be consolidated are so hopelessly scrambled and commingled that it is impossible to separate them and tell them apart thereby resulting in harm to all creditors." Thus, the court expressly adopted the *Owens Corning* analysis.

***In re Owens Corning*, 419 F.3d 195 (3d Cir. 2005).**

In *Drabkin v. Midland-Ross Corp. (In re Auto-Train Corp.)*, 810 F.2d 270 (D.C. Cir. 1987), the court touched on many analytical bases for determining whether to substantively consolidate, but "in the end chose as its overarching test the 'substantial identity' of the entities and made allowance for consolidation in spite of creditor reliance on separateness when 'the demonstrated benefits of consolidation heavily outweigh the harm.'" *In re Owens Corning*, 410 F.3d at 208 (describing the *In re Auto-Train Corp.* test and citing *In re Auto-Train Corp.*, 810 F.2d at 276). The Third Circuit criticized the *Auto-Train* approach requiring substantial identity of entities to be consolidated, plus a finding that consolidation is necessary to avoid some harm or realize some benefit. *Id*. at 210. According to the Third Circuit, the *Auto-Train* approach "fails to capture completely the few times substantive consolidation may be considered and . . . allows a threshold not sufficiently egregious and too imprecise for easy measure." *Id.* The Third Circuit stated that if an objecting creditor relied on the separateness of the entities, consolidation could not be justified as to the claims of the creditor.

Although the Third Circuit stated that it favored the *Augie/Restivo* analytical approach over that of *Auto-Train*, it also noted that too "often the factors in a checklist fail to separate the unimportant from the important" and can result in spitting out a score "without an eye on the principals that give the rationale for substantive consolidation."

After reviewing the various tests and describing the principles to be followed, the Third Circuit developed the following rationales:

> In our Court what must be proven (absent consent) concerning the entities for whom substantive consolidation is sought is that (i) prepetition they disregarded separateness so significantly their creditors relied on the breakdown of entity borders and treated them as one legal entity, or (ii) post petition their assets and liabilities are so scrambled that separating them is prohibitive and hurts all creditors. Proponents of substantive consolidation have the burden of showing one or the other rationale for consolidation. *Id*. at 211. (footnotes omitted).

The Third Circuit applied its reasoning to the facts of the *Owens Corning* case and held that the evidence did not support either test for substantive consolidation. The court found that there was no prepetition disregard of corporate separateness and no hopeless commingling of the Debtors' assets and liabilities. The Court further noted that substantive consolidation should be used defensively to remedy identifiable harms, not offensively to achieve advantage over one group in the plan process. *Id.* at 215. Finally, the court found that the "flaw most fatal" was that the consolidation sought was "deemed" and thus was a stratagem "to strip the Banks of their rights under the Bankruptcy Code, favor other creditors and yet trump possible Plan objections by the Banks." *Id.* at 216. Consolidating the assets of affiliated companies was not equitable for those creditors who had lawfully bargained prepetition for unequal treatment by obtaining guarantees of separate entities. *Id.*

These cases must be analyzed in the context of *Grupo Mexicano de Desarrollo v. Alliance Bond Fund*, 527 U.S. 308, 119 S. Ct. 1961 (1999). In *Grupo Mexicano*, the Supreme Court held that the federal courts have the equity jurisdiction that was exercised by the English Court of Chancery at the time the Constitution was adopted and the Judiciary Act of 1789 was enacted. It was well established that, as a general rule, a creditor's bill could be brought only by a creditor who had already obtained a judgment establishing the debt. The respondents argued that the merger of law and equity changed the rule that a general creditor could not interfere with the debtor's use of his property. The court held that the merger did not alter substantive rights.

***Ion Media Networks, Inc. v. Cyrus Select Opportunities Master Fund, Ltd. (In re Ion Media Networks)*, 2009 WL 4047995 (Bankr. S.D.N.Y. Nov. 24, 2009).**

This was a very results-oriented case that centered around an Intercreditor Agreement. The court held that because of the Intercreditor Agreement, the second lien holder, "Cyrus," did not have standing to challenge the validity of the first lien, to object to the DIP financing, or to object to confirmation of a plan supported by the first lien holder. The court felt that "affirming the legal efficacy of unambiguous intercreditor agreements leads to more predictable and efficient commercial outcomes and minimizes the potential for wasteful and vexatious litigation," and therefore the Intercreditor Agreement was strictly enforceable in accordance with its terms. *In re Ion*, at *15.

Other parts of the opinion were less clear. Early in the opinion, the court recognized that silencing a second lien holder may be against public policy and stated that nothing in the Intercreditor Agreement infringed on Cyrus' right to vote or to appear as an unsecured creditor. *Id.* at *16. Later in the opinion, however, the court cited the Agreement, which explicitly stated that the second lien holders may not oppose, object to, or vote against any plan of reorganization or disclosure statement the terms of which are consistent with the rights of the first priority secured parties under the Agreement. *Id.* at *19.

In addition, the court approved third party releases. The releases for the continuing directors may be defensible in light of the unusual circumstances requiring FCC approval to transfer most of the debtors' assets, but the other third party releases seem to just be that the plan funders insisted on them. Furthermore, the court said it was appropriate to have a consolidated liquidation test even though the estates were not substantively consolidated. The court felt that a consolidated liquidation test was appropriate in light of the integrated nature of the debtors' broadcasting business.

K. <u>TRUST FUNDS</u>

***JP Morgan Chase Bank, N.A. v. Zwosta (In re Zwosta)*, 395 B.R. 378 (6th Cir. 2008).**

Two individuals owned and operated a company that provided nurses to various health care providers. The health care providers would pay the company directly and then the company would issue payroll checks to the nurses and withhold federal and state taxes from the nurses' weekly paychecks. The company obtained an installment loan from JP Morgan Chase Bank ("Chase"). The loan was personally guaranteed by the two debtors. Chase took a blanket security interest on all of the company's assets. As the company became insolvent, the company opened a separate account at another bank and paid the IRS outstanding taxes as well as certain nurses' regular pay. The individuals then filed chapter 7 petitions. Chase filed an adversary proceeding claiming that the debtors willfully and intentionally caused proceeds from the company to be transferred to other creditors without Chase's consent. Chase argued that such action should deprive the debtors of a discharge of their debt under section 523.

The bankruptcy court, in considering cross summary judgments, denied the debtor's summary judgment and granted Chase's summary judgment. The Sixth Circuit, after reviewing the Supreme Court's decisions in *Begier v. Internal Revenue Service*, 496 U.S. 53 (1990) and *Slodov v. United States*, 436 U.S. 238 (1978), held that the monies paid to the IRS out of the separate account were not trust fund taxes. The Sixth Circuit found that the Supreme Court had not considered the scenario where taxes were paid over a perfected and secured creditor's interest (distinguishing the holdings in *Beiger* and *Slodov*). The Sixth Circuit found that because Chase was a perfected secured creditor with valid security interests, the company's accounts receivable were the interests of the company and that Chase's interests were superior to the interests of the IRS. The Sixth Circuit reversed and remanded on the basis that there remained unresolved material facts and summary judgment was improper.

L. <u>VALUATION</u>

***VFB, LLC v. Campbell Soup Co.*, 482 F.3d 624 (3d Cir. 2007).**

In 1998, Campbell Soup Co. incorporated a wholly-owned subsidiary, and in a leveraged spin transaction, sold several food companies to the subsidiary in exchange for obtaining loans. The subsidiary's stock was issued to Campbell's shareholders as an in-kind dividend. This subsidiary filed for bankruptcy three years after the spin-off and, through the bankruptcy, sold the food companies for less than originally capitalized. The reorganized debtor then sued Campbell alleging that the spin-off was a fraudulent transfer and Campbell aided in the breach of the fiduciary duties of the subsidiary's directors. The district court ruled in favor of Campbell.

The district court found that the value of the subsidiary was worth well in excess of $500 million at the time of the spin-off in 1998. The district court relied on the price of the subsidiary's stock at the time to value the company. The district court also found that the subsidiary had been solvent at the time of the spin-off and as such, there was no fiduciary duty to future creditors' by the pre-selected directors. The reorganized debtor appealed. The Third Circuit found that the valuation of the company was appropriate by the district court. Thus, the Third Circuit ruled that the fraudulent conveyance claim failed because the reorganized debtor could not show that subsidiary's market price was clearly less than $500 million at the time of the spin. The Third Circuit also affirmed the district court on the finding that there was no fiduciary duty owed to the subsidiary's creditors at the time of the spin because the subsidiary was solvent. The district court was affirmed on all counts.

***Iridium Operating, LLC v. Motorola, Inc. (In re Iridium Operating, LLC)*, 373 B.R. 283 (Bankr. S.D.N.Y. 2007).**

The committee for the debtor sued Motorola for fraudulent and preferential transfers totaling approximately $3.7 billion. The debtor was a spun-off company from Motorola that was in the business of the development and deployment of sixty-six low earth orbit satellites and related systems. In a 60+ page opinion, the bankruptcy court dismissed all counts against Motorola for fraudulent and preferential transfers because the committee failed to carry its burden of proof in establishing that the debtor was insolvent or had "unreasonably small capital" during the relevant evaluated period. The court stated that it relied on the recent Third Circuit case *VFB LLC v. Campbell Soup Co.* (discussed above) regarding valuation of a business enterprise. The court found that the market data showed the that debtor's traded securities showed substantial enterprise value and was not insolvent. The court reasoned that the "market evidence is simply too voluminous and compelling to reach any other conclusion."

In a battle of competing valuation experts, the court held that the committee and its experts did not present compelling or credible testimony that the debtor was insolvent during the four years prior to the bankruptcy filing. The court applied the standard that to prove insolvency, the committee had to "demonstrate that the sum of [the debtor's] debts exceeded the value of all of its assets, at a fair valuation." The court found that it was typical to look at a combination of valuation methodologies including "(a) actual sale price, (b) discounted cash flow method, commonly referred to as DCF, (c) adjusted balance sheet method, (d) market multiple approach, (e) comparable transactions analysis, and (f) market capitalization." Moreover, the court addressed the role of contemporaneous valuations of the debtor – notably the debtor's stock price and assessments of market analysts. In relying on the Third Circuit's opinion in *VFB LLC*, the bankruptcy court reasoned that the company's stock price was an ideal datapoint for determining enterprise value and that "market price is 'a more reliable measure of the stock's value than the subjective estimates of one or two expert witnesses.'" In evaluating all valuation methods, the court found that the committee failed to prove that the debtor was insolvent or inadequately capitalized, and therefore dismissed the claims for fraudulent or preferential transfers since the committee was not able to meet the threshold requirement for these claims.