CR&B Alert

COMMERCIAL RESTRUCTURING & BANKRUPTCY NEWS – JUNE 2010, ISSUE 2

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STALKING HORSE BIDDER DENIED BREAK-UP FEE IN THE THIRD CIRCUIT

In *In re Reliant Energy Channelview, LP* (No. 09-2074, 2010 U.S. App. LEXIS 956, 3d Cir., Jan. 15, 2010), the Third Circuit Court affirmed the District Court's denial of a break-up fee to a stalking horse bidder, applying the reasoning of *Calpine Corp. v. O'Brien Env't. Energy, Inc.* (181 F.3d 527, 3d Cir. 1999) ("*O'Brien*").

In this case, the chapter 11 debtor, Reliant Energy, sought purchasers for its largest asset, a power plant. Several bids were submitted, with the Appellant Kelson being selected as the winning bidder. Kelson and Reliant executed an Asset Purchase Agreement ("APA"), and submitted the APA to the Bankruptcy Court for allowance of the sale. A provision of the APA required Reliant to seek an order approving certain bid protections and procedures for Kelson's benefit if the court determined that there should be an auction for the power plant. Specifically, the bid protections provided that: Reliant could not accept any other bid unless it was at least $5 million more than Kelson's; Kelson would be entitled to reimbursement of expenses incurred in the sale process, up to $2 million; and, if a competing bid was accepted, Kelson would be entitled to a $15 million break-up fee.

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The Bankruptcy Court refused to allow the sale without an auction, and Reliant asked the court to implement the bid protections. Fortistar, one of the previous bidders, objected, asserting it was willing to submit a higher bid at auction, but that the $15 million break-up fee and $2 million expense reimbursement would deter it from doing so. The Bankruptcy Court authorized an auction, implemented the $5 million overbid requirement, and authorized expense reimbursement to Kelson up to $2 million. The Bankruptcy Court, however, refused to authorize payment of the $15 million break-up fee.

Kelson did not participate in the auction process. Fortistar submitted the winning bid, which topped Kelson's bid by $32 million. After the Bankruptcy Court entered an order approving the sale to Fortistar, Kelson appealed to the District Court, arguing that the Bankruptcy Court abused its discretion in disallowing the break-up fee, that it was a stalking horse bidder entitled to the break-up fee as a matter of fundamental fairness, and that Reliant was estopped from opposing Kelson's appeal because Reliant had supported Kelson's request for the fee in Bankruptcy Court. The District Court upheld the Bankruptcy Court's ruling.

The Court Considers Whether the Break-up Fee is a 'Necessary' Expense Under Section 503(b)

Applying the *O'Brien* standard, the Circuit Court considered whether an award of a break-up fee was "necessary to preserve the value of the Debtor's estate." Specifically, relying on *O'Brien*, the court held that bankruptcy courts do not have the authority to create new ways to authorize the payment of fees from a bankruptcy estate, and that there was no compelling reason to treat break-up fees differently from other administrative expense claims. As such, a proposed break-up fee must satisfy the criteria of section 503(b) of the Bankruptcy Code, and is allowable only to the extent that it represents the "actual, necessary costs and expenses of preserving the estate." In reaching this conclusion, the Circuit Court expressly rejected Kelson's argument that the business judgment rule applies to the payment of break-up fees in the context of a bankruptcy sale.

Applying *O'Brien* to the circumstances before it, the Third Circuit acknowledged that a break-up fee might preserve value of the estate by: (1) inducing Kelson to make its bid before the court ordered the auction; or (2) inducing Kelson to adhere to its bid after the court ordered the auction. These possibilities, however, were found not to be present in the context of the Kelson bid.

As a first matter, the Third Circuit held that the break-up fee did not induce Kelson to make its bid. In reaching this conclusion, the court noted that the terms of the APA did not condition Kelson's bid on the *receipt* of a break-up fee, but rather on Reliant's promise to *seek approval* to pay the fee. Since Kelson entered into the APA without the assurance of a break-up fee, Kelson's argument that the fee was needed to induce it to bid was baseless.

Further, after considering: (1) the expressed intent of other bidders to place bids for the assets; (2) the binding language of the APA; and (3) the logical belief that Kelson would not abandon a fully negotiated agreement if no other bidder materialized, the Third Circuit held that no break-up fee was necessary to induce Kelson to adhere to its bid after the court-ordered auction. Instead, the court held that the proposed $15 million break-up fee was not necessary to preserve the value of the estate, and was not an actual and necessary cost chargeable to the estate under section 503(b).

Going Forward

Although the court makes clear that there are circumstances in which break-up fees may be payable as administrative expense claims, the Third Circuit reinforces the requirement that a party seeking such fees must be able to demonstrate that they represent *necessary* expenses of preserving the estate's value.

SUBSTANTIAL PRE-PETITION CONTRIBUTION OF AN UNOFFICIAL COMMITTEE OF CREDITORS EARNS ADMINISTRATIVE EXPENSE STATUS

In late summer 2005, federal authorities seized the assets of the Bayou family of funds and placed the funds' principals in custody. Because of disagreements among the SEC, CFTC and the Department of Justice, however, the government did not immediately seek the appointment of an equity receiver for U.S. Bayou entities ("Onshore Entities"). As a result, in January 2006, various investors who had been unable to redeem their investments before the funds' collapse formed an Unofficial Committee ("Committee") to represent the interests of defrauded investors as a whole.

The Committee retained two law firms to represent its interests, and those law firms performed substantial services on behalf of the Committee prior to the chapter 11 filing by the Onshore Entities, including, but not limited to, petitioning to have a receiver appointed that thereafter filed a chapter 11 petition on behalf of the Onshore Entities. Following the commencement of the bankruptcy cases, the lawyers for the Committee sought the payment of some $677,000 in legal fees and Committee expenses, for the work that had been performed prior to the chapter 11 filing. The trustee objected.

Court Analysis of the Pre-Petition Work Under 503(b)(3)(D) and (b)(4)

In *In re Bayou Group, LLC, et al.* (Case No. 06-22306(RDD) U.S. Bankr., S.D.N.Y., April 5, 2010), the court thoroughly examined the question of whether sections 503(b)(3)(D) and (b)(4) apply to pre-petition work, and if so, whether the Committee's and its counsel's work may be compensated under those provisions. The court looked closely at the language of the sections, to determine if the pre-petition work made "a substantial contribution" to the case under chapter 11. In so doing, the court distinguished section 503(b)(1)(A), which addresses expenses of *preserving* the estate.

The court opined that Congress chose to put the "substantial contribution" test in a different subsection of 503(b) than 503(b)(1)(A), so that (b)(1)(A) case interpretations were not applicable. Relying on a Third Circuit case, *Lebron v. Mechem Fin. Inc.*, 27 F.3d 937 (3d Cir. 1994), the court held that it is the "'substantial contribution,' not the activity, that must occur in a case under chapter 11, and the [contrary] argument assumes that activities conducted and expenses incurred before the filing of a chapter 11 petition cannot substantially contribute to the reorganization efforts during the pendency of a chapter 11 case" when, in fact, they can.

After holding that pre-petition expenses could, in fact, be chargeable to the estate under section 503, the court examined the substance and effects of the Committee's and the lawyers' activities. Specifically, the court considered the Committee's substantial efforts to contact and gather the affected defrauded investors, and to represent the collective interests of all the unsecured creditors of the Onshore Entities. The court reviewed time records, by-laws, meeting minutes and other activities, noting that, "it is also clear that from its inception the Unofficial Committee expressly laid the groundwork for what became this chapter 11 case, including the means for administering the case."

In addition, the court considered the fact that the Committee, largely through its counsel: researched potential claims assertable on behalf of the unsecured creditors; searched for suitable candidates to serve as a receiver of the Onshore Entities; researched and prepared a complaint and motion for the appointment of a receiver; obtained the consent of important parties such as the Department of Justice; obtained the court's approval of the receiver; and, obtained and documented a preliminary financing commitment that served as the basis for debtor-in-possession financing.

The court also took particular note of the fact that the Committee and its counsel performed services that would normally be performed by professionals who would be compensated out of the debtor's assets. "The cost of such services will much more likely merit allowance under 503(b)(3)(D) if the services led directly to the efficient and proper administration of the case when other parties, who normally would be expected to do the work at the debtor's expense, were not doing it."

Direct, Tangible, Significant Benefits = Allowable Expenses

The court, after thorough examination of the facts, held that the lawyers' pre-petition actions did indeed lead directly to tangible benefits to the estate of the Onshore Entities. In doing so, however, the court was careful to note that third parties representing their clients' interests that only incidentally or indirectly confer a benefit to the bankrupt estate or case administration, do not qualify for expenses under 503(b).

This court concluded that the Committee's and lawyers' pre-petition actions provided significant value to the defrauded investors, and substantially benefited the estate and the case. The court found that the Committee and its counsel satisfied the requirements of 503(b)(3)(D) and (b)(4), and allowed the fees and expenses as administrative expenses.

Going Forward

The Third Circuit makes this clear: parties seeking reimbursement of expenses under 503(b)(3)(D) and 503(b)(4) for pre-petition work, must demonstrate tangible, direct benefits to the estate, and that the work does indeed make a substantial contribution to the chapter 11 case.

'SETTLEMENT PAYMENT' GIVEN WIDER SCOPE IN THIRD CIRCUIT

Trustees, eager to recover funds for the benefit of creditors, might try to use fraudulent transfer laws to avoid any transfers made from leveraged buyout purchasers to shareholder-sellers. However, as a general rule, so long as such payments are "settlement payments"—*i.e.*, securities transactions passing through a series of intermediaries and guarantees—they are expressly protected from avoidance by 11 U.S.C. section 546(e).

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More than 10 years ago, in *Lowenschuss v. Resorts Int'l. Inc.*, 181 F.3d 505 (3d Cir. 1999) ("*Resorts*"), the Third Circuit extended this protection to include transfers that did not pass through the ordinary securities settlement payment system, but, rather, were made directly by the purchasers to the sellers (through their respective banks, of course). In so extending 11 U.S.C. 546(e), *Resorts* relied on the language of 11 U.S.C. 741(8), which defines "settlement payment" to include, *inter alia*, "any…payment commonly used in the securities trade."

Notably, *Resorts* involved direct transfers from purchasers to shareholder-sellers in connection with the acquisition of a publicly traded company.

Section 546(e) Exemption Also Applies to Privately Held Companies, Not Just Publicly Held Companies

Now, any hopes of creditors seeking to avoid transfers made in leveraged buyout transfers from debtor-purchasers to shareholder-sellers have been further limited by the Third Circuit Court of Appeals in the case of *In re Plassein International Corporation*, 590 F.3d 252, (3d Cir. 2009), *cert. denied*, *Brandt v. B.A. Capital Co. LP*, __ S. Ct. __, 2010 WL 1180360 (Apr. 26, 2010). In *Plassein*, the Third Circuit extended the holding in *Resorts* to make private transfers to shareholders unavoidable, even where the acquired company is privately held.

In *Plassein*, the debtor gobbled up numerous privately held companies in leveraged buyouts, and, in the process, made direct bank-to-bank transfers to the companies' shareholders to complete the purchases. Unfortunately, the debtor overburdened the companies with cross-guarantied and cross-collateralized debts, leading to the debtor and all acquired companies filing bankruptcy petitions.

In adversary proceedings, the trustee sought to recover the direct transfers as fraudulent transfers. In so doing, the trustee argued that *Resorts* did not apply because it involved the acquisition of publicly traded companies, whereas in *Plassein*, the acquired companies were all privately held. The bankruptcy court disagreed with the trustee and granted the shareholders' motions to dismiss, holding that a "settlement payment" was a "settlement payment" exempted from avoidance under 11 U.S.C. 546(e), whether in the context of a public corporation or a private corporation.

On appeal, the Third Circuit concluded that *Resorts* was controlling, and, quoting an Eighth Circuit decision, *Contemporary Indus. Corp. v. Frost*, 564 F.3d 981, 986 (8th Cir. 2009) (which cited *Resorts*), stated that "[n]othing in the relevant statutory language suggests Congress intended to exclude these payments from the statutory definition of 'settlement payment' simply because the stock at issue was privately held." Therefore, the Third Circuit upheld the bankruptcy court's decision to grant the shareholders' motions to dismiss.

[For more on this topic, please see the discussion of the 6th Circuit case, *QSI Holdings, Inc. v. Alford*, in *CR&B Alert* Vol. V, No. 4, October 2009.]

AGGRESSIVE BEHAVIOR BY SECOND LIENHOLDER BREACHES INTERCREDITOR AGREEMENT AND EARNS JUDICIAL IRE

In *In re Ion Media Networks, Inc., et al.*, 419 B.R. 585 (Bankr. S.D.N.Y. 2009), a private equity firm ("PEF") "opportunistically" purchased its second lien interest at a steep discount prior to the debtor's bankruptcy filing, and was admonished by the Bankruptcy Court to abide the terms of its intercreditor agreement ("IA"), and not take any actions to reduce the recovery of the first lienholders.

Second Lienholder Rights *vis-à-vis* First Lienholder Rights In the Intercreditor Agreement

The IA at issue required that: second lien lenders would not object or take any action inconsistent with the validity, priority or enforceability of any security interests or claims of first lien lenders; the relative priorities of collateral shall remain unaffected by certain defined events; second lien lenders would not object to any post-petition financing provided by any first lien lenders; and second lien lenders would not oppose or object to any plan of reorganization or disclosure statements, the terms of which were consistent with the rights of the first lien lenders.

PEF, which the court identified as a "woefully out of the money creditor," sought to gain leverage in the bankruptcy case by engaging in scorched-earth litigation tactics to obtain a settlement from the debtor or first lienholders. PEF's litigation tactics included, among other things, objecting to the first lienholders' proposed DIP financing, commencing an adversary proceeding to carve out a portion of "disputed" collateral for itself, moving the District Court to withdraw the reference of an adversary case brought against PEF by the first lienholders, and objecting to the disclosure statement and plan confirmation.

PEF justified its conduct by arguing that its disputes all involved certain FCC licenses, which PEF asserted were not "collateral" under the IA because the FCC prohibits collateralization of such licenses. Thus, according to PEF, it was not seeking to affect any valid security interests of the first lienholders.

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Aggressive Behavior by Second Lienholder Breaches Intercreditor Agreement and Earns Judicial Ire—continued from page 4

The Court Rules – PEF's Breach of the IA Results in Lack of Standing

However, the court rejected PEF's arguments and held that PEF had breached the IA and thus had no standing to make any objections to debtors' disclosure statement, or confirmation of debtors' plan. The court strongly admonished PEF for engaging in these litigation tactics and "blithely disregard[ing] the restrictions" of the IA to obtain a tactical advantage. More than once, the court stated its belief that PEF's tactics had caused a material increase in administrative expenses, and that to the extent such increases were traceable, those expenses may be a measure of damages to be claimed against PEF.

The court's holding was based on a plain reading of the IA, which prohibited second lienholders from attacking not only "collateral," but also any "purported collateral." Thus, PEF could not rely on hypertechnical arguments regarding the lack of perfection of any collateral in order to end-run the protections afforded first lienholders by the terms of the IA. The court noted the importance of giving effect to the plain language of the IA, and noted that it was abundantly clear under the IA that the parties fully intended to place second lien lenders in an indisputably subordinate position.

The court concluded that PEF took a high-risk strategy without first obtaining a declaration of its rights under the IA, and, thus, assumed the consequence of being found liable for breach of the IA. The court overruled PEF's objections, and ordered the plan confirmed.

Going Forward

The lessons from *Ion Media* to junior lienholders are clear: before taking any actions against first lienholders, including objecting to disclosure statements or plans that are supported by the first lienholders, carefully review any intercreditor agreement to ensure that such actions are not prohibited by the agreement. If there is any doubt, a junior lienholder should at least consider seeking a declaration of its rights under the agreement before taking any steps that could violate the IA and put the junior lienholder at risk for a breach of contract claim. Further, the *Ion Media* case emphasizes the importance for all parties to an intercreditor agreement to clarify, prior to execution and to the fullest extent possible, what comprises "collateral" and "purported collateral."

THE PRICE OF IMPERFECT PERFECTION

Just one month before filing for bankruptcy protection, the individual debtors in the case of *In re Taylor*, 599 F.3d 880 (9th Cir. 2010), purchased a car that was financed by USAA Federal Savings Bank ("USAA") in an $18,020 loan transaction. Once the bankruptcy case was filed, the trustee sued USAA to avoid the security interest as a preferential transfer on the basis that USAA did not properly perfect its security interest.

USAA perfected its security interest in the car 21 days after its purchase. While USAA's perfection was timely under Idaho state law (30 days), it was one day late under 11 U.S.C. section 547(c)(3), which protects secured creditors from preferential avoidance actions only if a security interest is perfected within 20 days. Unfortunately for USAA, it was just one day too late under bankruptcy law.

The Bankruptcy Court Orders the Creditor to Return the *Value* of the Security Interest to the Estate

The Bankruptcy Court avoided the transfer, but, in an interesting turn, did not order the return of the property, as often happens with preferential transfers. Rather than ordering USAA to return the security interest and thus place itself in an unsecured position with respect to its loan, as would be expected, the Bankruptcy Court ordered USAA to return the value of the security interest. The Bankruptcy Court ordered this remedy because it ruled that the security interest had diminished in value based on monthly payments made by the debtors, and, thus, a mere return of the security interest would not make the estate whole. Accordingly, and quite strangely, the Bankruptcy Court ordered USAA to keep the security interest, but also ordered USAA to make a second $18,020 loan to the debtors for which USAA was only entitled to an unsecured claim.

The Court of Appeals Overturns the Decision

The Ninth Circuit Court of Appeals overruled the Bankruptcy Court's award. While the Court of Appeals agreed that the security interest had diminished in value, it also ruled that the record on appeal failed to provide any evidence of the amount of such diminishment. The Court of Appeals also ruled that the strange new loan arrangement ordered by the Bankruptcy Court was unsupported by any evidence that the arrangement was an appropriate remedy. Based on the lack of evidence, the Ninth Circuit reversed the Bankruptcy Court with instructions to order USAA to merely return the security interest, and also to return any preferential or otherwise avoidable monthly payments.

Going Forward

Secured lenders must be cognizant not only of state security perfection deadlines, but also of bankruptcy perfection deadlines. Otherwise, they risk losing validly perfected security interests.

NO PRIVATE RIGHT OF ACTION AGAINST RECIPIENTS OF TARP FUNDS

Recipients of funds from the Troubled Asset Relief Program ("TARP") created by the Emergency Economic Stabilization Act (the "Act") can breathe easier as the United States District Court for the Northern District of Georgia has held that there is no private right of action against the recipients for breaching duties under TARP, nor is there any affirmative evidence that Congress intended to create such a right.

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The case is *Regions Bank v. Homes by Williamscraft, Inc.*, No. 1:09-CV-91-TWT, 2009 WL 3753585 (N.D. Ga. Nov. 6, 2009) and involves a residential homebuilder ("Williamscraft") who obtained construction loans from Regions Bank in 2006 and 2007. When the housing market declined in 2008, Williamscraft failed to satisfy its payment obligations to Regions Bank.

In January 2009, Regions Bank sued Williamscraft for breach of contract based on the existing and continuing defaults under the loan documents. Williamscraft then filed a counterclaim alleging that Regions Bank, as a recipient of TARP funds, breached its duties under TARP by choosing to foreclose on, rather than modify, the loans, when doing so was not in the best interest of the taxpayer and Regions Bank.

Absent express statutory authorization, courts will find a private right of action only if there is affirmative evidence of Congress' intent to create a private right of action. Section 5229 of the Act expressly addresses judicial review under TARP, and allows individuals specifically harmed by TARP to challenge the Secretary of the Treasury's actions; there is no mention of a private right of action against fund recipients. Finding no express authorization in the Act or TARP, the District Court examined the legislative intent of both, and concluded that the existence under 12 U.S.C. section 5229 of the scheme for judicial review and other remedies was sufficient under federal common law to imply a lack of congressional intent to allow private actions against recipients of funds. Thus, the District Court held that there is no express or implied private right of action against recipients of TARP funds for breaching duties under TARP.

While it remains to be seen whether other courts will follow the District Court's holding, the holding is certainly a positive outcome for all TARP fund recipients.

NEW JERSEY SUPERIOR COURT BLESSES CONTINGENT RECOURSE CLAUSES

A Case of First Impression in New Jersey

The Superior Court of New Jersey has held that a clause in a loan document that turns a non-recourse loan into a recourse loan upon the occurrence of certain conditions is not an unenforceable penalty provision. The court reasoned that such a clause merely fixes liability and not damages and, thus, is fully enforceable.

The case is *CSFB 2001-CP-4 Princeton Park Corporate Center, LLC v. SB Rental I, LLC*, 410 N.J. Super. 114, 980 A.2d 1 (2009) and involves a loan Credit Suisse First Boston Mortgage Capital, LLC ("Credit Suisse") made to SB Rental I, LLC ("SB Rental"). To secure the loan, SB Rental granted Credit Suisse a first priority mortgage on SB Rental's commercial real property. In addition, Credit Suisse received personal guaranties of the principals of SB Rental.

A Non-Recourse Loan with a Contingent Recourse Clause

On its face, the loan was a non-recourse obligation that limited Credit Suisse's recovery to the real property and, thus, precluded Credit Suisse from seeking recovery against either SB Rental's or the guarantors' personal property. The mortgage note, however, contained a carve-out clause, providing that the debt would become fully recourse if SB Rental failed to obtain Credit Suisse's written consent before securing subordinate debt against the real property. Specifically, the mortgage note provided that "notwithstanding anything to the contrary in this Note or any of the Loan Documents…(B) the Debt shall be fully recourse to Maker in the event that…(iii) Maker fails to obtain Payee's prior written consent to any subordinate financing or other voluntary lien encumbering the Mortgaged Property." The guaranties contained similar contingent recourse provisions.

The Borrower Breaches, Then Cures, Then Defaults and is Foreclosed Upon

During the term of the loan, SB Rental obtained subordinate financing from L.G. Financial Consultants, Inc. ("L.G."). As security for the subordinate debt, SB Rental granted L.G. a second priority mortgage on the real property without first obtaining Credit Suisse's written consent. Seven months later, SB Rental paid the subordinate debt in full, and L.G. released the second priority mortgage. Eighteen months later, SB Rental failed to make its monthly loan payments to Credit Suisse. Shortly thereafter, Credit Suisse instituted a foreclosure proceeding, which SB Rental did not contest, and the real property was sold at sheriff's sale.

The sheriff's sale resulted in Credit Suisse having a deficiency claim. Credit Suisse sought to recover the deficiency claim from SB Rental and the guarantors on the basis that SB Rental had triggered the contingent recourse provisions. SB Rental and the guarantors opposed the recovery by arguing, among other things, that the contingent recourse provisions were unenforceable penalty provisions.

The Court Decides – The Carve-Out Clause is Enforceable

Specifically, SB Rental and the guarantors argued that the contingent recourse provisions were liquidated damages clauses. As such, the provisions were unenforceable penalties because they provided for damages against SB Rental

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New Jersey Superior Court Blesses Contingent Recourse Clauses—continued from page 6

and the guarantors, *i.e.*, the deficiency claim, that bore no reasonable relationship to the actual harm caused to Credit Suisse by SB Rental granting L.G., without Credit Suisse's prior written consent, the now-released second priority mortgage.

Contrary to SB Rental's and the guarantors' arguments, the court held that the contingent recourse provisions were not liquidated damages clauses, much less unenforceable penalties. The court pointed out that liquidated damages clauses define the terms and conditions of personal liability *and* measure and stipulate the amount of the damages. On the other hand, contingent recourse provisions define the terms and conditions of personal liability, but do not establish the amount of damages. Thus, contingent recourse provisions are neither liquidated damages clauses nor unenforceable penalties.

Curing the Breach Did Not Matter

The court also found that it didn't matter that SB Rental eventually paid off the subordinate debt in full and L.G. released the second priority mortgage, because it did not change the fact that SB Rental breached the very obligation identified by SB Rental, the guarantors, and Credit Suisse as posing a special risk to Credit Suisse.

In the court's words, "by further encumbering the property, even if only temporarily, defendants' action had the potential to affect the viability and value of the collateral that secured the original loan. Indeed, it cannot be said with any certainty that the subordinate financing in this case was entirely unrelated to the defendants' ultimate default on their mortgage payments."

The court also acknowledged that a borrower with a nonrecourse loan is less motivated to act in the best interests of the lender and the lender's collateral. Thus, lenders should be entitled to identify defaults that pose special risks to the lenders and carve them out of the general nonrecourse provision.

Simply put, the court's holding in this case confirms that contingent recourse provisions are enforceable in New Jersey.

SECURED CREDITOR LOSES OUT WHEN 363 SALE IS DENIED AS A *SUB ROSA* LIQUIDATION PLAN

A sale of all or substantially all of a debtor's assets free and clear of liens under section 363 of title 11 of the United States Code (the "Bankruptcy Code"), followed by a conversion of the chapter 11 case to chapter 7 or, in some instances, a chapter 11 plan of liquidation, can be a comparatively quick, easy, and inexpensive way for a secured creditor to obtain a recovery in a chapter 11 bankruptcy case.

In a recent chapter 11 case, however, the United States Bankruptcy Court for the District of Maryland decided that such a 363 sale was nothing more than an attempt to execute a liquidation plan without satisfying the requirements and undergoing the rigors of plan confirmation, or anything comparable to it, and, as such, was too quick, easy, and, impermissible.

The Proposed 363 Sale

The case is *In re Cloverleaf Enterprises, Inc.*, Case No. 09-20056, 2010 WL 1445487 (Bankr. D. Md. April 2, 2010) and involves a chapter 11 debtor ("Cloverleaf") who owned and operated a horseracing track prepetition. Early in the case, Mark Vogel, a former competitor of Cloverleaf's, acquired the $6,771,145.06 secured claim of PNC Bank (the "Secured Claim"). Cloverleaf then agreed to sell all or substantially all of its assets free and clear of liens under section 363 of the Bankruptcy Code to Rosecroft Future, LLC, a company formed and funded by Mr. Vogel. The proposed consideration for the 363 sale was (1) the assumption or paying off of the Secured Claim, (2) a $100,000 cash payment, and (3) the assumption of $331,432 of unsecured debt. Cloverleaf planned on following the 363 sale with a chapter 11 plan of liquidation, where unsecured creditors would become the beneficiaries of Cloverleaf's third-party claims.

The 363 sale was opposed by several of Cloverleaf's other competitors, who argued that the 363 sale was an impermissible *sub rosa* liquidation plan.

A 363 Sale is Extraordinary and the Exception, Requiring Close Scrutiny

The Bankruptcy Court began its analysis by noting that, for chapter 11 cases, the Bankruptcy Code expressly contemplates that a sale of all or substantially all of a debtor's assets free and clear of liens will be conducted under a confirmed plan after approval of the disclosure statement and balloting. Thus, conducting such a sale outside of a confirmed plan under section 363 of the Bankruptcy Code should be viewed as extraordinary and the exception to the rule. The Bankruptcy Court reasoned that such a 363 sale could deprive interested parties of substantial rights inherent to the plan confirmation process and, therefore, must be scrutinized closely.

In examining the proposed sale, the Bankruptcy Court concluded that it must consider the following factors:

- Whether the proposed sale is in the debtor's sound business judgment
- Whether there is a valid business justification to sell the assets under section 363 of the Bankruptcy Code rather than through a confirmed plan
- Whether there is sufficient notice to inform all creditors and interested parties of the effect of the sale on the distributions to creditors
- Whether the sale notice is the functional equivalent of a disclosure statement
- Whether the sale recognizes the fiduciary duties owed by the debtor-in-possession to all creditors and interest holders

The Bankruptcy Court then concluded that Cloverleaf's proposed 363 sale failed to satisfy any of the five factors. The court found that, at the outset of the case, Cloverleaf had decided to sell its assets to Mr. Vogel and, to that end, did not

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California Update

NEW CASES

Two new California cases serve as a reminder that passing information informally or making verbal promises can have a critical impact on the rights of the parties; a third new case reminds us to read preliminary reports carefully and ask follow-up questions; and a fourth reiterates that sometimes it doesn't count unless it happens in the public record. Here is the lineup of cases discussed below:

- In *Garcia v. World Savings FSB*, a mortgage foreclosure case, a complaint against a lender for wrongful foreclosure survived summary judgment because of verbal statements made by the loan officer promising to delay foreclosure.
- In *Forsgren v. Pacific Golf Community Development, LLC*, a contractor was charged with actual knowledge of a transfer of the project property long before the grant deeds were recorded. The knowledge reduced its ability to gain mechanics lien rights on *adjacent* property.
- In *612 South LLC v. Laconic Limited Partnership*, the property owner was held to have knowledge of a street improvement assessment, even though it was not indexed under the property owner's name, but only under the parcel number.
- In *Chase Manhattan Bank, USA, N.A. v. Taxel*, the Ninth Circuit stuck strictly to the Bankruptcy Code's requirements that an unrecorded deed of trust was subordinate to the bankruptcy trustee's rights as a hypothetical lien creditor, even if the lender's secured status was listed on the debtor's schedules.

Promissory Estoppel: If You Say You'll Postpone Foreclosure – Make Sure it Happens (*Garcia v. World Savings FSB*)

"Don't worry, I have the final say-so. As long as I know you could close [your refinance] in the first week of [September], I'll extend [the foreclosure sale] for you." So said the foreclosure department manager in *Garcia v. World Savings FSB* (2010) 183 Cal. App. 4th 1031. The borrower, upon hearing these words, went forward with a high-cost, high-interest loan secured by another property and sent the lender a check to cure the default. The borrower only learned that the foreclosure sale had *not* been postponed when the lender returned the check uncashed. It appears that, even though the borrower's broker had left several voicemail messages for the foreclosure department manager, confirming that he did in fact need additional time to close the refinance, the manager either did not pick up the messages in time, or failed to notify the person conducting the trustee's sale.

While the court found no breach of contract, it did find that the borrower had raised material issues of fact, to defeat a motion for summary judgment on a theory of promissory estoppel. A cause of action for promissory estoppel is established where:

- The promissor should reasonably expect a substantial change in position in reliance on his or her statement
- Such a change of position in fact occurs
- The person who relied is materially injured as a result

> "[H]e who by his language or conduct leads another to do what he would not otherwise have done shall not subject such person to loss or injury by disappointing the expectations upon which he acted."

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By now, you may be asking: "But what about the language in the contract that says that oral promises are not enforceable, and that the contract can only be modified in writing?" While this might save you from a breach-of-contract claim, it won't save you from a promissory estoppel claim.

This decision comes as no great surprise. It's also a reminder that it's a good idea to put your promises in writing. Not only will the writing make it clear just how long you've promised to forbear, it will also help get you out of a troublesome lawsuit at the summary judgment stage. Summary judgment motions are lost by lenders when there is a "triable issue of fact," *i.e.*, when verbal statements form the crux of the case.

Mechanics Lien Claimant Has Limited Ability to Reach Adjacent Property (*Forsgren v. Pacific Golf Community Development, LLC*)

Under the Convenient Use Doctrine, embodied in California Civil Code section 3128, a mechanics lien attaches "to the work of improvement and the land on which it is situated ***together with a convenient space about the same or so much as may be required for the convenient use and occupation thereof***, if at the commencement of the work or of the furnishing of the materials for the same, the land belonged to the person who caused such work of improvement to be constructed." (Emphasis added.)

In *Forsgren v. Pacific Golf Community Development, LLC* (2010) 182 Cal. App. 4th 135, a contractor constructing a golf course recorded its mechanics lien not only on the golf course property, but also on the neighboring property (which was slated for homes), alleging that the homebuilding property benefited from the golf course construction. The trial court, relying on the Convenient Use Doctrine, agreed that the lien could stand on the adjacent property as well as the golf course because of the fact that the two properties had been under common ownership at the time construction had begun. While the Court of Appeal cut way back on the amount of adjacent property that could be subjected to the "convenient use" lien, it did so through a fact-based inquiry addressing two distinct subjects:

- The extent to which the neighboring property can be subjected to mechanics liens, based on the degree to which their uses are intertwined
- The point at which a contractor's knowledge of a pending property transfer that is not yet in the public record can destroy or diminish those lien rights

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The decision opens the door to great uncertainty as to how far courts will go in future cases to surcharge adjacent property for supposed benefits conferred by construction next door. Lenders who plan to lend against property adjacent to new construction, particularly if it is in a phased development, are advised to take steps to ascertain whether the property they intend to take a lien on is (or in the recent past has been) under common ownership with nearby property on which construction is already underway. If common ownership is identified, further steps should be taken to ensure that the costs being incurred on the property under construction have been adequately provided for, and/or that potential lien rights against the adjacent property have been released.

Read the Preliminary Title Report Carefully (*612 South LLC v. Laconic Limited Partnership*)

In *612 South LLC v. Laconic Limited Partnership*, (2010) 2010 WL 2044675, the property owner was held to have constructive knowledge of a street improvement assessment, even though it was not indexed under the property owner's name, but only under the parcel number.

In 1987, the Twentynine Palms Water District issued a street improvement bond, which it sold to the plaintiff, 612 South. The then-owner of the property, Velez, made assessment payments for 10 years, but then defaulted. The property was sold at a public auction and Laconic acquired it. Plaintiff 612 South then made demand for the defaulted bond payments, and thereafter filed a judicial foreclosure action. The trial court granted judgment for the plaintiff. (The trial court awarded a personal judgment against the property owner, which was reversed on appeal.)

On appeal, property owner Laconic argued that it had acquired the property free and clear of the lien for the street improvement bond, because the water district's notice of assessment had listed only parcel numbers – not the name of the property owner. However, the Court of Appeal held that Laconic had constructive notice of the bond and assessment lien because notice of the assessment, listing the parcel number of the property, had been properly recorded in the county recorder's office. In so holding, the Court of Appeal took note of the expert testimony by a representative of the County Recorder's Office that it, as well as all other recorder's offices in California, relies on *The Recorder's Document Reference and Indexing Manual*. This *Manual*, based on the California statutory scheme, requires that a notice of assessment contain: (1) the name of the assessment; (2) the date of the assessment; (3) a description of the property; and (4) the signature of the district clerk. The names and addresses of the property owners "may be included" but are not required.

The Court of Appeal noted that the preliminary title report obtained by Laconic prior to the purchase of the property also provided constructive notice of the assessment. "With these facts a reasonable person would have investigated the possibility that an assessment lien might have attached to the property outside the chain of title…." Thus, Laconic could not claim bona fide purchaser status.

The Holder of an Unrecorded Deed of Trust is an Unsecured Creditor in a Bankruptcy Case – Even if the Schedules Say Otherwise (*Chase Manhattan Bank, USA, N.A. v. Taxel*)

Section 544 of the Bankruptcy Code has long held that a bankruptcy trustee has, as of the commencement of the case, and without regard to any knowledge of the trustee, the rights and powers of a bona fide purchaser of real property as of the time of commencement of the bankruptcy case. This provision has allowed bankruptcy trustees to avoid the liens of creditors who have neglected to record their deeds of trust prior to the bankruptcy case.

In *Chase Manhattan Bank, USA, N.A. v. Taxel* (9th Cir. 2010) 594 F.3d 1073, the lender came up with a new argument, after somehow failing to get its deed of trust recorded. It argued that the debtor had, simultaneously with the filing of the petition, filed schedules that listed the lender as a secured creditor, and that these schedules provided constructive notice of the unrecorded lien to the trustee. This constructive notice, the lender argued, defeated the trustee's ability to be a bona fide purchaser without notice of its lien, as of the commencement of the case.

The Ninth Circuit Court of Appeals rejected this argument on public policy grounds, noting: a fundamental purpose of bankruptcy is fair distribution pro rata within the classes of creditors. That purpose could be defeated if a debtor were able to jump an unrecorded security interest over the trustee's status on behalf of other creditors, simply by mentioning it when the debtor filed the petition.

COUNSEL'S CORNER: NEWS FROM REED SMITH

Speakers' Bureau

Amy Tonti addressed the Pittsburgh Turnaround Management Association April 13 on the topic of "Workout & Litigation Issues Related to Distressed Real Estate."

James McCarroll and **Michael Venditto** spoke at a May 6 seminar hosted by Reed Smith and Mesirow Financial Consulting in the firm's New York office. The program was titled, "Credit Bidding and the Evolving Rights of Secured Creditors."

Molly Baier and **Peter Muñoz** gave a presentation April 30 at the California Bankers Association annual conference in Dana Point, Calif. The title was "Real Estate Issues in Bankruptcy."

Peter Clark spoke at the Risk Management Association's Senior Workout Officers Roundtable Meeting in Charleston, S.C., on May 6 on "Recent Developments in Cramdowns and Credit Bidding."

Amy Tonti is the scheduled speaker, along with Judge Jeffery A. Deller of the Bankruptcy Court for the Western District of Pennsylvania, at the 2010 Pennsylvania Bar Institute Bankruptcy Update. The presentation will take place September 30 in Pittsburgh, and will address important bankruptcy appellate decisions rendered in the past year.

Secured Creditor Loses Out When 363 Sale is Denied as a *Sub Rosa* Liquidation Plan—continued from page 7

market its assets to any other prospective purchaser and only negotiated an asset purchase agreement with Mr. Vogel. Thus, the proposed sale was not an exercise of sound business judgment by Cloverleaf, had no business justification, and did not recognize the fiduciary duties owed by Cloverleaf to all of its creditors and interest holders. The Bankruptcy Court further found that the sale notice did not resemble a disclosure statement for a plan in the slightest. Thus, the Bankruptcy Court denied the 363 sale as an impermissible *sub rosa* liquidation plan.

Going Forward

At the end of its opinion, the Bankruptcy Court noted that the "Debtor may well produce sufficient evidence to confirm a plan over the objection of the parties opposing this sale, but that is for another day." Of course, from the perspective of the secured creditor, all that means are additional costs and a delay in receiving a recovery. While the Bankruptcy Court's holding does not necessarily represent the prevailing law in all jurisdictions, careful planning and consideration at the outset of a case of the form and substance of any contemplated 363 sale can go a long way toward avoiding this result.

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