CR&B Alert

COMMERCIAL RESTRUCTURING & BANKRUPTCY NEWS – JUNE 2011, ISSUE 2

IN THIS ISSUE:

ReedSmith

The business of relationships.℠

NEW YORK
LONDON
HONG KONG
CHICAGO
WASHINGTON, D.C.
BEIJING
PARIS
LOS ANGELES
SAN FRANCISCO
PHILADELPHIA
PITTSBURGH
OAKLAND
MUNICH
ABU DHABI
PRINCETON
N. VIRGINIA
WILMINGTON
SILICON VALLEY
DUBAI
CENTURY CITY
RICHMOND
GREECE

WHAT YOU NEED TO KNOW ABOUT THE PROPOSED NEW LIQUIDATION REGIME UNDER DODD-FRANK

Peter S. Clark, II
Firmwide Practice Group Leader
Philadelphia

Under the proposed new insolvency regime created by Dodd-Frank, the FDIC may be appointed as receiver of a financial company if it is determined that the financial company is in default or in danger of default, and the failure of the financial company would have serious adverse effects on financial stability in the United States.The receiver is required to liquidate the failing financial company in a manner that imposes all losses on the company's creditors and shareholders (rather than on taxpayers). Creditors of these financial institutions, who likely are familiar with reorganization and liquidation under the Bankruptcy Code, should be prepared to adapt to a different claims procedure and priority scheme. Although the FDIC is attempting to harmonize the claims procedure with the Bankruptcy Code, significant differences exist. For instance, as currently written, oversecured creditors will not be able to recover post-appointment interest, fees and costs, unless unsecured creditors are paid in full - unlike recovery under the Bankruptcy Code. We have prepared a Client Alert which focuses on those provisions of the proposed rule that are of interest to creditors of financial companies, including the administrative process for the initial determination of claims, the process of judicial review for disallowed claims, the priority of expenses and unsecured claims, and the treatment of secured claims. The *Client Alert* can be accessed here.

IN A CASE OF FIRST IMPRESSION, THE THIRD CIRCUIT HOLDS THAT DISCOUNTED CASH FLOW ANALYSIS MAY BE USED AS A 'COMMERCIALLY REASONABLE DETERMINANT OF VALUE' WITH RESPECT TO REPURCHASE AGREEMENT ACCELERATION UNDER SECTION 562

Brian M. Schenker
Associate
Philadelphia

Crédit Agricole Corporate and Investment Bank New York Branch, f.k.a. Calyon New York Branch v. American Home Mortgage Holdings, Inc. (In re American Home Mortgage Holdings, Inc.), No. 09-4295, 2011 WL 522945 (3d Cir. February 16, 2011)

CASE SNAPSHOT

American Home entered into a mortgage loan repurchase agreement transaction with the repo buyer, Calyon. Following American Home's default on some of its repo obligations, Calyon accelerated the repurchase agreement. The acceleration obligated American Home to repurchase the mortgage loans at their value on the acceleration date, approximately $1.1 billion. Within one week of the acceleration notice, American Home filed for bankruptcy under chapter 11. Calyon filed claims for damages, i.e., the difference between the repurchase price and the value of the mortgage loans, and American Home objected.

In a case of first impression, the Third Circuit decided the meaning of "commercially reasonable determinants of value" as used in section 562 of the Bankruptcy Code, which addresses the timing for the measurement of damages suffered in connection with repo agreements. Under section 562, such damages are measured as of the earlier of the date of rejection, liquidation, termination, or acceleration, unless there are not any commercially reasonable determinants of value (here, for the mortgage loans) as of such dates, in which case the damages are measured on the earliest date on which there are commercially reasonable determinants of value.

The Third Circuit held that it would be commercially unreasonable to determine the value of the mortgage loans on the acceleration date by use of a market valuation methodology, because of the global financial crisis at that time and resultant dysfunctional market, where market prices were unavailable or did not fairly reflect worth. The court concluded that a commercially reasonable determinant of value did exist on the acceleration date in the form of a discounted cash flow analysis. Further, because the discounted cash flow analysis determined that the value of the mortgage loans was greater than the repurchase price, Calyon had suffered no damages, and the court denied Calyon's claims.

FACTUAL BACKGROUND

In 2006, American Home entered into a repurchase agreement with Calyon, whereby American Home sold to Calyon and agreed to repurchase from Calyon approximately 5,700 mortgage loans with an original unpaid principal balance of just under $1.2 billion. In August 2007, American Home defaulted on some of its obligations under the repo agreement and Calyon accelerated the repurchase agreement; the acceleration obligated American Home to repurchase the mortgage loans for approximately $1.1 billion. Less than a week later, American Home filed for bankruptcy under chapter 11. Calyon filed claims for damages, i.e., the difference between the repurchase price and the value of the mortgage loans, and American Home objected.

At the time of the default, acceleration notice, and bankruptcy filing, the financial markets were in distress. Buyers of mortgage loans were difficult to find, and if buyers could be found, the offered purchase prices were extremely low, e.g., 10 percent of the unpaid principal balance of the mortgage loan. While Calyon's original intent in entering into the repurchase agreement was to resell the

CONTINUED ON PAGE 3

In a Case of First Impression, the Third Circuit Holds that Discounted Cash Flow Analysis May be Used as a 'Commercially Reasonable Determinant of Value' with Respect to Repurchase Agreement Acceleration Under Section 562—continued from page 2

mortgage loans within a short period of time, because of the market dysfunction, Calyon decided to keep the mortgage loans; in particular, because the borrowers were still making the principal and interest payments and, thus, the mortgage loans were generating cash flow.

COURT ANALYSIS

Section 562 of the Bankruptcy Code addresses the timing for the measurement of damages suffered in connection with repo agreements. Under section 562, such damages are measured as of the earlier of the date of rejection, liquidation, termination, or acceleration, unless there are not any commercially reasonable determinants of value as of such dates, in which case the damages are measured on the earliest date on which there are commercially reasonable determinants of value.

Calyon argued that the only appropriate determinants of value under section 562 were a sale or market valuation and, because the mortgage loan market was dysfunctional on the acceleration date, i.e., unavailable or not fairly reflecting worth, a sale or market valuation of the mortgage loans was commercially unreasonable at that time. Thus, no commercially reasonable determinant of value was available on the acceleration date. Calyon, therefore, contended that its damages should be measured on the earliest date on which a market value for the mortgage loans could be determined, which it argued was 12 months after the acceleration date. Using that date, Calyon concluded that the market value of the mortgage loans was less than the repurchase price by nearly $500 million. Thus, Calyon claimed it had suffered nearly $500 million in damages.

American Home argued that sale or market valuations were not the only appropriate determinants of value under section 562. Instead, a discounted cash flow analysis was also appropriate and commercially reasonable; in particular, when the market for the subject asset is dysfunctional and the asset generates cash flow, as in the present case. Using that method, American Home: (1) adjusted the interest rate

CONTINUED ON PAGE 12

CLAIMS TRADER LOSES OUT ON CURE PAYMENTS WHERE DEBTOR'S APPROVED PLAN PERMITS POST-CONFIRMATION REJECTION OF EXECUTORY CONTRACTS

Christopher O. Rivas
Associate
Los Angeles

ReGen Capital I, Inc. v. UAL Corporation, et al., (In the Matter of UAL Corporation, et al.), 635 F.3d 312 (7th Cir. 2011).

CASE SNAPSHOT

AT&T sold its general unsecured claims for defaulted telecom services contracts against debtor United Airlines to ReGen Capital for a discount of their $5 million value. United stated an arguably ambiguous intent to assume the AT&T executory contracts, after which claims-trader ReGen filed a cure claim for the entire contract amount. United subsequently rejected the AT&T contracts. The Court of Appeals held that ReGen's purchase of the claim included any recovery of cure payments for assumed contracts, but that ReGen was not entitled to cure payments because United rejected the contracts.

FACTUAL BACKGROUND

United Airlines contracted with AT&T for the provision of certain telecommunications services. UAL (United's parent) filed a petition for chapter 11 reorganization in 2002. At that time, United was in default with respect to the AT&T contracts. AT&T sold its general unsecured claim to ReGen Capital, a claims-trader that purchased bankruptcy claims from creditors at discount. ReGen duly filed "Notice of Transfer of Claim" and "Notice of Assignment of Claim" with the Bankruptcy Court, recording its purchase of AT&T's claim.

Late in 2005, United filed its reorganization plan, including an exhibit of "Assumed Executory Contracts and Unexpired Leases," which identified 10 AT&T leases. The plan included a reservation of rights permitting United to reject any of the identified executory contracts once the cure amounts were established by agreement of the parties or by order of the court. The Bankruptcy Court approved United's plan effective February 1, 2006.

ReGen then submitted a cure claim for the full contract amount of its purchased AT&T contracts, asserting that, by including the AT&T contracts on the Assumed Executory Contracts exhibit to the plan, United had elected to assume the contracts.

On June 4, 2008, United filed notice of its intent to reject the AT&T contracts. United objected to ReGen's cure claim on the grounds that: one, United rejected the contracts; and two, even if it had assumed the contracts, ReGen's purchase of AT&T's general unsecured claims did not entitle it to receive any cure claims for assumed contracts.

The Bankruptcy Court agreed with United on both points, and the District Court affirmed. ReGen appealed to the Court of Appeals for the Seventh Circuit.

COURT ANALYSIS

The Court of Appeals first took up the Bankruptcy Court's decision that AT&T had not assigned ReGen a right to file a cure claim. The assignment document defined "claim" as, "any general pre-petition unsecured claim of AT&T against a debtor together with interest, if any, payable thereon from and after the Effective Date, *and any actions, claims, lawsuits or rights of any nature whatsoever,* whether against a debtor or any other party, *arising out of or in connection with the Claim,* including, Assignor's right to receive, from and after the Effective Date, any cash, securities, instruments, and/or other property as distributions on the Claim." (Emphasis in opinion.)

CONTINUED ON PAGE 4

TRADEMARK LICENSE AGREEMENT DEFINES MATERIALITY, EFFECTIVELY ESTABLISHING A PERPETUAL EXECUTORY AGREEMENT SUBJECT TO PERPETUAL REJECTION

Christopher O. Rivas
Associate
Los Angeles

Lewis Brothers Bakeries Incorporated and Chicago Baking Company v. Interstate Brands Corporation (In re Interstate Bakeries Corporation, et al.), Bk. Case No. 04-45818-11-JWV (W.D. Mo. March 21, 2011)

CASE SNAPSHOT

Interstate Bakeries entered into an agreement, pursuant to which Interstate agreed to license certain of its trademarks to certain licensees. Two years after receiving the licensees' final payment, Interstate filed a chapter 11 petition and sought to reject the licensing agreement as an executory contract. The licensees objected on the grounds that the agreement was effectively a "sale," had been fully performed, and there were no outstanding material obligations. The Bankruptcy Court disagreed, looking to the agreement's provision requiring licensees to maintain the quality of the licensed products. This provision expressly stated that it was a "material" obligation, and the agreement permitted Interstate to terminate the agreement upon its breach. The Bankruptcy Court held that this provision effectively created a perpetually executory contract, ruling that Interstate could, thus, reject the agreement. On appeal, the District Court affirmed.

FACTUAL BACKGROUND

In 1996, Interstate Bakeries licensed certain of its trademarks in the Chicago area to Lewis Brothers Bakeries and Chicago Baking Company, after being ordered to do so pursuant to certain antitrust rulings against Interstate. The license was "perpetual," and final payment for the license was made to Interstate in 2002. Although the license agreement had many of the markings of a sale, several provisions in the license agreement made clear that Interstate retained full and exclusive ownership of the trademarks.

The license agreement gave Interstate the right to terminate the agreement upon a material breach. In relevant part, "material breach" was defined as, "a failure of LBB to maintain the character and quality of goods sold under the Trademarks…."

In 2004, Interstate Bakeries and its subsidiaries filed petitions for chapter 11 protection. In 2008, Lewis Brothers and Chicago Baking filed an adversary action, seeking a declaratory judgment that the license agreement was not executory. On cross-motions for summary judgment, the Bankruptcy Court found that the agreement was executory, and granted Interstate's motion. The licensees appealed.

COURT ANALYSIS

Section 365 of the Bankruptcy Code authorizes a debtor to assume or reject any executory contract. While the Code does not define "executory contract," courts

CONTINUED ON PAGE 5

Claims Trader Loses Out on Cure Payments Where Debtor's Approved Plan Permits Post-Confirmation Rejection of Executory Contracts—continued from page 3

The Bankruptcy Court ruled that the AT&T assignment had only assigned general pre-petition unsecured claims, and that the "right to cure does not arise out of a claim [but] out of a contract." The Court of Appeals disagreed, holding that the assignment language was broad, and that the agreement clearly assigned all claims of any nature, including claims arising out of or in connection with an assigned claim. "The claims stem from the same transaction giving rise to a single right to payment." The court noted that this decision brought it in line with the Second Circuit's decision regarding the identical contract language. Thus, had United assumed the contracts, ReGen would be entitled to the full cure payments.

However, the court also ruled that United successfully rejected the subject contracts. Although United included the contracts in its list of "Assumed" contracts in the plan, it also reserved its right to reject those contracts once the cure amounts had been determined. Additionally, Bankruptcy Code section 365 permits a debtor to assume executory contracts "subject to the court's approval," and only where the debtor cures the defaults or provides adequate assurance of a prompt cure. United had provided neither as to AT&T's claims. The court also noted that, although there might be some concerns about executory contracts being assumed and/or rejected post-confirmation, ReGen had waived any such arguments by failing to object to confirmation of the plan.

The Court of Appeals upheld the lower court decision to deny ReGen's cure claim.

PRACTICAL CONSIDERATIONS

The Court of Appeals noted that claims-trading, as engaged in by ReGen, "remains a gray area in bankruptcy law that the courts and Congress have left to the parties to negotiate." At first blush, the case might be read as good news for claims purchasers hoping to recover possible cure payments on executory contracts, and for claims sellers, it could conceivably augment the price of traded claims that might result in cure payments being paid to the claims purchaser. However, the UAL case is of fairly limited practical usage. As the court noted in its decision, AT&T was free to continue doing business with United without demanding a cure, and "because ReGen held only an assigned claim, it had nothing to offer United in return for assumption." In other words, in most situations, there is very limited incentive for a debtor to assume an executory contract (and make cure payments) for a traded claim.

SECURITY INTEREST IN FCC LICENSE AND PROCEEDS THEREOF IS 'AFTER-ACQUIRED' PROPERTY WHERE NO SALE AGREEMENT EXECUTED PRE-PETITION, WIPING OUT LENDER'S LIEN

Christopher O. Rivas
Associate
Los Angeles

Spectrum Scan LLC and Joli Lofstedt, Trustee v. Valley Bank & Trust Co. (In re Tracy Broadcasting Corporation), 438 B.R. 323 (Bankr. D. Colo. 2010)

CASE SNAPSHOT

Debtor Tracy Broadcasting operated a radio station under a license from the FCC. Tracy executed a note in favor of Valley Bank and granted a security interest to the bank in Tracy's general intangibles, as well as the proceeds thereof. Tracy filed a chapter 11 petition, and Spectrum, an unsecured creditor, filed an adversary action seeking determination of whether the bank had a security interest in the potential sale proceeds from the FCC license. The court ruled that, although the bank would ordinarily have a security interest in proceeds from the sale of the FCC license, if such sale occurred post-petition, the proceeds were "after-acquired" property under section 552(a), and thus not subject to any pre-petition liens.

FACTUAL BACKGROUND

In May 2008, Valley Bank & Trust loaned Tracy Broadcasting $1.5 million, evidenced by a promissory note and security agreement. Pursuant to the security agreement, Tracy pledged as collateral its "general intangibles" and proceeds thereof. The bank perfected its liens by filing UCC-1 financing statements in the relevant states, listing the general intangibles and proceeds, among other things, as collateral.

In August 2009, Tracy filed a chapter 11 petition. In October 2009, the bank filed a motion for relief from the automatic stay to enforce its security interest. The trustee and Spectrum, a vendor and unsecured judgment creditor, objected to the bank's motion, alleging that the bank had no security interest in Tracy's FCC license or any proceeds from the sale of the license. The court granted relief from the stay, but bifurcated the issue of whether the FCC license was collateral for the bank's loan. The parties filed cross-motions for summary judgment on the issue. The Bankruptcy Court ruled against the bank and held it did not have a security interest in the post-petition proceeds of the license.

CONTINUED ON PAGE 6

Trademark License Agreement Defines Materiality, Effectively Establishing a Perpetual Executory Agreement Subject to Perpetual Rejection—continued from page 4

define it, under the Countryman Standard, as "a contract under which the obligation of both the bankrupt and the other party to the contract are so far underperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other." Courts in the Eighth Circuit, as in many others, look at whether any material obligations remain unperformed, and define a "material obligation" as any important or substantial obligation.

Arguing that there were no outstanding material obligations, the licensees relied heavily on *In re Exide Technologies,* 607 F.3d 957 (3rd Cir. 2010), in which the court found that there were no unperformed material obligations (i.e., no executory contract) in a licensing agreement where the licensee had already paid the full purchase price of the license.

However, in the *Interstate* case, the question of materiality was an easy one that did not require the sort of detailed materiality analysis conducted in *Exide*. The agreement expressly provided that the failure of licensees to maintain the character and quality of the goods sold under the trademarks constitutes a "material" breach, giving Interstate the right to terminate the agreement. "The parties agreed and acknowledged that this obligation was material in 1996 when they entered the License Agreement."

In short, because material obligations permitting termination of the agreement would perpetually exist in the license agreement, the agreement was, therefore, perpetually an executory contract subject to rejection under section 365 of the Bankruptcy Code.

The licensees argued that they fully paid under the agreement, which was effectively a sale. Additionally, the quality control provision set forth no actual quality control standards and Interstate never checked the quality of the products. Most importantly, the agreement provided a cure period that allowed the licensees to easily cure any quality deficiencies, and thus no actual breach would ever realistically occur. The court set aside these arguments, stating that the issue was simply a legal one: if the term was breached (regardless of whether the scenario was realistic), Interstate could terminate the agreement. Thus, the contract was executory on its face.

The District Court upheld the Bankruptcy Court's grant of Interstate's motion for summary judgment.

PRACTICAL CONSIDERATIONS

Generally, trademark license agreements are found to be executory contracts. The exception is where the trademark license agreement looks more like a sale, as was the case in *Exide*. (For a discussion of *Exide*, please view the September 2010 CR&B *Alert* on the Reed Smith website). However, as is often the case in contract cases, the express terms of the contract will bind the parties. Unwitting licensees may purchase and fully pay for a "perpetual" license without considering that the licensor's bankruptcy may permit the licensor to later reject the contract despite already being paid in full. Licensees should seek legal advice from bankruptcy counsel to determine whether their "perpetual" license will actually remain effective perpetually, even in bankruptcy.

Security Interest in FCC License and Proceeds Thereof is 'After-Acquired' Property Where No Sale Agreement Executed Pre-Petition, Wiping Out Lender's Lien—continued from page 5

COURT ANALYSIS

Underlying the parties' dispute was section 310(d) of Title 46 of the U.S. Code, which prohibits FCC licenses from being pledged as collateral. The issue was two-fold: one, whether the future proceeds of the sale could be pledged as collateral; and two, whether the bank had a perfected security interest where such sale proceeds arise post-petition. "The case presents a question of law: does the Bank's security interest extend to 'proceeds' received by the Trustee upon a future transfer of the Debtor's interest in the FCC license, where there was no contract for transfer of the license in existence at the time the Chapter 11 petition was filed?"

Spectrum made two arguments. First, it argued that UCC 9-315(c) states that security interests in proceeds are perfected only if the security in the original collateral is perfected. Because security interests could not be perfected against the FCC license, there could be no security interest in the proceeds from its sale. Second, Spectrum argued that, even if a security interest in the proceeds could be perfected, UCC 9-322 states that a security interest cannot attach to proceeds until the debtor has a right to receive such proceeds. Tracy did not have a contract to sell the license at the time it filed its chapter 11 petition, so it did not have a pre-petition right to any such proceeds. Therefore, any right to proceeds Tracy might receive for the license would only arise post-petition, and Bankruptcy Code section 552 barred the bank from asserting a lien against the post-petition property.

The bank argued that an FCC license may be bifurcated into "public rights" and "private rights." The public rights deal with who may become a licensee, and the conditions attached to using the license. These public rights, the bank acknowledged, could not be subject to a security interest under federal law. However, the bank asserted that private rights, such as the sale of the FCC license and proceeds from such sale, could be pledged as collateral. Therefore, the bank's pre-petition security interest in private rights of the FCC license, including any right to sell or sale proceeds, were perfected by its pre-petition UCC financing statements listing all general intangibles of Tracy's.

The court determined that the issue had not been addressed by the Tenth Circuit, and that other circuits dealt with the issue inconsistently. One line of cases from the Sixth and Seventh Circuits rejected any security interest in any aspect of the FCC license. Another line of cases in the Ninth Circuit and Fourth Circuit (at the trial level) recognized a bifurcation of "public rights" and "private rights" in FCC licenses. These cases held that while public rights could not be pledged as collateral, private rights (e.g., sale of the license) could. The *Tracy* court assumed, for the purposes of this order, that the bifurcation line of cases had been decided rightly.

This was, however, only the beginning of the analysis. The court acknowledged that the bank would have a perfected security interest in the sale proceeds of the FCC license outside of bankruptcy, but noted that Bankruptcy Code section 552, which prohibits any liens against property acquired post-petition, was applicable here. Section 552(a) provides that any "property acquired by the estate after the commencement of the case is not subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case." Section 552(b) provides an exception to this general rule. If the debtor entered into a pre-petition security agreement, and "if the security interest … extends to property of the debtor *acquired before the commencement of the case* and to *proceeds* … of such property," then the security interest will extend to "such proceeds" acquired by the estate post-petition, "to the extent provided by such security agreement and by applicable non-bankruptcy law …." (Emphasis in opinion.)

The court framed the question: did the debtor have sufficient rights in the sale and proceeds of the FCC license for a UCC lien to attach prior to filing its bankruptcy petition? Put more generally, was there any pre-petition property against which the bank could assert its lien? The court's answer to that question was "no."

The debtor's right to receive value for its license (i.e., its "private right") was subject to two contingencies, and thus too remote. First, there was no pre-petition agreement to sell the license; and second, the FCC had not approved a transfer of the license. Since neither contingency occurred pre-petition (or post-petition, for that matter), the debtor did not have a sufficient private property interest in proceeds of the FCC license, pre-petition, against which a security interest could be asserted. The court therefore concluded that section 552(a) of the Bankruptcy Code prevented the bank from encumbering any value that the debtor's estate may receive from any future post-petition transfer of the license.

The bank's motion for summary judgment was denied, and Spectrum's and the trustee's motions for summary judgment were granted. The court entered a judgment declaring that the bank had no security interest in the license or any future proceeds derived from a transfer of the license.

PRACTICAL CONSIDERATIONS

The *Tracy* court cuts a fine line on the securitization of FCC licenses. The court rejected the bright-line rule prohibiting any security interest against any aspect of the FCC license, but this ruling only helps creditors where the right to proceeds from the sale of the FCC license arise before the petition date. To the extent a creditor has any say in a debtor's affairs, it should encourage such sales to occur pre-petition. This decision is on appeal, and we will update you when a decision is reached.

FAA REGISTRATION LAW DOES NOT PREEMPT STATE UCC WHERE PARTIALLY COMPLETED AIRPLANES FAIL TO SATISFY FAA DEFINITION OF "AIRCRAFT"

Kathleen A. Murphy
Associate
Wilmington

Mata, et al., v. Eclipse Aerospace, Inc. (In re AE Liquidation, Inc., et al.) Case No. 08-51891, 2011 BL 51047 (Bankr. D. Del. Feb. 28, 2011)

CASE SNAPSHOT

The debtor had filed its chapter 11 petition while in the process of manufacturing custom-designed airplanes for several purchasers. After the case had been converted to a liquidation, the bankruptcy trustee sought to sell all the debtor's assets, including the partially completed planes, to a purchaser. The original airplane purchasers objected to the sale to reserve what they believed were superior interests in the planes under New Mexico's Uniform Commercial Code. The trustee's purchaser argued that a federal registration statute administered by the Federal Aviation Administration preempted New Mexico's UCC, so that the original purchasers had no secured claim to the planes. Because the partially-completed planes did not constitute "aircraft" within the FAA definition, the Bankruptcy Court held that the FAA statute did not preempt New Mexico's UCC here, and that the original purchasers did have claims sufficient to survive the motion to dismiss.

FACTUAL BACKGROUND

Eclipse Aviation Corporation developed and manufactured private jets, and had agreed to construct jets for a group of purchasers. Each purchase was evidenced by a purchase agreement. Pursuant to the purchase agreements, each purchaser paid a downpayment (usually 60 percent of the total purchase price), and Eclipse Aviation agreed to manufacture each jet according to each purchaser's specifications. Prior to completing any of these jets, Eclipse Aviation filed its chapter 11 petition.

Within a month of the debtor's filing, the purchasing group filed an adversary proceeding, seeking a determination that: (i) they possessed superior property rights to those of the debtor in the partially completed jets and parts; (ii) they held equitable liens and constructive trusts on the jets; (iii) the jets could not be sold free and clear of their interests; and (iv) the jets were not property of the bankruptcy estate.

When a buyer of substantially all of the debtor's assets was unable to obtain financing, the sale fell through, the case converted to a liquidation and a chapter 7 trustee was appointed. The trustee sought approval to sell substantially all the assets free and clear of all liens, claims and encumbrances, to Eclipse Aerospace, Inc. The purchasing group did not object to the sale to Eclipse Aerospace, Inc., but sought to amend the order approving the sale to preserve the purchasing group's rights in the partially completed aircraft pending the outcome of the adversary proceeding. The order approving the sale to Eclipse Aerospace, Inc. would also give Eclipse the rights that the debtor or trustee would have had to avoid any interests in the disputed jets. Eclipse Aerospace agreed to this amendment, and the court entered an order approving the sale to Eclipse Aerospace.

Subsequent to the entry of the sales order, Eclipse Aerospace intervened in the adversary proceeding, and filed a motion for summary judgment.

COURT ANALYSIS

Eclipse Aerospace argued that its interest in the jets was superior to that of the purchasing group's because the group members never registered their interests in the jets under federal aviation law, but instead filed interests under New Mexico's UCC. Eclipse further argued that the federal aviation laws preempted New Mexico's UCC.

The purchasing group disagreed, arguing that the partially completed jets were not "aircraft" as defined in the statute and, therefore, the federal law was inapplicable.

The court agreed with the purchasing group. The court distinguished the cases relied upon by Eclipse because those cases addressed completed aircraft. Because none of the jets in this case had been completed (in fact, several were more "parts" than "jets"), they did not satisfy the statutory definition of "aircraft" and therefore could not be registered under the federal statute.

Because the Bankruptcy Court found that the partially completed jets were incapable of being registered under the federal statute, it held that the registration statute could not preempt New Mexico's UCC. Thus, the court denied Eclipse's motion for summary judgment.

The court likewise denied Eclipse's motion to dismiss the purchasing group's claims with respect to its rights to the jets under a constructive trust theory. Eclipse argued that state law required that the group show fraud or other similar wrongful conduct for the imposition of a constructive trust. The purchasing group argued that, while it did have to show wrongful conduct, any breach of a legal or equitable duty would suffice; a showing of fraud was not required. The Bankruptcy Court agreed with the purchasing group, and denied Eclipse's motion to dismiss.

PRACTICAL CONSIDERATIONS

Federal and state law may establish different requirements to preserve a party's interests in property. It is important to understand the definitions provided in any statutory scheme, as those definitions establish the scope of the statute. The governing statute dictates the necessary steps to protect a party's superior interest in property.

COLLATERAL-ORDER DOCTRINE UTILIZED IN A CASE OF FIRST IMPRESSION; COURT AFFIRMS BROAD EQUITABLE POWERS OF A RECEIVER

Ann E. Pille
Associate
Chicago

Securities and Exchange Commission v. Wealth Management, LLC, et al., 628 F.3d 323 (7th Cir. 2011)

CASE SNAPSHOT

The principal officers of a small group of related investment funds had invested money in impermissible investments, received kickbacks, and inflated investment results, to the extent that the funds eventually had to be closed down. The SEC filed an enforcement action for fraud, requested that the court freeze the firm's assets, appoint a receiver to perform an accounting, and design a plan to distribute the recoverable assets. The District Court, over some investor objections, approved the receiver's plan of pro rata distribution. This decision was appealed. The Circuit Court of Appeals affirmed, and, in a case of first impression, held that reviewing the interlocutory order approving the receiver's plan was reviewable, under the collateral-order doctrine.

FACTUAL BACKGROUND

For more than 20 years, Wealth Management, LLC managed funds for hundreds of clients. Most clients were conservative investors, and Wealth Management invested accordingly, in low-risk securities. In 2003, Wealth Management established six unregistered funds, and began investing heavily in unconventional, illiquid and risky securities, in contravention to the stated investment parameters of these funds. These six funds were organized either as limited liability companies or limited partnerships; Wealth Management was the general partner or managing member for each of these funds. Two Wealth Management executive officers had complete authority to manage these funds.

The express language in the offering documents of these funds provided that the funds would invest only in "investment-grade" debt securities. In fact, these funds were operated more along the lines of high-risk hedge funds, investing in life-insurance premium financing funds, real-estate financing funds and a water park. Monthly reports issued to investors falsely indicated that the funds were performing well. The situation began to unravel in February 2008, when the funds notified investors that there was not enough money to pay redemptions in full, and that redemptions would be limited to 2 percent per quarter of the value of each investor's investment.

In June 2008, the two principal officers responsible for managing these funds informed Wealth Management's board of directors that they had mismanaged the funds and had received kickbacks for investing in certain securities. Investors learned at this time that the SEC was investigating Wealth Management, the funds and the officers. In December 2008, Wealth Management notified investors of its decision to completely close down.

In May 2009, the SEC commenced its enforcement action against Wealth Management and the two principal officers. The court granted the SEC's request to freeze the firm's assets, and appoint a receiver for the firm and its assets. In September 2009, the receiver filed her report. Roughly $102 million had been invested in these six funds. The receiver, however, was able to recover little more than $6 million. The receiver determined that no investors were creditors of the firm, and that the fairest approach was to treat all investors equally as equity holders, regardless of whether a redemption request had been made. Thus, the receiver proposed to distribute the $6.3 million to investors on a pro rata basis. The receiver also selected May 31, 2008 as a "redemption cutoff date." Redemption distributions received after this cutoff date would be offset against the investor's total distributions; redemption distributions received prior to this date would not be offset. The receiver selected this date because news of the SEC investigation became public in June 2008, causing a spike in redemption requests.

Two investors are involved in this appeal. Both had, after receiving the 2008 letter limiting redemptions to 2 percent, placed redemption orders for the full amount of their investments, before May 1, 2008. These redemption requests were in Wealth Management's records, and each investor had received partial redemptions in accordance with the 2 percent limitation. These objecting investors argued that their redemption requests required that they be treated as creditors, entitled to priority over non-redeeming investors. The District Court disagreed, holding that the investors were not creditors, that the receiver's plan was fair and reasonable, as was the redemption cutoff date. The receiver distributed more than $4 million to investors after this decision, then moved to dismiss the investors' appeal or in the alternative, to affirm the plan.

COURT ANALYSIS

Collateral-Order Doctrine

The Court of Appeals first addressed its jurisdiction to review the appeal. The appeal regarding the receiver's plan was interlocutory; no final determination on the merits of the SEC enforcement action had been made. The question therefore was whether this issue was ripe for appeal. The Court of Appeals, as a matter of first impression in the Seventh Circuit, determined that it did have jurisdiction to review the decision under the collateral-order doctrine.

The court noted that the Fifth and Sixth Circuits had held that the collateral-order doctrine permits interlocutory review of a District Court's order approving a receiver's plan of distribution. The doctrine permits review of a small class of decisions that finally determine claims separable from, and collateral to, rights asserted in an underlying action. "To fall within the scope of this doctrine, the order must conclusively determine the disputed question, resolve an important question completely separate from the merits of the underlying action, and be effectively unreviewable on appeal from a final judgment." The court found that all three requirements were met, and held that it had jurisdiction to decide this appeal.

CONTINUED ON PAGE 9

Collateral-Order Doctrine Utilized in a Case of First Impression; Court Affirms Broad Equitable Powers of a Receiver —continued from page 8

Receiver's Motion to Dismiss

Following the filing of the appeal, the appellants filed a motion to stay distributions until the appeal had been resolved. This motion was denied, and the receiver made distributions under the fund. Following these distributions, the receiver moved to dismiss the appeal as moot, arguing that unwinding the distributions that had already been made would be inequitable to innocent investors, as well as an administrative headache. This argument, sometimes called "equitable mootness," is based on an equitable principle in bankruptcy law. Acknowledging that the term can cause confusion (because there is no actual mootness involved), the court noted that the term derives from the equitable principle that a court, in determining equitable relief, must consider the effects of the relief on innocent parties. This equitable doctrine has been applied in other securities fraud/receiver cases, where courts have decided whether to unwind distributions.

The court stated that there were two key issues in resolving the receiver's motion: the legitimate expectations engendered by the plan, and the difficulty of unwinding the distributions. The court looked to precedent, noting that the inquiry is fact-intensive, and "weighs the virtues of finality, the passage of time, whether the plan has been implemented and whether it has been substantially consummated, and whether there has been a comprehensive change in circumstances." The court determined that unwinding the distributions of $4.2 million to some 300 investors would raise "serious equitable concerns," and pose

CONTINUED ON PAGE 18

COURT HOLDS THAT 'ALL VALUE' MUST BE CONSIDERED IN DETERMINING 'REASONABLY EQUIVALENT VALUE' IN FRAUDULENT TRANSFER CASE

Brian M. Schenker
Associate
Philadelphia

First State Bank of Red Bud v. Official Committee of Unsecured Creditors (In re Schaffer), No. 10-198-GPM, 2011 WL 1118666 (S.D. Ill. March 28, 2011)

CASE SNAPSHOT

A bank made three loans to finance a business. Two loans were made to the corporate entity and personally guaranteed by the principals. The third loan was made directly to the principals. In connection with a later forbearance agreement, the principals executed a mortgage in favor of the bank to secure their loan and guaranties. Six months later, the principals filed for chapter 11 bankruptcy. The Official Committee of Unsecured Creditors sought to avoid the mortgage as a fraudulent transfer under section 548 of the Bankruptcy Code. The Committee argued that the debtors had not received reasonably equivalent value in exchange for the mortgage. The Bankruptcy Court agreed with the Committee, finding that the antecedent debt did not provide reasonably equivalent value. The bank appealed, and the District Court overturned the Bankruptcy Court, holding that all value received by the debtors must be considered when determining "reasonably equivalent value," and the antecedent debt, together with the bank's forbearance, provided the debtors with reasonably equivalent value.

FACTUAL BACKGROUND

Roger and Eva Schaffer, the principals, were in the pork farming business. They were also the shareholders in Premium Pork, Inc., a pork production business. The First State Bank of Red Bud made one loan to the Schaffers and two to the corporation, which the Schaffers personally guaranteed. In connection with a later forbearance agreement, the Schaffers executed a mortgage in favor of the bank, securing the loans and guaranties against real property they owned.

Six months later, the Schaffers filed for chapter 11 bankruptcy and commenced an adversary proceeding against their creditors to determine the validity and priority of the liens against and security interests in the real property. The Committee cross-claimed in the adversary proceeding, seeking to avoid the mortgage as a fraudulent transfer.

The Bankruptcy Court held for the Committee, and the bank appealed.

COURT ANALYSIS

Section 548(a)(1)(B) of the Bankruptcy Code authorizes a debtor to avoid any transfer made within two years before the petition date, if the debtor received less than reasonably equivalent value in exchange for the transfer. Under this section, "value" means "property, or satisfaction or securing of a present or antecedent debt of the debtor." In the present case, there was no dispute regarding insolvency, and there was no dispute that the antecedent debt constituted value. The parties' sole dispute was whether the debtors had received reasonably equivalent value in exchange for the mortgage.

The Bankruptcy Court had focused on the antecedent debt and the fact that, at the time the mortgage was executed, no money had changed hands and no new funds were loaned to the debtors personally, and determined that the debtors had not received reasonably equivalent value. The District Court concluded that the Bankruptcy Court had applied the incorrect standard, and all value received by the debtors must be considered when determining reasonably equivalent value.

The District Court noted that the Committee had stated that the mortgage "was done in connection with an out of court work out or forbearance, where the [bank] agreed not to foreclose on its various security interests in exchange for certain promises by the Debtors and the Mortgage." The bank had admitted this allegation in its answer, and further answered that: "The [Bank] also extended the terms of the Debtor's notes and lowered the Debtor's interest charges as

CONTINUED ON PAGE 12

DEBTOR UNABLE TO PROVIDE ADEQUATE ASSURANCE; COURT DENIES MOTIONS TO USE CASH COLLATERAL AND OBTAIN DIP FINANCING PRIMING ORIGINAL LIEN

Ann E. Pille
Associate
Chicago

In re LTAP US, LLLP, Case No. 10-14125 (KG) (Bankr. D. Del. Feb. 18, 2011)

CASE SNAPSHOT

The debtor sought to use cash collateral to enable it to pay insurance premiums on policies essential to the continuation of its business. The debtor also moved for approval of DIP financing provided by a new lender that would, among other things, prime the interests of the debtor's pre-petition secured lender. The secured lender opposed the debtor's motions, and moved for relief from the automatic stay. The Bankruptcy Court denied the debtor's motions, finding that the debtor was unable to provide adequate protection to the secured lender. The court granted the lift stay motion.

FACTUAL BACKGROUND

LTAP was in the life settlement business, purchasing unmatured life insurance policies at a discount from face value, receiving revenue (and profiting) only when the insured died. Cash flow of LTAP, as well as the ability to pay premiums and purchase policies on an ongoing basis, depended on a steady rate of maturity of the policies. Unfortunately for LTAP, policies did not mature at the projected rates. In 2010, LTAP experienced significant cash flow issues that rendered it unable either to pay the policy premiums coming due or purchase new policies. Indeed, although the aggregate death benefits of the policies in LTAP's portfolio were $1.36 billion, LTAP faced imminent policy premiums of $9 million that needed to be paid in order to maintain the policies. At the same time, LTAP had only $9,000 in cash.

A U.S. bank was LTAP's pre-petition secured lender under a Loan and Security Agreement, with an outstanding balance in excess of $230 million as of the petition date. As and for security of the amounts due under the Agreement, LTAP granted the bank a security interest in substantially all of LTAP's assets.

Prior to the petition date, the bank terminated the Agreement, and LTAP filed a petition for chapter 11 protection. On the petition date, LTAP filed a motion seeking approval to use the bank's cash collateral to pay the upcoming policy premiums, alleging that if it could not pay the imminent premiums of $9 million, policies with face value of $297 million would lapse and become valueless. In addition, LTAP sought court approval of a DIP financing facility with Monarch Alternative Capital LP that would alleviate its impending premium crisis. The DIP financing facility was conditioned upon the DIP loan priming the bank's liens.

COURT ANALYSIS

At issue before the court were LTAP's motion for use of the bank's cash collateral, LTAP's motion seeking approval of the DIP financing facility that would prime the bank's liens, and the bank's motion for relief from stay. The outcome of each of these motions was predicated on the value of the life insurance policies, and whether that value exceeded the obligations to the bank.

The Debtor's Motions

LTAP's request to use cash collateral was governed by section 363 of the Bankruptcy Code. In order to prevail, LTAP was required to prove that there was sufficient value in its assets to protect the secured lender's position. Both the bank and LTAP presented expert testimony on the value of LTAP's portfolio. The bank's expert valued the portfolio by examining the fair market value of the portfolio in the life settlement market. In contrast, LTAP's expert valued the portfolio by examining LTAP's future premiums, life expectancy of the insureds, administrative expenses, and projected monthly cash flows, and then applied appropriate discount rates. After evaluating the testimony of both experts, the court found that the bank's evidence was strongly persuasive. The court determined that LTAP's expert made several key assumptions, including the use of inaccurate policy maturity projections, which led to a flawed ultimate conclusion as to value. Moreover, the court found that LTAP's expert failed to take into consideration the fact that the life settlement industry as a whole was suffering, and that willing buyers for LTAP's assets were difficult to locate without offering steep discounts.

The court concluded that the prognosis for LTAP's continued viability was negative, and that its ability to reorganize was also unlikely. In addition, the court found that the value of LTAP's assets did not provide adequate protection of the bank's loan, thereby necessitating the denial of LTAP's motion to use the cash collateral. Similarly, since the bank's security interests were not adequately protected, the court declined to approve the DIP financing facility and granted the bank's motion for relief from stay. In doing so, the court held that "[p]roviding [the bank] with a replacement lien on assets against which it already has a lien is illusory. Debtor must provide the bank with additional collateral, and there is none."

PRACTICAL CONSIDERATIONS

Court approval of the use of cash collateral requires a showing that the secured lender's interests are adequately protected. Clearly, courts are looking hard at valuation evidence, to ensure that protection is truly adequate. Replacement liens in collateral must provide actual security to the lender. Lenders and debtors alike must be prepared to present credible, thorough and persuasive evidence as to the value of collateral.

PRIMING LIEN APPROVED: NEW LOAN USE WOULD BENEFIT THE ESTATE + DEBTOR'S SIZABLE EQUITY CUSHION = ADEQUATE ASSURANCE

Ann E. Pille
Associate
Chicago

In re Olde Prairie Block Owner, LLC, Bankr. No. 10B22668 (Bankr. N.D. Ill. March 11, 2011)

CASE SNAPSHOT

The single-asset chapter 11 debtor sought approval from the Bankruptcy Court to borrow funds from a new lender, and grant the new lender superpriority status over the liens of the debtor's pre-petition secured lender. The debtor had a substantial equity cushion in the subject property, and planned to use the relatively small new loan to complete the steps necessary to attract investors to develop the property. The secured lender objected to the new loan priming its lien. In holding for the debtor, the court stated that it did not rely solely on the $30 million equity cushion of the debtor as the basis for its ruling. The court evaluated the likelihood that the new loan would benefit the property and advance the purposes of reorganization, and evaluated whether the secured lender's interest would be adequately protected.

FACTUAL BACKGROUND

Olde Prairie Block Owner, LLC, the debtor in this case, owned parcels of what the court described as "choice" real estate in Chicago. CenterPoint Trust Properties was the debtor's pre-petition secured lender, having loaned approximately $50 million for the purchase of the property. Olde Prairie Block had defaulted on its mortgage obligations to CenterPoint, and the lender initiated foreclosure proceedings. Before the foreclosure action was completed, Olde Prairie Block filed its chapter 11 petition. An evidentiary hearing determined that the property was worth $81 million, and the balance due CenterPoint was $48 million; thus, the debtor had an equity cushion in excess of $30 million in the property.

The debtor had been taking steps to develop the property into a hotel complex, which steps included substantial investments in pursuing Tax Increment Financing for the property, as well as obtaining and monetizing various tax credits (such as "historic tax credits" and "new market" tax credits). The debtor had retained several experts to help with this process, including consultants, attorneys, and architects.

The debtor faced an immediate problem, though, in the form of an imminent due date for payment of property taxes. The debtor had negotiated for a relatively small loan of $4 million from JMB Capital Partners, LP. In exchange for this loan, the debtor proposed that the JMB loan be given senior priority over CenterPoint's lien and superpriority administrative expense status.

The debtor filed a motion with the court, proposing to use the JMB loan proceeds to pay the property taxes, and pay several other expenses related to the development of the property into a hotel complex.

CenterPoint objected to the debtor's motion. The Bankruptcy Court approved in part, and denied in part, the debtor's motion.

COURT ANALYSIS

A debtor-in-possession may incur debt only in accordance with the requirements of section 364 of the Bankruptcy Code. If a debtor is unable to obtain unsecured credit, a court may authorize the debtor to obtain new, secured credit with priority over other administrative expenses (sometimes called "superpriority" administrative expenses). Section 364(d) authorizes the debtor to obtain credit secured by a senior or equal lien on encumbered estate property (a "priming" lien), after notice, hearing and court approval, only if: (1) the debtor is unable to obtain credit otherwise; and (2) the interest of the creditor to be primed is adequately protected.

In the instant case, CenterPoint objected to the debtor's motion, arguing that its interest was not adequately protected, and that the various expenditures proposed by the debtor would not advance its reorganization.

In approving the motion in part, the court took into consideration the sizable equity cushion in the property, but found that the equity cushion was not, by itself, determinative of the motion. Instead, the court held that "[i]t is not enough for Debtor to rely on a large equity cushion resting on expert opinions as to the value of the property…. The uses contemplated for the new loan must have serious likelihood of benefitting the property and advancing the purposes of reorganization. A priming lien without such a showing would impose unwarranted risk on the secured creditor if reorganization failed." In doing so, the court recognized that valuations (and, by implication, equity cushions) are determined by expert testimony that could prove to be inaccurate. As such, "some restraint is warranted in allowing priming liens based on equity cushions." The court evaluated the proposed uses of the JMB loan, and found that most of the expenses would likely advance the value of the property and make it easier for the debtor to reorganize. The court further noted with approval the steps the debtor had already taken with respect to obtaining TIF financing and various tax credits, to make the project more appealing to potential investors, and concluded that the debtor had shown a serious business justification for most of the proposed uses of the JMB loan.

The court, however, declined to allow the JMB facility to be used to pay expenses that had already been incurred. Instead, it held that, because the debtor had already succeeded in obtaining those services on an unsecured basis, it was unable to prove that it was "unable to obtain unsecured credit" from those entities as required by section 364(d)(1). As such, "permitting Debtor to borrow from JMB in exchange for a priming lien in order to pay past due expenses would be contrary to the plain language of the requirements under section 364(d)." For these reasons, the Bankruptcy Court authorized the borrowing for expenses necessary to fund future, but not past, services that will be provided to the debtor.

CONTINUED ON PAGE 17

In a Case of First Impression, the Third Circuit Holds that Discounted Cash Flow Analysis May be Used as a 'Commercially Reasonable Determinant of Value' with Respect to Repurchase Agreement Acceleration Under Section 562—continued from page 3

of each mortgage loan to reflect market conditions, as described in the Federal Home Loan Mortgage Corporation's Primary Mortgage Market Survey conducted by Freddie Mac; (2) accounted for actual delinquency rates on the mortgage loans as of the acceleration date; and (3) then applied the adjusted rates to discount cash flows for each mortgage loan. By this method, American Home determined the value of each mortgage loan and concluded that the aggregate value of the mortgage loans on the acceleration date exceeded the repurchase price. Thus, American Home contended that Calyon had suffered no damages.

The Third Circuit found that a sale or market price should be used to determine an asset's value under section 562 when the market is functioning properly. However, when the market is dysfunctional and a sale is impossible or prices do not reflect the asset's worth, it would be commercially unreasonable to do so, and, thus, other determinants of value should be used under those circumstances. Under the current circumstances, where the market for the mortgage loans was dysfunctional and the mortgage loans were generating a cash flow, the court found the use of the discounted cash flow analysis to be both appropriate and commercially reasonable.

In particular, the Third Circuit found an intrinsic problem and logical flaw with Calyon's position that no commercially reasonable determinant of value existed in the context of the dysfunctional mortgage loan market. Specifically, in that context, the commercially reasonable action to take was to retain the mortgage loans and receive and retain the cash flows generated thereby. Cash flows, of course, can be used to determine value, as demonstrated by discounted cash flow analysis.

Furthermore, the Third Circuit pointed out that accepting Calyon's position would create a moral hazard contrary to the policy of the Bankruptcy Code to preserve liquidity of mortgage loans. Under Calyon's interpretation of section 562, Calyon would be incentivized to continue to hold the mortgage loans and obtain the benefit of the cash flows being produced thereby because the risk of doing so would be reduced by the availability of damages claims against American Home.

The Third Circuit concluded that a commercially reasonable determinant of value existed on the acceleration date in the form of the discounted cash flow analysis, and, because the discounted cash flow analysis determined that the value of the mortgage loans was greater than the repurchase price, Calyon had suffered no damages. The court noted that: "[W]here the court concludes that a valuation methodology other than a market value (in a dysfunctional market context) evidences that the asset's value exceeds the underlying repurchase price obligation, the result is not that the counter-party is deprived of recourse to recover its damages, but rather that the counter-party has incurred no damages capable of being recovered."

PRACTICAL CONSIDERATIONS

Section 562 addresses swap agreements, securities contracts, forward contracts, commodity contracts, and master netting agreements, in addition to repurchase agreements. Therefore, the Third Circuit's interpretation of "commercially reasonable determinants of value" could impact a large universe of financial instruments; in particular, because the Third Circuit is the first circuit in the Court of Appeals to weigh in on the issue. While the Third Circuit admonished that its reading would not chill the repurchase agreement market, the actual consequences of the opinion are yet to be seen.

Court Holds that 'All Value' Must be Considered in Determining 'Reasonably Equivalent Value' in Fraudulent Transfer Case —continued from page 9

further consideration for the granting of the third mortgage to secure prior Debtor debts of $5,074,906.09."

The District Court then found that the debtors had received the following value: the antecedent debt, the extended maturity dates, and the bank's forbearance. Taken together, the District Court held that the debtors had received reasonably equivalent value in exchange for the mortgage. The court held that a fraudulent transfer had not occurred, and therefore ordered that the bank's lien be reinstated.

PRACTICAL CONSIDERATIONS

Obtaining new or additional collateral to secure antecedent debt is often a primary goal of restructuring and forbearance agreements. This case points out that lenders must give enough in return for the collateral to protect the transfer from avoidance. Of course, what is "enough" will differ in every factual situation. Thus, the structure of such agreements should be carefully considered in light of the surrounding circumstances.

COURT VACATES THE FORECLOSURE SALE AND AWARDS DAMAGES, FINDING THAT THE LENDER VIOLATED THE AUTOMATIC STAY BY PROCEEDING WITH THE SALE WHERE DEBTOR GUARANTEED THE LOAN, BUT HAD NO OWNERSHIP INTEREST

Brian M. Schenker
Associate
Philadelphia

In re Ebadi, No. 10-73702, 2011 WL 1257211 (Bankr. E.D.N.Y. March 30, 2011)

CASE SNAPSHOT

In this case of first impression, the United States Bankruptcy Court for the Eastern District of New York held that a lender knowingly violated the automatic stay, by proceeding with a foreclosure sale of real property in which the debtor had no interest because the debtor, as a guarantor of the loan, had been named as a defendant in the foreclosure judgment obtained by the lender before the debtor filed for bankruptcy. The results of the foreclosure sale would determine the lender's deficiency claim against the debtor, i.e., the debtor's remaining personal liability for the loan. Proceeding with the sale constituted both a continuation of a judicial proceeding against the debtor, and a continuation of a judicial action to recover a pre-petition claim against the debtor, both of which clearly violate the automatic stay. The Bankruptcy Court therefore vacated the foreclosure sale and awarded actual damages to the debtor.

FACTUAL BACKGROUND

Mr. Abadi, the debtor, owned a company called CBC Media Realty. In 2001, CBC executed a note and mortgage in favor of the lender, securing a loan against real property that CBC owned. At that same time, Abadi executed a guaranty, under which he personally guaranteed all payments and obligations due under the note and mortgage. CBC subsequently defaulted, and in 2008, the lender instituted foreclosure proceedings against CBC and Abadi. Early in 2010, the state court entered judgment in favor of the lender, setting May 14, 2010, as the date of the foreclosure sale. The foreclosure judgment included a determination that, if the sale proceeds were insufficient to satisfy the lender's claim, "the plaintiff shall recover from defendants CBC Media Realty, LLC … and Madjib Ebadi, the whole deficiency … provided a motion for deficiency judgment shall be made."

On May 14, 2010, mere hours before the scheduled time of the foreclosure sale, Abadi filed for chapter 13 bankruptcy. The lender's attorneys and the foreclosure referee were notified prior to the sale of the bankruptcy filing. Nevertheless, the sale proceeded as scheduled, and the lender acquired the rights to the property.

Abadi neglected to fulfill many of his responsibilities as a chapter 13 debtor, and so on June 29, 2010, his bankruptcy case was closed. On August 24, 2010, the lender served CBC with a Notice to Quit the Premises. On September 8, 2010, Ebadi filed a motion to re-open his bankruptcy case, arguing that the foreclosure sale had violated the automatic stay, that the sale should be vacated, and that he should be awarded actual and punitive damages for the lender's willful violation of the stay. At a hearing on this motion, Ebadi conceded that he was not seeking to re-open his case in order to reorganize and confirm a plan; he was simply seeking to vacate the foreclosure sale and obtain a damages award.

The lender argued that it had not violated the automatic stay because the real property was owned by CBC and the debtor had no interest in it.

COURT ANALYSIS

This case presents an issue of first impression in the Second Circuit: whether a foreclosure sale under New York law of real property in which a bankruptcy debtor has no ownership interest is a violation of the automatic stay, where the debtor is a guarantor of the underlying debt and a named defendant in a foreclosure judgment.

Section 362(a) of the Bankruptcy Code provides: "[A] petition filed under … this title … operates as a stay, applicable to all entities, of – (1) the commencement or continuation … of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the case under this title, or to recover a claim against the debtor that arose before the commencement of the case under this title; … (6) any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title…."

The foreclosure judgment obtained by the lender named the debtor as a defendant, and specifically provided that if the proceeds from the foreclosure sale were insufficient to pay the full amount due, the lender could recover the deficiency from the debtor. The court determined that proceeding with the foreclosure sale constituted a continuation of a judicial proceeding against the debtor. In addition, "[b]ecause the Foreclosure Sale is a substantial step in a process that could lead to recovery of a deficiency judgment from Debtor, it falls within the contours of 'any act to collect, assess, or recover a claim against the debtor,' which is prohibited by the automatic stay…." Therefore, the Bankruptcy Court found that the lender had knowingly violated the automatic stay.

In reaching this conclusion, the court noted the well-established principle of bankruptcy law that, when a principal obligor is a debtor in bankruptcy (and thus shielded by the automatic stay), a creditor is generally not barred from pursuing non-filing co-obligors or guarantors when pursuing the collection of a debt.

The court, however, distinguished the current case on the grounds that the lender's actions were taken in furtherance of a foreclosure judgment directly against the debtor. "Had [the lender] dismissed Debtor from the Foreclosure Action and removed Debtor from the Foreclosure Judgment prior to the sale going forward, the case likely would have been sufficiently analogous to collecting from a non-filing co-obligor such that [the lender] would likely not have been stayed from collecting against CBC. That is not the case here, though. Here, [the lender] pursued a Foreclosure Judgment against Debtor while Debtor was protected by the automatic stay." The court noted that the lender chose to bring the foreclosure action not just *in rem* (seeking determinations relating to title

CONTINUED ON PAGE 17

COURT GRANTS PARENT COMPANIES STANDING TO SUE LENDER AS THIRD-PARTY BENEFICIARIES OF LOAN COMMITMENT AGREEMENTS

Christopher O. Rivas
Associate
Los Angeles

Basic Capital Management, Inc. v. Dynex Commercial, Inc., 2011 WL 12067376 (Tex. Sup. Ct. J. Apr. 1, 2011)

CASE SNAPSHOT

A real estate lender agreed to finance three existing projects by lending money to three separate Single-Asset Bankruptcy Remote Entities (SABREs), owned by certain real estate investments trusts, and to finance $160 million in future ventures of the trusts, with further SABREs to be created as each deal came to fruition. As financial and credit conditions worsened, the lender withdrew its future lending commitments and stopped funding the current commitments. The trusts sued the lender for breach of contract, winning judgments at the trial level. However, the lender successfully non-suited the judgment on the grounds that the trusts lacked standing to recover damages because the current and future lending commitments were with the SABREs, not the trusts, and also that damages for the future commitments were not foreseeable. On appeal, the Texas Supreme Court overruled the non-suit on both grounds, holding that the trusts were third-party beneficiaries and that damages were foreseeable.

FACTUAL BACKGROUND

Basic Capital Management managed publicly traded real estate investment trusts (REITs) in which it owned stock. Two of these REITs, ART and TCI, are involved in this case. Dynex Commercial, Inc. provided financing for multi-family and commercial real estate investors.

ART and TCI held investment property in single-purpose entities (SPEs), also known as SABREs (single-asset, bankruptcy remote borrowing entities). The purpose of each SABRE was to own a single piece of real estate, so that if one SABRE became insolvent, its problems were separate and remote from the other SABREs, which provided additional security to lenders doing business with the SABREs.

Dynex agreed to loan three TCI-owned SABREs $37 million to acquire and rehabilitate three commercial buildings (one building each) in New Orleans. This loan was conditioned on Basic Capital's promise to find other deals acceptable to Dynex, similarly structured through as-yet-to-be created SABREs. Dynex required that these SABREs borrow $160 million over the next two years.

The New Orleans agreement was between Dynex and TCI (not a SABRE), and provided that the $37 million would be loaned to the "borrower" for use by three yet-to-be-created SABREs acceptable to Dynex.

The $160 million Commitment was between Basic Capital and Dynex, and it likewise required that each deal be structured through a SABRE, each of which would be created and owned by either ART or TCI.

Dynex partially performed under the agreements, but when market interest rates rose, making the deals unfavorable to Dynex, it refused to loan any more funds either for the New Orleans project or under the Commitment. Basic Capital, TCI and ART sued Dynex for breach of contract, alleging that real estate transactions that would have qualified for financing under the Commitment were financed at higher costs, if at all. The plaintiffs sought damages for interest paid in excess of what would have been paid under the terms of the Commitment, as well as lost profits from investments that could not be financed at all. ART and TCI alleged that they were intended third-party beneficiaries under the Commitment, because their wholly owned SABRE subsidiaries would own the properties and borrow the funds from Dynex. Dynex argued that ART and TCI were not the intended beneficiaries, and they lacked standing to sue for breach of contract.

At trial, the jury found for ART and TCI, but the trial court set aside that verdict. The Court of Appeals upheld the trial court's judgment notwithstanding the verdict, and Basic Capital, TCI and ART appealed to the Texas Supreme Court.

COURT ANALYSIS

Standing Issue

The court first considered whether ART and TCI could recover for breach of the Commitment, and TCI for breach of the New Orleans deal, as third-party beneficiaries. More generally, could the owners of a SABRE be the beneficiaries under the contract? The court first set forth the well-established law regarding third-party beneficiaries: "The fact that a person might receive an incidental benefit from a contract to which he is not a party does not give that person a right of action to enforce the contract. A third party may recover on a contract made between other parties only if the parties intended to secure some benefit to that third party, and only if the parties entered into the contract directly for the third party's benefit." The court went on to state that the intention of the parties was controlling, that the intent to benefit a third party must be clear, and that a court could not create a third-party beneficiary by implication.

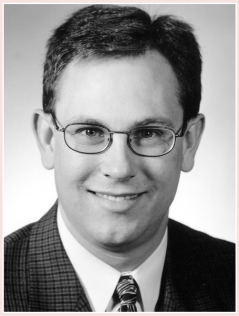
The court found the evidence, including the contracts themselves, to be clear. Dynex knew that the purpose of the Commitment was to obtain future financing for ART and TCI (each of which was owned and managed by Basic Capital), and that Basic Capital was never going to be the named borrower. "On the contrary, the Commitment expressly required that the borrowers be SABREs acceptable to Dynex. Nor was Basic to own the SABREs." The court also pointed out that the SABRE requirement was of great benefit to Dynex, which sought to limit its potential losses in the event any of the projects failed and sought to shield each venture's collateral from each of the others.

The court found Dynex's arguments that only a SABRE had standing to sue under the Commitment illogical, because a SABRE would not be created until an investment opportunity presented itself. Without financing, an investment opportunity would not exist, and thus neither would a SABRE. "It would be unreasonable to require ART and TCI to have created SABREs for no business purpose, merely in order that those otherwise inert entities could sue Dynex."

The court acknowledged that a corporate parent is not automatically a third-party beneficiary of its subsidiary's contract, but here the deal was structured to benefit both the parent and the lender. "If Dynex and Basic did not intend the Commitment to benefit ART and TCI directly, then the Commitment had

CONTINUED ON PAGE 18

LANDLORD'S CORNER



Derek J. Baker
Partner
Philadelphia

In re Heller Ehrman, LLP No. 10-CV-03134 2011 WL 635224 (N.D. Cal. Feb. 11, 2011)

In *In re Heller Ehrman, LLP,* the court analyzed whether the statutory cap imposed on a landlord's damages resulting from the rejection of a lease should be computed based on the time remaining in the lease, or the full damages resulting from the rejection. While noting a split of authority, the District Court determined that the computation of the cap should be based on a temporal measure to be consistent with statutory language.

When a lease of non-residential real property is rejected, the lease is deemed breached. The landlord has the right to assert damages against the debtor/tenant resulting from such breach. The Bankruptcy Code establishes a landlord's damages so as to enable the landlord to have a claim against the tenant, but prohibits a claim so large that it would provide the landlord with a "disproportionate" share of the debtor/tenant's estate. That calculated limitation, known as the statutory cap, is codified in section 502(b)(6) of the Bankruptcy Code. It provides that the landlord's damages are limited to the greater of one year's rent or 15 percent of the remaining term of the lease, not to exceed three years. The question raised by *Heller Ehrman* is whether the second part of the clause (i.e., 15 percent of the remaining term of the lease not to exceed three years) requires the landlord to compute its damages based on the actual rent that would have been paid for the remainder of the lease limited to 15 percent of such amount (the "gross rent calculation"), or whether the actual amount of time for which the landlord can assert damages is limited by 15 percent of the remaining term of the lease (the "temporal calculation").

In *Heller Ehrman,* the landlord computed its statutory cap and used the gross rent calculation. The debtor, on the other hand, asserted that the landlord's claim was overstated and should be limited to the temporal calculation. In this instance, the difference in calculation was about $2.5 million.

The court analyzed both arguments and concluded that the statutory text of the Bankruptcy Code required that the damages be calculated based on the rent that would otherwise be due during the time that equated to 15 percent of the remaining term of the lease. The court concluded that the statute used "temporal" references throughout, and therefore the computation of the statutory cap based on a time limitation was more consistent with the overall scope of the Bankruptcy Code. Also, the court relied on pre-Code decisions and legislative history to bolster its conclusion.

Since there is a split of authority among various jurisdictions, and understanding that the nuances in calculating the gross rent calculation or the temporal calculation can lead to varying amounts, it is important for landlords to recognize these differences to adequately apply the statutory cap.

THE NEW FAST-TRACK RESTRUCTURING PROCEDURE IN FRENCH INSOLVENCY LAW: THE 'ACCELERATED FINANCIAL SAFEGUARD PROCEDURE'

Introduction

Inspired by the American "prepackaged restructuring plan," the French authorities have yet again decided to reform French insolvency law, with the creation of an "accelerated financial safeguard procedure" *(procédure de Sauvegarde Financière Accélérée).* This procedure is available to debtors who start conciliation proceedings after 1 March 2011.

Though most French specialists refer to this procedure as the "SFA," the full name of the procedure best describes what it encapsulates: an "Accelerated" procedure applied in a limited amount of time (maximum of two months) that only applies to "Financial" creditors with a view to the "Safeguard" for debtors facing difficulties.

With this procedure, France seeks to improve its competitiveness in the restructuring and business rescue arena. However, some flaws inevitably remain.

The Key Features of this Procedure

Only financial creditors are affected by this fast-track procedure:

Only financial creditors, comprised mainly of banking establishments and bondholders, are affected by this procedure. Trade creditors are not directly affected and their claim will be payable at term: they will not be under any obligation to notify the creditor's representatives of the amount of their claim, nor will payment of their claim be frozen or rescheduled.

Furthermore, this procedure can only be taken advantage of by the debtor on the following conditions:

1. The company's accounts must be certified by a statutory auditor or prepared by an accountant; and

2. The company's turnover must equal or exceed €20 million per year; or

3. The company has 150 or more employees on the date of filing for the SFA

A safeguard procedure:

Differentiating itself from the original safeguard procedure, the fast-track procedure directly follows on from a "conciliation procedure" during which a restructuring is negotiated. This is not necessarily the case for the original safeguard procedure, which can be started without a prior conciliation procedure.

The conciliation procedure is a confidential procedure under which unanimous consent of the creditors involved in the negotiation is generally required. Before implementation of the new fast-track procedure, it was possible for a few

CONTINUED ON PAGE 16

The New Fast-Track Restructuring Procedure in French Insolvency Law: The 'Accelerated Financial Safeguard Procedure' —continued from page 15

recalcitrant creditors to block the restructuring negotiations and prevent the debtor from reaching an amicable agreement with its key creditors.

In this respect, a main objective of the reform is to act as a counterweight against dissenting minority creditors, by converting a conciliation agreement that does not have unanimous creditor approval into a mandatory restructuring plan. The underlying objective is to indirectly force minority creditors to consent to the agreement during the conciliation negotiations, by threatening to use this procedure during the conciliation period.

A debtor who wishes to invoke this procedure must convince the court that the restructuring plan will not only address the financial difficulties it faces, but will also be adopted by a qualified majority vote of the banking establishments' committee and the bondholders in assembly (but not of the suppliers' committee, as trade creditors are not involved in this procedure).

It is important to note that the vote is achieved with at least two-thirds of the total value of the claims of all the creditors who actually take part in the voting procedure (keeping in mind that committee members whose claims are not affected by the proposed restructuring plan are not allowed to vote).

To obtain the court's approval on the restructuring plan, the creditors must follow the same voting procedures as with the standard safeguard procedure. In this respect, this reform does not implement a new procedure, but an accelerated version of the standard safeguard procedure.

It is a fast-track procedure:

After the court's approval to proceed under an SFA, the financial creditors have one month (with a possible extension of another month), to vote on and adopt the restructuring plan in the creditors' committee and among the bondholders, respectively, instead of six months under the standard procedure (with the possibility to extend this period by a further six months).

Before both groups of financial creditors, respectively, proceed to vote on the restructuring plan as mentioned above, the administrator must notify each banking establishment that it is a member of the banking establishments' committee.

Instead of requiring the 20 and 15 days' notice of the meetings of the committee of banking establishments and assembly of bondholders, respectively, under the standard safeguard procedure, only eight and 10 days' notice, respectively, need be given under the accelerated procedure.

After the banking establishments' committee and the bondholders in assembly have voted on the restructuring plan, disgruntled members of the committee or assembly have 10 days to object on the voting process. When this 10-day period has expired, the court has a minimum period of five days to reflect on the plan before giving its approval, including ruling on the appeal, if any, lodged by members of the committee and assembly.

If the plan is not adopted by the financial creditors, the court will bring the SFA to an end.

Comments

The reform is a welcome attempt to address the often lengthy process businesses in France have to go through to restructure their financial arrangements. It is also a highly competitive measure in the context of the EU as, unlike the conciliation procedure, the safeguard procedure is already recognised under the EC Insolvency Regulation. However, it is arguable that the reform was passed into law too quickly as it has omitted certain key aspects, which subsequent secondary legislation failed to address.

For example, the legislation failed to take into account the fact that a great number of holding companies are non-operational. As a result, few holding companies involved in a leveraged buy-out will currently meet the required thresholds in turnover or number of employees, and therefore will not be able to benefit from the SFA. In this respect, less than two months after the SFA entered into force, the French parliament adopted an amendment bill introducing an alternative condition as to the application of the SFA. In effect, a debtor who does not meet the required thresholds would have been able to engage in an SFA if its assets as per its balance sheet met an amount to be determined by secondary legislation. However, before the bill entered into force, the French Constitutional Court cut out this disposition of the bill as it was inserted into a legislative article with which it had no direct relation. As this disposition was only cut out based on its form and not on its substance, we will most certainly be seeing a similar legislative or regulatory act come into force shortly. Whilst waiting for this amendment, the SFA still remains unavailable to non-operational holding companies, the first companies that were supposed to be targeted by this reform.

Another question which may be raised is how this procedure is going to be applied in practice. With this reform, the restructuring plan will be discussed during the conciliation procedure before the SFA procedure starts. One issue that will arise is how the confidentiality of the conciliation procedure will be preserved as the provisional restructuring plan must be disclosed to the works council and, in certain circumstances, during a shareholders' meeting.

Reed Smith's restructuring team in Paris and lawyers regularly involved in restructuring matters:

Anker Sorensen
Partner

Andrew Tetley
Counsel

Clara Zerbib
Partner

Stéphane Illouz
Partner

Nadia Chatraoui
Associate

Aymeric Discours
Associate

Brice Mathieu
Associate

Imogen Holmgren
Trainee

COUNSEL'S CORNER: NEWS FROM REED SMITH

Articles

Edward Estrada is the author of "The Immediate and Lasting Impacts of the 2008 Economic Collapse – Lehman Brothers, General Motors and the Secured Credit Markets," for the *University of Richmond Law Review,* 2011 Vol. 45.

Presentations

Edward Estrada has made two presentations since the last issue of the CR&B newsletter. One was titled "Emerging from the Great Recession: Perspectives on Law and Policy Implemented Along the Road to Economic Recovery," at the 2011 Allen Chair Symposium at the University of Richmond. The other was on "Fraudulent Transfers and Preference Claims," at the ABA Spring Meeting in Boston – Business Litigation – Insolvent Affiliate Panel. Reed Smith also prepared materials for this presentation.

Priming Lien Approved: New Loan Use Would Benefit the Estate + Debtor's Sizable Equity Cushion = Adequate Assurance —continued from page 11

PRACTICAL CONSIDERATIONS

Although the existence of a substantial equity cushion certainly makes it easier to obtain approval of DIP facilities conditioned upon the provision of priming liens or superpriority claims, the size of the equity cushion is not always determinative of these issues. Instead, because valuation analysis is sometimes imperfect, a debtor must still be able to demonstrate that the purposes for which the facility will be used benefit the estate and that they are unable to obtain financing on an unsecured basis.

Court Vacates the Foreclosure Sale and Awards Damages—continued from page 13

only), but also *in personam* (seeking general recovery against individuals or other entities), ultimately allowing the lender to seek a deficiency judgment against the debtor. "An *in rem* action against property in which a debtor does not have an ownership interest would likely not run afoul with the automatic stay. . . . An action that is at least partially *in personam* against a debtor, on the other hand, is stayed . . . ."

The Bankruptcy Court concluded that the lender's violation of the automatic stay was sufficient to vacate the sale and award actual damages. The court, however, found no malicious conduct or bad faith by the lender on which to base an award of punitive damages, and characterized the lender's continuation with the foreclosure sale as a mistake of law.

PRACTICAL CONSIDERATIONS

This case is certainly a cautionary tale for lenders. The Bankruptcy Court acknowledged that the debtor filed his chapter 13 petition solely to try to forestall the foreclosure sale, demonstrated no real intention of reorganizing under chapter 13, and admitted to having no intent to reorganize under chapter 13 going forward. Yet, the court, strictly reading the language of section 362, found that the lender had knowingly violated the automatic stay. The important takeaway for lenders, however, is that the violations of the automatic stay discussed in the case are perfectly avoidable. The lender could have either removed the debtor as a defendant or proceeded solely *in rem* in the first instance. Furthermore, the circumstances were such that, had the lender postponed the foreclosure sale for a limited period of time, the lender most likely would have been able to obtain relief of stay in the debtor's bankruptcy case, or the debtor's bankruptcy case would have been dismissed prior to the postponed foreclosure sale.

Collateral-Order Doctrine Utilized in a Case of First Impression; Court Affirms Broad Equitable Powers of a Receiver —continued from page 9

"administrative hurdles." The court declined to analyze this equitable question further, however, because "we are affirming on the merits."

The Distribution Plan

In supervising an equitable receivership, the courts have broad equitable powers to ensure that the plan is fair and reasonable. In this case, since the recoverable funds were just a small fraction of the overall investments, the District Court agreed with the receiver that it was more reasonable to distribute the assets to investors on a pro rata basis, rather than trying to trace assets to specific investors. The District Court concluded that all investors were in the same boat, regardless of whether they'd been redeeming investors or not, and to give redeeming investors some priority over non-redeeming investors would impermissibly "elevate form over substance."

In reviewing the lower court's decision, the Court of Appeals began "with the principle that where investors' assets are commingled and the recoverable assets in a receivership are insufficient to fully repay the investors, 'equality is equity.'" Pro rata distribution ensures that substantively similar claims receive proportionately equal distributions. The court then likened receivership to equitable subordination in bankruptcy law, stating that the goal of liquidation bankruptcy and securities-fraud receiverships is identical – the fair distribution of the liquidated assets. "Equitable subordination promotes fairness by preventing a redeeming investor from jumping to the head of the line and recouping 100 percent of his investment by claiming creditor status while similarly situated nonredeeming investors receive substantially less." The court held that the District Court faithfully applied these principles, and reasonably exercised its discretion, in approving pro rata distribution to all investors.

The objecting investors argued that, under 28 U.S.C. section 959(b), they were entitled to be treated as creditors, not equity holders. This statute governs receiver conduct, and requires that a receiver "manage and operate" the subject property in accordance with the laws of the state in which the property is located. The court cited case law in support of its conclusion that this statute has no relevance in the liquidation context. Moreover, under Wisconsin law, the objecting investors failed to satisfy the conditions of becoming creditors of the investment fund. Finally, the court rejected the appellants' argument that the cutoff date of May 31, 2008 was arbitrary and unfair, finding that, in light of the public notice of the SEC investigation in June and the ensuing spike in redemption requests, the receiver exercised discretion reasonably and equitably.

The Court of Appeals held that the lower court did not abuse its discretion in approving the receiver's distribution plan.

PRACTICAL CONSIDERATIONS

Unfortunately for investors, there will always be some segment of investment managers that succumbs to the temptation to benefit themselves at the expense of their investors. Receivership and forced liquidation is often the only possible remedy, and it is almost always far less than a complete remedy. This decision affirms the broad, equitable powers and discretion of receivers in fashioning the distribution plan that is as fair as possible to as many investors as possible – equality is equity.

Court Grants Parent Companies Standing To Sue Lender as Third-Party Beneficiaries of Loan Commitment Agreements —continued from page 14

no purpose whatever." The court held that ART and TCI were third-party beneficiaries and entitled to recover for breach of the Commitment.

Dynex also argued that TCI was not a third-party beneficiary of the New Orleans projects, because the three promissory notes had been executed by the three TCI-created SABREs, not TCI itself. The court rejected this argument, holding that the notes had been executed pursuant to the New Orleans agreement, which was expressly between Dynex and TCI. As a party to the agreement that provided financing to its wholly owned SABREs, TCI was a third-party beneficiary of the New Orleans agreement.

Foreseeability of Damages Issue

Dynex contended that Basic Capital could not recover lost profits as consequential damages because the loss of profits was not foreseeable. Dynex argued that it had no idea what specific investments Basic Capital would propose, or that alternative financing would not be available. The court agreed with the overarching principle that general knowledge of a prospective borrower's business does not give a lender reason to foresee the probable results of its refusal to make a loan. "But Dynex cites no authority, and we are aware of none, for the proposition that the consequences of a lender's breach of a loan commitment are not reasonably foreseeable unless the lender knew, at the time the commitment was made, not only the nature of the borrower's intended use of the money, but the specific venture in which the borrower intended to engage."

The court held that it was not necessary for the lender to know the specific venture the borrower had in mind, only the general nature of the intended use. Dynex was in the business of providing financing to commercial real estate developers, and had discussed for months with Basic Capital its intended uses for the financing. "In sum, the evidence establishes that Dynex clearly knew how the Commitment would be used. Indeed, it would be surprising if Dynex had agreed to lend Basic $160 million without such knowledge." The court held that Dynex knew that if interest rates rose and it pulled its financing, Basic Capital would have to arrange less favorable financing. Thus, the damages were foreseeable.

The Texas Supreme Court reversed and remanded the case for a determination of the actual damages Basic Capital sustained.

PRACTICAL CONSIDERATIONS

Lenders that require prospective borrowers to form multiple SABREs to protect the lender's security interests should also expect that a court may find that the company standing behind the SABRE (even if not an actual signatory to the loan agreement) will have standing to sue pursuant to the contracts.

REED SMITH COMMERCIAL RESTRUCTURING & BANKRUPTCY GROUP

PRACTICE LEADER

Peter S. Clark II
+1 215 851 8142 (Philadelphia)
pclark@reedsmith.com

ABU DHABI

Julian L. Turner
+971 (0)2 418 5767
jlturner@reedsmith.com

CHICAGO

Stephen T. Bobo
+1 312 207 6480
sbobo@reedsmith.com

Aaron B. Chapin
+1 312 207 2452
achapin@reedsmith.com

Timothy S. Harris
+1 312 207 2420
tharris@reedsmith.com

Ann E. Pille
+1 312 207 3870
apille@reedsmith.com

Alexander Terras
+1 312 207 2448
aterras@reedsmith.com

DUBAI

Sean L. Angle
+971 (0)4 319 7929
sangle@reedsmith.com

FALLS CHURCH

Linda S. Broyhill
+1 703 641 4328
lbroyhill@reedsmith.com

Robert M. Dilling
+1 703 641 4255
rdilling@reedsmith.com

HONG KONG

Andrew K. Brown
+ 852 2507 9778
akbrown@rsrbhk.com

LONDON

Sebastian Barling
+44 (0)20 3116 3890
sbarling@reedsmith.com

Jeffery Drew
+44 (0)20 3116 5930
jdrew@reedsmith.com

Emma J. Flacks
+44 (0)20 3116 6896
eflacks@reedsmith.com

Andrea N. Haughton
+44 (0)20 3116 2972
ahaughton@reedsmith.com

Ian E. Huskisson
+44 (0)20 3116 6763
ihuskisson@reedsmith.com

Monika Kuzelova
+44 (0) 20 3116 2900
mkuzelova@reedsmith.com

Charlotte Møller
+44 (0)20 3116 5926
cmoller@reedsmith.com

Anna B. Morgan
+44 (0)20 3116 3926
abmorgan@reedsmith.com

Georgia M. Quenby
+44 (0)20 3116 3689
gquenby@reedsmith.com

LOS ANGELES

Marsha A. Houston
+1 213 457 8067
mhouston@reedsmith.com

Christopher O. Rivas
+1 213 457 8019
crivas@reedsmith.com

MUNICH

Dr. Stefan Kugler, LL.M.
+49 (0)89 20304 131
skugler@reedsmith.com

Dr. Etienne Richthammer
+49 (0)89 20304 141
erichthammer@reedsmith.com

NEW YORK

Arnold L. Bartfeld
+1 212 205 6008
abartfeld@reedsmith.com

Aaron Bourke
+1 212 231 2640
abourke@reedsmith.com

Edward J. Estrada
+1 212 549 0247
eestrada@reedsmith.com

Jeffrey L. Glatzer
+1 212 205 6037
jglatzer@reedsmith.com

James C. McCarroll
+1 212 549 0209
jmccarroll@reedsmith.com

Nicole K. O'Sullivan
+1 212 549 0234
nosullivan@reedsmith.com

Andrea J. Pincus
+1 212 205 6075
apincus@reedsmith.com

J. Andrew Rahl Jr.
+1 212 205 6078
arahl@ReedSmith.com

John L. Scott
+1 212 205 6099
jlscott@reedsmith.com

Mark D. Silverschotz
+1 212 205 6086
msilverschotz@reedsmith.com

Debra S. Turetsky
+1 212 549 0398
dturetsky@reedsmith.com

Cameron G. Van Tassell
+1 212 231 2647
cvantassell@reedsmith.com

Michael J. Venditto
+1 212 205 6081
mvenditto@reedsmith.com

PARIS

Anker Sorensen
+33 (0) 1 44 34 80 88
asorensen@reedsmith.com

PHILADELPHIA

Derek J. Baker
+1 215 851 8148
dbaker@reedsmith.com

Scott M. Esterbrook
+1 215 851 8146
sesterbrook@reedsmith.com

Barbara K. Hager
+1 215 851 8864
bhager@reedsmith.com

Elizabeth A. McGovern
+1 215 851 8151
emcgovern@reedsmith.com

Jennifer P. Knox
+1 215 851 8190
jknox@reedsmith.com

Brian M. Schenker
+1 215 241 7966
bschenker@reedsmith.com

Claudia Z. Springer
+1 215 241 7946
cspringer@reedsmith.com

Matthew E. Tashman
+1 215 241 7996
mtashman@reedsmith.com

PITTSBURGH

Joseph D. Filloy
+1 412 288 3842
jfilloy@reedsmith.com

Jeanne S. Lofgren
+1 412 288 5936
jlofgren@reedsmith.com

Jared S. Roach
+1 412 288 3277
jroach@reedsmith.com

Eric A. Schaffer
+1 412 288 4202
eschaffer@reedsmith.com

Robert P. Simons
+1 412 288 7294
rsimons@reedsmith.com

Paul M. Singer
+1 412 288 3114
psinger@reedsmith.com

Luke A. Sizemore
+1 412 288 3514
lsizemore@reedsmith.com

Gregory L. Taddonio
+1 412 288 7102
gtaddonio@reedsmith.com

Amy M. Tonti
+1 412 288 3274
atonti@reedsmith.com

David Ziegler
+1 412 288 3026
dziegler@reedsmith.com

SAN FRANCISCO

Douglas G. Boven
+1 415 659 5652
dboven@reedsmith.com

Mike C. Buckley
+1 415 659 4761
mbuckley@reedsmith.com

WILMINGTON

J. Cory Falgowski
+1 302 778 7522
jfalgowski@reedsmith.com

Kurt F. Gwynne
+1 302 778 7550
kgwynne@reedsmith.com

Kimberly E.C. Lawson
+1 302 778 7597
klawson@reedsmith.com

Kathleen A. Murphy
+1 302 778 7572
kmurphy@reedsmith.com

Timothy Reiley
+1 302 778 7528
treiley@reedsmith.com

Richard A. Robinson
+1 302 778 7555
rrobinson@reedsmith.com

ReedSmith

The business of relationships.℠