CR&B Alert

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GIFTING

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For over 30 years, most bankruptcy courts have approved plans where the secured lender "gifts" a distribution to a junior class in order to obtain a consensual plan. These courts note that the distribution is from the secured lender's property (not estate property) and the secured lender can do what it wants with its own property. However, the Second Circuit recently held that where an objecting intervening creditor class is not paid in full, such a gift to a junior class violates the absolute priority rule—which provides that a senior class must be paid in full before a junior class can receive anything. *In re DBSD North America, Incorporated (DISH Network Corp. v. DBSD North America),* __ F. 3d __, 2011 WL 350480 (2nd Cir. Feb. 7, 2011). In *DBSD*, the first lien lenders were oversecured and the second lien lenders were undersecured. DBSD proposed a plan where: (a) the first lien lenders would be issued new debt obligations; (b) the second lien lenders would be issued most of the stock in the reorganized debtor; (c) the second lien holders would gift some shares of stock to the unsecured creditors (amounting to 0.15% of the equity in the reorganized debtor); and (d) the second lien holders would gift some shares of stock and warrants to the equity owner (amounting to 4.99% of the equity in the reorganized debtor). An unsecured creditor objected to the plan and argued that the gift to the equity owner violated the absolute priority rule, in that the equity owner would receive a significant amount of shares and warrants while the unsecured creditors would not be paid in full (and in fact would receive less than the equity owner). Although the Bankruptcy Court and the District Court approved the gifts as not violative of the absolute priority rule (as they were derived from value that the second lien holder would otherwise have been entitled to receive), the Second Circuit said that the absolute priority rule is clear that a class junior to a dissenting class may not receive any property regardless of its source. Although the *DBSD* decision creates challenges to secured creditors in the context of a cramdown plan confirmation process, it is important to note that the holding does not apply to gifting in the context of a consensual plan or a chapter 7 liquidation (where, in both cases, the absolute priority rule is not implicated), or in the context of a settlement "outside of a plan."

TOUSA OVERTURNED; DISTRICT COURT REJECTS NARROW DEFINITION OF 'EQUIVALENT VALUE'; REJECTS FINDING OF LENDERS' BAD FAITH

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In re TOUSA, Inc., Nos. 10-60017-CIV/Gold, 10-61478, 10-62032, 10-62035, and 10-62037 Slip Op. (S.D. Fla. Feb. 11, 2011)

CASE SNAPSHOT

The recent decision of the United States District Court for the Southern District of Florida in the bankruptcy case involving TOUSA, Inc. (and several subsidiaries) has received a lot of attention, especially from financial institutions. Lenders, for now, can breathe a sigh of relief, because this decision overturns the controversial decision of the Bankruptcy Court in *In re TOUSA, Inc.* Many bankruptcy practitioners believed the Bankruptcy Court had expanded the scope of the fraudulent conveyance provision found in section 548 of the Bankruptcy Code, as well as the ability of the trustee to recover pre-petition transfers under section 550 of the Bankruptcy Code. Not only did the District Court overturn the findings and holdings of the Bankruptcy Court, but the District Court also was highly critical of the manner in which the Bankruptcy Court reached its conclusions. The District Court so strongly rejected the findings of the Bankruptcy Court that it refused to send the case back to the Bankruptcy Court to make new findings of fact and issue a new opinion consistent with the District Court's holdings.

FACTUAL BACKGROUND

TOUSA, Inc., a large homebuilder with a principal place of business in Florida, along with a number of its affiliates and subsidiaries, filed for bankruptcy relief in January 2008. The bankruptcy filing came on the heels of one of the worst crashes ever to affect the United States housing market. TOUSA and its subsidiaries operated as a highly integrated enterprise, even though they were separate and distinct companies.

Financing Structure

TOUSA was financed by an $800 million secured revolving loan facility, which provided the lion's share of its liquidity. The Revolving Facility was funded by Revolving Facility Lenders, whose administrative agent, Citicorp, held a lien on the assets of TOUSA, as well as its subsidiaries, as security for the debt. TOUSA's subsidiaries were not separately financed and depended upon the Revolving Facility for their liquidity. Many of them were either co-borrowers or guarantors of the Revolving Facility. Among the default provisions in the Revolving Facility documents was the entry of a final judgment or judgments against TOUSA or one or more of its subsidiaries in an aggregate amount exceeding $10 million, which was not covered by insurance and was not satisfied within 30 days.

TOUSA was also financed by several bond issuances. These unsecured bonds were issued between 2002 and 2006. Even though TOUSA was principally responsible for the payment of the bonds, the prospectuses regarding the bond issuances made it clear that the funds to repay the bond debt would derive from TOUSA and its subsidiaries. The subsidiaries were jointly and severally liable as guarantors of the bond debt. Under the bond indentures, a judgment

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against TOUSA in an amount greater than $10 million would constitute an Event of Default, permitting the exercise of remedies by the bond trustee. Further, an Event of Default under the bond indentures triggered a default under the Revolving Facility.

In June 2005, TOUSA became involved in a joint venture (the Transeastern JV) that was financed with separate loan facilities. These Transeastern Loans aggregated $675 million, and the lenders to the Transeastern JV were known as the Transeastern Lenders. TOUSA and certain of its affiliates guaranteed the repayment of the Transeastern Loans, as well as the completion of the residential developments that the JV was intended to build. The guarantees also guaranteed full repayment of the Transeastern Loans in the event of a bankruptcy of the JV.

Underlying Litigation and New Financing – In late 2006, the Transeastern Loans went into default and the Transeastern Lenders demanded payment from TOUSA and one of its subsidiaries. Litigation soon ensued. In early 2007, as a result of the continuing problems involving the Transeastern JV and the drain on TOUSA's resources caused thereby, the Revolving Facility Lenders demanded additional collateral for the Revolving Facility. It was at this time that the Conveying Subsidiaries (as defined below) pledged liens on their assets to further collateralize the Revolving Facility, and many became co-borrowers under the Revolving Facility.

The litigation among the Transeastern Lenders and TOUSA grew more and more acrimonious, with the Transeastern Lenders positing that the debt under the TOUSA guarantees could be higher than $2 billion. TOUSA's board grew increasingly concerned about the possibility of an adverse judgment, and the potential demise of TOUSA and its subsidiaries. TOUSA's management and board became convinced that if it did not settle this litigation, TOUSA would be compelled to seek bankruptcy protection for itself and its subsidiaries.

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STILL IN THE MINORITY, 9TH CIRCUIT BAP HOLDS THAT CREDITORS MAY SEEK ADEQUATE PROTECTION RETROACTIVELY

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People's Capital and Leasing Corp. v. BIG3D, Inc. (In re BIG3D, Inc.), 438 B.R. 214 (9th Cir. BAP 2010)

CASE SNAPSHOT

A secured creditor filed a motion for adequate protection payments six months after the debtor's chapter 11 filing. The creditor and debtor stipulated on the amount of prospective adequate protection payments, but the creditor also sought retroactive payments to the date of the petition based on the decline in collateral from that time. The creditor relied on the Ninth Circuit Bankruptcy Appellate Panel's 1992 decision in *In re Deico Electronics, Inc.* The Bankruptcy Court denied retroactive payments, holding that the creditor did not make a sufficient showing under *Deico*. The creditor appealed, and the debtor requested that the BAP review the continuing validity of *Deico* (which deviated from the decisions in other circuits), and questioned the ability of any court to award adequate protection payments prior to the creditor filing a motion under the Bankruptcy Code. The BAP, sitting *en banc*, agreed that retroactive payments were not appropriate on these particular facts.

More importantly, the BAP upheld the *Deico* ruling, declining to create a bright-line rule allowing adequate protection payments only after a creditor filed a motion for such relief. In affirming the authority of bankruptcy courts to permit retroactive payments, the BAP kept the Ninth Circuit in the minority of jurisdictions.

FACTUAL BACKGROUND

BIG3D, a commercial printing company, leased a large piece of specialty equipment from People's Capital. The lease term was for 60 months, at the end of which the debtor could purchase the equipment for a nominal sum. Based on the nominal purchase price at the end of the lease, the Bankruptcy Court treated People's Capital as a secured creditor rather than as a lessor. Prior to the petition, BIG3D repeatedly fell behind in its payments, and the creditor ultimately sued in state court for breach of contract and to repossess the equipment. The creditor was granted a prejudgment writ of possession. Two days later, however, before the equipment could be repossessed, BIG3D filed its chapter 11 bankruptcy petition.

BIG3D, a debtor-in-possession, continued to use the equipment, but failed to make any payments after its filing. In its schedules, BIG3D listed the value of the printer at $400,000 and listed an undisputed secured debt in favor of the creditor in the amount of $350,000. About six months after the chapter 11 filing, the creditor filed a motion for relief from the automatic stay to repossess, or alternatively, to be paid adequate protection payments from the date of the chapter 11 filing.

In support of its motion, the creditor offered undisputed evidence that the value of the printer had remained constant at $380,000 from the date of BIG3D's final default until the date of its petition, but the value had declined $45,000 at variable depreciation rates between the filing of the chapter 11 petition and the creditor's motion, as a result of what the creditor called "deteriorating economic conditions." The evidence showed that the equipment would prospectively lose value at an annual rate of 12 percent, or $3,350 per month. BIG3D agreed to make prospective adequate protection payments of $3,500 per month, but opposed retroactive payments.

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The Bankruptcy Court granted the creditor prospective $3,500 monthly payments, but denied the creditor's request for retroactive payments, holding that the creditor did not make an adequate showing under *Paccom Leasing Corp. v. Deico Elects., Inc. (In re Deico Elects., Inc.)*. The creditor appealed, and the Bankruptcy Appellate Panel determined that it was appropriate for the full panel to hear the appeal in order to determine the continuing validity of the *Deico* decision.

COURT ANALYSIS

Of primary concern to the BAP was the continuing validity of its earlier decision in *Deico*, which held that bankruptcy courts had broad discretion to fix the beginning date (including prior to the motion for adequate protection payments), as well as the amount and frequency of adequate protection payments. The creditor argued that the Bankruptcy Court misapplied *Deico*, whereas the debtor argued that *Deico* should no longer be good law at all.

The BAP ruled that *Deico* was still good law and found that it was consistent with the Bankruptcy Code, which it found was silent on the issue of the timing of adequate protection payments. In so doing, the BAP recognized that the Ninth Circuit was in the minority and that, although early decisions found that it was appropriate to award adequate protection payments back to the date of the petition, the clear trend in the majority of recent decisions in other circuits has been that adequate protection payments should only be paid from the time a creditor moved the court to recover such payments.

In upholding *Deico*, the BAP analyzed the statutory framework of the Bankruptcy Code. Section 362(a) of the Bankruptcy Code establishes the automatic stay, which, among other things, prevents creditors from exercising their usual contractual and state court remedies during a bankruptcy case. Under section 362(d)(1), a court may grant relief from the stay when the creditor does not have "adequate protection" in the collateral. In turn, "adequate protection" is addressed in section 361, and is intended to compensate a secured creditor whose collateral suffers a decline in value while in the possession of, or being used by, the debtor. Section 363 sets forth the provisions for a debtor's continued use of secured property during the bankruptcy case. Section 361(1) provides that adequate protection may take the form of a lump-sum and/or periodic payments by the debtor to the creditor, "… to the extent that the stay under section 362 of this title, [or] use, sale or lease under section 363 of this title … results in a decrease in value of such entity's interest in such property." The BAP determined that the Bankruptcy Code was silent on the issue of the timing of adequate protection payments.

Turning to the facts of this particular case, the BAP affirmed the Bankruptcy Court's findings that the creditor failed to make an appropriate showing under *Deico*. The court determined that, although the creditor obtained a pre-petition order permitting repossession, it had not actually started exercising its possession rights before the bankruptcy, and, thus, it was not clear when the adequate protection payments should have started. Moreover, the creditor sat on its rights by waiting six months to move for relief from stay and for adequate protection payments, and the BAP held that equity favored the diligent. Under the circumstances, it would be unfair to require the debtor to make a large lump sum payment for the prior use; it appeared the debtor would have been unable to make such a large payment, anyway.

Lastly, the court found that the evidence showed that the equipment depreciated as a result of the economy worsening, not as a result of the automatic stay or the debtor's use of the equipment (as required by *Deico* and Bankruptcy Code section 361(1)). The court further held that the evidence was not clear precisely when the property began to depreciate post-petition, and, thus, the court had no way of assigning a start time for adequate protection payments, nor an appropriate schedule for such retroactive payments.

The BAP concluded that the Bankruptcy Court had not abused its discretion in denying the creditor's motion for adequate protection payments commencing from the chapter 11 filing date.

CONCURRING OPINION

Chief Judge Pappas and Judge Jury concurred in the decision affirming the Bankruptcy Court's decision not to award retroactive payments, but argued that *Deico* should be rejected going forward. The concurring opinion stated that *Deico* was inconsistent with the Bankruptcy Code and that the "modern" rule in most courts was to permit adequate protection payments on a prospective basis, only. Specifically, section 363(e) permits a debtor to use non-cash collateral property, and only grants adequate protection payments "on request of an entity that has an interest in the property . . ." In other words, "except as to cash collateral, a chapter 11 debtor need not provide adequate protection payments to a secured creditor for the use of collateral until the secured creditor requests such relief." In light of the statutory language, as well as the difficulty of applying the *Deico* standards to determine when adequate protection payments should start, the concurring opinion argued for a bright-line rule allowing adequate protection payments starting only after a motion for such payments has been filed.

PRACTICAL CONSIDERATIONS

In the Ninth Circuit, *Deico* remains the law of the land and creditors may ask for adequate protection payments retroactive to the bankruptcy petition filing. However, as the *BIG3D* concurring opinion made clear, although bankruptcy courts have discretion to grant such relief, it has rarely been granted. Creditors should not rely on *Deico*, and should be diligent about pursuing relief from the automatic stay and adequate protection payments at the earliest opportunity after the bankruptcy petition is filed. As the court in *BIG3D* recognizes, "equity aids the diligent." If a creditor is, nevertheless, in a position of asking for retroactive payments, it should seek the advice of experienced bankruptcy counsel to avoid pitfalls and evidentiary traps encountered in the *BIG3D* and *Deico* decisions.

REPLACEMENT LIEN IN RENTS IN FAVOR OF SECURED CREDITOR IS NOT ADEQUATE PROTECTION WHERE THE DEBTOR HAS NO EQUITY CUSHION

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In re Buttermilk Towne Center, LLC, No. 10-8036, 2010 Bankr. LEXIS 4563 (B.A.P. 6th Cir. Dec. 23, 2010)

CASE SNAPSHOT

The debtor, the developer of a retail shopping center, executed: (i) a mortgage securing the property, and (ii) an assignment of all rents from the property, in favor of its lender. The assignment of rents transferred all the rents and profits derived from the shopping center to the mortgagee, but allowed the debtor to collect and use the rents, provided that the debtor was not in default of its obligations to the mortgagee. Several years later, the debtor defaulted on its mortgage obligations, and within a few months of that default, filed a chapter 11 petition. The debtor sought to use cash collateral (comprised of rents from the shopping center) to, among other things, pay professional fees. The mortgage lender objected, asserting that: (i) the rents were not property of the bankruptcy estate due to the assignment; and, (ii) the lender was not adequately protected. The Bankruptcy Appellate Panel held that the rents were estate property, and, relying primarily on an unpublished opinion, held that a replacement lien in the rents did not constitute adequate protection when the lender had an existing security interest in the rents and where the debtor had no equity cushion in the property. In doing so, it overturned the bankruptcy court order permitting the debtor's use of cash collateral.

FACTUAL BACKGROUND

Buttermilk Towne Center, LLC entered into a construction financing agreement with its lender, pursuant to which it borrowed $34 million in order to purchase municipal bonds to finance its retail development. In order to maintain the tax-exempt status of the bonds, Buttermilk transferred its fee interest in the property to the issuing municipality, which, in turn, entered into a ground lease with Buttermilk. Buttermilk's sole source of revenue was the rents collected from tenants in the center. In order to secure the amounts loaned by it, the lender obtained a mortgage securing both Buttermilk's leasehold interest, and the municipality's fee interest, in the real property. In addition, Buttermilk executed an assignment of rents and subleases in favor of the lender as additional security, pursuant to which Buttermilk assigned and transferred all rents and profits derived from the property to the lender. This assignment was subject to a license back to Buttermilk to collect and use such rents, provided that Buttermilk was not in default of its obligations to the lender. Both the mortgage and assignment were properly recorded by the lender.

Buttermilk failed to satisfy the obligations due under the bonds on or before their maturity date. This failure constituted a default under the mortgage and the assignment that, in turn, terminated Buttermilk's license to collect and use rents. Following the default, the lender sent a notice to the retail center tenants directing them to pay all rents directly to lender. In response, Buttermilk filed a chapter 11 petition and sought authority to use cash collateral (i.e., the rents) to, *inter alia*, pay its professionals. The lender objected, arguing that the rents were not property of the bankruptcy estate, and instead belonged to the lender pursuant to the assignment of the rents. In addition, the lender objected to Buttermilk's use of cash collateral, asserting that it was not adequately protected because there was no equity cushion in the property and no other unencumbered asset in which it could be given a replacement lien. The Bankruptcy Court disagreed and held: (i) that the rents were estate property, and (ii) that, in light of the debtor's testimony that the anticipated rents would be sufficient to pay the lender in full, the provision of replacement liens on the rents was sufficient to adequately protect the lender's interests. The lender appealed.

COURT ANALYSIS

The Bankruptcy Appellate Panel's opinion focused primarily on two issues: (i) whether the assignment of rents in favor of the lender was an absolute assignment, thus removing those funds from the bankruptcy estate; and (ii) whether the lender, having been granted a replacement lien in the rents, and despite the debtor's lack of an equity cushion, was adequately protected.

In its briefs before the BAP, the lender characterized the assignment of rents as an "absolute assignment," and argued that this assignment meant that the rents were not property of the estate. In contrast, the debtor argued that the assignment was a security interest, and that the rents were part of the estate. The BAP, applying Kentucky law, agreed with the debtor. In doing so, it considered the language of the assignment and determined that, when viewed as a whole, the assignment demonstrated that the intent of the parties was to grant a security interest in the rents, and not to effect an outright assignment. Specifically, the BAP found it compelling that: (i) the express terms of the assignment provided that it was a "Grant of Security Interest" that was "given to secure" payment to the lender; (ii) the assignment permitted the debtor to collect rents so long as it was not in default of the mortgage; (iii) even upon the occurrence of an event of default, the rents could only be used to reduce the debt to the lender; and (iv) the assignment of rents automatically terminated upon Buttermilk's satisfaction of its obligations to the lender. The court concluded that these provisions evidenced the parties' intent that the assignment serve as a security, rather than as an absolute assignment. As such, title to the rents did not transfer to the lender upon Buttermilk's default, and the rents continued to constitute assets of Buttermilk's bankruptcy estate as of the petition date.

Next, the BAP turned to the adequate protection issue, and considered the Bankruptcy Court's holding that a replacement lien in the rents adequately protected the lender. In doing so, the BAP relied heavily on a 12-year-old unpublished opinion from the Sixth Circuit, *Stearns Bldg. v. WHBCF Real Estate (In re Stearns Bldg.). Stearns* was similar to the facts before the court, in that it dealt with a single-asset real estate debtor that, prior to the petition date, had executed an assignment of rents in favor of its lender. Following its bankruptcy filing, the

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CREDITOR/DEBTOR AGREEMENT ON LOAN PAYOFF CAN RESULT IN 'IMPAIRED ACCEPTING CLASS' WHERE THERE IS NO PROVISION FOR INTEREST

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In re Introgen Therapeutics, Inc., 429 B.R. 570 (Bankr. W.D. Tex. 2010)

CASE SNAPSHOT

In this chapter 11 bankruptcy case, the class of general unsecured creditors opposed confirmation of the debtors' proposed plan of liquidation on the grounds that: reliance on the cramdown provisions of the Bankruptcy Code was impermissible because there was not an "impaired" accepting class of creditors; substantive consolidation of the parent debtor and its wholly owned subsidiary was improper; and the plan violated the absolute priority rule. The Bankruptcy Court found that the class of creditors consisting of one accepting oversecured creditor was impaired because the plan did not provide for the payment of the creditor's post-petition interest. The court acknowledged that substantive consolidation of debtors should be utilized sparingly, then applied the "traditional test" and "balancing test" to approve consolidation. The court also found that the right provided to the equity holders to have a representative on the board of the liquidating trust did not violate the absolute priority rule. Thus, the Bankruptcy Court confirmed the plan.

FACTUAL BACKGROUND

Introgen Therapeutics, Inc. was a biopharmaceutical company, which developed and controlled a broad intellectual property portfolio of roughly 400 applied-for and issued patents. In an effort to generate additional revenue, Introgen spun off its wholly owned subsidiary, Introgen Technical Services, which was the manufacturing arm of the parent company. Introgen encountered difficulty obtaining approval from the FDA for one of its drugs, and the delay led to a severe lack of cash flow. Introgen determined that the best course of action would be to file for chapter 11 reorganization, engage in an orderly disposition of assets, and wind down its affairs through a liquidating trust.

Introgen proposed one plan for consolidating the assets and liabilities of itself and its subsidiary. The plan would establish a liquidating trust containing the assets of the debtors. This trust would be overseen by a liquidating trustee, as well as a liquidating trust board. The board would be composed of one allowed priority claimant, one allowed unsecured claimant, and one representative from the sole equity holder class. The plan itself proposed liquidating the debtors' remaining assets and using the money from the asset sales and retained interests in revenue streams to fund the plan.

There were four classes of creditors. Class 1, Allowed Secured Claims, consisted of one creditor. This creditor had agreed to reduce and settle its debt upon the sale of the manufacturing business; this secured claimant would be paid in full. Class 2 consisted of all Priority Claims, and these creditors would be paid in full. Class 3 consisted of Allowed General Unsecured Claims. The debtors anticipated paying these creditors in full over time, by giving them beneficial interests in the liquidating trust, allowing these creditors to be paid their pro rata share of any cash distributions from the trust. Class 4 consisted of all Equity Interests. The plan provided that equity holders would be entitled to beneficial interest (and pro rata distributions) in the liquidating trust only after all classes of creditors had been paid in full.

Classes 1, 2 and 4 had accepted the debtors' proposed plan. Only Class 3, General Unsecured Claims, objected to the plan. The Class 3 creditors asserted that: there was no impaired accepting class as required by section 1129(a)(10) and section 1129(b)(1) of the Bankruptcy Code; the two debtors could not be joined together for substantive consolidation; and that providing rights to the equity holders violated the absolute priority rule.

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Replacement Lien in Rents in Favor of Secured Creditor is Not Adequate Protection Where the Debtor Has No Equity Cushion —continued from page 5

debtor sought to use its cash collateral to pay expenses that were unrelated to the maintenance and operation of the subject property.

The *Stearns* court relied upon sections 363(a) and 552(b) of the Bankruptcy Code to conclude that rents are cash collateral, and that the lender's pre-petition security interest in the rents continued post-petition to the extent provided in the assignment. As such, in order to use cash collateral, the debtor was obligated to adequately protect both the lender's interest in the real property and the rents. In reviewing the facts before it, the *Stearns* court held that, because the debtor did not possess any unencumbered property, the debtor could not provide adequate protection of the lender's interests in the rents. Further, the *Stearns* court held that the use of future rents to replace the expenditure of prior months' rents could not constitute adequate protection.

Relying principally on *Stearns*, the BAP overturned the Bankruptcy Court and instead held that, since a replacement lien in rents in which the lender already had a security interest could not constitute adequate protection, Buttermilk had been unable satisfy the burden necessary to entitle it to use the cash collateral. Therefore, the BAP reversed the Bankruptcy Court on this point.

PRACTICAL CONSIDERATIONS

This decision heightens the pressure on single-asset real estate debtors that have executed pre-petition assignments of rents, and that will require the use of cash collateral to operate. Unless they have equity in the property, it is very likely such debtors will need to obtain the lender's permission to use the cash collateral.

Creditor/Debtor Agreement on Loan Payoff Can Result in 'Impaired Accepting Class' Where There is No Provision for Interest —continued from page 6

The Bankruptcy Court denied these objections, and confirmed the debtors' plan.

COURT ANALYSIS

Impaired Class

The court first addressed the contention that there was no impaired accepting class of creditors. The debtors argued that there was one such class of creditors – Class 1, the Secured Creditor. The court began by reviewing the security agreement between the debtors and the Secured Creditor. That agreement authorized the Secured Creditor to accelerate all obligations under the agreement upon the occurrence of a default and impose the default rate of interest of 18 percent. The debtors' plan called for Class 1 either to be paid in full on the effective date or to be paid by a promissory note without interest. The debtors argued that because Class 1 could be paid by a note that would not bear any interest, the Class 1 creditor would be impaired.

Although it ultimately ruled in favor of the debtors, the court rejected the debtors' argument. "While a promissory note would certainly leave Class 1 impaired, this Court disagrees with Creditors' [*sic*] assessment that because Class 1 may receive a promissory note which would make them an impaired class, they are therefore an impaired class." The court decided that a fair construction of the proposed plan would be to assume that the Secured Creditor would be paid in full on the effective date, and then determine if this creditor was truly impaired or not.

The Bankruptcy Court looked to section 1124 of the Bankruptcy Code. This section currently sets forth two means of leaving a class of creditors unimpaired. Prior to 1994, however, a third subsection of 1124 provided that a creditor was deemed unimpaired if the plan called for payment in full of its claim on the effective date. Congress repealed this third subsection in 1994, because Congress determined that it unfairly deprived unsecured creditors of post-petition interest. Thus, while this court found no Fifth Circuit opinion discussing the effect of the deletion of section 1124(3), "it appears clear from legislative intent and case law from around the country that Class 1, through the modification of [the Secured Creditor's] contract rights and not allowing for post-petition interest," was truly an impaired class.

Substantive Consolidation

The court next turned to the objection to the substantive consolidation of the two debtors. The Fifth Circuit had determined that substantive consolidation occurs "when the assets and liabilities of separate and distinct legal entities are combined in a single pool and treated as if they belong to one entity." The objecting creditor class cited Fifth Circuit cases for the proposition that consolidation is to be used sparingly, and that it is an extreme and unusual remedy. The court agreed that consolidation is to be used rarely, but the court did cite Fifth Circuit, as well as U.S. Supreme Court cases, to assert its authority to order substantive consolidation when appropriate.

The court noted that the Fifth Circuit had not developed its own criteria for ordering substantive consolidation, nor was there any universal standard. Two distinct tests had been applied by courts – the traditional test and the balancing test. Under the traditional test, courts looked to several factors to make this decision. Under the balancing test, courts weighed the impact on the creditors of consolidating against the benefits of consolidating. Since there was no Fifth Circuit standard in existence, this Bankruptcy Court applied both tests to make its decision.

The court first applied the traditional test. In reviewing case law from several jurisdictions, the court ultimately utilized "two critical factors: (i) whether creditors dealt with the entities as a single economic unit and did not rely on their separate identity in extending credit …; or (ii) whether the affairs of the debtors are so entangled that consolidation will benefit all creditors." While the court stated that the satisfaction of either factor was sufficient, it found that both factors were satisfied here. There was no evidence that creditors relied on the separate identities of the debtors in extending credit. The court also found substantial evidence that the debtors' assets and liabilities were nearly thoroughly commingled, and that attempting to "unscramble" the assets and liabilities would be time-consuming and costly. The court concluded that all creditors would benefit from consolidation in avoiding the time and cost it would require to fully separate the accounts of the debtors.

The court then applied the balancing test. To satisfy the balancing test elements, the parties proposing consolidation must show that consolidation is necessary in order to prevent harm or prejudice, or to effect a benefit generally. This showing can be overcome by a creditor showing that it relied on the separateness of the identities in extending credit, and that it would suffer harm by consolidation. If the benefits outweigh the harm, a court will order substantive consolidation. The court noted that potential harm is prevalent generally when one of the debtors has no secured creditors, and the unsecured creditors would therefore be put further back in line if that debtor were to be consolidated with the debtor having significant secured creditors. Also, the court pointed out that allowing those unsecured creditors to be paid before the unsecured creditors of the related debtor with large amounts of unsecured debt "would also seem to be unjust."

Here, the debtors presented credible evidence showing the necessity of consolidation, and no creditor had presented any evidence of reliance on separateness of identity or harm to be suffered by consolidation. Therefore, the court proceeded to weigh potential benefits of consolidation against potential harm. The court stated that the potential for harm existed for the unsecured creditors of the subsidiary debtor because their claims would fall behind the claims of the parent debtor's secured creditor. Further, the creditors of the parent debtor would potentially appear to be harmed by allowing the unsecured creditors of the subsidiary debtor to be paid before them. The debtors pointed out that there was no evidence presented of any harm to any creditor by substantive consolidation.

The Bankruptcy Court therefore concluded that the debtors had satisfied their burdens under both the traditional test and the balancing test, and ordered that the debtors would be substantively consolidated for purposes of confirming the plan.

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Creditor/Debtor Agreement on Loan Payoff Can Result in 'Impaired Accepting Class' Where There is No Provision for Interest —continued from page 7

Absolute Priority Rule

The court then turned to the objection that the proposed plan would violate the so-called absolute priority rule, set forth in section 1129(b)(2)(B)(ii) of the Bankruptcy Code. Preserving property on account of a claim junior to an objecting class is a violation of the absolute priority rule. This objection was two-fold: the provision for Class 4 – Equity Holders, of distributions of any cash remaining after the payment in full of Classes 1 – 3 is property retained on account of the equity interest; and the provision of a seat for Class 4 on the board of the liquidating trust is property in violation of the absolute priority rule.

Contingent Right to Payment

The debtors argued that Class 3 creditors would be paid in full, but the court chose to analyze these objections as if Class 3 would not be paid in full. This objection turned on the question of whether the right to receive a contingent interest in a liquidating trust, when the contingency is "payment in full of all senior classes," is really "property." The court declined to address the numerous cases cited by debtors and creditors, and relied instead on "common sense." The court stated that the objecting creditors, Class 3, seemed to be trying to "have it both ways. Either they will ultimately receive adequate property to satisfy their claims as contemplated in the Plan, or this property right does not now, and will never exist." The court pointed out that the only way that Class 4 would receive any property would be if and when all three higher classes were paid in full. Payment in full of Classes 1 – 3 would satisfy section 1129(b)(2)(B)(i), so that the absolute priority rule would not come into play at all. If the creditor classes were not paid in full, "Class 4's 'property interest' is not just valueless, as Creditors argue, it simply does not exist." Therefore, the court found that this aspect of the proposed plan did not violate the absolute priority rule.

Seat on Liquidating Trust Board

The objecting creditors also argued that granting Class 4 a seat on the liquidating trust board constituted a property interest in violation of the absolute priority rule. The Bankruptcy Court reviewed several cases in which it had been held that an interest granting control, even when the degree of control is minimal, does constitute a property interest in violation of the absolute priority rule. The court therefore agreed that the case law established that "control" over a company will be considered to be a property interest. What the case law did not establish, however, was what exactly constituted "control." The court cited *Black's Law Dictionary*, defining "control" as the "direct or indirect power to govern the management and policies of a person or entity…." As proposed in the plan, the liquidating trust board would be comprised of three members. The board's only authority would be to approve or disapprove transactions proposed by the liquidating trustee, and that such transactions could only be effected after a hearing and approval by the Bankruptcy Court. The court concluded that this arrangement was so far from any definition of control, that the board seat could not be considered to be property and thus, there was no violation of the absolute priority rule.

The Bankruptcy Court confirmed the debtors' proposed plan.

PRACTICAL CONSIDERATIONS

This case serves as a good reminder of the care that must be taken when either seeking or opposing the confirmation of a chapter 11 plan. The debtors ultimately confirmed their desired liquidating plan by ensuring the existence of an impaired accepting class of creditors and carefully considering the structure of the liquidating trust. That said, not all bankruptcy courts may have reached the same conclusions as this one on those issues. The details of how the one accepting secured creditor and debtor reached agreement as to the amount of its secured claim, and the voting mechanisms of the board of the liquidating trust, are not fully explored in the opinion. Also, on the issue of substantive consolidation, the opposing class of general unsecured creditors apparently failed to present necessary evidence to oppose consolidation, or did so in an insufficient manner. On similar issues, an opposing class of general unsecured creditors could prevail in other cases by, perhaps, more closely exploring (i) whether the plan truly impaired the secured creditor by denying the creditor's post-petition interest if the creditor and debtor had agreed to the amount of the creditor's claim as part of an overall settlement, and (ii) whether the voting mechanisms of the board of the liquidating trust provided for any veto powers by one of the three members.

CONTRACTUAL REPRESENTATIONS AND WARRANTIES PROVIDE JUSTIFIABLE RELIANCE IN FRAUD ACTION

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DDJ Management, LLC, et al. v. Rhone Group, LLC, et al. 15 N.Y.3d 147, 931 N.E.2d 87 (NY 2010)

CASE SNAPSHOT

In this New York state court case, the plaintiffs/lenders brought a fraud action against the borrower, its affiliates and accountants. The plaintiffs alleged that the defendants had materially misrepresented the borrower's financial statements, and had breached contractual representations and warranties with respect to those financials, thereby inducing the plaintiffs to loan $40 million. The defendants filed a motion to dismiss, arguing that the plaintiffs did not justifiably rely on the financial or contractual statements. The lower court granted the defendants' motion; the Court of Appeals reversed.

FACTUAL BACKGROUND

The plaintiffs loaned a total of $40 million to an auto parts remanufacturer, ARI. ARI was owned by affiliates of Rhone Group, LLC and affiliates of Quilvest S.A. After ARI failed to repay the loan, the plaintiffs brought suit against ARI, its management and outside accountants, Rhone, Quilvest, and individuals associated with the defendants. The plaintiffs alleged that ARI sought to obtain financing from plaintiffs using written presentations and information that grossly inflated ARI's EBITDA and were false and intentionally misleading; that the defendants intended to induce the plaintiffs' reliance on the misrepresentations; and that the plaintiffs did justifiably rely on the misrepresentations in making the loan.

The plaintiffs alleged that ARI approached them in July 2004, and provided detailed financial information on several occasions. As part of the loan process, ARI was required to provide audited financials to the lenders for the year ended December 31, 2003. In fact, the loan documents required these financials as a condition of closing the loan. There was a significant delay in providing these financials, and they were not provided until the loan closing date in March 2005. Prior to the loan closing, the plaintiffs made numerous inquiries of ARI and related personnel, as well as others in the industry, and received reassuring information from all.

In addition to these inquiries, the plaintiffs obtained several contractual representations from ARI. The loan agreement contained representations and warranties from ARI that: (i) the financial statements fairly portrayed, in all material respects, the financial condition of ARI; (ii) the financial statements had been prepared in accordance with generally accepted accounting principles; (iii) no events had occurred between December 31, 2003 and the closing date of the loan that "could reasonably be expected to have a Material Adverse Effect on ARI's business, assets, operations or prospects or its ability to repay the loans;" and (iv) there was no information in the loan agreement, other loan documents, or the financials that contained "any untrue statement of a material fact or omits to state a material fact necessary to make the statements contained therein not misleading…."

In seeking to dismiss the plaintiffs' claim for fraudulent misrepresentations, the defendants argued that the plaintiffs failed to make reasonable inquiry into the veracity of the financial statements, representations and warranties, since the plaintiffs had never examined the underlying books and records. The defendants also argued that the plaintiffs should have been suspicious of the financials, given the length of time it took to prepare the 2003 audited statements, and the unusually rosy picture that the December 2004 statements painted. As such, the defendants argued that the plaintiffs' lack of diligence precluded them from seeking to recover on their fraudulent misrepresentation claims.

COURT ANALYSIS

Justifiable reliance is a necessary element in showing fraud. The defendants claimed, despite nine months worth of inquiry and examination by the plaintiffs, and despite the detailed contractual representations and warranties in the loan agreement, that the plaintiffs should have been suspicious of all of the information ARI and others had provided, and should have dived deep into the underlying books and records of ARI before closing on the loan.

The rule upon which the defendants relied was more than a century old. Namely, "[i]f the facts represented are not matters peculiarly within the party's knowledge, and the other party has the means available to him of knowing, by the exercise of reasonable intelligence, the truth or the real quality of the representation, he must make use of those means, or he will not be heard to complain that he was induced to enter into the transaction by misrepresentations." This rule had been relied upon in recent years in circumstances to preclude a plaintiff from asserting a claim based on justifiable reliance where the plaintiff was a sophisticated business person or entity, and had been particularly lax in taking steps to protect itself from representations made by defendants.

The court, however, distinguished this rule, and instead held that where a plaintiff had taken reasonable steps to protect itself, "it should not be denied recovery merely because hindsight suggests that it might have been possible to detect the fraud when it occurred." In doing so, the court reasoned that a plaintiff that goes to the trouble of obtaining written representations and warranties "will often be justified in accepting that representation rather than making its own inquiry."

The court conceded that there may have been hints that all was not as it seemed with respect to ARI, but, given that the plaintiffs made significant effort to protect themselves, the court refused to find, as a matter of law, that the plaintiffs did not justifiably rely on the financials, representations and warranties. The court concluded that such a determination was to be made by a jury.

The defendants also emphasized that the representations were provided only by ARI, and that the non-ARI defendants could not be held responsible. The court

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LENDER JUSTIFIABLY RELIED ON CONTRACTOR'S REPRESENTATIONS AND WARRANTIES, THEREBY MAINTAINING FIRST PRIORITY LIEN

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Otay River Constructors v. South Bay Expressway (In re South Bay Expressway), 2010 WL 4688213 (Bankr. S.D. Cal., Nov. 10, 2010; Case Nos. 10-04516-A11, 10-04518)

CASE SNAPSHOT

A general contractor sought to prime the first-priority deed of trust of a construction lender and collect $145 million of collateral, on the basis that the contractor started working on the project before the deed of trust was executed and recorded. Under California construction law, mechanic's liens are ordinarily second behind a prior-recorded construction lien, unless the contractor or its subcontractors started working on the project before the deed of trust was executed and recorded. The construction lender raised an equitable estoppel defense, because the general contractor signed a consent agreement in which the contractor represented that it had no claim or lien on the construction project at the time the loan documents and deed of trust were executed. The court agreed with the lender, holding that: the lender justifiably relied on the contractor's representations and warranties; the lender would not have entered the loan agreement without such representations and warranties; and, further holding that the general contractor intended that the lender rely on its representations and warranties.

FACTUAL BACKGROUND

SBX, a developer and operator of toll roads, hired Otay River Constructors as a general contractor to build a four-lane toll road in Southern California. SBX negotiated with Wells Fargo Bank, as construction lender, to finance the construction project. On May 22, 2003, SBX and the lender executed financing documents that included a first-priority deed of trust executed by SBX, which was secured by virtually all of SBX's assets. ORC was present and participated in the financing discussions, and, concurrent with the execution of these financing documents, ORC executed a "Consent and Agreement" in favor of the lender stating that it had "no present claim against [SBX] or lien upon the project." ORC expressly agreed, pursuant to the financing documents, that it would not commence work on the project until after the financing documents were executed, the Consent and Agreement signed, and it received the approval to commence work from SBX.

Subsequently, ORC submitted payment applications and invoices that indicated ORC commenced work on the project May 22, 2003. SBX paid ORC on account of these invoices, but obtained lien releases for the payments that were not in compliance with either the financing agreement or California lien release statutes. Ultimately, SBX did not pay ORC on account of all work on the project, and ORC, which was owed $145 million, sued to enforce its unpaid mechanic's liens. ORC sought to prime (take priority over) the lender's prior-recorded deed of trust on the basis that, under California law, all mechanic's liens (regardless of when recorded), dated back to the day that the contractor commenced work on the project. ORC argued that it commenced work before May 22, 2003, and thus its liens were prior-in-time to the lender's liens.

The lender raised defenses of equitable estoppel and waiver, arguing that ORC's representations and warranties that it did not commence work before May 22, 2003, estopped ORC from now asserting that its work commenced before that date. The court heard pre-trial motions on the issues of equitable estoppel and waiver, and held that ORC was equitably estopped from asserting that it commenced work before May 22, 2003. Thus, its mechanic's liens could not prime the lender's deed of trust.

COURT ANALYSIS

The court held that the burden of establishing equitable estoppel rested with the lender, which had to prove its defense by a heightened "clear and convincing evidence" standard. The lender needed to prove that: (i) ORC knew the true facts; (ii) ORC must have intended that the lender act upon ORC's conduct; (iii) the lender was ignorant of the true facts; and (iv) the lender detrimentally relied on ORC's conduct.

Applying the elements, the court found that, although ORC knew it had started work before the financing agreement, it stated otherwise with the intent that the lender rely on the representations and warranties to enter the financing agreement. The court found that the lender was not aware of any prior work being done on the project and relied, to its detriment, on ORC's misrepresentations.

The court found that the lender would not have entered into the financing agreement with SBX but for the fact that ORC had represented and warranted that it had no "present claim" or lien on the project. The court held that "ORC knew that SBX needed the Consent and Agreement, including the representations and warranties," to induce the lender to finance the construction project.

ORC argued that it was unreasonable for the lender to rely on the representations because it did not independently inspect the site. The court called ORC's argument "silly," because the entire purpose of the representations and warranties was to save the lender from the trouble, expense and uncertainty of inspecting a 14-mile-long stretch of undeveloped land to find any tools or other evidence of work. Similarly, ORC argued that its representation that there was "no lien" meant only recorded liens, not inchoate liens, such as an as-yet unrecorded mechanic's lien. The court found the argument unconvincing, because the clear intent of the representation and warranty was to include precisely this kind of unrecorded lien.

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Lender Justifiably Relied on Contractor's Representations and Warranties, Thereby Maintaining First Priority Lien —continued from page 10

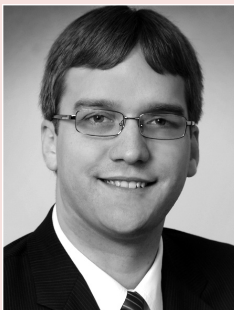
Lastly, ORC argued that its lien releases were ineffective because they did not comply with California's lien release statutes. The court concluded that the non-compliant lien releases were very likely prepared by ORC, and that ORC should thus not be allowed to use the deficiencies that ORC, itself, introduced into the documents for its own benefit. The court held that ORC clearly intended that SBX and the lender rely on its lien releases, which they did, so to permit ORC to profit from its own improper forms would be fundamentally unfair.

The court concluded that ORC was equitably estopped from claiming that it began work prior to May 22, 2003.

PRACTICAL CONSIDERATIONS

Construction lenders ought to conduct site inspections, whenever practical – or have the title company conduct such inspections and confirm no work has begun – immediately prior to entering construction loans and recording deeds of trust. However, *South Bay Expressway* provides construction lenders with a roadmap to avoid having mechanic's liens prime their deeds of trust: obtain representations and warranties from the general contractor (and any known subcontractors), that they have no liens and have not commenced work as of the date of the deed of trust. Such representations and warranties are particularly important where, as was the case here, to fully inspect the site and verify that no work has been done to commence the project is impractical or impossible.

ORIGINAL LENDER SUES REFINANCE LENDER FOR FAILURE TO PAY OFF ORIGINAL LOAN, DESPITE LACK OF A CONTRACT TO DO SO



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City Bank v. Compass Bank, No. EP-10-CV-62-KC, 2010 WL 2680585 (W.D. Tex. July 2, 2010)

CASE SNAPSHOT

A commercial line of credit lender sued a refinance lender under theories of negligence and breach of contract. At the time of the refinance, the refinance lender did not directly pay off the original line of credit, but instead made the new line of credit available to the borrower without restriction and, based on a verbal understanding, entrusted the borrower to draw on the line to pay off the original lender. The borrower drew on the line but failed to pay the original lender. A little more than a year later, the borrower went out of business. The District Court denied the refinance lender's motion to dismiss the negligence and breach of contract claims.

FACTUAL BACKGROUND

City Bank extended a $3 million line of credit to Sambrano Corp. in 2005. In 2007, Sambrano secured a $4 million line of credit from State National Bank (Compass Bank's predecessor-in-interest). Both credit lines were secured by assets of Sambrano, as well as personal guaranties of Sambrano principals. One of the primary purposes of the second line of credit was to pay off the City Bank line of credit. Compass Bank was aware of this purpose, although there was no written agreement among City Bank, Compass Bank and Sambrano to that effect. Despite this understanding, Compass Bank opened the line of credit to Sambrano without restriction and without making any direct bank-to-bank payment to City Bank. Sambrano did not payoff the City Bank line of credit. In 2008, both banks became aware that both credit lines were open and were drawn down, which led the banks to declare Sambrano to be in default. Sambrano Corp. subsequently collapsed, and City Bank brought suit against Compass Bank, alleging negligence, breach of contract, and money had and received. Compass Bank filed a motion to dismiss under Rule 12(b)(6).

The District Court denied Compass Bank's motion to dismiss with respect to the negligence claim and breach of contract claim, and granted the motion to dismiss with respect to the money had and received claim.

COURT ANALYSIS

The court set forth the four elements necessary to state a claim for negligence: the defendant owed a duty to the plaintiff; the defendant breached that duty; the breach of duty proximately caused the plaintiff's injuries; and, the plaintiff, as a result, suffered injuries.

Compass Bank argued that it did not owe a duty of care to City Bank, since it did not have a relationship with City Bank in the context of the Sambrano transaction. In considering the argument, the court considered various policy factors, including the "risk, foreseeability, and likelihood of injury weighed against the social utility of the actor's conduct, the magnitude of the burden of guarding against the injury, and the consequences of placing the burden on the defendant."

Compass Bank cited Texas case law for the proposition that banks do not owe a duty to a party that is not a customer or a party with whom the bank has no relationship. The court distinguished those cases, however, stating that they generally dealt with non-customers bringing suit against a bank when the actions of a bank customer harmed the non-customer. The court instead looked to other cases in which it had been found that the bank did owe a duty to a non-customer where the potential victim's identity, the mode of harm, and the way to avoid the harm are particularly known by the bank in advance.

The District Court found that the circumstances of the case were aligned with the cases in which a duty was found to exist. Compass Bank knew in advance

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CREDITOR OF INSOLVENT DELAWARE LLC IS NOT ENTITLED TO DERIVATIVE STANDING

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CML V, LLC v. Bax, et al., 6 A.3d 238 (Del.Ch. 2010)

CASE SNAPSHOT

Pursuant to the express language of the Delaware Limited Liability Company Act, a creditor of an insolvent limited liability company does not have derivative standing to sue the members of an LLC on behalf of the LLC. The plaintiff made a $34 million loan to JetDirect Aviation Holdings, LLC. Despite two of JetDirect's auditors highlighting material deficiencies in JetDirect's internal controls, JetDirect's board approved major acquisitions several months after the loan. JetDirect defaulted in its loan obligations. Arguing that it had derivative standing to sue (like a creditor of an insolvent corporation has), the lender filed suit against (i) JetDirect, alleging breach of contract, and (ii) individual defendants, comprised of 12 of its members and officials, alleging breaches of their fiduciary duties to JetDirect. The individual defendants argued that the LLC Act precludes creditor standing and challenged the plaintiff's ability to bring the suit. Delaware's Chancery Court agreed with these defendants, concluding that the plain language of the LLC Act does not provide a creditor of an LLC with derivative standing to bring an action, and dismissed the complaint.

FACTUAL BACKGROUND

JetDirect was a private jet management company that provided a variety of services to its customers, including charter, maintenance and fuel services. In 2005, as part of a roll-up strategy, JetDirect acquired a number of small to midsized private jet management and charter companies. This expansion left JetDirect highly leveraged and with an unstable cash flow.

In 2006, JetDirect's auditor informed officers and members of 19 material and significant issues in JetDirect's internal controls. In 2007, JetDirect's new auditor found, among other problems, that JetDirect's management had failed to properly collect and account for the financial data of JetDirect's subsidiaries, and declined to perform the audit because JetDirect's internal controls lacked sufficient integrity for an audit.

In April 2007, CML V, LLC, loaned JetDirect $34,243,912 as evidenced by a loan agreement. In late 2007, and despite lacking accurate financial information, JetDirect's board approved four significant acquisitions. In June 2007, JetDirect defaulted on its loan obligations to CML, and by January 2008, JetDirect was insolvent.

COURT ANALYSIS

The Chancery Court began its analysis by referencing the established equitable principle that creditors of an insolvent corporation have derivative standing to bring claims on behalf of the corporation against the corporation's officers and directors. CML argued that creditors of an insolvent LLC were entitled to the same equitable considerations. The individual defendants countered that the plain language of the LLC Act precludes creditor standing of an insolvent LLC.

The Chancery Court then applied the tenets of statutory construction and turned to the plain language of the LLC Act. Section 18-1001, entitled "Right to Bring Action," provides that only a member or assignee of a limited liability company interest may bring an action on behalf of the company, and section 18-1002, entitled "Proper Plaintiff," requires that the plaintiff "be a member or an assignee of a limited liability company interest at the time of bringing the action." The Chancery Court noted that both sections of the LLC Act limit derivative standing exclusively to members or assignees of the LLC. By contrast, section 327 of the Delaware General Corporation Law uses non-exclusive language to limit the derivative actions brought by stockholders, only one set of possible derivative plaintiffs.

The court acknowledged that two prior decisions issued by the Chancery Court implicitly assumed that creditors of an insolvent LLC have derivative standing. The court distinguished these two prior cases from the current matter because the standing issue was not squarely before the Chancery Court in those cases, and therefore was never reached.

In reaching its decision here, the court looked not only to the plain language of the LLC Act, but also looked to: (i) parallel standing provisions of other alternative entity statutes; (ii) the source and development of the alternative entity standing provisions; and (iii) whether enforcing the plain meaning of section 18-1002 would create an absurd result.

The standing provisions of the Delaware Limited Partnership Act contain phrases identical to sections 18-1001 and 18-1002 of the LLC Act. The comparable standing provisions of the LP Act also facially bar a creditor from suing derivatively. The similar wording in both the LLC Act and the LP Act bolstered the Chancery Court's conclusion that the plain language of the LLC Act precludes creditor derivative standing. The court also noted that the legislative history behind the standing provisions of the LP Act further supported the Chancery Court's interpretation of the similar language contained in the LLC Act.

Finally, the court turned to the policy and purpose of the LLC Act, which provide that "[i]t is the policy of this chapter to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements." Creditors of LLCs are presumed to be capable of protecting their interests through contracts. Further, the LLC Act includes other provisions that provide creditor protections, such as section 18-101(7), which allows for a creditor to receive rights under an LLC agreement without being a party to such agreement, and section 18-1101, which enables a creditor to expand its available remedies under the terms of the governing LLC agreement.

PRACTICAL CONSIDERATIONS

While there may have been doubt prior to the entry of this decision, creditors of an insolvent Delaware LLC can no longer rely upon statutory or equitable grounds for derivative standing to bring suit against an insolvent LLC. Prior to entering into

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Creditor of Insolvent Delaware LLC is Not Entitled to Derivative Standing—continued from page 12

a creditor/debtor relationship with an LLC, creditors should require that the LLC agreement adequately protect the creditor in the event the LLC can no longer pay its debts. While the plain language of the Delaware LLC Act precludes derivative standing for a creditor, the LLC Act does enable a creditor to enforce bargained-for terms and seek remedies included in an LLC agreement.

Original Lender Sues Refinance Lender for Failure To Pay Off Original Loan, Despite Lack of a Contract To Do So —continued from page 11

that its line of credit was to be used to pay off the City Bank line of credit, and knew or should have known that the best way to avoid the potential harm of City Bank's loan not being paid off was to pay off the loan by a bank-to-bank payment. Further, Compass Bank knew or should have known that Sambrano having two lines of credit open and drawn down at the same time was dangerous to Sambrano and its creditors.

The District Court found that the "questionable" social utility of giving money directly to the borrower, as well as the "trivial" costs involved with a direct bank-to-bank payment, and the "open question of who, if not the new lender, may better ensure that the old lender is repaid," did not outweigh the consequences of placing a duty of care on Compass Bank. The District Court concluded that Compass Bank's decision to entrust Sambrano with the payoff of the City Bank loan could constitute negligence.

The District Court, however, then addressed another aspect of Texas negligence law. Purely economic harm, unaccompanied by personal or property injury, is generally not allowable as a negligence claim under Texas law. Rather than dismissing the negligence claim, however, the court instructed the parties to brief the "purely economic harm" issue as part of any summary judgment pleadings.

City Bank also brought a claim for breach of contract, arguing that it was the intended third-party beneficiary of the refinancing transaction. Generally, a third party may sue contracting parties when the contracting parties intended to benefit the third party and entered into the contract directly for the third party's benefit. Where, however, a third party only incidentally benefits from a contract, that third party is not generally entitled to sue to enforce the contract. City Bank alleged that the loan documents supported its contention that it was a third-party beneficiary of the refinancing transaction. City Bank did not attach the pertinent documents to its pleadings, however, and Compass Bank argued that this omission was fatal to City Bank's claim. Compass Bank also "invite[d] the Court to examine" the documents filed in a companion case. Rather than examining the documents, however, the court instructed the parties to brief the matter at the summary judgment stage. Finding the pleadings sufficient, the court denied Compass Bank's motion to dismiss the breach of contract claim.

City Bank also asserted a claim for money had and received with respect to a check for about $1 million. The check was paid to Sambrano from one of its customers and deposited in Sambrano's operating account held at Compass Bank shortly before Sambrano's collapse. Money had and received is an equitable remedy under Texas law. To prove this claim, a plaintiff must show that the defendant holds money that in equity and good conscience belongs to the plaintiff. Compass Bank had applied this deposit to the line of credit Sambrano held at Compass and then subsequently advanced the same amount from the line of credit back into Sambrano's operating account. The court dismissed City Bank's claim, finding that Sambrano had spent and dissipated the funds, and that Compass Bank therefore did not hold the funds.

PRACTICAL CONSIDERATIONS

A payoff letter should be included among the documents for any commercial refinance transaction. A payoff letter sets forth the terms and conditions on which the lender to be paid will accept payment. In order to best protect the refinance lender, the original lender, and the borrower, the payoff letter can be either executed by: the borrower and both lenders; or, the borrower and the original lender, clearly specifying the refinance lender as an intended third-party beneficiary. It is, in essence, the written agreement that was missing in the City Bank, Compass Bank and Sambrano refinance transaction. The letter protects both the refinance lender and the lender to be paid. The refinance lender is protected because, if it complies with the terms and conditions of the letter, it will have discharged its duty to the lender to be paid. The lender to be paid is protected because, through the payoff letter, it dictates the exact duty the refinance lender owes it. Many of the issues raised in this case likely could have been avoided had a payoff letter been completed with the refinance transaction.

Contractual Representations and Warranties Provide Justifiable Reliance in Fraud Action—continued from page 9

replied that, if the plaintiffs could only prove that the warranties were false, they could recover only from ARI. If, however, the plaintiffs could prove that Rhone and Quilvest knew that the facts represented and warranted were false, then the plaintiffs could potentially recover from them as well. The court believed that a reasonable inference could be drawn from the plaintiffs' allegations that they believed that Rhone and Quilvest would not knowingly cause a company they controlled to make material misrepresentations, and that this determination was to be made by a jury.

The Court of Appeals reversed the order granting the defendants' motion to dismiss this particular count, and remitted the case.

PRACTICAL CONSIDERATIONS

A key word in a fraud action is "justifiable," and even sophisticated parties lending $40 million can justifiably rely on seemingly truthful financial statements and assurances, and contractual representations and warranties. Lenders must be sure, however, not to take a robotic approach in obtaining and reviewing financials and other pertinent information. Due diligence must, after all, be diligent.

TOUSA Overturned; District Court Rejects Narrow Definition of 'Equivalent Value'; Rejects Finding of Lenders' Bad Faith —continued from page 3

In 2007, TOUSA agreed to pay the Transeastern Lenders the approximate sum of $476 million to settle the claims against TOUSA. In order to finance the settlement, TOUSA entered into several loan agreements, borrowing an aggregate of $500 million from another set of lenders (the New Loan Lenders). In connection with the New Loans, many of TOUSA's subsidiaries (the Conveying Subsidiaries) that were not implicated in the Transeastern litigation, granted liens and security interests in their assets and became co-obligors with respect to the New Loans. Under the loan agreements evidencing the New Loans, the proceeds thereof were earmarked to pay the fees associated with the New Loans and the Transeastern settlement amount. On or about July 31, 2007, the New Loan proceeds (less fees and interest) were wired directly to a title company controlled by TOUSA, which, in turn, disbursed the funds to the agent for the Transeastern Lenders. At that time, TOUSA and its subsidiaries had loans outstanding under the Revolving Facility in the amount of $373 million, as well as obligations under the bond indentures approximating $1.06 billion.

Unfortunately, the steps TOUSA had taken to protect itself with respect to the Transeastern litigation did not save it, as almost immediately thereafter the real estate and credit markets throughout the United States began to crater. This collapse was the "straw that broke the camel's back," and ultimately caused TOUSA and its subsidiaries to file for bankruptcy protection in January 2008. The cases were jointly administered. Soon after the bankruptcy filing, an Official Committee of Unsecured Creditors was formed, and the Committee initiated litigation against the Transeastern Lenders and others seeking to avoid the Transeastern settlement as a fraudulent conveyance, and to recover the New Loan proceeds that funded the settlement.

What is a Fraudulent Conveyance?

The Bankruptcy Code contains several provisions establishing what are known as the "trustee's avoidance powers." These provisions empower a trustee or a debtor-in-possession (or a committee, if given the right to bring the action in lieu of the debtor-in-possession) to seek to unwind pre-petition transactions and conveyances of property if the statutory requirements are met. A fraudulent conveyance under section 548 may be deemed to have occurred: if the transfer at issue occurred within a certain time period prior to the bankruptcy case involving the transferor; if the transfer was made at a time when the transferor was insolvent or rendered insolvent by virtue of the transaction; and, when such transaction provides less than equivalent value to the transferring entity.

The Bankruptcy Court Decision

No one disputed the fact that the Conveying Subsidiaries were rendered insolvent by virtue of the lien pledge, so to a great extent, the Bankruptcy Court focused on the issue of what value, if any, the Conveying Subsidiaries received in exchange for the lien pledges. The Committee posited that the Conveying Subsidiaries did not receive reasonably equivalent value for becoming obligors under the New Loans, or for granting liens and security interests in their assets that secured the repayment thereof, because they were not implicated in the Transeastern litigation.

The Bankruptcy Court agreed with the Committee's position, adopting its findings of fact and conclusions of law almost verbatim. The court found that the Conveying Subsidiaries had a property interest in the New Loan proceeds, and that the payment thereof to the Transeastern Lenders constituted a fraudulent conveyance as far as the Conveying Subsidiaries were concerned, because they had no stake in the outcome of the Transeastern litigation. In reaching this decision, the Bankruptcy Court essentially collapsed the New Loan transaction and the Transeastern settlement transaction, finding that the granting of the liens and security interests by the Conveying Subsidiaries was "to or for the benefit of" the Transeastern Lenders, and that the Conveying Subsidiaries received negligible consideration (i.e., *not* equivalent value) for granting liens on their assets in order to secure the funding necessary to settle the Transeastern litigation.

Also of particular concern to lenders, the Bankruptcy Court found that the Transeastern Lenders had acted in bad faith by accepting the settlement payment, and by failing to investigate the source of the settlement payment and the impact of the settlement on TOUSA, as well as on its subsidiaries.

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Consequently, the Bankruptcy Court held that $421 million of the settlement proceeds paid to the Transeastern Lenders should be disgorged and refunded to the estates of the Conveying Subsidiaries under section 550 of the Code. The Transeastern Lenders, along with other parties, appealed the Bankruptcy Court decision and obtained a stay of the disgorgement obligations pending the appeal.

The District Court Opinion

On appeal, in a decision that was highly critical of the Bankruptcy Court, the District Court overturned, and in fact, quashed, every aspect of the Bankruptcy Court's decision pertaining to the Transeastern Lenders; and in so doing, the District Court found fault with both the Bankruptcy Court's factual findings and its application of the law.

The District Court made several findings that are instructive for parties going forward. First, the District Court disagreed with the narrow way in which the Bankruptcy Court chose to evaluate the value received by the Conveying Subsidiaries in connection with the settlement of the Transeastern litigation. Although the Conveying Subsidiaries did not receive monetary consideration (or other types of property with a value that was relatively easy to quantify) in return for the liens they conveyed as credit support for the New Loans used to fund the Transeastern settlement, and although they were not directly implicated in the Transeastern litigation, this did not mean that the *settlement* did not confer "reasonably equivalent" value upon them.

The District Court's view of reasonably equivalent value was considerably more expansive than that of the Bankruptcy Court. The District Court observed that when evaluating value, the "totality of the circumstances" should be taken into account. In this case, even though the Conveying Subsidiaries were not guarantors of the Transeastern Loans and were not directly implicated in the litigation with the Transeastern Lenders, a large judgment against TOUSA in the Transeastern litigation would have certainly impacted the subsidiaries and would likely have threatened the entire corporate enterprise's ability to continue in business. Moreover, because a large judgment in that litigation would be an Event of Default under the Revolving Facility, as well as the bond indentures, and because the Conveying Subsidiaries were obligated on all of that debt and had no independent source of liquidity other than the Revolving Facility, their fortunes were inextricably tied to those of their parent entity, TOUSA.

The District Court noted that "eliminating the threat of the [the Transeastern Lenders'] claims against the Conveying Subsidiaries' parent" should not be discounted as the *equivalent value* required to defeat a fraudulent conveyance claim, when a large judgment in that litigation (which was found to be likely) would have threatened the transferors' (here, the Conveying Subsidiaries) ability to continue as viable, going concerns.

The District Court's decision supports the view that when a large group of companies act as an integrated group and are dependent upon one another and their parent for their liquidity and sustenance, "upstream" guarantees or value provided by the subsidiaries on behalf of the parent may be appropriate, especially when the subsidiaries' ability to continue as going concerns is threatened *unless* they offer such guarantees or value. The District Court found that lending that facilitates "a debtor's opportunity to avoid default, to facilitate its rehabilitation and to improve its prospects of avoiding bankruptcy are precisely the kind of benefits that, by definition, are not susceptible to exact quantification, but are nonetheless legally cognizable under section 548."

The District Court also found that the Bankruptcy Court had engaged in "Monday morning quarterbacking" by finding that because the TOUSA companies eventually failed, the "value" given by the Conveying Subsidiaries in the form of liens on their assets was considerably greater than the value they received by temporarily avoiding defaults under other loan agreements and a chapter 11 filing. The District Court found that the Bankruptcy Court erred by not evaluating the value of the Transeastern settlement to the Conveying Subsidiaries as of the time the settlement was entered into, rather than later, when other factors came into play that ultimately contributed to the downfall of these entities.

Further, the District Court found that the Bankruptcy Court's conclusion regarding the property interest held by the Conveying Subsidiaries in the New Loan proceeds was also legally incorrect. The District Court agreed with the Transeastern Lenders that the Conveying Subsidiaries never held a property interest in the New Loan proceeds because those proceeds were never within their control or reach. Consequently, under applicable Eleventh Circuit law, the Conveying Subsidiaries were not "transferors" of a property interest with respect to the Transeastern Lenders.

The District Court also rejected the Bankruptcy Court's finding regarding "for whose benefit" the transfer of the liens by the Conveying Subsidiaries was made. In the District Court's view, there were three types of entities from whom a trustee could recover a pre-petition transfer: (1) an initial transferee, (2) an entity for whose benefit the initial transfer was made, and (iii) a subsequent transferee. The "transfer" here was the conveyance of liens by the Conveying Subsidiaries to the New Lenders. Obviously, the Transeastern Lenders were not the initial transferees in that they did not receive these liens. The Bankruptcy Court reasoned that the liens, however, were made for the benefit of the Transeastern Lenders, because without the conveyance of these liens, the New Loans would never have been made and the Transeastern Lenders would not have received the proceeds thereof. The District Court disagreed, finding that the liens by the Conveying Subsidiaries were made for the benefit of TOUSA, which was then able to acquire the New Loans and use them to pay the settlement amount, a valid antecedent debt. Thus, there was no ability to recover these funds under section 550 of the Code.

Lastly, but of paramount importance to lenders, the District Court was very troubled by the Bankruptcy Court's finding of bad faith on the part of the Transeastern Lenders by virtue of their failure to fully investigate the source of the settlement proceeds and the effect of the terms of the New Loans on the Conveying Subsidiaries. The District Court found that the standards elicited by the Bankruptcy Court were "patently unreasonable and unworkable" and, if accepted, would "impose extraordinary duties of due diligence on the part of creditors

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accepting repayment – duties that equal or exceed those imposed on lenders extending credit in the first place." The District Court held that the Transeastern Lenders had no reason and no legal duty to conduct such extraordinary due diligence before accepting a payment on account of a valid antecedent debt.

The District Court invoked an extraordinary procedural move by refusing to remand the case to the Bankruptcy Court for further proceedings and findings of fact. Instead, it quashed the Bankruptcy Court's order as it related to the Transeastern Lenders and authored new findings of fact and conclusions of law.

I am sure we have not heard the last of this important case. Stay tuned.

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