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In This Issue:

- Deed-In-Lieu, or Not—2
- Ninth Circuit Reverses Lower Courts, Finds Substantially Completed Plan Is Not Equitably Moot—2
- The Inconsequential Value Exception to the Section 1111(b) Election: Analyzing the When and How—4
- Chapter 7 Trustee's Claim of Breach of Fiduciary Duty Based on Failure to Comply with the WARN Act Survives Motion to Dismiss—5
- Section 303 Requirements Not Enough – Involuntary Chapter 7 Petitioner Must Also Demonstrate Good Faith in Filing—6
- Regardless of Claim Priority, State Department of Revenue Entitled to Adequate Protection Thanks to Bulk Sales Act—7
- Separate Agreements Comprising One Unitary Contract Must Be Assumed or Rejected *Cum Onere*—8
- Issues of Material Fact Preclude Summary Judgment on Whether Lender Impliedly Assumed Liability to Return Membership Deposits—8
- Sale of Substantially All of Debtor's Assets Cannot Be Approved in a Final Cash Collateral Order—10
- Counsel's Corner: News From Reed Smith—10

DEED-IN-LIEU, OR NOT

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The fact situation was fairly typical in *In re 364 N.B.E. Corp.*, United States Bankruptcy Court, Eastern District of New York (Case No. 13-46771) (December 29, 2015). After the debtor defaulted on a commercial real estate loan, the debtor and the lender entered into a Forbearance Agreement whereby the lender agreed to forbear from foreclosing on the property as long as the debtor abided by the terms of the Forbearance Agreement. When the debtor later defaulted under the Forbearance Agreement, the parties entered into a Stipulation whereby the debtor executed and delivered to an escrow agent a Deed in Lieu of Foreclosure to the property. The Stipulation provided that upon a default, the escrow agent shall deliver the Deed in Lieu to the lender who shall then be entitled to record the Deed in Lieu. After further defaults, the lender obtained and recorded the Deed in Lieu. The debtor then filed for bankruptcy and filed an adversary proceeding against the lender seeking a determination that the Deed in Lieu was not an instrument of conveyance but was, instead, equivalent to a mortgage. The bankruptcy judge, applying New York law, agreed. Even though the Stipulation stated that the lender could record the Deed in Lieu, the court found persuasive: (1) language in the Stipulation that the escrow agent was holding the Deed in Lieu "as security" for the debtor's obligations under the Stipulation; and (2) that the Stipulation preserved the debtor's right of redemption, which is a right that flows from a mortgage. In so holding, the court attempted to distinguish a 2nd Circuit case which came to a contrary conclusion.

Lesson learned: make sure the written language is very clear that the conveyance is intended as a deed in lieu and not a mortgage.

NINTH CIRCUIT REVERSES LOWER COURTS, FINDS SUBSTANTIALLY COMPLETED PLAN IS NOT EQUITABLY MOOT

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In re Transwest Resort Properties, Inc., 801 F.3d 1161 (9th Cir. 2015)

CASE SNAPSHOT

The Ninth Circuit finds that a substantially consummated plan is not equitably moot, even if the appellant creditor could only be given partial relief to redress its grievances under the plan.

FACTUAL BACKGROUND

Debtors owed the lender approximately $250 million secured by first priority liens on the debtors' hotel properties, which the lender and debtors agreed were worth $92 million. The lender elected to be treated as fully secured pursuant to Bankruptcy Code section 1111(b), thereby receiving a $250 million secured claim rather than a $92 million secured claim with a $158 million unsecured deficiency claim.

The debtors' plan provided for the full payment of the $250 million secured claim through an interest-only loan with a balloon payment due in 21 years. The plan provided the lender with "due-on-sale" protections (i.e., a clause requiring the debtors to remit sufficient sale proceeds to pay off the lender upon a sale of the hotels) but only for a limited period of time. The plan provided that there would be no "due-on-sale" protections between five and 15 years after confirmation of the plan. Notably, there was no "due-on-sale" clause in the lender's underlying loan documents. Pursuant to the plan, a new owner and investor, SWVP, was to take over control of the debtors.

The lender objected to the plan on the grounds that the lack of "due-on-sale" rights throughout the life of the plan would effectively take away the lender's 1111(b) election. The lender theorized that should the properties significantly increase in value, the debtors could sell the properties for more than the loan amount during the five-to-15 year period, and keep equity proceeds for themselves while insisting that the lender continue to receive interest-only payments for the remainder of the loan period.

The lender also objected on the grounds that, although the debtors proposed a single plan, certain of the debtors had no impaired classes of creditors voting for approval, which the lender argued violated Bankruptcy Code section 1129(a)(10)'s requirements that at least one impaired class vote to approve the plan. The lender purchased certain of the unsecured claims in order to ensure that such claims would vote against the plan.

The plan was confirmed over the lender's objection, and the lender appealed to the district court. The lender sought a stay on appeal from the bankruptcy court, arguing that absent such a stay, the appellate court may find its appeal equitably moot. The bankruptcy court denied the stay motion, finding that mootness was "speculative, at best." The lender then sought a stay from the district court, which likewise denied the stay motion. The district court then considered the appeal on its merits, but determined that the appeal was equitably moot because the plan had been substantially consummated, third parties had relied on the confirmation of the plan, and it would be inequitable to upset the plan. The lender appealed to the Ninth Circuit.

COURT ANALYSIS

The Ninth Circuit reversed the district court, finding that the appeal was not equitably moot. The Ninth Circuit identified four factors that should be analyzed to determine equitable mootness: (1) whether appellant sought a stay pending appeal; (2) whether substantial consummation of the plan had occurred; (3) the effect a remedy may have on third parties not before the court; and (4) whether the bankruptcy court "can fashion effective and equitable relief without completely knocking the props out from under the plan."

CONTINUED ON PAGE 3

As to the first factor, the Ninth Circuit found that the lender was diligent in seeking a stay pending appeal, and found that courts should be cautious about applying equitable mootness against appellants diligently seeking such a stay. The Ninth Circuit found that this factor cut heavily in the lender's favor.

As to the second factor, the Ninth Circuit found that the plan had been substantially consummated and that SWVP had taken over control of the debtors. Although recognizing that some courts found a presumption of equitable mootness, the Ninth Circuit found that there was no such presumption if effective relief could be fashioned to give the appellants redress.

As to the third factor, the Ninth Circuit analyzed how SWVP, as the "third party," would be impacted by the appeals. Looking first at the lender's "due-on-sale" arguments, the Ninth Circuit found that the imposition of a "due-on-sale" clause for the entire duration of the loan would only impact the division of proceeds between the debtors and the lender, and that no other parties would be impacted by such a division. The Ninth Circuit also observed that SWVP was not an "innocent" third party, since it was a major participant in court hearings and in the plan approval process. Looking next at the lender's arguments that the plan was not properly approved by sufficient impaired classes, the Ninth Circuit noted that the lender indicated it would accept payment for the unsecured dissenting claims it had purchased. Again, the Ninth Circuit found that such relief would impact the lender and the debtors, not SWVP, and even if SWVP was indirectly affected, it was involved in the plan process and was therefore not truly an "innocent" third party.

As to the fourth factor, the Ninth Circuit determined that numerous forms of relief or partial relief could be fashioned. As to the "due-on-sale" clause, the Ninth Circuit found that even if the clause was not imposed for the entire duration of the plan, it could be imposed for a longer duration than currently provided for in the plan. The Ninth Circuit also speculated that a court could, if the hotels were sold during the window, order that there was no "due-on-sale" clause, and the debtors should pay the lender a percentage of the difference between the remainder of the sale proceeds and the loan's present value. The Ninth Circuit also took a dim view of the debtors' and SWVP's position that they would now be harmed if such relief were granted to the lender, noting that the debtors and SWVP actively opposed the lender's motion for stay pending appeal by arguing that the lender failed to demonstrate evidence of immediate or non-speculative harm. As to the lender's arguments that it was denied the right to vote the claims of its unsecured creditors against the plan, the Ninth Circuit acknowledged that although it might be impossible to now give the lender the right to veto the plan, the lender could nevertheless be compensated for the loss of voting rights in some amount determinable by the bankruptcy court (even if such rights were worth only $1).

Finding that at least three of the factors favored the lender, the Ninth Circuit reversed and remanded for further proceedings.

Dissenting Opinion

Judge Milan Smith dissented from the opinion, criticizing the majority's focus on SWVP's participation in the plan process. Judge Smith argued that because SWVP was not an insider and had no pre-petition interest in the debtors, its participation in the process was irrelevant. Judge Smith stated that the decision was "grossly inequitable to SWVP and would surely jeopardize the reorganization." Judge Smith further opined that SWVP should be permitted to rely on the finality of the confirmation order, and that changes to the bargain in the plan would deprive SWVP of the benefits of the agreement to which it agreed. The dissent pointed out that SWVP might cease funding improvements on the hotel in light of the Ninth Circuit's ruling, and the only thing preventing SWVP from walking away was the substantial costs it had already invested.

Judge Smith then turned specifically to the lender's objections: first, Judge Smith observed that the lender had no "due-on-sale" protections in its original agreement, so it should not now complain that the plan lacked similar protections; and second, Judge Smith pointed out that the lender only purchased the unsecured claimants' debts in order to obtain veto power over the plan, not because it believed the claims had any monetary value.

PRACTICAL CONSIDERATIONS

The Ninth Circuit's decision casts serious doubts on the finality of confirmation orders, and may dissuade prospective investors from funding reorganization plans that are contested and are the subject of appeals in this Circuit. At the very least, it may discourage such investors from participating in the process in all but the most passive roles, for fear of being found to be "too involved" in the process to rely on equitable mootness arguments on appeal.

THE INCONSEQUENTIAL VALUE EXCEPTION TO THE SECTION 1111(B) ELECTION: ANALYZING THE WHEN AND HOW

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In re Houston Regional Sports Network, L.P., No. 13-35998-H1-11 (S.D. Texas, Aug. 20, 2015)

In re At-Net Services-Charlotte, Inc., No. 14-32047 (Bankr. W.D.N.C., Aug. 17, 2015)

Generally, when a secured creditor's claim is undersecured (i.e., the collateral is worth less than the creditor is owed), the secured creditor's claim is bifurcated such that the secured portion of the creditor's claim is reduced to the value of the collateral, and the remainder of the claim (the deficiency) is treated as an unsecured claim. When a claim is bifurcated, the court engages in a valuation of the creditor's collateral and estimates the appropriate value in light of the proposed disposition of the collateral. In order to remove the risk that the bankruptcy court will undervalue the collateral, a secured creditor may elect, under section 1111(b), not to bifurcate its claim. If the creditor chooses the "1111(b) election," however, the creditor agrees to waive its right to an unsecured claim for the deficiency. A creditor cannot make an 1111(b) election if its collateral is being sold or if the collateral has an "inconsequential value."

In re Houston Regional Sports Network, L.P. - Two recent decisions address the standards applicable when determining whether a secured creditor's collateral has an "inconsequential value." In *In re Houston Regional Sports Network, L.P.*, the United States District Court for the Southern District of Texas concluded that the collateral should be valued as of the petition date, as opposed to the effective date of the debtor's chapter 11 plan. In that case, the timing of the determination was crucial because the secured creditor's collateral would be worthless if valued as of the petition date, but was worth more than $54 million if valued as of the effective date of the plan.

In support of its argument that the collateral should be valued as of the effective date, the secured creditor first relied on the notion that collateral must be valued in a manner that reflects the debtor's use of that collateral, and argued that collateral that is tied to a plan must be valued as of the effective date of the plan. The court rejected that argument, finding that "[v]aluing the collateral in light of its disposition informs *how* to value the collateral, not *when*. Temporal juxtaposition or a loose-causal connection is no logical reason to prefer the effective date." (Emphasis in original).

The secured creditor's next argument relied upon the "fair and equitable" plan confirmation requirements of section 1129(b)(2). Under section 1129(b)(2), to confirm a plan over the objection of a secured creditor, the plan must provide the secured creditor with "deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property." Thus, if the creditor makes an 1111(b) election, the plan, to be confirmable, must provide the creditor with payments having a face value equal to the amount of the secured portion of its claim, and the present value of those payments must be at least equal to the value of the collateral. The secured creditor argued that it would be odd for the Bankruptcy Code to require that the secured creditor be paid the present value on the effective date for collateral valued as of the petition date.

The court rejected this argument, finding that "[t]he collateral's value is tied to the amount of the allowed claim, which necessarily must be determined before deciding whether the plan is fair to secured creditors. Put differently, the amount of the deferred-cash payments is determined on the effective date of the plan, not the amount of the allowed claim or the value of the collateral that secures it." Thus, the court determined that the bankruptcy court did not err in valuing the secured creditor's claim as of the petition date and, therefore, in holding that the secured creditor was unable to make an 1111(b) election.

In re At-Net Services-Charlotte, Inc. - In *In re At-Net Services-Charlotte, Inc.*, the United States Bankruptcy Court for the Western District of North Carolina addressed a split in authority with the appropriate standard to be applied when determining whether collateral has an "inconsequential value." The first approach (the "*Wexler* Approach") considers the "fair and equitable" plan confirmation requirements of section 1129(b)(2), and considers whether the debtor would be able to propose a plan that would make payments to the secured creditor in the amount of the secured portion of its claim that have a present value of the secured creditor's lien amount. If not, under the *Wexler* Approach, the secured creditor's lien is "of inconsequential value" and the 1111(b) election is not available to that creditor.

Under the second approach (the "*McGarey* Approach"), the court compares the value of the secured creditor's lien with the value of the collateral to determine if the secured creditor's interest is "of inconsequential value." The *At-Net Services-Charlotte* court adopted the *McGarey* Approach, finding that the statutory language required the court to compare the value of the secured creditor's lien with the value of the collateral. In so holding, the court observed that "[h]ad Congress intended inconsequential value to be determined by analyzing whether the debtor can satisfy the requirements of section 1129(b) in light of the secured creditor's section 1111(b) election, it would have said so in section 1111(b) or elsewhere in the Bankruptcy Code."

PRACTICAL CONSIDERATIONS

Because there is a relative dearth of case law addressing the 1111(b) election, these decisions shed some very helpful light on the issues that may arise and the standards that may be employed by courts when addressing section 1111(b) elections, which will be helpful for secured creditors and their counsel to consider when analyzing whether the 1111(b) election is available to a secured creditor in a particular case.

CHAPTER 7 TRUSTEE'S CLAIM OF BREACH OF FIDUCIARY DUTY BASED ON FAILURE TO COMPLY WITH THE WARN ACT SURVIVES MOTION TO DISMISS

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In re Golden Guernsey Dairy, LLC, Case No. 13-10044 (KG), Adv. Pro. No. 14-50953 (KG), (Bankr. D. Del. Sept. 21, 2015)

CASE SNAPSHOT

A chapter 7 trustee brought an adversary complaint against the parent company, director, and president of a debtor, alleging that the defendants breached their fiduciary duties by exposing the debtor to a potential $1.56 million priority claim stemming from the debtor's alleged violations of the Wisconsin WARN Act. The defendants moved to dismiss the claim on the grounds that it was a "deepening insolvency" claim not recognized under the laws of the state of Delaware. The bankruptcy court disagreed, holding that the complaint properly stated a claim for breach of the duty of loyalty by alleging that the controlling owner, manager, and president of the debtor failed to act in good faith when ignoring their responsibilities to give appropriate notices to employees under the WARN Act.

FACTUAL BACKGROUND

The chapter 7 trustee alleged that the defendants had maintained the debtor's operations until the very last moment and, when forced to cease operations, had not given employees the prior notices required under the Wisconsin WARN Act. The trustee further alleged that, by ignoring their responsibilities under the WARN Act, the defendants had failed to act in good faith, thereby breaching their duty of loyalty to the debtor.

The defendants argued that the debtor's potential liability under the WARN Act arose merely because of an imprudent business decision to continue the debtor's operations. Furthermore, because the debtor was already insolvent at the time of such alleged violations, such potential liability only "deepened" the debtor's insolvency. On that basis, the defendants argued that the trustee had stated only a "deepening insolvency" claim for which relief cannot be granted under Delaware law.

COURT ANALYSIS

The bankruptcy court began its analysis by making clear that it viewed the trustee's claim as alleging misconduct rather than strategic error. The court clarified that a "deepening insolvency" claim involves the latter but not the former. The bankruptcy court then explained that Delaware law has long recognized that a fiduciary may breach its duty of loyalty to the company if the fiduciary fails to act in good faith. In other words, "[w]here directors fail to act in the face of a known duty to act, demonstrating a conscious disregard for their responsibilities, they breach their duty of loyalty by failing to discharge a fiduciary obligation in good faith." The court held that the trustee had properly stated a claim for breach of the duty of loyalty by alleging that the controlling owner, manager, and president of the debtor had ignored their responsibilities to give appropriate notices to employees under the WARN Act and, therefore, had failed to act in good faith.

PRACTICAL CONSIDERATIONS

Whether the defendants in this case only made an imprudent business decision or consciously disregarded the debtor's obligations under the WARN Act will ultimately turn on the facts and circumstances. Thus, this case counsels fiduciaries of troubled companies to seek appropriate guidance on their duties – which may not be necessarily apparent – to avoid potential liability.

SECTION 303 REQUIREMENTS NOT ENOUGH – INVOLUNTARY CHAPTER 7 PETITIONER MUST ALSO DEMONSTRATE GOOD FAITH IN FILING

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In re Forever Green Athletic Fields, Inc.,
Case No. 14-3906 (3d Cir., Oct. 16, 2015)

CASE SNAPSHOT

The United States Court of Appeals for the Third Circuit recently held that an involuntary petition filed under 11 U.S.C. section 303 may be dismissed for filing in bad faith, despite the petitioning creditors' compliance with statutory requirements set forth therein.

FACTUAL BACKGROUND

In 2005, Forever Green filed suit in Pennsylvania against one of its competitors, ProGreen, for diversion of corporate assets. Shortly after Forever Green filed its lawsuit, a former employee of Forever Green – and then owner of ProGreen, Charles Dawson – sued Forever Green for unpaid commissions. After years of litigation, the court in Louisiana entered a consent judgment for approximately $300,000 in favor of Mr. Dawson against Forever Green.

While Mr. Dawson's litigation was pending in Louisiana, Forever Green and ProGreen agreed to arbitrate their case in Pennsylvania. Following Mr. Dawson's receipt of the consent judgment, however, ProGreen sought to terminate the arbitration. Forever Green filed a complaint in the Pennsylvania state court to reinstate the arbitration. Shortly before his brief was due, Mr. Dawson, his wife, and another creditor filed an involuntary chapter 7 bankruptcy petition against Forever Green. Forever Green moved to dismiss the involuntary petition as a bad faith filing. The Bankruptcy Court ruled in favor of Forever Green, finding that the petition was filed in bad faith. The District Court affirmed the decision.

COURT ANALYSIS

On appeal, the Third Circuit addressed three issues. First, whether a court may dismiss an involuntary petition as a bad faith filing. Second, whether the Bankruptcy Court erred in finding bad faith. And finally, whether good faith creditors could have cured the involuntary petition. The Third Circuit affirmed the lower courts on each issue.

Section 303 sets forth three requirements that must be met in order to commence an involuntary petition:

1. There must be three or more petitioning creditors.
2. Each petitioning creditor must hold a claim against the debtor that is neither contingent as to liability or the subject of a bona fide dispute.
3. The claims must aggregate at least $15,325 more than the value of any liens held with respect to the debtor's property.

The Third Circuit acknowledged that the petitioning creditors met the technical requirements of section 303, but went on to analyze whether "bad faith may serve as a basis for dismissal even where the debtor is admittedly not paying its debts as they become due." The court determined that, in addition to the three filing requirements found in section 303, a court can dismiss an involuntary petition if it is brought in bad faith. Restated, a court can dismiss an involuntary petition if it finds that the petitioning creditors filed the petition in bad faith, even if they complied with the technical requirements of section 303. Because bankruptcy courts are courts of equity, the Third Circuit emphasized the bankruptcy court's ability to "patrol the border between good- and bad-faith filings." Further, the Third Circuit found policy support for its holding; creditors should not be compelled to force a debtor into bankruptcy as retribution.

The Third Circuit adopted the "totality of the circumstances" standard for determining bad faith under section 303. The Third Circuit affirmed the lower courts' rulings and found that Mr. Dawson filed the involuntary petition in bad faith because he was using the bankruptcy as a litigation tactic to force Forever Green's abandonment of its claims against ProGreen.

In response to the final issue on appeal, the Third Circuit held that, because the involuntary petition was dismissed by the lower courts, the petition could not be cured. Pursuant to section 303(c), creditors can join an involuntary petition "before the case is dismissed." Here, the case was dismissed for some time. The Third Circuit noted further that no other creditors appeared interested in joining the petition, as nine months lapsed between the hearing on the motion to dismiss and the bankruptcy court's decision.

PRACTICAL CONSIDERATIONS

The Third Circuit's decision in *Forever Green Athletic Fields* should cause any creditor contemplating filing an involuntary petition against a debtor to carefully scrutinize the decision. Beyond the need to comply with section 303 of the Bankruptcy Code, the creditor's involuntary filing must withstand a challenge that the creditor filed the action in good faith.

REGARDLESS OF CLAIM PRIORITY, STATE DEPARTMENT OF REVENUE ENTITLED TO ADEQUATE PROTECTION THANKS TO BULK SALES ACT

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IDOR v. Elk Grove, Case No. 14 C 5072 (N.D. Ill., Sept. 30, 2015)

CASE SNAPSHOT

The United States District Court for the Northern District of Illinois reversed the bankruptcy court's decision that the Illinois Department of Revenue's (the "IDOR") interest in the debtor's property was without value and thus not entitled to adequate protection under section 363(e) of the Bankruptcy Code, because the IDOR's liens were subordinate to the debtors' secured creditor. The district court held that the Illinois Bulk Sales Act allowed the IDOR to go after the purchaser personally, regardless of the priority of the IDOR's claims against the debtors, and this interest deserved adequate protection.

FACTUAL BACKGROUND

The four debtors operated five BP gas stations in the Chicagoland area (each a "Debtor" and collectively, the "Debtors"). Prior to filing for bankruptcy, the Debtors entered into loan agreements with United Central Bank ("UCB") that were secured by mortgages on the real properties upon which the gas stations operated, as well as security interests in the Debtors' personal property. The Debtors subsequently defaulted on their obligations to UCB. Consequently, each Debtor filed a separate chapter 11 petition between December 2012 and January 2013, and the cases were jointly administered.

The bankruptcy court appointed a chapter 11 trustee, and the trustee moved to sell the Debtors' gas stations pursuant to sections 363(b) and (f) of the Bankruptcy Code. Shortly after the sale motion was filed, the IDOR filed a limited objection to the sale. In its objection, the IDOR noted that the Debtors owed approximately $1.8 million in outstanding pre-petition tax liabilities to the state of Illinois. The tax liens on account of these tax liabilities were recorded after UCB's liens. The IDOR argued that under the Illinois Income Tax Act and the Retailers' Occupation Tax Act (the "Bulk Sales Act"), it had the right to pursue any purchaser personally for the Debtors' outstanding tax liabilities. Because section 363(f) of the Bankruptcy Code, which permits the trustee to sell property "free and clear" of "any interest," would extinguish this right, the IDOR sought adequate protection for this interest pursuant to section 363(e) of the Bankruptcy Code.

In November 2013, after conducting a hearing, the bankruptcy court entered an order approving the sale of the gas stations and told the IDOR that no additional language was required in the sale order to preserve its interests. The Debtors' gas stations were sold to the purchaser, and the sale order authorized the sale "free and clear of all liens, claims, encumbrances and interests, with all liens, claims, encumbrances and interests to attach to the proceeds." The trustee closed the sale of the gas stations over the next two months, and received net sales proceeds totaling approximately $5.2 million.

In January 2014, UCB filed a motion for allowance of its secured claim and turnover of the sale proceeds. The motion asserted claims against the Debtors totaling approximately $14 million. The IDOR objected to the allowance motion and filed a cross-motion for partial turnover of the sales proceeds. The IDOR requested that the bankruptcy court order the trustee to turn over sufficient funds from the sales proceeds to satisfy the Debtors' outstanding tax liabilities as adequate protection for the IDOR's interest under the Bulk Sales Act.

The bankruptcy court granted UCB's motion, finding that UCB's secured claims were deemed allowed in the full amount, consisting of a secured claim in the amount of approximately $5.2 million and an unsecured claim in the amount of approximately $8.8 million. The bankruptcy court further found that the IDOR's claims were allowed in the amount of approximately $1.8 million, but the IDOR's right under the Bulk Sales Act to pursue the purchaser for the Debtors' outstanding tax liabilities was an interest extinguished by the sale order. Despite the IDOR having lost that interest, the bankruptcy court found that the loss was without value and thus was not entitled to adequate protection. This was because the IDOR's claims were subordinate to UCB's claims, thus leaving the IDOR "out of the money." The IDOR appealed the decision to the district court.

COURT ANALYSIS

As an initial matter, the district court agreed with the bankruptcy court's determination that UCB's liens took priority over the IDOR's lien. However, the district court found that the bankruptcy court overlooked an additional issue that warranted consideration, explaining that "the issue is not limited to whether UCB held a superior claim over the money the purchaser would have been required to withhold under the Bulk Sales Act to cover the Debtors' outstanding tax liabilities. That is because the IDOR's rights under the Bulk Sales Act are not limited to going after just the sale proceeds, whether or not those proceeds have been transferred to the Debtors or held by the purchaser. Rather, the Bulk Sales Act empowers the IDOR also to go after the purchaser 'personally' if he does not remit the amount withheld from the sale to the IDOR upon demand."

The district court found that under the Bulk Sales Act, had UCB asserted a claim superior to the IDOR for the amount withheld from the purchase price by the purchaser – as UCB argues it would have done – and the purchaser remitted the withheld sale proceeds to UCB and not the IDOR despite the IDOR's demand for that money, then the purchaser would still be personally liable to the IDOR for the amount owed by the seller. The district court found, therefore, that the IDOR's statutory right had value even though UCB may have a superior claim to the sale proceeds. In this case, UCB had not asserted a superior claim over the purchaser's personal assets or shown that, even if it did have a superior claim, the purchaser lacked sufficient personal assets to satisfy both UCB and the IDOR's claims. Because the Bulk Sales Act provided another source of funds from which the IDOR could recover the Debtors' outstanding tax liabilities, regardless of the priority of the IDOR's claims against the Debtors, the district court found that this interest deserved adequate protection.

PRACTICAL CONSIDERATIONS

This case should serve as a warning to potential purchasers in a section 363 sale that they must research the relevant bulk sales statutes of the taxing jurisdiction to determine whether there may be personal exposure, as is the case in Illinois pursuant to the state's Bulk Sales Act.

SEPARATE AGREEMENTS COMPRISING ONE UNITARY CONTRACT MUST BE ASSUMED OR REJECTED *CUM ONERE*

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Huron Consulting Services, LLC v. Physiotherapy Holdings, Inc. (*In re Physiotherapy Holdings, Inc.*), 538 B.R. 225 (D. Del. 2015)

CASE SNAPSHOT

The United States District Court for the District of Delaware held that the debtors could not assume a software licensing agreement without also assuming the related agreements, which together comprised one unitary contract. (This decision overturns the bankruptcy court decision, which was discussed in the October 2014 CR&B alert).

FACTUAL BACKGROUND

The bankruptcy court was presented with a contested assumption dispute involving six agreements between the debtors and Huron Consulting Services. The debtors sought to assume the software licensing agreement, the only agreement necessary to ongoing operations, and reject the other agreements. Huron objected, arguing the agreements were not assumable and that in any event, because the agreements are unitary, the debtors must assume all agreements together or none at all. The bankruptcy court, overruling Huron's objection, allowed the debtors to assume only the software licensing agreement and reject the other agreements; Huron appealed.

COURT ANALYSIS

The district court first concluded that nothing precluded the assumption or assignment of the agreements. The district court then considered whether the debtors could assume only the software licensing agreement and reject the other agreements.

In the Third Circuit, a debtor can only assume a contract *cum onere*—accepting the burdens along with the benefits. The determination of whether multiple agreements are separate contracts or a unitary contract focuses on the intent of the contracting parties. When the parties have reduced their agreement to writing, the agreement is the final expression of the parties' intention.

The district court held that the parties intended to create one unitary contract. The agreements manifested the parties' intent that the complete contract encompassed more than simply the four corners of any individual agreement. Each agreement also included provisions governing how to construe conflicting and inconsistent provisions among the agreements. In addition, simultaneous execution of multiple agreements is not required for those agreements to establish a unitary contract.

Because the agreements indicated the parties' intent for unity, the bankruptcy court erred in granting the debtors' request to assume only the software license agreement and its benefits, while rejecting the remainder of the agreements and their burdens. On remand, the debtors must reject the agreements or assume the agreements *cum onere*.

PRACTICAL CONSIDERATIONS

Courts may view separate agreements as a unitary contract, depending on the intent of the parties. Where the court determines that the parties intended separate agreements to constitute a unitary contract, a debtor must assume a contract *cum onere*, and accept the burdens along with the benefits.

ISSUES OF MATERIAL FACT PRECLUDE SUMMARY JUDGMENT ON WHETHER LENDER IMPLIEDLY ASSUMED LIABILITY TO RETURN MEMBERSHIP DEPOSITS

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Cayne, et al. v. Washington Trust Bank, et al., Case No. 12-cv-00584 (D. Idaho, Sept. 1, 2015, amended Sept. 3, 2015)

CASE SNAPSHOT

The United States District Court for the District of Idaho held that even though a bank did not expressly assume liability for membership deposits when taking a deed in lieu of foreclosure of a golf course, the bank's conduct thereafter raised genuine issues of material fact precluding summary judgment on the issue of whether the bank impliedly assumed such liability.

FACTUAL BACKGROUND

Plaintiffs are a class of individuals who had purchased membership in an exclusive golf course development in Northern Idaho ("Club"). The membership fees were as much as $100,000 and members were also required to pay monthly dues. The borrower, the company that constructed the Club, had funded its development with loans made by Washington Trust Bank; these loans were secured by the real and personal property associated with the Club. In August 2010, the Club ran into financial difficulties and, in a workout with the borrower, the bank took over ownership of the Club by way of a deed in lieu of foreclosure ("DIL"), with respect to the real property, and a Bill of Sale, with respect to the personal property, including "all assignable . . . contracts, . . . licenses, . . . and agreements, of every kind and nature, relating to the Club." Among the contracts assigned were the Club's membership agreements and related documents ("Membership Agreement"). This DIL was chosen over a judicial foreclosure or bankruptcy proceeding because the bank wanted to retain the membership base, believing this would best preserve the assets' value.

CONTINUED ON PAGE 9

Following the DIL, the Club continued to operate as if there had been no change in ownership: vendors were paid (including on account of pre-DIL obligations of the Club); members still had full use of the Club's amenities; and, purportedly unable to locate a third-party manager to run the Club, the bank used members of the pre-existing management team to operate the Club. The bank also invested many hundreds of thousands of dollars to fund the Club's operations. In November 2010, the Club was sold to a buyer that conditioned the purchase on the termination of the existing Membership Agreement. As the bank maintained it was not authorized to terminate the memberships, the managing member of the borrower sent notice to the pre-existing membership that their memberships would terminate and the Club would close as of October 31, 2010. Plaintiffs commenced an action against the bank asserting a breach of contract claim and seeking return of their membership deposits, which aggregated tens of millions of dollars, arguing that the bank assumed that liability when it took ownership of the Club, which included an assignment of the Membership Agreement.

COURT ANALYSIS

The court found as a matter of law that the Membership Agreement was assigned to the bank. This finding was based on the plain language of the Bill of Sale in which all "contracts . . . and agreements . . . relating to the Club" were assigned to the bank. The court noted that because the Membership Agreement was in existence at the time of the transaction, it was assigned to the bank.

The court next considered whether the bank assumed the obligations under the Membership Agreement, including the membership deposit Refund Obligations contained therein. Under governing Washington law, an assignee is only liable on the obligations underlying the assigned agreement if there is an assumption of those obligations. Assumption can be expressed as a written promise to perform one or all obligations, or it can be by implication where the assignee's conduct reflects an intention to be bound to such liabilities. Citing the bank's express disclaimers in the DIL and Bill of Sale of any responsibility for the debt or other obligations of the borrower, the court found as a matter of law that the bank did not expressly assume the borrower's obligations under the Membership Agreement, including the Refund Obligations.

Despite these disclaimers, however, the court found that the bank's conduct post-execution of the DIL and Bill of Sale was such as to create a triable issue of fact on the issue of implied assumption. Under Washington law, as under the law of most jurisdictions, implied assumption requires consideration of all circumstances, including the subject matter of the contract, the assignee's acts and words, and whether the assignee acquiesced in the terms of the contract, performed its obligations, or accepted its benefits.

The court highlighted certain evidence that precluded summary judgment. First, in the DIL, the bank agreed that it would continue to operate the Club for a period and at a level of service consistent with prior ownership, so long as a threshold number of paying members remained. Second, consistent with the DIL, the bank did operate the Club until it was sold with full amenities to members. In fact, the bank paid pre-DIL vendors in full and retained the pre-existing Club management team. From a member's perspective, nothing had changed. Further, members continued to pay dues and, to the extent those dues were insufficient to cover operating expenses, the bank infused its own money to cover both pre- and post-DIL payables of the Club. Finally, if members did not pay, their membership was suspended.

Considering the totality of the circumstances, the court found that the issue of the bank's implied assumption of the Refund Obligations is a question for the jury, and denied both parties' motions for summary judgment on this issue.

PRACTICAL CONSIDERATIONS

Taking possession of collateral by way of deed in lieu, as opposed to a judicial foreclosure or through an insolvency proceeding, can sometimes best preserve value of an asset by "keeping the lights on." When doing so, however, the lender must be careful not to assume any unintended obligations. As *Cayne* demonstrates, expressly disclaiming such liabilities may not be enough, and the lender should conduct itself in a manner that minimizes the risk that a court will find that those unintended obligations were assumed by implication.

SALE OF SUBSTANTIALLY ALL OF DEBTOR'S ASSETS CANNOT BE APPROVED IN A FINAL CASH COLLATERAL ORDER

Chrystal Puleo
Associate, New York

In re Thornton & Co., Case No. 15-21416 (Bankr. D. Conn., October 2, 2015)

CASE SNAPSHOT

The United States Bankruptcy Court for the District of Connecticut found that the debtor's sale of substantially all of its assets could not be approved in a final cash collateral order, as such a sale is an action outside the ordinary course of business that must be approved through a sale under Bankruptcy Code section 1129.

FACTUAL BACKGROUND

The debtor, Thornton & Co., was in the business of purchasing low-grade plastic resins, which it held in inventory, and selling this inventory to purchasers as their needs arose; and directly shipping low-grade plastic resins to buyers as a broker without ever storing the product.

Since the petition date, the debtor had been collecting outstanding accounts receivables and continuing to sell its inventory as if it were operating as a going concern. The inventory was not being sold below market value. Pursuant to its first and second interim cash collateral motions, the debtor had been applying the proceeds from its collections and sales, less operating and professional expenses, to pay down the pre-petition secured claim of People's United Bank, which held a security interest in the debtor's cash collateral. The bank held a secured claim of approximately $20 million, and had received approximately $3.3 million under the cash collateral orders – more than it would have been entitled to as adequate protection. In the final cash collateral motion, the debtor proposed a budget under which it would continue to collect the outstanding accounts receivables and sells its remaining inventory, while paying its operating expenses and repaying the bank's remaining $16.7 million pre-petition secured claim in full, leaving a balance of $831,000 in cash for unsecured creditors and administrative expenses. The Official Committee of Unsecured Creditors objected to the final cash collateral motion.

COURT ANALYSIS

While the debtor maintained that payment of the bank's remaining pre-petition secured claim was intended to demonstrate the fundamental strength of the debtor's business in order to attract potential lenders to fund a chapter 11 plan, the court found that the debtor's attempt to liquidate substantially all of its assets for the benefit of a single creditor was outside the ordinary course of business, and could not be approved in a cash collateral motion under section 363(c)(2) of the Bankruptcy Code. The court held that "[a] debtor that is liquidating its major assets for the benefit of a single secured creditor is no longer operating in the ordinary course of business." Instead, the court held that the debtor must file a liquidation plan under section 1129 so that all of the creditors would have the benefit of the procedural protections provided in a chapter 11 plan approval process.

PRACTICAL CONSIDERATIONS

Debtors and creditors should be apprised that transactions outside the ordinary course of business cannot be approved in the form of a cash collateral motion. In particular, the liquidation of major assets must be approved in a plan filed under section 1129.

COUNSEL'S CORNER: NEWS FROM REED SMITH

Derek Baker gave a presentation on the "Future Relevance of Chapter 11" to the Pennsylvania Bar Institute, on October 28 in Philadelphia.

Peter Clark and **Matthew Tashman** presented "Issues in Oil & Gas and Coal Workouts and Bankruptcies" for the restructuring and bankruptcy group of a financial institution client, on November 5 in California.

Marsha Houston and **Christopher Riva**s presented "The Theory of Relativity: When Bankruptcy and Copyrights Collide" for the Los Angeles Copyright Society, on October 12 in Los Angeles.

Jennifer Knox recently was honored as a "Lawyer on the Fast Track" by *The Legal Intelligencer.*

Robert Simons contributed to the book, *Inside the Minds: Chapter 7 Commercial Bankruptcy Strategies* (2015-2016 ed.), published by Aspatore Books. His chapter is entitled: "Conversion of a Chapter 11 Case to a Liquidation Under Chapter 7 or Structured Dismissal: The Debate Continues."

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