Legal Notes

by CFA Co-General Counsel

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Amicus Briefs

In July of this year, the Commercial Finance Association filed an *amicus curiae* brief in the United States Court of Appeals for the Sixth Circuit in the case of *In re: Spearing Tool and Manufacturing Co., Inc.* (Case No. 04-1053). In its brief, CFA supported the decision of the United States District Court which held that the Internal Revenue Service, when filing a notice of federal tax lien, should be held to the same standard with regard to the identification of the taxpayer as a secured lender with respect to the identification of the borrower on a U.C.C. financing statement. *In re Spearing Tool & Mfg. Co.*, 302 B.R. 351 (E.D. Mich. 2003).

CFA has also requested, and has been granted, leave by the New York Court of Appeals to file an *amicus* brief in the matter of *JMD Holding Corp. v. Congress Financial Corporation*, 2004 N.Y. LEXIS 1542 (N.Y. June 10, 2004) in support of Congress Financial Corporation's motion for leave to appeal. The case involves the enforceability of an early termination fee in the context of a revolving loan facility.

UNCITRAL Secured Transactions Guide

CFA has been actively involved in assisting the United Nations Commission on International Trade Law ("UNCITRAL") with its preparation of a guide on secured transactions to assist countries in modernizing their secured lending laws. CFA's Co-General Counsel has recently completed a revision to the chapter of the Guide dealing with priority, and last May presented to UNCITRAL a paper addressing the intellectual property issues that should be addressed by a comprehensive secured transactions regime. Copies of both the chapter on priority and paper on intellectual property issues are available on CFA's Web site: www.cfa.com

Till v. SCS Credit Corp., ____ U.S. _____, 124 S. Ct. 1951 (2004) (U.S. Supreme Court adopts "formula rate" for purposes of cram down.)

Any decision by the United States Supreme Court concerning bankruptcy is worthy of attention, and the recent decision of *Till v. SCS Credit Corp.* has been receiving a great deal of it. In *Till*, the issue addressed by the Court was the appropriate method for determining the interest rate to be used for purposes of the cram down power of Bankruptcy Code §1325(a)(5)(B). As discussed below, although *Till* was a Chapter 13 case, the principle it announces is equally applicable to Chapter 11 cases.

(Continued on page 48)

Section 1325(a)(5)(B) permits a debtor, under a plan of reorganization, to continue to own and use property subject to a lien even if the lienholder rejects the plan, so long as the creditor's lien remains in place and the present value of the restructured obligation to the creditor is equal to the replacement value of the collateral. The issue presented in *Till* was the rate of interest that the restructured obligation should bear. (Coincidentally, *Till* is the second U.S. Supreme Court bankruptcy decision involving cram down in a Chapter 13 case where the collateral is a truck; the other is *Associates Commercial Corp. v. Rash*, 520 U.S. 953, 117 S. Ct. 1879 (1997), which held that the appropriate method of valuing the retained collateral is replacement value).

In *Till*, the Court considered four choices:

1. The "formula rate," sometimes referred to as the "prime plus" method, determined by adding a risk factor to the national prime rate in effect at the time of determination;
2. The "coerced loan rate," which is the rate the creditor could obtain if it were permitted to foreclose and reinvest the proceeds in equivalent loans;
3. The "presumptive rate," which is the prepetition contract rate, subject to adjustment up or down based upon the particular facts of the case; and
4. The "cost of funds rate," which is the cost the creditor would incur to obtain the cash equivalent of the collateral (*i.e*, the interest rate the creditor would have to pay on a loan in an amount equal to the value of the collateral).

The Bankruptcy Court had used the formula rate, the prime rate of 8percent plus a 1.5 percent risk factor, for a total of 9.5 percent. The District Court reversed, applying the contract rate of 21percent. On appeal to the U.S. Court of Appeals for the Seventh Circuit (301 F.3d 583), the majority opinion adopted the "presumptive rate" and the dissenting opinion the "cost of funds rate."

In a 5 to 4 decision, the Supreme Court adopted the formula rate. The Court had divided four to four on the formula rate and presumptive rate. The fifth vote for the formula rate was that of Justice Thomas, who agreed with the plurality result but not its reasoning.

The majority opinion, written by Justice Stevens, describes the formula rate as follows:

> Taking its cue from ordinary lending practices, the approach begins by looking to the national prime rate, reported daily in the press, which reflects the financial market's estimate of the amount a commercial bank should charge a creditworthy commercial borrower to compensate for the opportunity costs of the loan, the risk of inflation, and the relatively slight risk of default. Because bankrupt debtors typically pose a greater risk of nonpayment than solvent commercial borrowers, the approach then requires a bankruptcy court to adjust the prime rate accordingly. The appropriate size of that risk adjustment depends, of course, on such factors as the circumstances of the estate, the nature of the security, and the duration and feasibility of the reorganization plan. The court must, therefore, hold a hearing at which the debtor and any creditors may present evidence about the appropriate risk adjustment. Some of this evidence will be included in the debtor's bankruptcy filings, however, so the debtor and creditors may not incur significant additional expense. Moreover, starting from a concededly *low* estimate and adjusting *upward* places the evidentiary burden squarely on the creditors, who are likely to have readier access to any information absent from the debtor's filing (such as evidence about the "liquidity of the collateral market," *post,* at 1973 (SCALIA, J., dissenting)). Finally, many of the factors relevant to the adjustment fall squarely within the bankruptcy court's area of expertise.
>
> Thus, unlike the coerced loan, presumptive contract rate, and cost of funds approaches, the formula approach entails a straightforward, familiar, and objective inquiry, and minimizes the need for potentially costly additional evidentiary proceedings. Moreover, the resulting "prime-plus" rate of interest

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depends only on the state of financial markets, the circumstances of the bankruptcy estate, and the characteristics of the loan, not on the creditor's circumstances or its prior interactions with the debtor. For these reasons, the prime-plus or formula rate best comports with the purposes of the Bankruptcy Code.

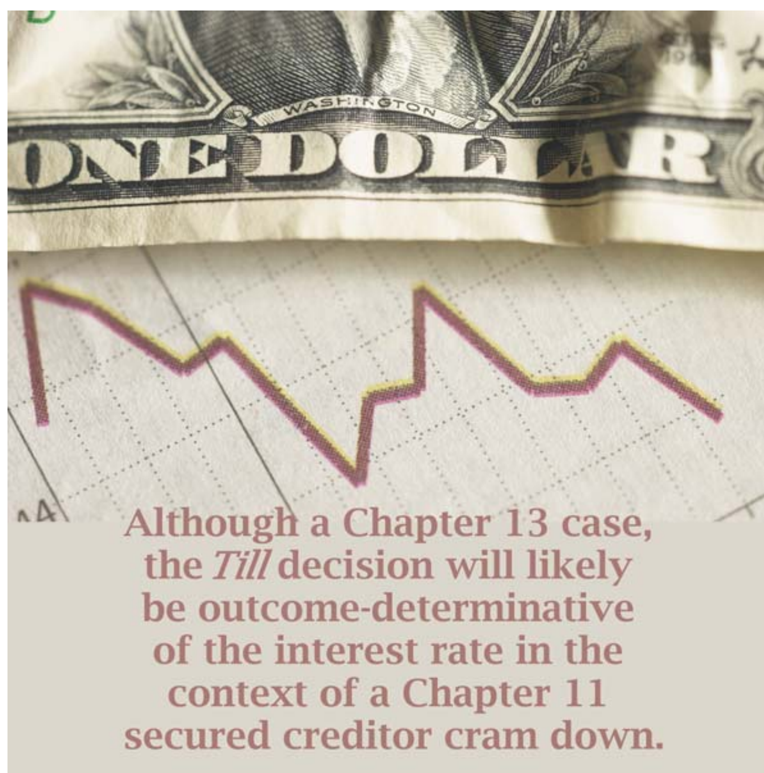
We do not decide the proper scale for the risk adjustment as the issue is not before us. 124 S. Ct. at 1961-62.

As a result of this case, absent an amendment to the Bankruptcy Code or a subsequent case being presented to a differently constituted Supreme Court, the formula rate is the rule of law. Although a Chapter 13 case, the *Till* decision will likely be outcome-determinative of the interest rate in the context of a Chapter 11 secured creditor cram down. The provisions of §1325(a)(5)(B) are, for legal purposes, the same as those contained in §1129(b)(2)(A)(i) of Chapter 11. The Supreme Court has been adamant in applying the same interpretation to the same statutory language.

There clearly are factors that a secured lender must address in arguing for an appropriate rate of interest under the formula rate, such as the cost of an expert witness and other evidentiary costs, and the fact that arguing for a higher risk may, in some circumstances, contradict the feasibility of the plan. Nevertheless, the *Till* decision presents a conceptual framework for secured lenders to seek an interest rate on a crammed down loan obligation that reflects the true risk inherent in the restructured obligation.

In re Lernout & Hauspie Speech Products N.V., 308 B.R. 672 (D. Del. 2004) (Bankruptcy Court was correct in approving a Chapter 11 plan that would leave virtually no assets for creditors in a parallel Belgian insolvency proceeding.)

A recent decision involving international issues is *Lernout & Hauspie Speech Products.* This decision represents the next Chapter in the interesting Lernout & Hauspie saga. We last reported on this case in the March/April 2004 issue of *The Secured Lender*. As you may recall, the case involved the relationship between a United States Chapter 11 case and a Belgian insolvency proceeding. In summary, Stonington Partners, Inc. and its affiliates (collectively, "Stonington") purchased Dictaphone Corporation in 1995 and in mid-2000 sold it to *Lernout & Hauspie* Speech Products, N.V. ("L&H"), a Belgian company, in exchange for L&H stock that turned out to be worthless. Stonington sued L&H and certain of its former officers and directors in Delaware for fraud. Stonington then applied to a Belgian court seeking an order requiring L&H to relinquish its shares of Dictaphone to a court-approved trustee, which the Belgian court granted. In response, L&H filed dual bankruptcy cases: a Chapter 11 case in Delaware and an insolvency proceeding in Belgium. Stonington filed claims against L&H for fraud in both proceedings.



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The twist created by the dual proceedings was the difference in the treatment of fraud claims under United States and Belgian bankruptcy law. Under U.S. law, such claims are subject to subordination (Bankruptcy Code §501(b)), while under Belgian law they are *pari passu* with unsecured claims. Accordingly, the Delaware court found that Stonington's claims were subordinated to the claims of the unsecured creditors in the Chapter 11, while the Belgian court found no basis for such subordination. L&H also sought an order from the Delaware Bankruptcy Court declaring that Stonington's claims must be determined exclusively by United States law. Despite the fact that L&H did not actually request that Stonington be enjoined from pursuing claims in the Belgian court, the Delaware court issued an injunction. The District Court in Delaware affirmed the Bankruptcy Court's decision and Stonington appealed to the Third Circuit.

The Third Circuit stated that, under the standard it had adopted (the "restrictive" standard), a foreign proceeding should only be enjoined in the rare circumstance where an

(Continued on page 52)

injunction is needed to protect jurisdiction or an important public policy. The court found that the Belgian proceeding was not filed to deprive the United States Bankruptcy Court of jurisdiction and expressed doubt that an important United States public policy was at stake. As a result, the Third Circuit remanded the case to the Delaware court, instructing the court to apply the restrictive standard adopted by the Third Circuit when considering whether an injunction is proper. The court concluded its opinion with a strong recommendation that the parties should work together to develop an agreement (known as a "protocol") for the administration of the case, of the kind made famous in the Second Circuit's decision in *Maxwell Communication Corp. v. Societe Generale (In re Maxwell Communication Corp.)*, 93 F.3d 1036 (2d Cir. 1996).

That's where we pick up with the next chapter of our story. On remand, L&H did not defend the appropriateness of the injunction, but rather proposed a plan of reorganization that allocated the assets between the Belgian and United States proceedings. The plan afforded all creditors the opportunity to pursue their claims in the Chapter 11 case as well as in the Belgian proceeding. The Bankruptcy Court approved the plan, concluding that the coordination between the two court systems recommended by the Third Circuit was no longer relevant because an anti-suit injunction was no longer at issue.

Unfortunately for Stonington, the plan allocated very little in the way of assets to the Belgian insolvency estate. Thus, even though Stonington was free to pursue its claim against L&H in Belgium without the claim being subordinated to other unsecured creditors in the Belgian proceeding, that remedy was relatively meaningless to Stonington from an economic perspective.

Stonington appealed to the Delaware District Court, contending that the Bankruptcy Court erred by not concluding that the proposed plan violated Section 1129(a)(3) of the Bankruptcy Code because "it was not proposed in good faith" and "was meant to side-step the choice of law analysis required by the Third Circuit." *Lernout & Hauspie,* 308 B.R. at 674. Stonington pointed to the Bankruptcy Court's admission "that '[t]he efforts [to coordinate proceedings] that were actually conducted, are not the level of diligent effort and coordination that the Circuit was contemplating or urging be undertaken in this case.'" *Id*. (quoting Bankruptcy D.I. 141 at 96). Stonington maintained that the proposed plan did not resolve the conflict between the dual proceedings because it did not actually allocate any assets for Stonington to pursue under Belgian law.

L&H, on the other hand, argued that the plan was proposed in good faith and that, because there were no remaining conflicts of law, a choice of law analysis would be inappropriate. The District Court agreed with L&H and concluded that the Bankruptcy Court did not err in confirming the proposed plan. The District Court noted that the Bankruptcy Court had given serious consideration to the views of the curators (the Belgian insolvency representatives) and determined that the fact that the curators did not openly object to the proposed plan supported the conclusion that "the Plan was proposed in good faith and avoided a 'true conflict' with Belgian law." *Id*. at 676. The District Court maintained that the matter no longer presented a conflict of law because there was no anti-suit injunction imposed on creditors. The court stated that "[t]he Third Circuit's decision…was premised on the existence of an anti-suit injunction. Absent such an injunction, the choice of law and serious comity concerns expressed by the Third Circuit are no longer implicated." *Id*. The court also concluded that the coordination of the two cases, strongly recommended by the Third Circuit, was merely a recommendation and not a mandate and, therefore "the Plan did not violate the good faith requirements of the Bankruptcy Code as a result of the Bankruptcy Court's failure to take the suggested, non-mandatory action." *Id.*

It remains to be seen whether this is the final Chapter in this matter. In any event, this case represents an interesting example of the types of situations that can arise as asset-based lending becomes increasingly globalized.

Biase v. Congress Financial Corp. (In re Tops Appliance City, Inc.), 372 F.3d 510 (3d Cir. 2004) (Borrower's collateral assignment to lender of its right to receive proceeds from the sale of leaseholds constituted the transfer of a contract right under the UCC and not the transfer of an interest in real estate.)

On October 31, 1996, Congress Financial Corporation ("Congress") entered into a loan agreement ("LSA") with Tops Appliance City ("Tops"), a retailer of electronics and home

appliances. The LSA granted Congress a security interest in, among other things, all of Tops' present and future contract rights and general intangibles. Congress perfected its security interest by filing UCC-1 financing statements in New York and New Jersey (where Tops' store locations were located).

When Tops decided to exit its retail electronics business in October 1999, it agreed to sell and assign three of its New Jersey retail store leases (and two related parking lot leases) to Best Buy Stores, L.P. ("Best Buy") for a total price of $10.5 million. The leasehold sale transaction closed on October 29, 1999. Tops, however, continued to occupy the three stores after the closing under separate occupancy "License Agreements" with Best Buy that gave Tops up to three months to liquidate its electronics inventories from the store locations sold to Best Buy. Best Buy made an initial $2.1 million down payment shortly after the closing, but the balance of the proceeds due Tops from the leasehold sale were not required to be paid by Best Buy until Tops actually vacated the premises upon the expiration of its occupancy licenses.

Also on October 29, 1999, Tops and Congress amended the LSA to reflect, among other things, Congress' consent to the leasehold sales, provided the proceeds realized by Tops from the sales were paid to Congress in reduction of Tops' borrowings (subject to reduced re-lending). Congress' consent was required since the leasehold sales were prompted by Tops' decision to exit its retail electronics business, which constituted a material change of its business plan. Also on October 29, Tops executed in favor of Congress a "Collateral Assignment of Acquisition Agreements," which recited that Tops *had* sold "all of its right, title and interest in, to and under" the New Jersey leaseholds to Best Buy, and granted Congress a security interest in all of Tops' rights under the various leasehold sale agreements with Best Buy, including all payments due Tops under those agreements. Pursuant to the Collateral Assignment, Best Buy's $2.1 million down payment was paid to Congress on November 3, 1999, and the $8.4 million balance due from the leasehold sale transaction was paid to Congress on December 7, 1999.

Tops filed for bankruptcy under Chapter 11 on February 2, 2000, its bankruptcy case being converted to Chapter 7 on April 16, 2000. On June 26, 2000, the Chapter 7 Trustee filed an adversary complaint to avoid, as preferential transfers, the $10.5 million that Congress received under the Collateral Assignment in respect of Tops' leasehold sales to Best Buy. On May 1, 2002, the Bankruptcy Court granted Congress summary judgment dismissing the Trustee's complaint, and holding that (i) the $10.5 million received by Congress had been paid pursuant to a perfected assignment of proceeds and (ii) Tops had transferred to Congress the right to receive all proceeds from the leasehold sale transaction on October 29, 1999, *i.e.*, more than 90 days prior to Tops' bankruptcy filing. The Trustee appealed to the District Court for the District of New Jersey, which affirmed the Bankruptcy Court's decision. The Trustee then pursued a further appeal to the Third Circuit.

In support of its appeal, the Trustee argued, among other things, that Congress' Collateral Assignment was never perfected because the interest transferred was, in reality, an interest in the underlying leases, and therefore a real property interest that required recording in accordance with the New Jersey recording statute in order to be perfected. The Third Circuit rejected this argument, finding that the record demonstrated that

> the leases were completely transferred by Tops to Best Buy as of the date of the closing on October 29, 1999, and … Congress was granted an interest only in the proceeds from that transfer.
>
> Congress never had any property right in the leases themselves because, as of October 29, 1999, they were wholly owned by Best Buy. The [sale agreement] between Tops and Best Buy clearly stated that Tops was to convey 'all of Seller's right, title and interest in…the Leases' … Tops did not hold any remaining

(Continued on page 54)

> property interest in the leases, and thus could not have granted Congress what it did not have itself.
> *Id.* at 513-14.

The Third Circuit further found that Tops' "absolute assignment" of its property rights to Best Buy was not "incomplete" just because the final payment to Tops was not made until Tops vacated the premises that it continued to occupy under the separate license agreements. At the October 29 closing, Tops had turned over all keys, blue prints and financial documents to Best Buy, and the license agreements themselves recited that they were "revocable" and "shall not be deemed as…conveying any interest in the Licensed Area (other than as set forth herein)." *Id*. at 514 (quoting sales agreement at §12(1)). Because Tops retained no property interest in the underlying leaseholds, it could grant Congress only what remained: a simple contract right to the proceeds from the leasehold sales, which right the Third Circuit concluded was subject to Article 9 of the Uniform Commercial Code. As such, the Court held that Congress' security interest in the assigned proceeds was properly perfected by the prior filing of Congress' UCC-1 financing statement.

The Third Circuit also rejected the Trustee's second argument that the transfer of money from Tops to Congress did not occur on October 29, 1999, the date of the Collateral Assignment, but actually occurred on December 7, 1999, the date on which Tops vacated all three stores and Best Buy made final payment for its purchase of the leaseholds. The Court found that Best Buy's remedy, if Tops had breached the license agreements and failed to vacate the stores by December 31, would have been eviction and a suit for damages. Tops, however, fully "earned" the sale price under the leasehold sales agreements by conveying all of its right, title and interest in the leaseholds to Best Buy on October 29, regardless of the fact that it had a continuing future duty to vacate.

The decision in Tops is particularly significant to secured lenders in that it confirms that a secured lender can separately perfect a security interest in the proceeds to be realized from the sale of real property without first obtaining a lien against the underlying real property itself. Although Congress did not hold a perfected lien on Tops' New Jersey leaseholds, Congress was nonetheless able to obtain an enforceable security interest in the proceeds generated from the disposition of those leaseholds, which security interest was deemed to be perfected by Congress' prior UCC filing with respect to general intangibles and contract rights. Moreover, because Congress obtained its security interest in the proceeds to be realized by Tops from the disposition of its New Jersey leaseholds more than 90 days prior to Tops' bankruptcy filing, the amounts recovered by Congress in respect of the leasehold disposition were not subject to avoidance by the bankruptcy trustee when Tops ultimately filed for bankruptcy.

Heller Financial, Inc. v. Prudential Ins. Co. of America, 371 F.3d 944 (7th Cir. 2004) (Where loan documents contained conflicting provisions regarding the application of proceeds of a bankruptcy sale, the proceeds were to be shared among the revolving lenders and the term loan lenders in proportion to their shares in the loans as a whole.)

A recent decision by the United States Court of Appeals for the Seventh Circuit illustrates the importance of having explicit language in loan documents regarding how the proceeds of a borrower's assets arising from a bankruptcy sale are to be distributed among different classes of secured lenders.

Heller Financial, Inc. ("Heller") entered into a Credit Agreement and certain other loan documents with American Paper Group ("APG"), pursuant to which Heller agreed to make up to $43 million of revolving and term loans to APG. Heller sold a share of the revolving loans to Key Corporate Capital, Inc. ("Key") and sold shares of the term loans to Key and to Prudential Insurance Company of America ("Prudential"). As a result, Heller and Key had shares in both the revolving and the term loans, but Prudential had a share of only the term loans. Heller acted as agent for all of the lenders under the credit facility.

APG "went broke" (the court's expression) and its assets were sold in a bankruptcy sale for $13 million, which was less than the total outstanding amount of the loans. Heller filed an interpleader action with a U.S. District Court in Illinois seeking a judicial allocation of the sale proceeds among the three lenders. The District Court ruled that Heller and Key were entitled to repayment of the entire revolving loan first, with the remaining proceeds, if any, to be applied to the term loans, divided among the three term loan lenders in accordance with their pro rata shares of the term loans. Prudential appealed the decision to the United States Court of Appeals for the Seventh Circuit, arguing that the entire $13 million of proceeds should be distributed among the lenders in proportion to their shares in all of the loans, taken as a whole.

The District Court based its ruling on Section 1.5(C) of the Credit Agreement, which provides that the net proceeds of any sale of assets of APG in excess of $250,000 (other than sales in the ordinary course of business) are to be used to prepay the revolving loans by the amount of the reduction in the borrowing base attributable to such sale, subject to certain limited rights of APG to reinvest such proceeds in similar assets. Section 1.5(C) further states that any net proceeds that are neither used to pay down the revolving loans nor reinvested shall be used to prepay the term loans. The District Court ruled

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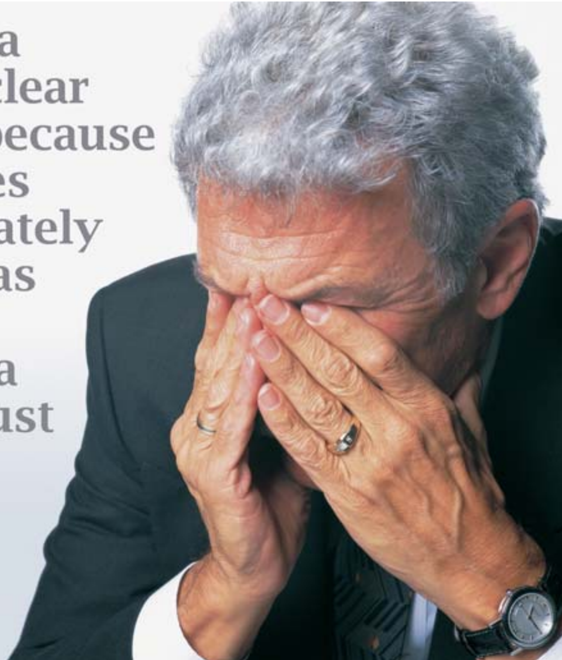

that the proceeds from APG's bankruptcy sale constituted net proceeds from an asset sale pursuant to Section 1.5(C), and that, since the borrowing base had been reduced to zero, the revolving loans were to be paid down in full before any of such proceeds were applied to the term loans.

Prudential appealed the District Court's decision to the Seventh Circuit, arguing that Section 1.5(C) of the Credit Agreement should not apply in the context of a bankruptcy sale. Rather, Prudential argued that the application of the proceeds of sale should be governed by Section 12 of the Security Agreement, which provides that, in the event of a default by APG under the Loan Documents, the proceeds of any sale of collateral securing the loans shall be applied to "the principal amounts of the Secured Obligations outstanding," without making any distinction between the revolving loans and the term loans.

The Seventh Circuit agreed, in a colorful opinion written by Judge Posner. The court noted that, while Section 1.5(C) of the Credit Agreement and Section 12 of the Security Agreement each appeared to be clear on its face, the two provisions were unclear when taken together. As Posner describes it:

> Both Heller and Prudential … argue absurdly that the two contracts constituting the overall loan agreement are perfectly clear on their face, and consistent with this position neither party attempted to present any evidence that might be used to disambiguate a contract that is not clear on its face, evidence for example of how similar conflicts between revolving and term lenders are typically resolved. It is true that section 1.5(C) of the credit agreement and section 13 of the security agreement taken separately are clear within their respective domains. But the domains overlap. Section 1.5(C) is about the revolving loan and section 13 is about insolvency, and it is unclear which governs the repayment of the revolving loan in the event of insolvency.
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> To say that a contract is clear on its face because all its clauses taken separately are clear is as sensible as saying that a sentence must be clear if each of the words in it is clear.
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> *Id.* at 946.

The court went on to note that its "best guess" as to the meaning of the two loan documents, when read together, was that Section 1.5(C) of the Credit Agreement did not apply in the context of a bankruptcy. The court reasoned that Section 1.5(C) (which deals with borrowing-base adjustments) only makes sense when dealing with a solvent company engaged in business. Once APG's loans had been called due to a default under the loan documents, APG had no further need for borrowing base availability, and there was no danger of APG continuing to draw on the revolving loans without furnishing adequate collateral to secure the revolving loans (since APG no longer had the right to borrow loans of any kind). In that situation, there is no reason to give preference to one type of loan over the other. The court stated that the parties could have drafted a provision in the loan documents subordinating the term loans to the revolving loans if that was the result they had intended, but since they did not, Section 13 of the Security Agreement was the appropriate provision to apply in the context of a bankruptcy sale.

The court concluded that the $13 million in proceeds should be shared among all three lenders in accordance with their shares in the total loans taken as a whole. Although the decision is probably the right one in light of the arguments that the parties appeared to make, a better way of reconciling both provisions of the loan documents might have been to apply the sale proceeds first to the revolver to the extent that they could be shown to represent proceeds of assets included in the borrowing base, and then to all of the loans as a whole. However, the real lesson to be learned from this case is that, where a credit facility provides for revolving loans and one or more tranches of term loans, and the lenders participate in the loans in different combinations or percentages, great care must be taken in the loan documents to specify precisely how proceeds of collateral

(Continued on page 58)

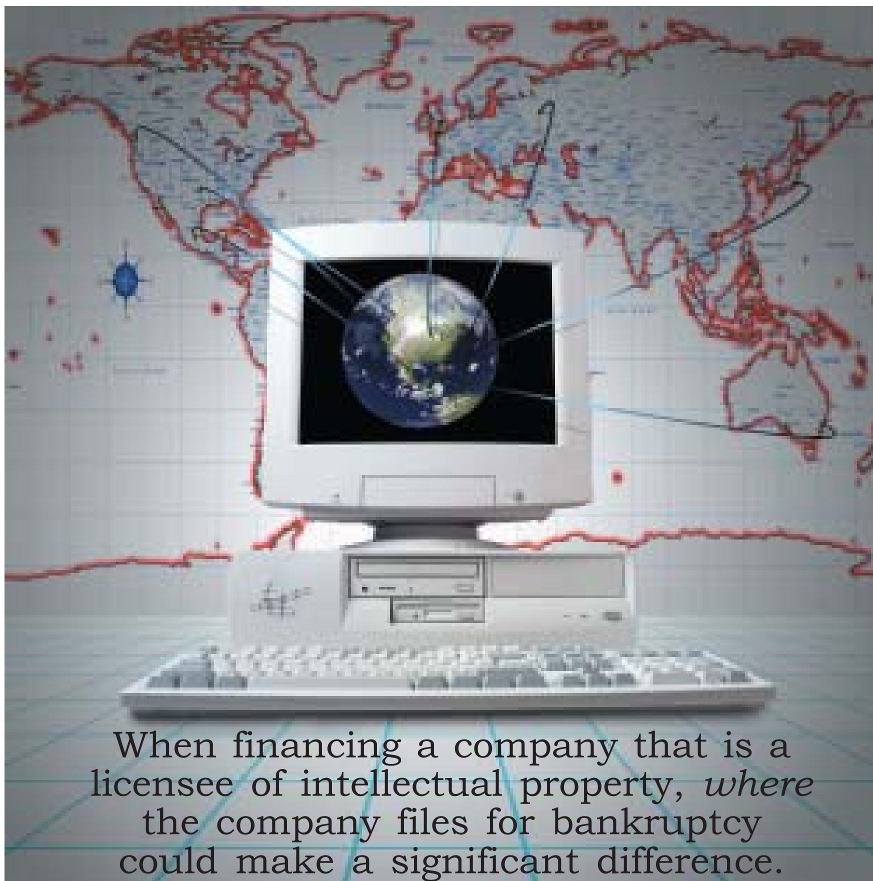
are to be allocated among the lenders, both before and after the occurrence of a default.

RCI Tech. Corp. v. Sunterra Corp., 361 F.3d 257 (4th Cir. Md. 2004) (Bankruptcy Code §365 prevents not only the assignment by a Chapter 11 debtor of a non-exclusive intellectual property license, but also the assumption of such license by the debtor unless the licensor consents or other non-bankruptcy law allows it.)

When financing a company that is a licensee of intellectual property, *where* the company files for bankruptcy could make a significant difference. At least four circuits – the Third, Ninth and Eleventh, and now the Fourth Circuit as a result of *Sunterra* – have adopted an interpretation of Section 365(c) of the Bankruptcy Code that has the effect of preventing a debtor that is a licensee of intellectual property from being able to assume the license to which it is a party, unless the license otherwise provides or the licensor consents. On the other hand, the First Circuit and the majority of bankruptcy courts have reached a more reasonable conclusion that allows a licensee that commences a bankruptcy proceeding to assume the license and therefore continue to use the licensed intellectual property.

RCI was a software development company that developed software for the resort and hospitality industry. These software products were used by such companies in the industry as Sunterra in managing their resorts. When Sunterra launched a program to allow timeshare owners at Sunterra resorts to trade their timeshare rights among each other, it needed new software to manage the program. Essentially, Sunterra took an RCI software program that it licensed from RCI and modified it to manage the new timeshare program.

When Sunterra filed for Chapter 11, RCI, as the copyright licensor to Sunterra, moved for the license to be rejected because RCI refused to consent to Sunterra's assumption of the license. Typically, in a Chapter 11 the debtor has the right to assume or reject an executory contract, often a lease or a license, under Section 365 of the Bankruptcy Code. If the debtor wants to assume the executory contract, it must cure any existing defaults under the contract and provide adequate assurance of its ability to perform under the contract going forward. If such matters are adequately addressed, the bankruptcy court will approve the assumption of the contract by the debtor.



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In addition, the Bankruptcy Code allows a Chapter 11 debtor, once it has assumed an executory contract, to assign the contract. Often as a practical matter, a Chapter 11 debtor will assume *and* assign a contract at the same time as part of a single transaction to sell all or part of its business, including assumed executory contracts. The proceeds of the sale are then used to repay its creditors, including the secured lender. Section 365(f)(1) of the Bankruptcy Code facilitates this process by expressly providing that the debtor may assign the contract, notwithstanding a provision in the contract that prohibits, restricts or conditions the assignment of it.

So, why was RCI arguing that Sunterra could not even assume the license, even apart from any discussion about the possibility of assigning it? There was no discussion in *Sunterra* of Sunterra assuming and assigning the license. It merely wanted to continue business as usual, using the software that it had licensed and then enhanced to serve its particular needs by assuming the license agreement.

The problem lies in an interpretation of Section 365(c) of the Bankruptcy Code. Section 365(c) provides that a debtor-in-possession or a trustee in bankruptcy may not "assume or assign any executory contract" if "applicable law excuses a party other than the debtor to such contract from accepting performance

from or rendering performance to any entity other than the debtor...”

The first issue then becomes whether the license agreement is an executory contract. In *Sunterra*, the Fourth Circuit found that the license agreement was an executory contract, as is usually the case in these situations. As the Fourth Circuit noted in *Sunterra*, an executory contract, as such term is used in the Bankruptcy Code, is generally understood to mean a contract where the obligations of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete the performance would constitute a material breach excusing the performance of the other. In other words, if each party owes at least one continuing material duty to the other, it is an executory contract. The Court in *Sunterra* found that the license agreement was an executory contract because each party possessed an ongoing obligation to maintain the confidentiality of the source code of the software developed by the other.

The next question is whether “applicable law,” understood to mean applicable non-bankruptcy law, excuses the non-bankrupt entity (in this case RCI as the licensor) from accepting performance from a party other than the debtor. In *Sunterra*, the applicable law was copyright law since the software subject to the license was a copyright. Under copyright law, a licensor under a nonexclusive license is not required to accept performance from another party without its consent.

So, the question then becomes, is Section 365(c) intended to mean that a Chapter 11 debtor cannot merely *assume* an executory contract if applicable non-bankruptcy law would not require the other party to accept performance from someone else, or is it intended to mean that a Chapter 11 debtor cannot both assume and assign an executory contract under such circumstances?

Sunterra argued, and courts such as the First Circuit have found, that Section 365(c) means that the Chapter 11 debtor can assume the executory contract and effectively maintain the status quo, but cannot assume and then assign the contract. The Fourth Circuit, however, adopted a more literal reading of Section 365(c), focusing on the fact that the statute says that the debtor-in-possession cannot “assume or assign” the executory contract, depending on the rules of applicable non-bankruptcy law. The Fourth Circuit’s ruling was based on the conclusion that, as the statute is drafted in the conjunctive, the mandates of the “plain meaning rule” of statutory construction dictates that Section 365(c) must be interpreted to prohibit the assumption of the license without the consent of RCI.

Sunterra argued against the application of the plain meaning rule, relying on two narrow exceptions. The first exception, premised on absurdity, exists “when literal application of the statutory language at issue results in an outcome that can be truly characterized as absurd.” 361 F.3d at 265. The second exception is premised on legislative intent, and exists only “when literal application of the statutory language at issue produces an outcome that is demonstrably at odds with clearly expressed congressional intent.” *Id.*

Sunterra argued that adherence to the plain meaning rule produced an absurd result because it rendered “inoperative or superfluous” Section 365(f)(1), which allows a Chapter 11 debtor to assign an executory contract notwithstanding a provision in the contract, or in applicable law, that prohibits, restricts, or conditions the assignment. The apparent inconsistency arises from the use by both provisions of the term “applicable law”. The Court recognized that Section 365(c)(1) bars assumption (absent consent) when “applicable law” would bar an assignment, and Section 365(f)(1) provides that executory contracts may be assigned notwithstanding a contrary provision in applicable law. The Court held that the conflict between these subsections is “illusory” because “each subsection recognizes an applicable law of markedly different scope.” *Id.* at 266. Under Subsection (c)(1), “applicable law” embraces “legal excuses for refusing to render or accept performance, regardless of the contract’s status as assignable”. *Id.* Under Subsection (f)(1), “applicable law” is the law prohibiting or restricting assignments.

Sunterra also argued that adherence to the plain meaning rule produced an absurd result because it rendered “inoperative or superfluous” the phrase “or the debtor in possession” found in Section 365(c). The Court found this not to be the case because, pursuant to Section 365(c), the debtor-in-possession must first obtain the nondebtor’s consent to the assumption of the contract, and must thereafter obtain the nondebtor’s consent to the assignment of the contract. Therefore, the Court held that “where a nondebtor consents to the assumption of an executory contract, Section 365(c)(1) will have to be applied a second time if the debtor-in-possession wishes to assign the contract in question.” *Id.* at 267.

Sunterra argued that reading Section 365(c) literally is absurd because it conflicts with the general bankruptcy policy of fostering a successful reorganization and maximizing the value of the debtors’ assets. The Court disagreed, indicating that Congress did not sacrifice every right of a nondebtor party to the reorganization process, and that courts should not assume that “sections of the Bankruptcy Code unfavorable to the debtor were enacted in error.” *Id.* at 268.

HSBC Bank USA v. Branch (In re Bank of New Engl. Corp.), 364 F.3d 355 (1st Cir. 2004) (First Circuit rejects the “Rule of Explicitness” in determining whether to award post-petition interest pursuant to a subordination agreement.)

(Continued on page 60)

In this matter, The Bank of New England ("Bank"), well prior to the filing of a bankruptcy petition, issued various tranches of senior debt as well as various tranches of junior debt. All of these debt instruments provided that New York law governed the construction and interpretation of each of the debt instruments. The junior debt instruments contained the following subordination provision:

> Each Holder likewise covenants and agrees by his acceptance thereof, that the obligations of the Company to make any payment on account of the principal of and interest on each and all of the Notes shall be subordinate and junior, to the extent and in the manner hereinafter set forth, in right of payment to the Company's obligations to the holders of Senior indebtedness of the Company.
> 364 F.3d at 360.

In addition, each of these instruments also specified that:

> The Company agrees that upon ... any payment or distribution of assets of the Company of any kind or character, whether in cash, property or securities, to creditors upon any dissolution or winding up or total or partial liquidation or reorganization of the Company, whether voluntary or involuntary or in bankruptcy, insolvency, receivership, conservatorship or other proceedings, all principal (and premium, if any), sinking fund payments and interests due or to become due upon all Senior Indebtedness of the Company shall first be paid in full, or payment thereof provided for in money or money's worth in accordance with its terms, before any payment is made on account of the principal of or interest on the indebtedness evidenced by the [Junior] Notes due and owing at the time... *Id.*

On January 7, 1991, Bank filed a voluntary bankruptcy petition. At the time of the filing, certain of its senior and junior debt was still outstanding. The bankruptcy estate contained sufficient assets to pay all principal and pre-petition interest on the senior debt, together with all approved fees and expenses incurred through the date of filing of the bankruptcy petition. The bankruptcy trustee thereafter sought permission to pay $11 million to the holders of the junior debt. However, the holders of senior debt objected to this distribution because the trustee had not yet paid *post-petition* interest on the senior debt, notwithstanding the fact that the subordination agreement between the senior and junior debtholders did not specifically refer to the payment of post-petition interest.

In spite of this objection, the Bankruptcy Court authorized the trustee's proposed distribution to the junior debt, holding that the language of the subordination agreement failed to meet the requirements of the "Rule of Explicitness." The Rule of Explicitness is an equitable doctrine that was fashioned by bankruptcy courts prior to the enactment of the current Bankruptcy Code, inasmuch as the prior Bankruptcy Act gave no statutory guidance on the issue of the payment of post-petition interest to senior debt under a subordination agreement. The Rule of Explicitness requires that "only unequivocal language could overcome the generic bar on recovery of post-petition interest" where a subordination agreement does not specifically refer to post-petition interest. *See id.* at 362. The United States District Court for the District of Massachusetts affirmed the Bankruptcy Court's decision.

On appeal, the United States Court of Appeals for the First Circuit held that, because the Rule of Explicitness was adopted before the enactment of Section 510(a) of the Bankruptcy Code — which provides, in part, that a subordination agreement is enforceable in bankruptcy to the same extent as under "applicable non-bankruptcy law" — there is no longer any basis or need for the preservation of the Rule of Explicitness because there is now statutory authority governing the payment of post-petition interest under a subordination agreement.

The Court held that the phrase "applicable non-bankruptcy law" refers to state contract law because (i) the construction of private contracts is usually a matter of state law, (ii) there is no federal statute that governs the interpretation of subordination agreements, (iii) federal common law of contract enforcement is only justified when required by a distinct national policy or interest, (iv) by requiring that the enforceability of subordination agreements be subject to "applicable nonbankruptcy law," Congress determined that such agreements should be interpreted using non-uniform principles (*i.e.*, state law) and (v) the Supreme Court in *Butner v. United States*, 440 U.S. 48 (1979), held

(Continued on page 77)

Legal notes

(Continued from page 60)

that, in the absence of specific statutory provisions to the contrary, property interests should not be analyzed differently as a result of a party's involvement in a bankruptcy proceeding. In addition, the Court held that "Congress has conferred on the federal courts the power to apply any and all generally applicable state rules of contract interpretation in construing subordination agreements." *Id.* at 364.

The Court then sought to apply New York State law (the law chosen by the parties to govern the interpretation of the subordination agreements) to determine the priority of the payment of post-petition interest. In so doing, the Court held that the subordination agreements contained ambiguous language with respect to the payment of post-petition interest, and that New York's general principles of contract law do not specifically speak to the payment of post-petition interest under subordination agreements. Therefore, the Court vacated the decision and remanded the case for a determination of the parties' intent with respect to the payment of post-petition interest in the context of New York State general contract law.

In so holding, the First Circuit created a split with the Eleventh Circuit, which recognized the Rule of Explicitness in *Chemical Bank v. First Trust of N.Y., N.A (In re Southeast Banking Corp.)*, 156 F.3d 1114 (11th Cir. 1998). Rather than determining the applicability of Section 510(a) or examining the law of the State of New York with regard to the issue of post-petition interest when faced with facts similar to those of the instant case, the Eleventh Circuit instead invited the New York Court of Appeals to give their view by certifying to that court the question "[w]hat, if any, language does New York law require in a subordination agreement to alert a junior creditor to its assumption of the risk and burden of the senior creditor's post-petition interest?". *Id.* at 365. In response, the New York Court of Appeals adopted the Rule of Explicitness and held that the senior debt was not entitled to the payment of post-petition interest because the subordination agreement did not explicitly indicate that the junior debt agreed to the priority in payment of post-petition interest to the senior debt.

In *Branch,* the First Circuit specifically found that such a question was beyond the state court's competence to answer as it required the New York State Court of Appeals to determine matters of post-petition interest, which are strictly bankruptcy issues. The First Circuit is of the belief that the Eleventh Circuit was also incorrect in referring the question of post-petition interest to the New York Court of Appeals as a federal court should not defer to a state court's interpretation of federal bankruptcy law. A federal court has exclusive jurisdiction over the interpretation of the Bankruptcy Code. While the First Circuit has created a split that only the Supreme Court can resolve, the reasoning of the First Circuit seems persuasive. ▲