Summary of Significant Judicial Developments Affecting Secured Financing 2002-2003

Part Two

by CFA Co-General Counsel

Jonathan N. Helfat, partner, Otterbourg Steindler Houston & Rosen, PC

and

Richard M. Kohn, partner, Goldberg Kohn Bell Black Rosenbloom & Moritz, Ltd.

Lender Liability

Cardinal Fastener & Specialty Co. v. Progress Bank, 67 Fed.Appx. 343 (6th Cir. 2003) (Secured creditor who took over management of borrower to liquidate its collateral not liable to borrowers' creditors under theory of successor liability.)

Allied Nut & Bolt Co. ("Allied") borrowed $2 million from Progress Bank, secured by a first priority lien on substantially all of Allied's assets. Allied was also a longtime customer of Cardinal Fastener & Specialty Co. Inc. ("Cardinal"), and had frequently been slow in settling its accounts with Cardinal. In late 1999, Allied experienced serious financial difficulties and was unable to pay $87,000 due and owing by Allied to Cardinal. Later that year, Allied entered into an agreement to surrender its assets to Progress Bank for liquidation. Although Allied continued to do business with Cardinal and other customers over the next two months, Progress Bank took over management of Allied's financial affairs in order to protect its security interests in Allied's assets. In accordance with the terms of the agreement between Allied and Progress Bank, the business was liquidated and subsequently sold to House of Threads.

Cardinal subsequently filed suit in state court in Ohio against Progress Bank, Allied, Allied's principals and House of Threads to recover its unpaid debt in the amount of $87,403.88. The complaint alleged theories of corporate successor

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liability, lender control liability, fraud, and conspiracy to commit fraud. Allied failed to answer the complaint resulting in a default judgment against Allied. Then Cardinal voluntarily dismissed Allied's principals and House of Threads, leaving only Progress Bank as an active defendant. Progress Bank successfully removed the case to the U.S. District Court for the Northern District of Ohio, where a bench trial ensued. The district court held that Progress Bank was not liable to Cardinal and dismissed all claims against Progress Bank.

Cardinal appealed to the U.S. Court of Appeals for the Sixth Circuit arguing that the district court failed to follow applicable state law with respect to Cardinal's claim against Progress Bank that the bank should be liable to Cardinal on a theory of successor liability. Citing *Dawejko v. Jorgenson Steel Co.*, 290 Pa. Super. 15, 434 A.2d 106 (Pa. Super. 1981), Cardinal argued that Progress Bank should be found liable for Allied's debt to Cardinal if any of the following situations were present:

> (1) the purchaser expressly or impliedly agrees to assume such obligation; (2) the transaction amounts to a consolidation or merger; (3) the purchasing corporation is merely a continuation of the selling corporation;... (4) the transaction is fraudulently entered into to escape liability[;]... [(5)] ...the transfer was without adequate consideration and provisions were not made for creditors of the transferor. *Id.* at 107.

The Sixth Circuit rejected Cardinal's argument "for the simple reason" that, unlike in *Dawejko,* Progress Bank did not "acquire" all or substantially all of the assets of Allied for the purpose of competing in Allied's industrial sphere. Furthermore, the Sixth Circuit noted that Progress Bank was not in the business of manufacturing or providing screws, nuts, and bolts, but was instead a lending organization to which Allied was indebted and to which Allied failed to make required loan repayments. The Sixth Circuit also pointed out that Progress Bank merely oversaw the liquidation of Allied to protect its investment and minimize further depletion of that corporation's assets.

Based on the foregoing, the Sixth Circuit held that Progress Bank did not either expressly or impliedly assume Allied's obligation to Cardinal, and clearly did not merge its banking business with Allied's manufacturing activities or alter its own functions to "continue" as a participant in the nut and bolt industry. Therefore, any transaction or transfer that took place was not an effort to escape liability or defraud other creditors, but rather merely an attempt to protect the bank's own secured interest.

Cardinal also contended that the district court abused its discretion in refusing to admit into evidence the videotaped deposition of Allied's former president in lieu of live testimony pursuant to Rule 32(a) of the Federal Rules of Civil Procedure ("FRCP"), which provides that such deposition may only be used "against any party *who was present or represented at the taking of the deposition or who had reasonable notice thereof*...." (Emphasis added.) The Sixth Circuit concluded that the district court properly refused to admit such deposition because Cardinal failed to meet the criteria set forth in FRCP Rule 32.

Dresses For Less, Inc., et al. v. CIT Group/ Commercial Services, Inc., 2002 WL 31164482 (S.D.N.Y. Sept. 30, 2002) (Motion to dismiss granted with respect to price fixing and contract claims asserted by garment manufacturers against factor.)

Between 1996 and 2000, The CIT Group/ Commercial Services, Inc ("CIT") factored the accounts receivable of a related group of garment manufacturing and "piece goods" vendors known as the DFL Apparel Group (collectively, the "DFL Entities") pursuant to traditional factoring agreements. Between September 30, 2000 and January 31, 2001, the DFL Entities went out of business, leaving significant unpaid debts. Subsequently, the DFL Entities and their principals commenced an action against CIT and several other factors alleging, among other things, various federal and state antitrust violations, illegal boycotting, price fixing and contract claims.

Many of these claims were based on alleged meetings of a group of factors known as Uptown Credit Group, Inc. (the "Uptown Group"). According to the plaintiffs, the Uptown Group conducted meetings to discuss highly confidential information about their factored clients, including the financial condition of their clients and whether credit was previously extended or denied to a particular client. The plaintiffs also alleged that the Uptown Group was engaged in a clandestine price fixing scheme and collectively decided to grant or withhold credit from certain DFL Entities for reasons unrelated to creditworthiness, as a result of which the DFL Entities failed.

The court dismissed the illegal price fixing claims. In so doing, the court agreed with CIT that there were no allegations or facts to support the claim that the Uptown Group ever discussed, much less agreed upon, any prices or terms for their factoring services.

The DFL Entities also alleged that CIT increased its market share of domestic piece goods factoring volume to 90% (through the acquisition of several competitors), and that CIT engaged in anti-competitive behavior. The DFL Entities claimed that CIT used its alleged "control" of the piece goods market to influence other factors to deny "credit checks," and therefore financing, to the DFL entities and other garment manufacturers, and that through its alleged control of piece goods factoring, CIT discouraged other factors from soliciting garment clients. According to

The plaintiffs...alleged that the Uptown Group was engaged in a clandestine price fixing scheme and collectively decided to grant or withhold credit from certain DFL Entities for reasons unrelated to creditworthiness, as a result of which the DFL Entities failed.

the DFL entities, the primary motive for CIT's anti-competitive behavior was to "weed out" creditworthy, albeit financially weaker, companies at the "slightest inkling" of their insolvency to ensure a full recovery from guarantors of the DFL Entities.

The DFL Entities also made various other claims against CIT, including claims that CIT violated New York State laws requiring good faith and fair dealing. According to the DFL Entities, CIT convinced certain principals of the DFL Entities to continue to operate the companies (and incur additional debt) with the promise of continued financing. Nevertheless, it is alleged that after receiving interest payments through 2000, CIT stopped extending credit to the DFL Entities, thus causing the companies to fail after having increased the liabilities of the guarantors. The DFL Entities also claimed that CIT acted in bad faith by deliberately inflating the debts of certain DFL Entities by allegedly authorizing piece goods vendors to ship unordered merchandise to those entities, and by refusing to credit check one DFL Entity because another may have been in arrears.

The court dismissed all of the good faith claims involving CIT's extension or refusal of credit to the DFL Entities. Among other things, the court cited certain provisions in CIT's factoring agreements with piece goods vendors, which permit CIT to refuse credit checks for any reason, or for no reason at all. The court found only that the DFL Entities had sufficiently alleged breach of good faith and fair dealing with respect to the unauthorized shipment of goods claims.

The litigation is proceeding as to the other claims that were not dismissed by the court. Notwithstanding that litigation as to such other claims may continue, in ruling on this motion to dismiss, the court has not made any determination regarding the truth of any of the allegations made by the DFL Entities. Needless to say, the court's decision to allow some of the claims to proceed has no bearing on whether the DFL Entities will ultimately prevail on the merits of any of their claims.

Official Comm. of Unsecured Creditors of Sunbeam Corp. v. Morgan Stanley & Co., et al. **(In re Sunbeam Corp.)**, 284 B.R. 355 (Bankr. S.D.N.Y. 2002) (Bankruptcy court dismisses equitable subordination, fraudulent conveyance, gross negligence, and breach of fiduciary duty claims asserted by unsecured creditors committee against lenders and financial advisors.)

Sunbeam Corp. acquired The Coleman Company, Inc., First Alert, Inc. and Signature Brands USA, Inc. before filing under Chapter 11 in the Bankruptcy Court for the Southern District of New York. Sunbeam obtained financing for the purchase of these three businesses from a note offering and from $1.6 billion in secured loans provided by Morgan Stanley Senior Funding, Inc. ("MSSF"), First Union National Bank ("First Union") and Bank of America National Trust & Savings Association ("Bank of America"). Morgan Stanley & Co., Inc. ("Morgan Stanley") acted as the underwriter for the note offering.

In Sunbeam's Chapter 11 case, the Official Committee of Unsecured Creditors (the "Committee") brought several actions, in which the Committee:

(a) asserted that the secured claims of MSSF, First Union and Bank of America in the bankruptcy should be equitably subordinated;

(b) claimed that the debt and liens of the lenders should be avoided as fraudulent transfers; and

(c) sought to recover damages from Morgan Stanley for its purported negligence and gross negligence in issuing a fairness opinion in connection with the acquisitions and recommending that Sunbeam proceed with the acquisitions, and for aiding and abetting both the fraud and the breaches of fiduciary duty purportedly committed by Sunbeam's senior management.

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The Bankruptcy Court dismissed each of the causes of action, but the basis for the Committee's arguments with respect to each of these claims, and the Bankruptcy Court's response, are very helpful to secured lenders.

First, with respect to the claims for equitable subordination brought against the secured lenders, the Committee was very creative. The concept of "equitable subordination," as described in the decision, is to permit the court to subordinate an otherwise legally valid claim when the claimant has engaged in conduct that makes it unjust or unfair for the claimant to share pro rata with similarly situated creditors. The type of conduct that warrants equitable subordination includes, among other things, fraud, illegality or breach of fiduciary duty or control or use of the debtor as an alter ego for the benefit of the claimant. As the Court noted, when the claimant is a non-insider or non-fiduciary, courts have required that the claimant's conduct be "egregious and severely unfair" to other creditors before its claim will be equitably subordinated, and have also insisted upon a higher level of proof.

According to the Committee, Morgan Stanley committed gross negligence by failing to uncover the fraudulent activity of the senior management of Sunbeam and "recklessly" advising Sunbeam to proceed with the acquisitions by giving a fairness opinion as to the acquisitions. In addition, the Committee alleged that Morgan Stanley committed fraud by omitting and misrepresenting material facts concerning Sunbeam's financial condition when acting as underwriter for the note offering, such as including in the offering materials for the notes a press release issued by Sunbeam that allegedly contained material misrepresentations concerning Sunbeam's financial condition.

What does the conduct of Morgan Stanley as the underwriter for the notes have to do with the secured claims of the lenders in Sunbeam's bankruptcy? This is where the Committee got creative. The Committee alleged that MSSF, the lender, was the alter ego of Morgan Stanley, the underwriter, and as such Morgan Stanley's alleged misconduct could be imputed to MSSF. The Committee then argued that Morgan Stanley's misconduct could also be imputed to Bank of America and First Union on an agency theory or because they willingly accepted the benefits of the note offering "knowing" that it was the product of fraud or by recklessly disregarding such fact.

In response, the lenders argued that the equitable subordination claims should be dismissed as to them because there was no allegation of any inequitable conduct by the lenders or any basis to attribute Morgan Stanley's alleged inequitable conduct to the lenders.

The Bankruptcy Court agreed with the lenders. The Court rejected the argument of the Committee that MSSF was an alter ego of Morgan Stanley and that the corporate veil should therefore be pierced. The Court found that the Committee's assertion that MSSF had no discretion was conclusory and there was no support for the assertion. It noted that the mere domination or control by one entity over another is not sufficient to require piercing of the corporate veil. According to the Court, the piercing of the corporate veil is intended to prevent a wrongdoer from using another entity to shield itself from liability, and there was no evidence that Morgan Stanley used MSSF for this purpose. MSSF was not an undercapitalized shell used to shield a related entity from creditors. MSSF had sufficient capital to fund the loan and there were no allegations that it did not have sufficient capital to fund its operations generally. The Court rejected the claims that Morgan Stanley was acting as agent for the lenders on the same basis. There were no allegations in the Committee's complaint that Morgan Stanley was acting subject to MSSF's direction and control. Therefore, there was no basis for finding that Morgan Stanley was the agent for MSSF.

As to the other lenders, the Court found that the allegations of the Committee were insufficient because there was no allegation that First Union or Bank of America controlled either Morgan Stanley or MSSF. The fact that the three lenders were referred to in the loan documents as Syndication Agent, Documentation Agent and Administrative Agent did not, by themselves, establish legal relationships. Moreover, there were no allegations that Morgan Stanley or MSSF acted as agent for First Union or Bank of America in connection with the note offering or the acquisitions.

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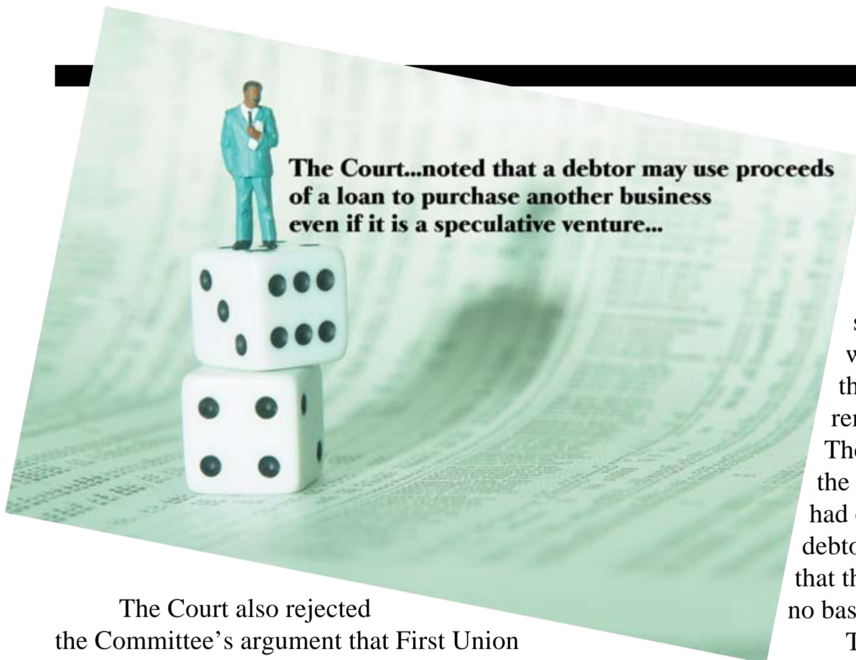


The Court also rejected the Committee's argument that First Union and Bank of America should be equitably subordinated because they failed to conduct due diligence concerning the press release issued by Sunbeam that was purportedly fraudulent. The Court found that the failure to conduct such due diligence cannot be considered inequitable conduct by the lenders since the lenders did not have a duty to conduct due diligence concerning the press release.

With respect to its fraudulent transfer claim against the lenders, the Committee contended that the loans were used to fund the acquisitions at a time when the lenders either knew or recklessly disregarded that Sunbeam would not receive reasonably equivalent value because the assets were overpriced and the acquisitions either occurred at a time when Sunbeam was insolvent or rendered Sunbeam insolvent. In response to this claim, the Court embarked on a very interesting discussion of whether the transactions should be "collapsed." Generally, the "collapsing of the transactions" is a critical aspect of finding a fraudulent transfer in the context of acquisition financing. As the Court observed, a loan may appear to provide fair consideration because the lender provided funds to an entity in exchange for the obligation incurred by the entity to the lender of the same amount and a security interest. If, however, the proceeds of that loan are transferred to a third party (that is the seller of property to the debtor) for less than fair consideration, the transactions (consisting of incurring debt and granting a security interest to secure such debt and the purchase of assets financed by such debt) may be collapsed and viewed as a single integrated transaction. In effect, when a court collapses the transactions, it does not just look at the loan made to the debtor, but looks at the value of the asset purchased relative to the debt incurred to finance such purchase to determine if the relative values are reasonably equivalent.

In this case, however, the Court declined to collapse the transactions. Principally, the Court relied on the fact that the Committee's assertion concerning the lenders' purported knowledge of Sunbeam's overpayment for the acquisitions was conclusory as there were no factual allegations to support it. Instead, the allegations concerned only what Morgan Stanley had discovered. The Court found that the Committee failed to allege that the lenders knew, consciously avoided discovering, or should have known that the acquired assets were worth substantially less than the debtor paid for them or that the debtor was insolvent (or would be rendered insolvent) as a result of the acquisitions. The Court concluded that, since no acts alleged by the Committee supported a finding that the lenders had either actual or constructive knowledge that the debtor was insolvent or would be rendered insolvent or that the acquisitions were valued incorrectly, there was no basis for the collapsing of the transactions.

The Court also noted that a debtor may use proceeds of a loan to purchase another business even if it is a speculative venture, and the fact that the acquired company later proves unprofitable is not a basis for retroactively imputing knowledge that the consideration paid to acquire it far exceeded its value to the purchaser. The approach taken by the Court on this issue may be helpful to lenders in resisting the "collapsing" of transactions in acquisitions and therefore fraudulent transfer claims against lenders.

On the other claims against Morgan Stanley for its negligence or gross negligence and for aiding and abetting the fraud of the insiders, Morgan Stanley responded that the Committee had no authority to commence an adversary action against it because the Committee failed to obtain the leave of the court to commence the action on behalf of the estate. The Court noted that the DIP financing order conferred standing on the Committee to prosecute certain actions against the pre-petition lenders but not Morgan Stanley. The Committee took the position that, since MSSF and Morgan were alter egos, it had authority to pursue Morgan Stanley by having authority to pursue MSSF as a lender under the DIP financing order.

However, the Court, having already rejected the contention that MSSF and Morgan were alter egos, found that the Committee must meet the standards for bringing actions on behalf of the estate set out in *In re STN Enterprises*, 779 F. 2d 901, 905 (2d Cir. 1985) and in *In re Commodore International Limited*, 262 F. 3d 96, 100 (2d Cir. 2001). These tests include that the court must find that the creditors' committee has presented a colorable claim and the action is likely to benefit the reorganization estate under *In re STN Enterprises*. Under *In re Commodore International Limited*, the committee may also acquire standing if the debtor consents and the Court finds that allowing the action by the committee is in the bankruptcy estate's best interest and is "necessary and beneficial" to the fair and efficient resolution of the bankruptcy proceedings. The Court found that the Committee had not met these

tests, and in fact that the claims the Committee was seeking to pursue would delay resolution of the reorganization proceedings.

Vornado PS, L.L.C. v. Primestone Investment Partners, L.P., 821 A.2d 296, 49 UCC Rep.Serv.2d 1348 (Delaware Chancery Court December 19, 2002) *affirmed* 822 A.2d 397 (Del.Supr. Apr. 16, 2003) (Summary judgment granted in favor of secured lender with respect to maturity and enforcement of loans and auction sale of collateral; counter-claims against secured lender for breach of contract, breach of fiduciary duty and tortious interference dismissed.)

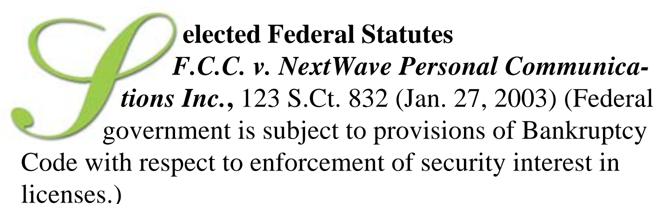
Prudential Securities Corp. ("Prudential") made a $62 million loan to Primestone Investment Partners, L.P. ("Primestone") in 1997, which was followed by a $40 million loan to Primestone from Vornado PS, L.L.C. ("Vornado") in 2000. An intercreditor agreement governed the relative rights and priorities between the Prudential loan, which was scheduled to mature on September 26, 2001, and the Vornado loan, scheduled to mature on October 25, 2001. As the maturity of the Prudential loan neared, Primestone scrambled successfully to obtain an extension from Prudential. The intercreditor agreement required Vornado's consent to the extension of the Prudential loan, which Vornado gave. Vornado did not, however, agree to extend its own loan to Primestone, and on October 25, 2001, the Vornado loan came due (preceded by a reminder notice of the maturity date from Vornado the day before and a default letter on October 26).

Soon after the maturity of the Vornado loan, Vornado purchased the Prudential loans at par, which had also become due as a result of acceleration by Prudential on the basis of a cross-default to the Vornado loan documents. With both of the loans now held by Vornado and still unpaid, Vornado turned its attention to foreclosing upon the collateral securing them. This collateral consisted of units in a limited partnership exchangeable into publicly traded stock. Vornado hired Goldman Sachs to assist it in pursuing a public sale of the partnership units and, with the assistance of Goldman Sachs, compiled an information memorandum and contacted more than 50 prospective buyers in its efforts to market the partnership units. After a series of delays associated with a bankruptcy filing by Primestone (which was ultimately dismissed on grounds of bad faith) and attempts by Primestone to block the sale, a public auction was conducted on April 30, 2002. Vornado was the successful bidder at the auction, bidding in debt of $66,339,856.55 (which roughly equaled the total market price of the corresponding publicly traded shares) and leaving a deficiency of $49,771,467 owing by Primestone.

Primestone argued in the Delaware Chancery Court that Vornado breached the loan documents and improperly enforced the loans. After analyzing the key provisions of the loan documents, the Court found that Vornado conducted itself in a manner consistent with those documents. A primary argument made by Primestone in support of its position was that, by virtue of its consent to the extension of the Prudential loans pursuant to the terms of the intercreditor agreement, Vornado also agreed to an extension of the Vornado loans (among other things, Primestone noted that the intercreditor agreement did not permit repayment of the Vornado loans prior to the repayment of the Prudential loans). The Court was not convinced, citing Vornado's repeated emphasis to Primestone that, notwithstanding its consent to the extension of the Prudential loan, the Vornado loans remained due on October 25, and pointing out that the intercreditor agreement both prohibited Primestone from relying upon or benefiting from its terms and stipulated that none of its terms would be deemed to affect the loan documents themselves or the existence of a default thereunder.

Primestone also contended that Vornado had failed to conduct the auction sale in a commercially reasonable manner, arguing that a private sale held at a later date would have fetched a higher price. Again, the court flatly disagreed with Primestone, finding that Vornado conducted the auction in a manner that comported with the loan documents and the UCC, utilized good faith efforts to maximize value, and provided ample notice. The Court also rejected Primestone's contention that the loan documents (and Vornado's conduct in connection therewith) created a fiduciary duty owed to Primestone that Vornado breached. According to the court, nothing in the lender/borrower relationship between Vornado and Primestone established by the loan documents or in Vornado's manner of enforcing its rights thereunder, including the fact that Vornado had a power-of-attorney in respect of the collateral, established any fiduciary duty. In addition to ruling in Vornado's favor with respect to these matter, the court also decided for Vornado on various counter-claims of Primestone relating to dealings and failed transactions ancillary to the loans.

On each claim involving the loans and Vornado's enforcement of its rights under the loan documents, the Court brushed aside Primestone's arguments and held for Vornado. And it did so in relatively simple fashion, noting repeatedly that the maturity of the loans and the enforcement by Vornado of its rights and remedies complied with the terms of the loan documents and applicable law. As a result, the *Vornado* decision is a welcome one, standing for the critical proposition that a secured lender who complies with the terms of its loan documents and applicable law in enforcing its rights can expect a favorable result.



elected Federal Statutes

F.C.C. v. NextWave Personal Communications Inc., 123 S.Ct. 832 (Jan. 27, 2003) (Federal government is subject to provisions of Bankruptcy Code with respect to enforcement of security interest in licenses.)

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NextWave interpreted the applicability of § 525(a) of the Bankruptcy Code to the United States. The Supreme Court held that § 525(a) prohibits the Federal Communications Commission, a governmental unit of the United States ("FCC"), from revoking spectrum licenses it sold to NextWave solely because of the debtor's failure to make timely payments of its debt to the FCC secured by the licenses. As stated in the majority opinion: "The government is not to revoke a bankruptcy debtor's license solely because of a failure to pay his debts."

The controversy originated in 1997 when NextWave purchased various licenses from the FCC for approximately $4.8 billion. NextWave made a downpayment, executed promissory notes for the balance, and granted the FCC a security interest in the licenses that the FCC perfected under the Uniform Commercial Code. The Security Agreement provided that the licenses were "conditioned upon the full and timely payment of all monies due pursuant to...the terms of the Commission's installment plan as set forth in the Note and Security Agreement executed by the licensee," and that "[f]ailure to comply with this condition will result in the automatic cancellation of this authorization."

When NextWave and other license purchasers encountered difficulties in obtaining financing for their operations, the FCC agreed to restructure the payment obligations. June 8, 1998 was fixed as the last day for a licensee to elect a restructuring option and October 29, 1998 as the last date to resume installment payments.

On June 8, 1998, NextWave commenced a Chapter 11 case in the Southern District of New York. After unsuccessfully challenging the amount of its indebtedness to the FCC, NextWave filed its Chapter 11 plan. The FCC objected to the plan, asserting that NextWave's licenses had been cancelled automatically when it failed to make the October 1998 payment. The Bankruptcy Court declared the cancellation to be null and void, which decision was affirmed by the District Court. The Second Circuit reversed, holding that "exclusive jurisdiction to review the FCC's regulatory action lies in the courts of appeals."

NextWave then petitioned the FCC to reconsider its license cancellation and appealed the FCC's denial to the Court of Appeals for the D.C. Circuit pursuant to 47 U.S.C. 402(b). NextWave argued that the cancellation was arbitrary and capricious, and contrary to law in violation of the Administrative Procedures Act and the Bankruptcy Code. The Court of Appeals agreed, holding that the FCC's cancellation violated § 525(a) of the Bankruptcy Code:

> Applying the fundamental principle that federal agencies must obey all federal laws, not just those they administer, we conclude that the Commission violated the provision of the Bankruptcy Code that prohibits governmental entities from revoking debtors' licenses solely for failure to pay debts dischargeable in bankruptcy. 254 F.3d 130, 133(2001). Certiorari was granted.

The Supreme Court affirmed in an 8-to-1 decision rendered January 27, 2003. The majority opinion rejected the FCC's arguments that it did not revoke NextWave's licenses solely because of nonpayment and that NextWave's obligations were not "dischargeable debts" under the Bankruptcy Code. Also rejected was the FCC's contention that the interpretation placed upon § 525 raises a conflict with the Federal Communications Act.

The FCC had sought to escape the operation of § 525 by stating that, although nonpayment was "the proximate cause" of the license cancellations, it had a "valid regulatory motive" for doing so. The majority opinion held that factor irrelevant:

> When the statute refers to failure to pay a debt as the sole cause of cancellation ("solely because"), it cannot reasonably be understood to include, among the other causes whose presence can preclude application of the prohibition, the governmental unit's *motive* in affecting the cancellation. Such a reading would deprive § 525 of all force...Section 525 means nothing more or less than that the failure to pay a dischargeable debt must alone be the proximate cause of the cancellation — the act or event that triggers the agency's decision to cancel, whatever the agency's ultimate motive in pulling the trigger may be....
>
> [W]here Congress has intended to provide regulatory exceptions to provisions of the Bankruptcy Code, it has done so clearly and expressly, rather than by a device so subtle as denominating a motive a cause. There are, for example, regulatory exemptions from the Bankruptcy Code's automatic stay provisions. 11 U.S.C. § 362(b)(4). And even § 525(a) itself contains explicit exemptions for certain agriculture Department programs.

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Summarily rejected were the FCC's arguments that the payment obligation was not a debt and, if a debt, it was nondischargeable in bankruptcy. The Court observed that the term "claim" is to be accorded the broadest available definition and that "a debt is a debt, even when the obligation to pay it is also a regulatory condition." As to the dischargeability issue, the opinion noted that "a preconfirmation debt is dischargeable unless it falls within an express exception to discharge." (See Code § 523).

In response to the FCC's argument that the ruling created a conflict with the Communications Act, the majority observed that their decision does not obstruct the auction provisions of the Communications Act and nothing in that Act required cancellation as the sanction for failure to make an agreed-upon payment. The Court held:

> What petitioners describe as a conflict boils down to nothing more than a policy preference on the FCC's part for (1) selling licenses on credit and (2) canceling licenses rather than asserting security interests in licenses when there is a default. Such administrative preferences cannot be the basis for denying respondent rights provided by the plain terms of a law.

A dissenting opinion filed by Justice Breyer contended that the majority's literal interpretation of § 525 "handicapp[ed] governmental debt collection in ways Congress did not intend." Justice Stevens filed a concurring opinion. He stated:

> In sum, even though I agree with Justice Breyer's view that the literal text of a statute is not always a sufficient basis for determining the actual intent of Congress, in these cases I believe it does produce the correct answer.

The majority decision is consistent with the Supreme Court's holding in *United States v. Whiting Pools, Inc.*, 462 U.S. 198 (1983), that the rights of even the Internal Revenue Service are circumscribed by bankruptcy law. While the *NextWave* case pertains to governmental agencies that have both a regulatory and creditor relationship with a licensee, it has the broader effect of promoting the financial community's confidence in the stability and predictability of the bankruptcy process.

***Secretary of Labor, United States Department of Labor v. 3RE.Com, Inc. and General Electric Capital Corporation*,** 317 F.3d 534 (6th Cir. 2003) (Accounts receivable aging reports are not "hot goods" per se pursuant to the Federal Labor Standards Act.)

3Re.com was a computer repairer and telemarketer that went out of business in the spring of 2001. Prior to going out of business, 3Re.com failed to pay its payroll for a period of time. It also deducted sums from employee paychecks for insurance and 401(k) plans that were never forwarded to the insurers and the plan.

During the period that 3Re.com failed to pay its employees, certain employees worked to distribute inventory in spite of not being paid. Others prepared agings of accounts receivable that were submitted to General Electric Capital Corporation ("GECC"). GECC was providing a secured working capital facility to the company.

Based on these facts, the Secretary of Labor instituted an action to enjoin the interstate shipping of any goods produced by 3Re.com in violation of the provisions of the Fair Labor Standards Act ("FLSA"). The FLSA allows the Secretary of Labor, who is charged with the responsibility of investigating and prosecuting violations of the statute, to restrain any actual or threatened transportation of any goods produced in violation of the FLSA — sometimes referred to as "hot goods." It is a violation of the FLSA "to transport, offer for transportation, ship, deliver, or sell in commerce...any goods in the production of which any employee was employed in violation of Section 206 or Section 207" of the FLSA. Section 206 and Section 207 require that employers pay employees at not less than the national minimum wage plus overtime at a rate one and one-half times the regular rate.

Based on the arguments of the Secretary of Labor, the District Court for the Western District of Tennessee ruled that, in addition to the computer equipment produced by 3Re.com, the accounts receivable aging reports prepared by certain employees also constituted "goods" under the FLSA, so that the production of such reports by such employees (who were not being paid) constituted the production of "goods" in violation of the FLSA. Therefore, in order to "cure the taint" and lift the injunction prohibiting the shipment of alleged "hot goods," the company was ordered to post a deposit with the district court in an

In 1984, PACA was amended to extend its protection to sellers of perishable commodities, who, because of the need to sell their products quickly, were often unsecured creditors of buyers whose creditworthiness they were unable to evaluate before the sale.

amount equal to the wages due to the employees that had worked to distribute the computer equipment, and also the employees that had prepared the accounts receivable agings for GECC, as well as the amounts not paid by the company to the employees' benefit plans.

GECC appealed the district court's decision to classify accounts receivable as "hot goods" under the FLSA, and argued that the district court erred in failing to distinguish between hourly workers who produced computer equipment and salaried employees who prepared accounts receivable reports. The Sixth Circuit found that the preparation of the accounts receivables reports had little or nothing to do with the goals of the FLSA to protect market competitors from unfair competition from products made in violation of the FLSA. Citing its earlier decision in *Chao v. Hosp. Staffing Servs., Inc*, 270 F. 3d 374, 392 (6th Cir. 2001), the Sixth Circuit found that where documents are merely records relating to services already rendered by employees, have little intrinsic value, will not be sold in interstate commerce and are used only to generate accounts receivable, such records are not *per se* "hot goods."

GECC also argued that the Secretary of Labor included, in the amounts required to be paid, wages for employees who were exempt from the FLSA, that the Secretary had not proved which employees handled the tainted goods, and that the Secretary had improperly included the amounts withheld for employee benefits in the amount required to be paid to the court to obtain the release of any goods remaining. The Sixth Circuit reversed the permanent injunction preventing the sale of any goods, and remanded the case to the district court to allow GECC to submit evidence relating to the issues of exemption, which employees handled tainted goods and the applicability of the FLSA to the withheld amounts from employees for 401(k) and health insurance benefit plans.

Reaves Brokerage Co. v. Sunbelt Fruit & Vegetable Co., 336 F.3d 410 (5th Cir. 2003) (Factor of accounts receivable deemed to be a secured lender, and not a bona fide purchaser for value, resulting in subordination to PACA trust beneficiary.)

Reaves Brokerage, Inc. ("Reaves") was a seller and broker of fresh fruits and vegetables. On several occasions, Reaves made interstate commerce sales of produce to a wholesaler, Sunbelt Fruit & Vegetable Company ("Sunbelt"). In March 2000, Sunbelt ceased operations, owing Reaves $195,060.55 in unpaid invoices for produce delivered between June and December of 1999. Reaves immediately filed suit against Sunbelt seeking damages under Perishable Agricultural Commodities Act, 7 U.S.C §§ 499a-499s ("PACA").

PACA was enacted in 1930 to regulate the sale of perishable commodities and "promote fair dealing" in the sale of fruits and vegetables. In 1984, PACA was amended to extend its protection to sellers of perishable commodities, who, because of the need to sell their products quickly, were often unsecured creditors of buyers whose creditworthiness they were unable to evaluate before the sale. To "remedy this burden on commerce in perishable commodities," PACA was amended to provide that all perishable commodities subject to the statute and the products and proceeds derived from such commodities that are delivered to a purchaser of them are subject to a nonsegregated "floating" trust in favor of the seller of such perishable commodities. If the seller is not paid promptly, the rights of the seller to the trust assets, including proceeds and products, have priority over any claims of any other creditor of the purchaser of such commodities, whether such creditor is secured or unsecured.

General principles of trust law govern PACA trusts. Accordingly, a "bona fide purchaser" of the perishable commodities constituting the "trust assets" may acquire them free and clear of the claims of the seller of such

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commodities. Consequently, unpaid sellers, as the beneficiaries of the PACA trust, are not able to recover trust proceeds conveyed to a third party if that party received the proceeds for value and without notice of the breach of trust. A transfer is for value if money is paid or other property is transferred or services are rendered as consideration for the transfer of trust property. A lender that acquires trust assets through the enforcement of its security interest under a security agreement is not considered a "bona fide purchaser" for this purpose since the lender is deemed not to have acquired the property "for value."

In July 2000, Reaves, as a seller and broker of perishable commodities entitled to the benefit of the PACA trust, filed an amended complaint in its action against Sunbelt, the wholesaler who had purchased such commodities, to add Fidelity Factors, L.L.C. ("Fidelity") as a defendant. Fidelity was the factor for Sunbelt. Reaves took the position that Fidelity, as a purchaser of the receivables of Sunbelt, received proceeds from the PACA trust established for Reaves benefit. In other words, not only was the inventory of Sunbelt purchased from Reaves subject to the PACA trust, but any proceeds from the sale of such inventory (i.e. the receivables of Sunbelt that had been purchased by Fidelity), were also subject to the PACA trust.

In response to this claim by Reaves, Fidelity argued that it was not a lender enforcing its security interest, but a "factor" who merely purchased Reaves' accounts receivable "for value" and "without notice of the breach of trust," and therefore acquired the receivables of Sunbelt free and clear of the PACA trust as a "bona fide purchaser." Reaves also sued James Heffington, Sr., Sunbelt's president and sole shareholder, and Lone Star Produce Company, Sunbelt's alleged successor.

Reaves sought summary judgment on its PACA trust claims against Fidelity and Heffington. The district court adopted the recommendation of a magistrate judge and entered judgment in favor of Reaves against Fidelity and Heffington, jointly and severally, in the amount of $195,060.55. Fidelity timely appealed the district court's ruling to the U.S. Court of Appeals for the Fifth Circuit. Heffington did not appeal.

According to the Fifth Circuit, the determinative issue presented on appeal was whether, as a matter of law, the "factoring agreement" between Sunbelt and Fidelity was a loan secured by Sunbelt's accounts receivable or a true sale or "factoring" of the accounts receivable to Fidelity. Reaves argued, and the district court concluded, that in spite of its label and the terminology used, the agreement executed between Fidelity and Sunbelt was <u>not</u> truly a sale of accounts receivable, but was in substance a secured lending agreement, under which Fidelity held all of Sunbelt's accounts (and other assets) as collateral and Sunbelt remained personally liable for any shortfall. Fidelity insisted that it purchased Sunbelt's accounts and "never made a loan of any type to Sunbelt."

As the decision points out, characterization of the agreement at issue turns on "the substance of the relationship" between Fidelity and Sunbelt, "not simply the label attached to the transaction." The Fifth Circuit, which had never addressed this issue under PACA, adopted the Second Circuit's analysis in *Endico Potatoes v. CIT Group/ Factoring Inc.*, 67 F.3d 1063 (2d Cir. 1995). In *Endico Potatoes*, the court identified several elements to consider in determining the true legal substance of a transaction involving PACA trust assets, including (1) the right of the creditor to recover from the debtor any deficiency if the assets assigned prove insufficient to satisfy the debt; (2) the effect on the creditor's right to ownership of the assets assigned if the debtor were to pay the debt from independent funds; (3) whether the debtor has a right to amounts recovered from the sale of assets in excess of that necessary to satisfy the debt; and (4) whether the assignment itself reduces the debt. All these features bear on a common question — which party bears the risk of the collection of the receivables? The Fifth Circuit quoted the explanation of the Second Circuit in *Endico Potatoes* as follows:

> [W]here the lender has purchased the accounts receivable, the borrower's debt is extinguished and the lender's risk with regard to the performance of the accounts is direct, that is, the lender and not the borrower bears the risk of non-performance by the account debtor. If the lender holds only a security interest, however, the lender's risk is derivative or secondary, that is, the borrower remains liable for the debt and bears the risk of non-payment by the account debtor, while the lender only bears the risk that the account debtor's non-payment will leave the borrower unable to satisfy the loan.

Application of the Second Circuit's risk-transfer analysis and an independent examination of the substance of the parties' agreement led the Fifth Circuit to conclude

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that the relationship between Fidelity and Sunbelt was that of a secured lender and debtor, not a seller and buyer. For example, although the agreement purported to distinguish between sales of accounts "with recourse" to Sunbelt, and those "without recourse," in reality, Fidelity would virtually always have recourse against Sunbelt if Sunbelt's account debtors defaulted or underperformed.

In addition, the "factoring agreement" required that Sunbelt grant Fidelity a "continuing lien and security interest in all of [its] accounts, instruments...and all proceeds of the foregoing as security for the payment and satisfaction of any and all of our present and future liabilities, indebtedness, and obligations to you [Fidelity]...." The parties also agreed that "recourse to any of the foregoing collateral shall not any time be required and we hereby authorize you [Fidelity] to charge or offset our account for the amounts of any and all of the liabilities, indebtedness, and obligations which are secured thereby." And, under the agreement, Fidelity was to "treat all indebtedness" as "an entire single indebtedness for which [Sunbelt] shall remain liable for full payment without demand" and to which Fidelity may apply any "funds, receivables, credits, or property of [Sunbelt]." Fidelity further insulated itself from risk by requiring Heffington to execute an unconditional personal guarantee.

Although the Fifth Circuit recognized that several terms and provisions used in the "factoring agreement" were characteristic of a "true sale" of accounts, it concluded that the arrangement between Fidelity and Sunbelt, when viewed in its entirety, was the functional equivalent of a secured lending relationship for purposes of PACA, and not a "true sale." The decision, however, emphasized that the "distinction between purchase and lending transactions can be blurred," and therefore expressly limited the holding to the facts and arguments presented in this admittedly close case. Factors who have clients that purchase perishable agricultural commodities should be aware of this decision, and be certain to address such risks in their factoring relationships with their clients.

Bankruptcy

***In re Trism, Inc.*,** 328 F.3d 1003 (8th Cir. 2003) (Section 363(m) of the Bankruptcy Code moots a challenge to the release of a creditor from avoidance liability where the provision authorizing the release is integral to the sale of the debtor's assets to a third party.)

A recent Eighth Circuit decision discusses the scope of §363(m) of the Bankruptcy Code with respect to the sale of a debtor's assets in bankruptcy. The issue is whether, in the context of such a sale, the release of any claims against the secured lender for avoidance of its debt or liens was a sufficiently integral provision of the sale that §363(m) will prevent anyone from subsequently challenging that provision.

CIT Group/Business Credit, Inc. provided Trism, Inc. and its thirteen subsidiaries with financing prior to Trism's Chapter 11 case. Glenn Garrett participated in Trism's prepetition financing as a last-out junior participant. When Trism entered Chapter 11, CIT continued to finance Trism's operations, and Garrett continued to participate in such financing on a last-out basis.

Approximately one month after the Chapter 11 began, Trism asked the bankruptcy court to authorize the sale of its assets to Bed Rock, Inc., a company in which Garrett was a principal shareholder and also the president. Bed Rock conditioned its purchase upon obtaining an order from the Bankruptcy Court releasing Garrett and Bed Rock from any avoidance liability. During the hearing on the sale, it became apparent that, because of Garrett's last-out participation, the court could not release him from liability without also releasing CIT. Upon realizing this, Bed Rock increased its bid by two million dollars, thereby negotiating CIT's release. The court thereupon approved the sale, and also approved the requested release of Bed Rock, Garrett, and CIT from all avoidance liability. The court concluded that Bed Rock's purchase of Trism's assets was in good faith, and that the sale of assets was in the best interest of Trism's creditors. After the sale was consummated, the Official Committee of Unsecured Creditors appealed CIT's release to the Bankruptcy Appellate Panel, which dismissed the appeal as moot in accordance with §363(m). The Creditors Committee appealed, and the Eighth Circuit affirmed the dismissal.

After the Eighth Circuit laid out the factual background that gave rise to the case, it began its analysis by discussing the purposes of §363(m). Section 363(m) provides:

> The reversal or modification on appeal of an authorization under sub-section (b) or (c) of this section of a sale or lease of property does not affect the validity of a sale or lease under such authorization to an entity that purchased or leased such property in good faith, whether or not such entity knew of the pendency of the appeal, unless such authorization and such sale or lease were stayed pending appeal.

The court noted that by preventing the overturning of a completed sale in the absence of a stay, §363(m) protects the reasonable expectations of good faith third-party purchasers, safeguards the finality of a bankruptcy sale, and also protects third parties who rely upon the bankruptcy court's sale order from litigation. The court also pointed out that the reliability and finality that §363(m) provides to bankruptcy sales enhances the value of the debtor's assets to prospective purchasers in bankruptcy.

The court proceeded to analyze the operation of §363(m) in the context of the sale of a debtor's assets. Section 363(m) moots any challenge to an order approving the sale of an asset, provided that no party has obtained a

a result of which §363(m) mooted the Committee's challenge to that provision of the bankruptcy court's order.

The court also rejected the Committee's argument that §363(m) should be limited to bidders who are not creditors of the debtor. The section protects good faith purchasers, and does not list other exceptions or qualifications to the protection it provides. The Committee also objected to a defect in the notice of sale, arguing that CIT's release had not been included as a term of the sale. The court did not consider the Committee's argument, however, because the Committee had not raised it in the court below.

This decision is notable because it provides a test to determine whether an ancillary provision of an order authorizing the sale of a debtor's property in bankruptcy may be challenged. If the provision is so closely linked to the agreement governing the sale that modifying or reversing the provision would adversely alter the parties' bargained-for exchange, the test would cause §363(m) to moot the challenge. This interpretation of §363(m) provides guidance to secured lenders, who should be alert to potential opportunities in a bankruptcy case to obtain a release from liability in the context of a sale of the debtor's property.

stay of the sale pending appeal, and that reversing or modifying the authorization to sell would affect the validity of the sale or lease. Because the Creditors Committee had not obtained a stay, §363(m) would moot the Committee's challenge if reversing or modifying the authorization to sell would affect the validity of the sale of Trism to Bed Rock. The court established a test to determine when a challenge involving an ancillary provision of a sale order affects the validity of a sale:

> [A] challenge to a related provision of an order authorizing the sale of the debtor's assets affects the validity of the sale when the related provision is integral to the sale of the estate's assets. A provision is integral if the provision is so closely linked to the agreement governing the sale that modifying or reversing the provision would adversely alter the parties' bargained-for exchange.

Thus, the court concluded that it only needed to determine whether the CIT release provision was integral to the sale of the estate's assets. The court concluded that the provision was indeed integral to the sale. First, Bed Rock had conditioned the sale upon the bankruptcy court entering an order releasing Garrett from liability to Trism's estate under various sections of the Bankruptcy Code. Second, the court found that CIT's release was "directly linked" to releasing Garrett from liability because of Garrett's status as a last-out junior participant. Because Garrett could not recover any money until CIT recovered its entire investment, any liability CIT might incur would adversely affect Garrett by reducing his recovery. Finally, the court agreed with the bankruptcy court's conclusion that the terms of the sale were more favorable to Trism because of various protections afforded to Bed Rock, Garrett, and CIT. Accordingly, the court held that CIT's release from avoidance liability was integral to the sale, as

In re Cybergenics, Inc., 330 F.3d 548 (3rd Cir. 2003), cert. dismissed, 124 S. Ct. (U.S. Nov. 6, 2003) (Third Circuit sustains derivative standing.)

Last year, in the November/December 2002 issue of THE SECURED LENDER, we reported on the decision in *Official Committee of Unsecured Secured Creditors of Cybergenics Corporation v. Chinery,* 304 F.3d 316 (3rd Cir. 2002), in which a panel of the Third Circuit Court of Appeals affirmed the decision of the federal District Court holding that only a trustee or debtor-in-possession may bring a fraudulent transfer action under §544(b) of the Bankruptcy Code, and that a creditors' committee lacks standing to do so.

The bankruptcy and lending communities were surprised by this decision, because it has become a common practice over the years for bankruptcy courts to authorize a creditors' committee to bring a fraudulent conveyance action in certain circumstances. This practice evolved in response to the situation in which the trustee or debtor-in-possession refused to prosecute a fraudulent conveyance action or other avoidance action that the creditors' committee believed should be brought. The judicial solution to this problem was the concept of "derivative standing," under which the court would appoint

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a committee or other designated person to prosecute the action on behalf of the estate.

In November 2002, the Third Circuit granted a motion for rehearing *en banc* and vacated the panel's decision (thereby leaving the District Court's decision standing). Briefs were filed not only by the parties, but by four *amici* urging reversal of the District Court's opinion and two *amici* urging its affirmance. On May 29, 2003, the Third Circuit reversed the District Court's decision by a vote of 7 to 4. As a result, creditor's committees may once again be authorized to bring fraudulent conveyance actions in bankruptcy cases in the Third Circuit.

The majority opinion found support for derivative standing in Code §§1109(b), 1103(c)(5), and 503(b)(3)(B) and in its acceptance by bankruptcy courts throughout the country. The majority observed that the alternatives of appointing a trustee to replace the DIP or to convert the case to Chapter 7 case in order to cause the avoidance action to be brought were too draconian compared to the simpler process of granting the Committee derivative standing.

The majority enumerated the following three conditions to the grant of derivative standing:

1. Ask the trustee or debtor-in-possession to take the requested action and, if appropriate, volunteer to bear the attendant costs;
2. If the request is refused, the creditors' committee must move the court to find the refusal unreasonable and request specific authority to act on behalf of the estate; and
3. Acknowledge that any recovery is for the benefit of the estate.

Although the court's decision only dealt with actions filed under §544(b), derivative standing would seem equally applicable to §§545, 547, 548, 549, and 553, which use language similar to §544(b). It would also appear that a single creditor complying with the three conditions specified by the majority opinion could obtain derivative standing to pursue any cause of action belonging to the estate.

As at the date of this article, no petition for certiorari has been filed.

Capital Factors, Inc. v. Kmart Corporation (In re Kmart Corporation), 291 B.R. 818 (N.D.Ill. 2003) ("Critical trade vendor order" in Kmart Chapter 11 held to be inappropriate.)

If there were a bankruptcy decision-of-the-month club, the likely winner for April 2003 would be this one. The decision, which has been appealed to the Court of Appeals for the Seventh Circuit, reversed a series of first-day orders entered in Kmart's Chapter 11 case, including an order authorizing the payment of prepetition claims to entities determined by Kmart to be "critical trade vendors" (known as a critical trade vendor order, or "CVO"). The decision has received a great deal of notoriety, both for its specific reversal of the CVO and for its effect on a prospective debtor's choice of the venue for its Chapter 11 case.

Kmart commenced the largest retail bankruptcy case in history on January 22, 2002. According to its then-current balance sheet, Kmart was solvent. Among the first day motions presented by Kmart was its request to pay the prepetition claims of domestic vendors which Kmart deemed critical to the success of its ongoing operation. Kmart contended before the Bankruptcy Court that the critical vendor payments were necessary to maintain relationships essential to its continued operation and ultimate reorganization. The legal predicate invoked by Kmart was the "doctrine of necessity" and the "all writs power" of Bankruptcy Code §105. In entering the CVO, the bankruptcy judge stated:

> Motions to pay certain critical trade creditors always present difficult questions for courts. We're seeing more and more of them, and our problem is that we have to stretch to find some authority to do them. However, I, after hearing this testimony and reading the affidavit [of Charles C. Conaway, Kmart's Chief Executive Officer], am convinced that Fleming, Handleman and the egg and dairy vendors — and I would like a list of the specific vendors that you would like included in this motion — as well as the advertising concerns, are necessary to keep this business going as a going concern.

Pursuant to the CVO, more than $350 million was paid to approximately 3,000 vendors.

Capital Factors, Inc. ("Capital") held $20 million in general unsecured claims against Kmart and was not designated a critical vendor. It objected to the CVO and appealed its entry to the District Court. The District Court considered three issues with respect to the appeal of the CVO: (i) whether the "doctrine of necessity" or Bankruptcy Code §105 provides a bankruptcy court with either statutory authority or equitable power to pay prepetition claims, (ii) whether there was a sufficient evidentiary basis for entering the CVO, and (iii) whether, as urged by Kmart, the significant payments made pursuant to the unstayed CVO rendered the appeal moot. 291 B.R. at 821.

The District Court held as a matter of law that neither the doctrine of necessity nor §105 authorized the entry of the CVO. While acknowledging that cases had allowed the payment of prepetition claims other than as part of a plan of reorganization, the District Court agreed with earlier decisions that to do so violates the Code's distribution

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scheme in favor of "equity," including decisions of the Fourth, Fifth and Ninth Circuits (*Official Comm. of Equity Sec. Holders v. Mabey*, 832 F.2d 299 (4th Cir. 1987); *Chiasson v. J. Louis Matherne & Assocs. (In re Oxford Mgmt. Inc.)*, 4 F.3d 1329 (5th Cir. 1993); *B & W Enters., Inc. v. Goodman Oil Co. (In re B & W Enters., Inc.)*, 713 F.2d 534 (9th Cir. 1983). The District Court found that the Seventh Circuit's holding in *In re Chicago, Milwaukee, St. Paul & Pac. R.R. Co.*, 791 F.2d 524, 528 (7th Cir. 1986), was binding precedent that §105 does not permit a court to redistribute rights contrary to the Code's provisions. The District Court ruled:

> The Bankruptcy Code sets forth a priority scheme for the payment of claims. See 11 U.S.C. §§503, 507. The Code does not carve out priority or administrative expense status for prepetition general unsecured claims based on the "critical" or "integral" status of a creditor. But the effect of the bankruptcy court's orders was to elevate the claims of the "critical" vendors over those of other unsecured creditors and to subordinate the claims of non-"critical" unsecured creditors. The bankruptcy court altered the priority scheme set forth in the Bankruptcy Code. 291 B.R. at 822.

Having determined that the Code prohibited entry of the CVO, the District Court viewed as moot the issue as to the adequacy of the evidentiary record.

The District Court also rejected Kmart's mootness argument. It held that Capital was not required to stay enforcement of the CVO to preserve its right to appeal. (*Compare* 11 U.S.C. Section 363(m) and 11 U.S.C. Section 364(e).) To the extent Kmart argued "equitable mootness," the Court noted that the Seventh Circuit did not recognize the concept. *In re UNR Industries, Inc.*, 20 F.3d 766 (7th Cir. 1994). As to actual mootness, the Court observed that the plan had yet to be confirmed, that Kmart's "doomsday speculations" were unpersuasive and lastly, that no prior case law indicated the Bankruptcy Court would not have the power to order the return of the monies paid to vendors pursuant to the CVO.

The payment of prepetition non-insider employee wage claims up to the current statutory cap of $4,650 is a routinely granted first-day order. The Kmart decision should not affect this practice. The District Court's opinion carefully distinguished between general unsecured prepetition claims and those entitled to priority, as in the case of employee wage claims. 291 B.R. at 822.

It is unlikely that the Seventh Circuit's determination of the appeal will occur before 2004. The immediate question is whether other bankruptcy courts will adopt a similar approach. However, even if other courts hold that a CVO cannot properly be granted under Bankruptcy Code §105, they may well follow the approach taken by those courts that have held a CVO to be proper under Bankruptcy Code §363 (as an appropriate use of the debtor's property) or under Bankruptcy Code §364 (as one of the terms necessary to induce vendors to extend post-petition trade credit to the debtor).

International

Stonington Partners, Inc., et al. v. Lernout & Hauspie Speech Products, N.V., 310 F.3d 118 (3d Cir. 2002) (Bankruptcy Court erred in enjoining U.S. company's participation in Belgian insolvency proceeding.)

As cross-border loans and other transactions have become more prevalent in recent years, it is not surprising that we should also see an increase in the number of court decisions involving cross-border insolvency proceedings. A recent addition to the list of these decisions is *Stonington Partners, Inc., et al. v. Lernout & Hauspie Speech Products, N.V.,* a decision out of the Third Circuit Court of Appeals dealing with the relationship between a U.S. Chapter 11 case and a Belgian *Concordat* insolvency proceeding. Although *Stonington* does not specifically involve a loan transaction, it nevertheless sets forth principles that are relevant to cross-border insolvencies involving lenders.

Stonington Partners, Inc. and its affiliates (collectively "Stonington") managed capital for pension funds, private endowments, financial institutions and other entities. In 1995, Stonington purchased Dictaphone Corporation, and in mid-2000 sold it to Lernout & Hauspie Speech Products, N.V. ("L&H"), a Belgian company with headquarters in Massachusetts and Belgium, in exchange for L&H stock — stock that later turned out to be worthless.

The period November 27-30, 2000, turned out to be a busy time for Stonington and L&H. On November 27, Stonington sued L&H and various of its former officers and directors in Delaware for fraud in connection with the purchase of Dictaphone. On November 28, Stonington applied to a Belgian court for an order directing L&H to turn over its shares of Dictaphone to a court-appointed trustee, and the Belgian court granted the order. On November 29, L&H filed a Chapter 11 case in Delaware and on November 30 filed an insolvency proceeding in Belgium (dual bankruptcy proceedings, which the Third Circuit aptly characterized as "dueling proceedings"). Stonington filed claims against L&H for fraud in both bankruptcy proceedings, and the Belgian Court allowed the claims.

Here's where it gets interesting. A claim in bankruptcy for fraud arising out of a stock sale is treated very differently under U.S. and Belgian bankruptcy law. In the U.S., such claims are subject to subordination under Bankruptcy Code §510(b), while under Belgian bankruptcy law they would not be subject to subordination, but rather would be *pari passu* with other unsecured claims. Which

court's law should apply? Obviously, the answer to this question could have a profound impact on how much Stonington would receive on its claim.

In May 2001, L&H asked the Delaware bankruptcy court for a declaratory judgment that Stonington's claim in the Chapter 11 would be subordinated under Bankruptcy Code §510(b). In response, the Delaware court found that all of Stonington's claims arose "from rescission of a purchase or sale of a security of the debtor" within the meaning of Bankruptcy Code §510(b), and therefore are subordinated to the claims of other unsecured creditors. L&H also asked the Belgian court to confirm a plan of reorganization in which Stonington's claims would be subordinated to the claims of unsecured creditors, but the Belgian court rejected the plan, finding that there was no basis for such subordination under Belgian insolvency law.

> **...in situations where there are bankruptcy proceedings pending in more than one country, the parties should work together to develop an agreement — known as a "protocol" — for the administration of the case.**

L&H then sought an order of the Delaware bankruptcy court declaring that Stonington's claims must be determined exclusively by that court in accordance with U.S. bankruptcy law, and not by the Belgian court or by Belgian law. Although L&H did not specifically ask the Delaware bankruptcy court to enjoin Stonington from pursuing its claim in the Belgian court, the Delaware court enjoined Stonington from doing so nevertheless. The District Court in Delaware affirmed the bankruptcy court's decision, and Stonington appealed to the Third Circuit.

The Third Circuit began its analysis by noting that the federal courts of appeals have developed two standards for determining when a U.S. court should enjoin a foreign proceeding: a "liberal" standard and a "restrictive" standard. The Third Circuit pointed out that it had adopted the "restrictive" standard, under which a suit in a foreign proceeding can be enjoined "on the rare occasions when needed 'to protect jurisdiction or an important public policy.'" 310 F.3d at 127 (quoting *General Electric Co. v. Deutz AG*, 270 F.3d 144, 161 (3d Cir. 2001)). The Court stated that this standard is based on a serious concern for "comity": the extent to which one country recognizes, within its own territory, the laws and judicial decisions of another country. The Third Circuit expressed the view that the proper standard for comity is that the laws and decisions of the other country should be given deference unless doing so would be contrary to the interest of the nation giving comity (a principle the Third Circuit found to be particularly appropriate in bankruptcy cases because of the challenges inherent in transnational insolvencies and because Bankruptcy Code §304 specifically mentions comity as an element in determining whether to permit an ancillary proceeding).

The Third Circuit stated that there was no indication that the Belgian proceeding was filed to deprive the U.S. bankruptcy court of jurisdiction, and that in fact it was L&H that filed the Belgian proceeding. The Court also expressed doubt that any important public policy was at stake, but suggested that L&H's argument that the injunction was proper in order to preserve the policy embodied in Bankruptcy Code §510(b) was one of the issues that the Delaware court should consider on remand. The fact that L&H had only asked for declaratory relief, and had not even asked for an injunction, further swayed the Third Circuit.

The Third Circuit then remanded the case to the Delaware court to apply the Third Circuit's standards concerning injunctions of this nature and comity. The Court also admonished the Delaware court to consider "the strength of the United States' interest in applying its bankruptcy laws and, specifically, its subordination rules" in light of the facts of the case, as well as "the countervailing Belgian subordination rules and underlying policies." 310 F.3d at 131.

The Court concluded its opinion with a recommendation that, in situations where there are bankruptcy proceedings pending in more than one country, the parties should work together to develop an agreement — known as a "protocol" — for the administration of the case. This was the approach first adopted in the case of *Maxwell Communication Corp. v. Societe Generale (In re Maxwell Communication Corp.)*, 93 F.3d 1036, 1048 (2d Cir. 1996), which the Court in *Stonington* characterized as "the 'poster' case for how courts can work together when dual proceedings take place." 310 F.3d at 132.

A strong concurring opinion agreed with the majority's decision to reverse, but strongly disagreed with the decision to remand, on the theory that under the facts of the case it would be an abuse of discretion if the Delaware court were, upon remand, to grant the injunction once again.

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