CT Bankruptcy Beat
Legal Developments in Restructuring and Creditors' Rights

PULLMAN & COMLEY

*A publication of Pullman & Comley, LLC*

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# FALL 2013

***"A bankruptcy judge can fix your balance sheet, but he cannot fix your company." - Gordon Bethune, Former CEO of Continental Airlines***

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## Note Provision Accelerating Debt Upon Bankruptcy Filing Was Not Invalid Ipso Facto Clause

An ipso facto clause is a provision in a contract or other written instrument which eliminates or limits the property or contract rights of a party upon its insolvency or filing of bankruptcy. See 11 U.S.C. §§363(l), 365 (b)(2), 541(c)(1)(B).

In *EETC v. AMR Corporation* (In re AMR Corporation), 2013 WL 4840574 (2d Cir. Sept. 12, 2013), secured notes provided by American Airlines ("AA") to finance a collection of aircraft contained ipso facto clauses which automatically accelerated the note indebtedness upon a bankruptcy filing. The notes also provided for the payment of a "Make-Whole Amount" in the event of a voluntary redemption prior to maturity, but exempted its payment in the event of debt acceleration due to bankruptcy. The Make-Whole Amount was defined as the present value of the remaining scheduled payments of principal and interest to maturity using a discount rate linked to the U.S. Treasury rate of interest.

On November 29, 2011, AA filed a voluntary Chapter 11 petition and shortly thereafter made elections under section 1110(a) of the Bankruptcy Code to perform all obligations under the notes and to cure any default other than a default of a kind specific in section 365(b)(2) (nullifying ipso facto clauses in executory contracts). The elections confirmed that they did not constitute assumptions of the underlying financing agreements. Under section 1110(a), a debtor must make such a timely election in order to keep the automatic stay in effect for aircraft pledged as collateral for a debt.

Later in the Chapter 11 proceeding, AA sought to refinance the note indebtedness without paying the Make-Whole Amount. U.S. Bank, the trustee of the notes, objected, arguing that the automatic acceleration of debt pursuant to the ipso facto clauses was unenforceable pursuant to 11 U.S.C. §§363(l), 365(b)(2) and 541(c)(2)(B) and that even if enforceable, the §1110(a) elections de-accelerated the debt, making the refinancing of the note indebtedness a voluntary redemption prior to maturity. As a result, maintained U.S. Bank, the Make-Whole Amount had to be paid.

The bankruptcy court and district court on appeal rejected these arguments and the Second Circuit affirmed. The Second Circuit ruled that the ipso facto clauses in the notes were enforceable since the applicable Bankruptcy Code provisions that nullify ipso facto clauses did not apply to promissory notes or trust indentures. In particular, the Second Circuit reasoned that while section 365(b)(2) nullifies ipso facto clauses in executory contracts, a note is not an executory contract. The other Bankruptcy Code sections implicated -- §§541(c)(1)(B) and 363(l) – also were held not to apply because they only protect property that otherwise would become property of the estate or the use of such property from forfeiture, whereas the debt acceleration clause at issue did not prevent property from becoming property of the estate or the use of property by the estate.

The Second Circuit also held that the note indebtedness was not de-accelerated by AA's §1110(a) elections because such elections merely establish an interim arrangement for compliance with debt obligations secured by aircraft in order to maintain the automatic stay in effect, and do not constitute assumptions of the underlying financing agreement. Although section 1110(a) requires a cure of defaults, other than a default of a kind specified in section 365(b)(2), AA's default giving rise to an acceleration of debt – which was its bankruptcy filing – was of the kind specified in section 365(b)(2) even though it was contained in a note that was not an executory contract.

## No Error in Requiring Equity Interest Holders to File Proofs of Interest Despite Listing of Interests on Debtor's Statement of Financial Affairs

In *Keough v. 217 Canner Associates, LLC* (In re Matter of Greenwich Sentry, L.P.) , 2013 WL 4750762 (2d Cir. Sept. 5. 2013 (Summary Order), the Second Circuit ruled that requiring all limited partners of the debtor to file proofs of interest by a date certain, notwithstanding their having been listed on the debtor's Statement of Financial Affairs without a notation that they were disputed or unliquidated, was not an abuse of discretion but an appropriate exercise of §105(a) because the listing was ambiguous.

## Automatic Stay Can Apply to Non-Debtor Parent and Affiliate of Debtor

In In re Residential Capital, LLC, 2013 WL 3491311 (2d Cir. July 15, 2013) (Summary Order), the debtor, ResCap, sought to apply the automatic stay to a lawsuit filed by the Federal Housing Financing Agency against ResCap's non-debtor corporate parents and an affiliate. In remanding to the bankruptcy court, which denied the relief requested, the Second Circuit reaffirmed its holding in *Queenie Ltd. v. Nygard Int'l,* 321 F.3d 282, 287 (2d Cir. 2003) that the automatic stay can apply to non-debtor entities if the claim against the non-debtor "will have an immediate adverse impact on the debtor's estate." A remand was found necessary for factual findings because the stay was denied as a categorical matter.

## Secured Creditor's Refusal to Return Vehicle Repossessed Prior to Bankruptcy Was a Violation of the Automatic Stay

In a case of first impression, the Second Circuit ruled in *Weber v. SEFCU* (In re Weber), 719 F.3d 72 (2d Cir. May 8, 2013), that a secured creditor's refusal, after demand, to voluntarily turn over a vehicle repossessed prior to the Chapter 13 debtor's bankruptcy filing was a violation of the automatic stay because it was an exercise of control over property of the estate. The Second Circuit rejected the secured creditor's argument that turnover should not have been automatically required without at least a tender of adequate protection, because it is up to the bankruptcy court, not the creditor, to determine adequate protection, which can be requested after the vehicle is turned over.

In defending against the motion for sanctions, the creditor argued that its actions were not willful because in retaining the vehicle, it had relied on the published decision in In re Alberto, 271 B.R. 223 (N.D.N.Y. 2001), which held that a secured creditor does not violate the automatic stay by failing to return a repossessed vehicle after learning of its debtor's bankruptcy. The Second Circuit rejected that argument, reasoning that under prevailing Second Circuit authority, the willful standard is satisfied whenever a creditor has the general intent to perform an act knowing the stay is in existence. In other words, a good faith belief that the stay is not being violated will not negate a finding of willfulness.

## Bankruptcy Court Reversed for Refusing to Allow Secured Creditor to Setoff Her Secured Claim Against Adverse Judgment

In this case, the secured creditor, Sally Ogden ("Ogden"), suffered an adverse judgment in the amount of $226,000 in an adversary proceeding commenced by the trustee of Bolin & Co, L.L.C. ("Bolin"). After judgment, Ogden sought to setoff her liability on the judgment with a secured claim she held against the Bolin estate in the amount of $270,000.

In *Ogden v. Chorches* (In re Bolin & Co., L.L.C.), 2013 WL 2302078 (May 28, 2013), the Second Circuit ruled that the bankruptcy court abused its discretion in failing to recognize the setoff on the erroneous ground that the trustee's judgment against Ogden arose post-petition and therefore could not be the subject of setoff under §553(a) since Ogden's secured claim arose pre-petition. For setoff to apply under §533(a), both debts must arise pre-petition. The Second Circuit reasoned that the judgment against Ogden, while entered post-petition, was based on pre-petition acts and therefore should be considered a pre-petition claim that simply had not been reduced to judgment.

The bankruptcy court further erred, ruled the Second Circuit, in holding that Ogden's and Bolin's debts were not "mutual" because Ogden's claim was secured and the Bolin trustee's claim was unsecured. According to the Second Circuit, §533 allows for setoff of both secured and unsecured claims, and its mutuality requirement does not demand that debts arise from the same transaction.

## Debtor's Causes of Action Were Property of the Estate and Could be Pursued and Settled Only By Chapter 7 Trustee

In *Desmores v. Charlotte School of Law (In re Desmores),* 497 B.R. 390 (D. Conn. Aug. 29, 2013) (Thompson, J.), the debtor filed and sought to pursue an adversary proceeding against one of his creditors, Charlotte School of Law ("Charlotte"). The action included claims of negligence and breach of contract which the debtor contended arose after his bankruptcy case was filed and therefore were not property of the estate.

The district court, after recognizing a split of authority on whether a cause of action belongs to the estate when it accrues after a bankruptcy petition is filed, but before the case is closed, held that under either line of authority the debtor's claims were property of the estate. Under the "categorical approach," which holds that a cause of action will belong to the estate if it accrues before the case is closed, the debtor's claims were property of the estate because his case was not closed. Under the case-by-case approach, the claims also belonged to the estate because the harm alleged was caused by a sequence of events that occurred both pre- and post-petition and therefore, the claims met the test of being "sufficiently rooted in the pre-bankruptcy past."

The trustee's sale of the claims to Charlotte, which the bankruptcy construed and approved as a compromise of the claims under Fed. R. Bankr. 9019, was affirmed by the district court on the ground that the debtor lacked standing to object to the sale/compromise given the absence of any evidence of a surplus after payment of all creditors' claims.

## No Post-Confirmation Jurisdiction for Adversary Proceeding Alleging Debtor Fraud and Non-Compliance with Professional Retention and Fee Provisions

In *Vanguard Products Corp. v. Citrin, (In re Indicon, Inc.),* 2013 WL 5435536 (D. Conn. Sept. 30, 2013 (Underhill, J.), the bankruptcy court's ruling that it lacked post-confirmation jurisdiction over an adversary proceeding was affirmed by the district court. The adversary proceeding at issue was brought by an administrative creditor who was provided no notice of the bankruptcy case, but who, after confirmation, reopened the case and obtained an allowed administrative claim. The suit alleged that the debtor and a financial advisor whose employment was not approved by the bankruptcy court failed to disclose an asset purchase agreement that had been negotiated and signed during the bankruptcy case, but which the parties delayed closing on until after confirmation. In the meantime, the plan that was confirmed did not propose a sale of assets, but represented that the debtor would continue to operate as a going-concern. From the asset sale, which was consummated three weeks after confirmation, the financial advisor was paid $82,000 in fees and the debtor's principal was given a four-year employment agreement worth $400,000 without any obligation that she remain employed by the purchaser.

Despite the egregious circumstances alleged, the district court found there was no post-confirmation jurisdiction under the "close-nexus test" applied in the Second Circuit, which, according to the district court, required that: (1) the post-confirmation action "impact the implementation, execution, and administration of the plan," and (2) the plan contain a provision reserving jurisdiction for the dispute at issue.

The district court found that the dispute did not satisfy the first part of the test because the simple assertion of a claim for post-confirmation payment, if allowed to serve as a basis for post-confirmation jurisdiction, "would obliterate any limits" on that type of jurisdiction. The second part of the test was also not satisfied, ruled the district court, because the confirmed plan did not contain a reservation of jurisdiction for the type of dispute brought by the administrative creditor.

The district court also rejected the creditor's argument that post-confirmation jurisdiction was properly exercised based on case law from other jurisdictions holding that a bankruptcy court can take such jurisdiction if the dispute implicates the integrity of the bankruptcy process. The district court was of the view that a connection between payments to administrative claimants and the bankruptcy proceeding was "too tenuous to implicate the bankruptcy plan" and that, in any event, the Second Circuit's close-nexus test is the exclusive test for post-confirmation jurisdiction.

## Chapter 12 Plan Denied Confirmation for Failure to Prove Feasibility and Improperly Eliminating Cross-Collateralization Rights of Secured Creditors

In In re Chickosky, 2013 WL 5434131 (Bankr. D. Conn. Oct. 1, 2013) (Dabrowski, J.), the debtor's Chapter 12 plan was denied confirmation because the debtor failed to prove the plan was feasible and the plan improperly eliminated a secured creditor's pre-petition rights to cross-collateralization of two different loans. Each of the loans was secured by the other loan's principal collateral, but the plan proposed that each loan would be secured by only its principal collateral.

Feasibility could not be established because no evidence was presented matching projected income with corresponding expenses and because past earnings history suggested that the debtor's optimistic projections were not realistic. The elimination of the secured creditor's cross-collateralization was held to be improper because section 1225(a)(5)(B)(i) requires that secured creditors retain their liens.

## Short-Term Loans and Repayments Too Informal And Atypical of Normal Business
## Routine to Protect Payments from Recovery as Preferences

At issue in *Official Committee of Unsecured Creditors v. Wellner* (In re Affinity Health Care Management, Inc.), 2013 WL 4525582 (Bankr. D. Conn. Aug. 27, 2013) (Dabrowski, J.), was whether the ordinary course of business defense to a preferential transfer could be applied to payments on short term loans that were not formally documented and where the record-keeping on the loans and repayments was indecipherable or non-existent. Given these circumstances, combined with the fact that the interest paid on the loans was very excessive and that no bills were ever sent or security provided, even though the loans were for substantial amounts, the bankruptcy court ruled that the payments were not of "a debt incurred by the debtor in the ordinary course of business . . .," one of the required elements of establishing the ordinary course of business defense.

## PACA Claimant Could Not Establish PACA Trust Allowing for Payment in Full from Bankruptcy Estate

Suppliers of produce are afforded a non-segregated floating trust over property of a debtor that is derived from sales of produce pursuant to the Perishable Agricultural Commodities Act ("PACA"). Such a trust is recognized in bankruptcy and affords produce suppliers a priority in payment ahead of all other creditors, including secured creditors.

In In re Quality Sales, LLC, 2013 WL 4482412 (Bankr. D. Conn. Aug. 19, 2013) (Dabrowski, J.), the bankruptcy court first noted that the federal statute providing for a PACA trust requires a PACA claimant to send written notice of an intent to preserve PACA trust benefits to both the USDA and the commodities broker within 30 days after payment is due. An invoice can satisfy the written notice requirement if it contains express notice of an intent to claim a PACA trust and certain language stating that the produce is being sold subject to a PACA trust.

The holding in Quality Sales was that "substantial compliance" with PACA's notice requirements is not sufficient to establish a PACA trust. In this case, the PACA claimant simply sent a letter to the USDA providing notification that it wished to file a complaint against Quality Sales, the debtor. The bankruptcy court also held that various written communications between the PACA claimant, the debtor and the USDA did not satisfy the strict notice requirements of PACA.

## Stay Pending Appeal of Order Granting Relief from the Automatic Stay Denied

In In re Dunne, 2013 WL 379979 (Bankr. D. Conn. July 18, 2013), the bankruptcy court granted limited relief from the automatic stay for an Irish bankruptcy proceeding to continue against the debtor (the "Relief Order"). The Irish bankruptcy proceeding had begun shortly before the debtor filed his own voluntary Chapter 7 case. Specifically, relief from the stay was granted to allow the Irish bank that commenced the proceeding to request alternate means of service on the debtor, participate in a "bankruptcy" determination in the Irish High Court, and potentially participate in nominating an Irish bankruptcy representative. The debtor's U.S. Chapter 7 trustee had supported relief from the stay, as most of the debtor's properties and creditors were located in Ireland. The debtor appealed the order and sought a stay pending appeal.

The bankruptcy court applied the Second Circuit's four-part test for determining whether to grant a stay pending appeal: (1) whether the applicant made a strong showing of likelihood of success on the merits; (2) whether the applicant would be irreparably harmed absent the stay; (3) whether a stay will substantially injure other parties in the proceeding; and (4) whether it is in the public interest. The degree of showing required for success on the merits is to vary according to the court's assessment of the other factors.

In this particular case, the bankruptcy court found that all four factors weighed against a stay. The debtor would not be irreparably harmed if a stay was not issued because his only interest in his U.S. bankruptcy proceeding would be getting a discharge, which would not be affected by permitting the Irish proceeding to go forward on the limited basis that was ordered.

The debtor also made no strong showing of likelihood of success on the merits. The debtor's argument that no evidence was presented to establish "cause" for relief was not considered persuasive because the trustee, the only party with legal responsibility for administering the debtor's property, consented to relief, and in any event, cause was established by the bank's submission of evidence of the Irish bankruptcy proceeding, which was not rebutted by the debtor.

As to the final two factors, the court found that the only party that would be substantially injured by a stay was the trustee, who would be impeded in expeditiously administering the estate, and that the public interest would not favor a stay because of the importance of recognizing the interwoven interests of two sovereigns in the estate's property and creditors.