

BANKRUPTCY FOR BREAKFAST

HON. ELIZABETH S. STONG
UNITED STATES BANKRUPTCY COURT
EASTERN DISTRICT OF NEW YORK

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***Marrama v. Citizens Bank*¹ – Does it Matter for Business Cases**

In this case, the debtor commenced a Chapter 7 case and unquestionably concealed his principal asset (having placed it in a self-settled trust and valuing his interest in the trust at zero). At the first meeting of creditors, the trustee discovered the concealed asset and indicated his intent to recover the property (and probably seek to deny the debtor a discharge). Having been caught, the debtor sought to convert his case to Chapter 13, which he presumably believed would permit him to get rid of the trustee, keep the asset, and get a discharge. The bankruptcy court denied the request to convert based on a finding of bad faith. The question presented to the Supreme Court was whether a debtor has an absolute right to convert his case from one under Chapter 7 to one under Chapter 13 or whether conversion could be denied based on bad faith.

Section 706 of the Code was the basis for the debtor's argument that he had an absolute right to convert the case:

(a) The debtor may convert a case under this chapter to a case under chapter 11, 12, or 13 of this title at any time, if the case has not been converted under section 1112, 1208, or 1307 of this title. Any waiver of the right to convert a case under this subsection is unenforceable.

....

(d) Notwithstanding any other provision of this section, a case may not be converted to a case under another chapter of this title unless the debtor may be a debtor under such chapter.

While the question of whether a debtor has an absolute right to convert may seem arcane, byzantine, boring, or just not all that interesting, the decision by the Supreme Court will undoubtedly have repercussions for business bankruptcy cases. Perhaps somewhat surprisingly, this bankruptcy case wound up being a battleground between the liberal and conservative wings

¹ 127 S.Ct. 1105 (2007).

of the Court. Justice Stevens wrote the majority opinion in which Justices Kennedy, Souter, Ginsburg, and Breyer joined. Chief Justice Roberts and Justices Scalia and Thomas joined Justice Alito's dissent.

The tension in the two opinions arose from the fact that Section 706 does appear to unambiguously grant the debtor the right to convert with only two limits. Bad faith is not listed in the text of the Code as a basis for denying conversion. Finding the statutory language clear and unambiguous, the dissent would have reversed the lower courts and granted the debtor's request to convert. The dissent wrote that Congress provided the bankruptcy courts with ample means to address the bad faith of the debtor **after conversion** (e.g. converting the case back to Chapter 7). The dissent found "no justification for disregarding the Code's scheme."

It was clear from the beginning that the majority was concerned about the possibility of abuse in the bankruptcy system finding that the issue of conversion by a bad faith debtor was an issue that was occurring with "disturbing frequency." Some might have expected the Court to find that the various Code provisions belied an absolute right to convert when read together, which would have allowed the majority to affirm without establishing any broader principles. Justice Stevens chose instead to rely on Section 105 and the inherent power of the courts to address abusive practices. For bankruptcy practitioners, the reliance on Section 105 has to be a surprise as it had been accepted black-letter law that Section 105's grant of broad equitable powers could not be construed in a manner to contravene an express provision of the Code. The question for the lower courts is how to interpret the *Marrama* decision. If Section 105 can be used to override what some claim was the plain meaning of Section 706, will the courts be inclined to view invocations of Section 105 with more tolerance. Has the Court created a possible exception to other apparently clear bankruptcy provisions? Wait and see.

Assumption of Intellectual Property Licenses

In general, a debtor is given wide latitude in deciding whether to assume, assign, or reject executory contracts. Section 365 (c)(1) of the Code, however, puts significant limits on a debtor's ability to assign such contracts when "applicable law" excuses a non-debtor party from accepting performance from or rendering performance to an entity other than the debtor or the DIP. This provision has become singularly important in the current wired era, where technology licenses may be significant assets in Chapter 11 cases.

The initial question is what is "applicable law." Many courts have held that patent, trademark, copyright laws are and these bodies of federal law excuse the non-debtor from accepting performance from anyone other than the debtor. These decisions have effectively given the non-debtor licensor the ability to veto the case by blocking assignment of a licenses.

As if this conclusion were not bad enough for technology debtors, a majority of courts have concluded that this provision bars assumption altogether without the licensor's consent. These courts read the statute's use of the disjunctive to mean that if applicable allows the non-debtor party to refuse to accept performance from anyone other than the debtor, then the debtor may not ASSUME the contract. These courts apply the so-called hypothetical test: if applicable prohibit a hypothetical assignment to a third party, then the debtor may not assume the contract. The Ninth Circuit issued the seminal decision in *Perlman v. Catapult Entm't (In re Catapult Entm't, Inc.)*, 165 F.3d 747 (9th Cir. 1999). The Catapult court read Section 365(c)(1) to "[bar] a debtor in possession from assuming an executory contract without the nondebtor's consent where applicable law precludes assignment of the contract to a third party." That court found that to read otherwise, allowing a debtor in possession to assume any executory contract as long it did not contemplate assignment thereof, would effectively rewrite the statute to prohibit "assumption

and assignment, rather than assumption or assignment." The Catapult court held that "where applicable nonbankruptcy law makes an executory contract nonassignable because the identity of the nondebtor party is material, a debtor in possession may not assume the contract absent consent of the nondebtor party." In addition to the Ninth Circuit, the Third and Fourth Circuits have adopted this test.

In contrast, the First Circuit has rejected the hypothetical test and has found the debtor in possession may assume as long it does not actually intend to assign the contract (the actual test). *Institut Pasteur, et al. v. Cambridge Biotech Corporation*, 104 F.3d 489 (1st Cir. 1997). The Fifth Circuit, albeit in the context a different subsection of Section 365, has rejected the hypothetical test and adopted the actual test. *Bonneville Power Admin. v. Mirant Corp.*, 440 F.3d 238 (5th Cir. 2006). In a slight twist, the Bankruptcy Court for the Southern District of New York has rejected the hypothetical test on the grounds that a literal reading of the statute distinguishes between the debtor in possession and the trustee. Therefore, the use of the specific terms has meaning and the limitation only applies if a trustee, not a DIP, seeks to assume the contract.

Given this clear split in the circuits, the question of where to file the case assumes greater significance in a case involve valuable IP licenses. If the debtor can justify filing in New York rather than Los Angeles, then the entire nature of the case is changed. One has to think that the Supreme Court will eventually have to resolve this split. The *Marrama* decision may be instructive as to how the Justices will vote.

Travelers Casualty & Surety Co. v Pacific Gas & Elec. Co.²

In this case, Travelers, an unsecured creditor, sought to include attorney's fees as part of its unsecured claim. The lower courts rejected the claim based on the Ninth Circuit's *Fobian* decision, which held: "Where litigated issues involve not basic contract enforcement questions, but issues peculiar to bankruptcy law, attorneys' fees will not be awarded absent bad faith or harassment by the losing party." The Supreme Court held that the Code did not support the *Fobian* limitation and reversed. The Court held that Section 502 (b) allows all claims unless the claim falls within one of nine exceptions. Because there was no provision in the Code disallowing the claim for fees and because they were otherwise valid under state law, there was no basis for a judicially fashioned rule precluding them.

The Court refused to address whether the Code otherwise bars the claim for fees because the parties did not raise it below. The principal bases for concluding that an unsecured creditor may not recover postpetition fees are found in Section 502 and Section 506 (b) of the Code. Section 506 (b) expressly allows an oversecured creditor to assert a claim for postpetition fees and interest. If an unsecured creditor may do the same, then Section 506 (b) is surplusage. Section 502 (b) seems to provide a basis for actually rejecting the claim. It provides that claims are to be allowed in an amount as of the filing of the petition. Fees and interest that are incurred or accrue postpetition would seem to be excluded on this basis (a conclusion that renders Section 506 (b) relevant). The fact that the Court simply remanded this issue rather than ruling on the basis of what many believe to be the clear state of bankruptcy law certainly raises a question as to whether there is more ambiguity in this area than one would have otherwise thought.

² 127 S.Ct. 1199 (2007).

** A California bankruptcy court has held that unsecured creditors are entitled to include a claim for post-petition fees on the basis that a creditor's nonbankruptcy rights can only be modified by a clear provision in the Code (such as Section 502 (b)?).

** A Florida bankruptcy court has held that an unsecured creditor is not permitted to include post-petition attorney's fees in its unsecured claim. The court relied on both Sections 502 (b) and 506 (b). Further, the Court found that the reasoning of the Supreme Court in *Timbers* remained viable and applicable to fee claims. Finally, the court found allowing fees to contract claimants would be inequitable in that tort claimants and trade creditors (without a contract) would have their claims diluted (though isn't this the result mandated by state law?). *In re Electric Mach. Enterprises, Inc.*

BAPCPA & Business Cases - Happy Second Birthday (a bit late)³

Commercial Leases

BAPCPA provides that a tenant under an unexpired lease of nonresidential lease of real property must assume or reject the lease within 120 days of the filing. The court may grant one 90 day extension, but no more absent lessor consent. This is in marked contrast to pre-BAPCPA practice where the deadline was repeatedly extended, often to confirmation. A lease may be a significant asset (esp. if below market) or at the very least a key element of the reorganization strategy. Under BAPCPA, these debtors must make the assume/reject decision much earlier in the case. Some have argued that the 210-day limit has put a cap on the value of the leases, which limits recovery for creditors. While this proposition may be in doubt, there is no question that the leverage has shifted in favor of the landlord.

Reclamation

When a debtor winds up in bankruptcy, a party who has sold goods in the period leading up to bankruptcy may be able to reclaim those goods under provisions of state law and the Code. BAPCPA made some changes to those rules. BAPCPA added a 45-day reclamation right to Section 546 (c) (the UCC has a 10-day rule). Although much has been made of this change, many predicted it would amount to much ado about nothing. Thus far, the naysayers have been proven correct. Courts that have addressed this issue since BAPCPA took effect have found that the superior rights of secured creditors trump the BAPCPA reclamation claim. The same was true under prior law and often made the reclamation claim worthless.

While the reclamation right appears to remain more promise than fulfillment, the administrative claim created by BAPCPA related to good received by the debtor within twenty

³ BAPCPA took effect on October 17, 2005.

days of the filing does provide some benefit to creditors. While it is a real claim, the courts that have addressed it have held that the creditor must wait until confirmation for payment. The Ninth Circuit has held that secured creditors may avail themselves of the administrative claim.

Key Employee Retention Plans

Key Employee Retention Plans (“KERPs”) were omnipresent in Chapter 11 practice prior to BAPCPA. In BAPCPA, Congress tightened up the rules regarding KERPs considerably. In fact the new standards (the employee must be essential to the business surviving, bona fide competing offer) have rendered KERPs obsolete. Achieving the goal that Congress perhaps wanted, debtors seem to have moved from KERPs to incentive plans.

Chapter 15

BAPCPA enacted a new chapter to the Code. It is used principally by parties to foreign insolvency proceedings to obtain assistance in the United States with respect to that proceeding.

Preferences

BAPCPA substantially eased the burden on preference defendants asserting the ordinary course defense. However, that hasn’t necessarily meant that defendants are winning. In *In re National Gas Distr., LLC*, 346 B.R. 394 (Bankr. E.D.N.C., 2006) the court allowed the defendant to assert a defense based on ordinary business terms (without proving ordinary course between debtor and defendant) as intended by Congress. However, the court required the debtor to prove that the payment was consistent with the payment practices of the industries of both the debtor and the creditor. Prior to BAPCPA, the courts had focused on either the debtor’s (8th Circuit) or the creditor’s industry (4th Circuit), but not both. The court found the pre-BAPCPA case to be “less instructive” when construing the new version of Section 547. Starting from a clean slate, the bankruptcy court determined it would be more appropriate consider the industry practices

from both perspectives. While this may make sense when viewed solely through the prism of bankruptcy policy, has this court set up a test that will be even more difficult to meet than the pre-BAPCPA standard? One has to wonder if the standards of both industries will be mutually exclusive.

Update on Florida Homestead Exemptions

Florida opted out of the Federal exemptions, Fla Stats. § 222.20 Property of the estate is defined in 11 USC § 541(a)(1) Exemptions are regulated by 11 USC §522, capping the exemption of property that the debtor or a dependent of a debtor uses as a residence or claims as a homestead at \$125,000 where that interest was acquired within 1215 days of the debtor's filing.

The 1215 day rule is found in 11 USC §522(p); and additionally there is the fraud look back of ten years under § 522(o) where there has been a disposition with the intent to hinder, delay, or defraud a creditor where "the debtor could not exempt under subsection [522(b)] if on such date the debtor has held the property so disposed of"

In re ROBEDEE, No. 06-10759-BKC-JKO, Adv. No. 06-1591-JKO-A, U.S. Bankr. Ct., S.D. Fla, April 12, 2007

In re RRUSSELL, No. 8:05-bk-26287-CPM, U.S. Bankr. Ct., M.D. Fla., April 16, 2007

In re GAINES, No. 05-14608, U.S. Bankr. Ct., M.D. Fla., April 18, 2007

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In re ENSENAT, No. 06-15979 BKC-LMI, U.S. Bankr. Ct., S.D. Fla., May 24, 2007

In re GAUTHIER, No. 04-34338-BKCC-SHF, Adv. No. 06-1113-BKC-SHF-A, U.S. Bankr. Ct., S.D. Fla., May 30, 2007

In re CAULEY, No. 06-2077-3F7, U.S. Bankr. Ct., M.D. Fla., June 19, 2007

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In re FRANZESE, No. 07-14518-BKC-RBR, U.S. Bankr. Ct. S.D. Fla., July 19, 2007

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In re KELLEY, No. 3:06-cv-881-J-33TEM, Bankr. No. 3:05-bk-13031-GLP, U.S. Dist. Ct., M.D. Fla, Aug. 30, 2007

In re GRIMES, Jr., No. 4D06-4591, Dist. Ct. of Appeal, Fla., Sept. 5, 2007

In re MOHAMMED, No. 07-12303-BKC-LMI, U.S. Bankr. Ct., S.D. Fla., Sept. 6, 2007

In re VERNELL, No. 07-15396-BKC-AJC, U.S. Bankr. Ct., S.D. Fla., Sept. 14, 2007

In re MERCADO, No. 06-03995, U.S. Bankr. Ct., M.D. Fla., Sept 24, 2007

**ABA FALL MEETING,
COMMITTEE ON BUSINESS AND CORPORATE LITIGATION,
WASHINGTON, DC, NOVEMBER 15, 2007**

UPDATES ON HOMESTEADS IN FLORIDA

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