BLANKROME

ANTICIPATING AND MANAGING BANKRUPTCY RISK

Materials prepared for the Lexis Practice Advisor® by:

Ira L. Herman, Esq.
212.885.5052 | iherman@blankrome.com

Introductory Note

Anticipating and Managing Bankruptcy Risk

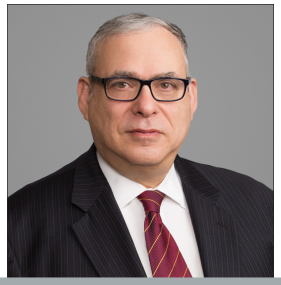
The materials that follow have been prepared by Ira L. Herman, Esq. for the Lexis Practice Advisor®

The Lexis Practice Advisor is organized by topic into a series of modules, including the following:

Labor & Employment, Intellectual Property & Technology, Real Estate, Financial Restructuring & Bankruptcy, Business & Commercial, Corporate Counsel, and California Business & Commercial, as well as Mergers & Acquisitions, Securities & Capital Markets, Banking & Finance, and Texas Business & Commercial.

See more at:
http://www.lexisnexis.com/en-us/products/lexis-practice-advisor.page#shash.4nR07e32.dpuf

Each of the articles in this booklet are excerpted from the Financial Restructuring & Bankruptcy module. The IP material also can be found in the Intellectual Property & Technology module, while several of the articles also appear in the Banking & Finance module.



Ira L. Herman
Partner
Finance & Restructuring Practice
212.885.5052
iherman@blankrome.com

Anticipating and Managing Bankruptcy Risk

Table of Contents

BLANKROME

TAB 1

Property of the Estate under the topic Bankruptcy Basics

Ira L. Herman

Understanding Property of the Estate

by Ira L. Herman, Blank Rome LLP

Ira L. Herman is a Partner in the Finance, Restructuring, and Bankruptcy group of Blank Rome LLP.

Anticipating the bankruptcy risks of a transaction involves determining in advance of a bankruptcy filing whether the property at issue would be property of a debtor's estate in bankruptcy. If the other party to the transaction files for bankruptcy, the court in which the bankruptcy case is commenced obtains exclusive jurisdiction over any and all property of a debtor's estate. 28 U.S.C. § 1334(e).

Under section 541(a) of the Bankruptcy Code, property of the estate is comprised of all of the following, "whenever located and by whomever held":

- All legal and equitable interests of the debtor in property as of the commencement of the case;
- Certain interests of the debtor and the debtor's spouse in community property as of the commencement of the case;
- Any interest in property that the trustee recovers under enumerated provisions of the Bankruptcy Code;
- Any interest in property preserved for or transferred to the estate under section 510(c) of the Bankruptcy Code (equitable subordination) or section 551 of the Bankruptcy Code (preservation of avoided transfer);
- Certain interests in property acquired by the debtor or to which an entitlement arises, within 180 days after filing, by bequest, devise, inheritance, property settlement, divorce decree, life insurance policy, or death benefit plan;
- Proceeds of any of the above, except for post-petition wages in a chapter 7 case; and
- Property that the estate acquires after commencement of the case.

The nature and extent of a debtor's interest in property is determined under applicable non-bankruptcy law, typically state law. Butner v. United States, 440 U.S. 48, 55 (1979). However, whether a property interest falls within the categories included in the estate under section 541 of the Bankruptcy Code is determined by application of the federal bankruptcy law. In re Haedo, 211 B.R. 149 (S.D.N.Y. 1997).

Pursuant to section 541(a)(1), property of the estate includes non-leviable or even non-transferable rights of a debtor. This is true even though these types of rights may not fall within more traditional or common law concepts of property, which usually encompass physical property, claims to property, and causes of action.

As a practical matter, property of the estate is an important concept when considering the consequences of a potential bankruptcy filing. First, "property of the estate" is the source of distributions to creditors. A creditor must consider whether the property from which it expects its claim to be satisfied could become part of a bankruptcy estate, to be distributed to the debtor's creditors.

Second, property that becomes part of the estate is protected by the automatic stay. A creditor relying on its rights against certain property must therefore be aware that its ability to exercise those rights will be limited if there is a bankruptcy filing. For more information about the Automatic Stay, *see Understanding and Examining the Automatic Stay*.

Third, a landlord or tenant of the debtor must be aware of the effect of a bankruptcy filing on any lease that becomes property of the estate. Similarly, a party to an executory contract with the debtor must be aware that if the contract becomes property of the

estate, it will be subject to assumption or rejection under section 365 of the Bankruptcy Code. For more information about Executory Contracts and Unexpired Leases, *see Understanding What Constitutes an Executory Contract and Unexpired Lease*.

Fourth, a creditor must be aware that trust funds held by an entity that files for bankruptcy relief are not property of the estate.

Fifth, a creditor must be aware of the type of claim it actually holds, i.e., secured, unsecured or priority. To the extent repayment of a creditor's claim is secured by the collateral, the creditor needs to understand the nature, extent, validity and priority of its lien or security interest.

Finally, a creditor must consider the ways that property can be extricated from the estate and from the jurisdiction of the bankruptcy court, including: (1) trustee distribution; (2) a confirmed plan under chapters 11, 12, or 13 of the Bankruptcy Code (*see Understanding Confirmation*); (3) relief from the automatic stay, thereby allowing a creditor to exercise its rights against certain property (*see Understanding and Examining the Automatic Stay*; (4) abandonment by the debtor or trustee; and (5) sale or assignment under section 363 of the Bankruptcy Code (*see Analyzing the Required Notice, Auction Procedures, and Bid Procedures Order for a Proposed 363 Sale*). Removing property from the estate means that a non-debtor party is either receiving as cash payment on account of its claim or property that can be sold or otherwise monetized to satisfy an outstanding obligation of a debtor.

BLANKROME

TAB 2

Secured Claims under the topic Bankruptcy Basics

Ira L. Herman

Understanding Security Interests and Liens: Attachment

by Ira L. Herman, Blank Rome LLP

Ira L. Herman is a Partner in the Finance, Restructuring, and Bankruptcy group of Blank Rome LLP.

Extent of Secured Claim – Valuation of Collateral

To ensure that a secured lender receives sufficient adequate protection, it is important to determine the value of the lender's secured claim early on in the bankruptcy case. Essentially, a lender's secured claim is equal to the sum of the value of its collateral as of the petition date (plus any property that the secured lender holds that is subject to setoff).

In determining the value of a secured lender's collateral, courts have employed varying methods of valuation depending on the facts of the case, including using fair market value, liquidation value, and going concern value.

Secured Claim Status – Validity, Priority and Extent of Security Interests and Liens

The law of secured transactions in the United States covers the creation and enforcement of a security interest. Usually, a secured transaction happens when a person or business borrows money for the purpose of acquiring property, including real estate, vehicles, or business equipment. A security interest exists when a borrower enters into a contract that allows the lender or secured party to take collateral that the borrower owns in the event that the borrower cannot pay back the loan. The term "security interest" is often used interchangeably with the term "lien" in the United States.

A security interest promotes economic security because it provides the lender with the promise of repayment: if the borrower defaults on the loan, the lender should be able to recoup the loan amount by taking the agreed-upon asset used as collateral and selling it. A security interest can be particularly valuable in bankruptcy because secured creditors will be able to collect their debts before creditors without a security interest.

The first step in the perfection of a lien is to cause "attachment" of the collateral to occur, which will thereafter allow the creditor to "perfect" the security interest, which is the ultimate goal in properly securing the collateral. Thus, as a first step, attachment of the collateral must occur. If the security interest has attached to the collateral, it is enforceable against the debtor; if it has not attached, it is not enforceable at all. Thereafter, if perfection is achieved, it will ensure that the lien of the secured party is enforceable against most third parties that acquire a lien in the collateral subsequent to the secured party.

An Article 9 security interest attaches when all of the following events have occurred:

a. Value has been given – Value in the context of Article 9 of the Uniform Commercial Code is broader than the contractual concept of consideration. Value includes giving a security interest in total or partial satisfaction of a pre-existing debt, as well as binding commitments to extend credit.

b. The debtor has rights in the collateral – For purposes of Article 9 of the Uniform Commercial Code, the debtor need not own the collateral. It is sufficient if the debtor has some limited rights to the collateral. Of course, the security interest would then attach only to the limited rights that the debtor has or has the power to transfer. *See* section 9-203 of the Uniform Commercial Code, comment 6. Additionally, a debtor, for purposes of this section of Article 9, may not necessarily be the primary obligor on the underlying loan. It is the party with rights in the collateral granting the security interest. Thus, the

primary obligor could be a corporation and the collateral securing the loan could belong to the president of the corporation or its sole shareholder. The president or sole shareholder in such a case would then be the debtor who would have rights in the collateral.

c. A security agreement has been entered into which:

- Is authenticated by the debtor;
- Describes the collateral; and
- Describes the land if the collateral includes timber to be cut.

Security Agreements

No particular form is required for a security agreement. The security agreement can be contained in the promissory note, the deed of trust, or a loan agreement. It must, however, include language granting a security interest. While no magic language is required, a present grant of a security interest should be evident from the words of the document. For instance, a UCC-1 financing statement has all of the information required to be in a security agreement. It is authenticated by the debtor, it describes the collateral, and it may describe the land. Indeed, by the very act of authenticating a financing statement, one could argue that it is implicit that the debtor intended to grant a security interest in the described collateral to the secured party. Nonetheless, this alone is not sufficient unless it contains specific granting language of some kind.

It should be noted that a security agreement is not required for attachment if collateral is in the possession of the secured party "pursuant to the debtor's security agreement," or the collateral is deposit accounts, electronic chattel paper, investment property, or letter of credit rights over which the secured party has control.

Description of Collateral

The security agreement must contain a description of the collateral being secured, although such description need not be exact and detailed (*i.e.,* serial numbers), but it must reasonably identify the collateral that is subject to the security interest. On the other hand, a super-generic description such as "all assets" or "all personal property" is not sufficient for a security agreement. (That would, however, be a sufficient description for a *financing statement* under revised Article 9 of the Uniform Commercial Code). It is sufficient if the security agreement lists the collateral by category, such as all equipment, inventory, and accounts.

Proceeds

In Article 9 parlance, proceeds means, among other things, any property acquired upon the sale, lease, exchange, or other disposition of collateral that is subject to a security interest, anything collected or distributed on account of the collateral, and insurance proceeds upon the loss or destruction of the collateral up to the value of the collateral. There is no need to put a statement in the security agreement providing for a security interest in the proceeds of collateral. The attachment of a security interest in collateral automatically gives a secured party rights to the identifiable proceeds.

After-Acquired Property

After-acquired property is property in which the debtor had no rights at the time of the loan transaction but in which it subsequently acquires rights. In order for a security interest to attach to that type of collateral, there must be an affirmative statement in the security agreement creating or providing for a security interest in after-acquired property. It is sufficient to insert the phrase "now owned or hereafter acquired" in the security agreement's description of collateral. Such a statement is *not* required in the financing statement for *perfection* of a security interest in after-acquired property.

Future Advances

If appropriate, a security interest in collateral may also secure future obligations owed by the debtor to the secured party. Those future obligations or advances do not need to be made pursuant to a commitment made or even be seriously contemplated at the time at which the security agreement is entered into. All that is required is a statement in the security agreement whereby the debtor grants the security interest to secure future advances. As a practical matter, it should be evident that when representing debtors, it is important to focus on the language in the security agreement. The language could be so broad that the agreement grants the security interest to secure any and every other oReview of the Requirements of a Security Agreementbligation of any kind ever owed by the debtor to the secured party. This is a clause that bears close examination to ensure that it accords with the intent of the parties at the time at which the contract is entered into.

Review of the Requirements of a Security Agreement

Requirements for a security agreement include that it:

- Be a written (or electronic) record;
- Be signed or authenticated by the debtor;
- Contain a sufficient description of the collateral;
- Be less than a specific serial number approach but be more than merely "all assets";
- A description by category is sufficient (*e.g.,* all equipment, accounts, and general tangibles).

Other requirements include that:

- Value has been given;
- The debtor has rights in the collateral;
- There is no need to include proceeds, which is automatically included;
- The after-acquired property clause must be included; and
- The future advances clause should be included, if appropriate.

Understanding Security Interests and Liens: Perfection

Go to: Perfection of Security Interests Generally

Reviewed on: ***09/16/2017***

by *Ira L. Herman*, Blank Rome LLP

Perfection of Security Interests Generally

An unperfected security interest is subordinated to a lien creditor and a bankruptcy trustee. Stated in the reverse, a perfected security interest prevails over a judgment creditor and a bankruptcy trustee. There are four basic methods of perfecting an attached security interest. First, and most common, is a properly completed financing statement filed with the appropriate UCC filing office. Second, the collateral may be in the possession of the secured party. Third, the secured party may have control over the collateral. Fourth, in a few cases, the attachment of the security interest automatically perfects the security interest.

1) Perfection by Filing

A security interest in many types of collateral may be perfected by filing a properly completed financing statement in the appropriate UCC filing offices. Except for security interests arising out of certain sales of accounts or payment intangibles, the filing of a properly completed financing statement is the only method of perfecting a security interest in accounts or commercial tort claim intangibles. This is because these types of collateral have no physical presence that enables perfection by possession. The filing of a financing statement is an alternative method of perfecting a security interest in goods, negotiable documents, instruments, chattel paper, and investment property.

A financing statement under revised Article 9 of the Uniform Commercial Code must set forth:

a. The debtor's name
b. The debtor's mailing address
c. Indicate whether the debtor is an individual or an organization
d. If the debtor is an organization, indicate the type of organization (*i.e.,* corporation, partnership, limited liability company, etc.), the jurisdiction of organization, and an organizational number
e. The name of the secured party or the secured party's representative
f. The mailing address of the secured party or its representative -and-
g. A description of the collateral covered by the financing statement

The two principal ingredients that cause the greatest trouble are (1) the debtor's name and (2) the description of collateral. Uniform forms for financing statements, continuation statements, termination statements, and the like are contained in Article 9 of the Uniform Commercial Code itself. Any document meeting these requirements may be filed as a financing statement.

A financing statement may be filed without the debtor's signature on the financing statement if the debtor authorizes the filing. By entering into a security agreement, a debtor automatically authorizes the filing of a financing statement covering the collateral described in the security agreement.

A collateral description in a financing statement is sufficient if it "indicates the collateral covered by the financing statement." A financing statement indicates the collateral when it has a description of the collateral or if it indicates

that it covers all assets or personal property of the debtor. "Supergeneric" collateral descriptions for financing statements are allowed under revised Article 9 of the Uniform Commercial Code. Where the security agreement creates a lien in all of the assets of the debtor, the supergeneric collateral description would be as follows: "All assets." A slightly expanded supergeneric, all-asset description is as follows:

> All personal property of debtor, wherever located, and now owned or hereafter acquired, including accounts, chattel paper, deposit accounts, documents, equipment, general intangibles, instruments, inventory, investment property, letter-of-credit rights and commercial tort claims, and the proceeds and products of the foregoing.

The debtor's correct name is crucial to the validity of the financing statement because records are indexed on that basis. The name of the debtor should appear on this form exactly as it appears on the security agreement, and if the debtor is a registered organization, exactly as the debtor's name appears in the public records of the organization. If the debtor is an individual, the financing statement must indicate the debtor's last name. A trade name is not a sufficient name for a debtor. For a trust, the rules are somewhat confusing. It is necessary to examine the trust documents and determine whether separate filings are required under the names of the individual trustee(s), and either the individual settlor(s) or the name of the trust itself, if it has one. Any name used for the debtor other than the correct name renders the financing statement insufficient and seriously misleading, unless the name used is so similar to the debtor's correct name that a search under the debtor's correct name, using the filing office's standard search logic, would disclose the filing with the incorrect name.

As a practical matter, consider taking the following steps:

- Getting the name of the registered organization from its certificate of formation, its certified articles of incorporation, its certified articles of organization, or its certificate of limited partnership, in each instance issued by the secretary of state of the jurisdiction of its formation
- Requiring any natural person who is a borrower to produce a passport, social security card, birth certificate, federal income tax return, or photocopy of his driver's license
- Getting copies of formation documents from unregistered entities (the partnership agreement, etc.)
- Getting a copy of the trust agreement and all amendments if the borrower is a trust to obtain the correct names of the trust, the trustee(s), and the settlor(s) and listing all three as debtors

According to *Section 9-516(b)(5)(A) of the Uniform Commercial Code*, the mailing address of the debtor must be included. Although the standard UCC-1 form previously had a space for both the debtor's social security number (for an individual) and federal employer identification number (for an organization), many states have eliminated this space out of concerns for debtors' privacy. See *e.g., Cal. Comm. Code § 9521* (allowing UCC-1 forms without a blank for social security number). But see *e.g.,* Idaho Comm. Code § 28-9-502(e)(3) (requiring "the debtor's social security number or other unique number, combination of numbers and letters, or other identifier selected by the secretary of state using a selection system or method approved by the secretary of agriculture, or in the case of a debtor doing business other than as an individual, the debtor's internal revenue service taxpayer identification number or other approved unique identifier" for a financing statement covering farm products). It is therefore important to check both the filing and the privacy requirements for the state in which the UCC-1 will be filed. If the debtor is an organization, the type of organization must be specified (*i.e.,* corporation, general partnership, limited liability company), along with the jurisdiction of the organization. See *Section 9-516(b)(5)(C) of the Uniform Commercial Code* (a filing against a debtor that is an organization is ineffective when it is rejected for failure to indicate the type of organization and the jurisdiction). Additionally, the form must contain the name and mailing address of the secured party. See *Section 9-516(b)(4) of the Uniform Commercial Code* (a filing does not occur when the filing office refuses to accept the filing because of failure to include the name and mailing address of the secured party of record).

The basic approach in the current version of Article 9 is that perfection centers on the debtor's location rather than on where the collateral is or may be located. Furthermore, Article 9 presently defines the location of the debtor in ways that, for many entities including corporations, change prior law by focusing on the place of incorporation or registration rather than on the location of the chief executive office.

A registered organization is one that is organized under the laws of a state or the United States. Examples include corporations, limited liability companies, and limited partnerships. For registered organizations that are organized under the law of the state, the filing location of the debtor is the state of organization (regardless of whether the debtor's actual business location or headquarters is in that state). Thus, for example, a Delaware limited liability company doing business in Nevada and having all of its assets in Nevada, the place of filing is the Delaware Secretary of State.

For an organization that is not registered, the filing location is in the jurisdiction of the place of business, or, if there is more than one place of business, the jurisdiction of its chief executive office. Examples of organizations that are not registered include a general partnership and an unincorporated association. A source of confusion occurs when the debtor is a trust. Specifically, it is not clear whether a trust is viewed as an unregistered organization or as one or more individuals who are acting in their capacities as trustees or settlors of the trust. As a practical matter, until the law with respect to trusts is settled, it is best to file in all possible locations: for individuals, their jurisdiction of residence and for the trust, the jurisdiction of the trust's place of business or chief executive office, if it has one. It is most important that the filing occur at least in the jurisdiction where the trustee is located if, under applicable law, the trustee has legal title to the collateral. For individuals, the filing location is the state of the individual's principal residence, with respect to both business and personal assets of the individual. Thus, if an individual lives in Montana but does business as a sole proprietorship in New Mexico, under Article 9 the place of filing would be the Montana Secretary of State.

If the debtor changes its location, the security interest must be perfected in the new jurisdiction within four months of the change. Similarly, if the debtor changes its name, a financing statement amendment must be filed within four months of the change. Moreover, if the collateral is transferred subject to the lender's existing security interest to a different entity and the new debtor is located in a different jurisdiction from the transferor, a financing statement must be filed within one year of the transfer in the new debtor's jurisdiction.

2) Perfection by Possession

A secured party may perfect a security interest by having possession, either itself or through a third party, of the collateral. Possessory security interests are the oldest form of security interests in personal property. As commerce has expanded, however, possessory security interests are increasingly less common. This tendency has been accelerated by the advent of electronic handling systems for various forms of semi-intangibles. Article 9 does not define such possession. It appears, however, that it means that the secured party or its agent has taken physical control of collateral that is a tangible asset.

Certain types of collateral must be perfected through possession:

- **Money.** The only way that a secured party may perfect its security interest in money is by possession.
- **Instruments.** A lender may perfect a security interest in an instrument either by filing or possession. Priority as between a secured party having possession and the secured party having a filing goes to the secured party having possession. A security interest arising out of a sale of a promissory note (*i.e.,* an instrument) is perfected automatically, without additional action, when it attaches. See *Section 9-304(4) of the Uniform Commercial Code*.
- **Letters-of-Credit.** Possession of a letter-of-credit does not perfect a security interest in proceeds of the letter-of-credit.
- **Certificated Securities.** A secured party perfects its interest in certificated securities by possession, without any necessary endorsement.
- **Chattel Paper.** Article 9 limits perfection by possession to tangible chattel paper. *In re Commercial Money Ctr., Inc., 392 B.R. 814, 825 n.22 (B.A.P. 9th Cir. 2008)*; *In re Inofin, Inc., 455 B.R. 19, 37 (Bankr. D. Mass. 2011)*. Electronic chattel paper may not be perfected by possession and instead may be perfected by control or filing. *See In re K-RAM, Inc., 451 B.R. 154, 173 (Bankr. D.N.M. 2011)* ("Perfection by possession applies only to tangible negotiable documents, goods, instruments, money or tangible chattel

paper . . . Perfection by control applies only to investment property, deposit accounts, letter-of-credit rights, electronic chattel paper and electronic documents.”).

- **Other Collateral.** A secured party can perfect by taking possession of collateral, including goods and negotiable documents. If collateral is in the possession of a third party, perfection will depend upon the third party’s ability to authenticate a record evidencing perfection (*i.e.,* signing a writing or otherwise authenticating an electronic record) acknowledging that the third party possesses the collateral for the benefit of the lender.

3) Perfection by Control

Control works to perfect an interest in collateral held by a third party by agreement for the benefit of the lender. Article 9 of the Uniform Commercial Code permits perfection of a security interest by control for investment property, deposit accounts, electronic chattel paper, and letters-of-credit.

- **Deposit Accounts.** The only way to perfect a security interest in a deposit account is by obtaining control of the deposit account – the filing of a financing statement does not work for a deposit account. A secured party has control of a deposit account if it is the depository bank or if the deposit account in the depository bank is in the secured party’s name. Additionally, a secured party has control if the depository bank agrees with the secured party that the depository bank will comply with the instructions from the secured party concerning the account, without allowing for consent by the account holder.
- **Investment Property.** “Investment property” is a catch-all term that includes certificated securities, uncertificated securities, security entitlements, and securities accounts. If the collateral does not qualify as investment property, it is probably a general intangible.

End of Document

Table Summarizing Methods of Perfection in Various Types of Collateral

Updated on: ***09/06/2017***

by *Ira L. Herman*, Blank Rome LLP

Article 9 of Uniform Commercial Code (UCC) provides for the attachment and perfection of contractual security interests in personal property of various types. The table below summarizes the UCC requirements for the perfection of security interest each of these asset classes. (For the different asset classes covered by Article 9, see *UCC § 9-102*).

How to Create a Security Interest in Personal Property that is Enforceable Against the Debtor and Its Other Creditors?

It is a two-step process:

1. Attachment. A security interest is said to attach to collateral when a security interest becomes enforceable against a debtor's property. Attachment requires:

- Value to have been given (which is generally satisfied when the secured party commits to extend credit to a debtor)
- A debtor to have rights in the property or the power to transfer rights in such property to a secured party (which is satisfied if the debtor owns the property)
- A debtor to have entered into a security agreement containing grant language and a legally sufficient description of the collateral (there are exceptions to this general rule requiring a description of the collateral, *e.g.,* if the security interest covers timber to be cut, a description of the land must be included, rather than a description of the collateral itself (the timber)). See *Selection of Form Security Documentation* and *Drafting the Granting Clause and Collateral Description*.

2. Perfection. Perfection places third parties, including a debtor's other creditors, on notice of the existence of a security interest. It should be noted that in limited circumstance the very act of attachment affects the perfection of the security interest without more. These limited circumstances are set forth in the chart below. Otherwise, perfection is accomplished either by filing of a notice or by taking possession or control of the property that has become the lender's collateral. For complete guidance regarding perfection of security interests, see *Understanding Security Interests and Liens: Perfection*.

The UCC provides more than one option to perfect in certain asset classes. For example, the UCC permits perfection both by filing and by possession or control when the collateral is chattel paper, investment property, negotiable documents, partnership interests, and securities. As possession or control of collateral by a secured party primes the rights of secured parties that have perfected solely by filing, the best practice for a lender is to take possession or control of these type of collateral when there is a choice of the means of perfection. See *Establishing Priority of the Secured Creditor's Lien by Joel F. Brown and Christopher M. Swartout, Goldberg Kohn Ltd.*.

In the table below, each asset class covered by Article 9 of the UCC is listed in the left hand column and the means of perfection regarding each such asset class is listed in the right-hand column. Note: typically, the location where a debtor is incorporated or formed governs perfection under the UCC, but in some circumstances, perfection rules is governed by the location of the collateral. See *Choice of Law Provisions under Article 9 by Joel F. Brown and Christopher M. Swartout, Goldberg Kohn Ltd.* .

COLLATERAL	PERFECTION

Table Summarizing Methods of Perfection in Various Types of Collateral

Accounts	Filing 9.310
Agricultural Liens	Attachment 9.308; Filing 9.310
Chattel Paper*	Filing 9.312; Possession 9.313 (tangible chattel paper); Control 9.314 (electronic chattel paper)
Commercial Tort Claims [no perfection in after acquired commercial tort claims]	Filing 9.310 (Note that there are different description requirements for this type of category.)
Commodity Accounts (a subset of Investment Property)*	Attachment 9.309 (security interest created by an intermediary); Otherwise, Filing 9.312; Control 9.314
Consumer Goods** other than vehicles, boats, etc.	Attachment 9.309 (purchase money); Otherwise Filing 9.310
Deposit Accounts (includes non-negotiable CDs)	Control 9.312 and 9.314
Equipment**	Filing 9.310
Farm Products**	Filing 9.310
Fixtures	Filing 9.310; *see* 9.501, 9.502 (fixture filing)
General Intangibles (includes most LLC and partnership interests)	Filing 9.310; Sale of payment intangible – Attachment 9.309
Goods subject to a statute or treaty such as boats, cars, aircraft	Compliance with applicable federal or state regulations 9.309(1) and 9.311
Health Care Insurance Receivables assigned to service provider	Attachment 9.309
Instruments	Filing 9.312; Possession 9.313
Inventory** (including motor vehicles, boats, manufactured homes, etc.)	Filing 9.312
Investment Property*	Filing 9.312; Control 9.314
Letter of Credit Rights	Control 9.312 and 9.314
Manufactured Home,** motor vehicles,** boats**	Filing 9.312 if inventory; Possession 9.313; Compliance with state regulations 9.311 (non-inventory)
Membership Interest in Limited Liability Company (a subset of either General Intangibles or Investment Property)*	Filing as a General Intangible 9.310; If LLC has opted into Article 8, Filing 9.312 or Control 9.314 as Investment Property
Money	Possession 9.312
Negotiable Documents*	Filing 9.312; Possession 9.313; Control 9.314 (electronic documents)
Partnership Interest (a subset of either General Intangibles or Investment Property)*	Filing as a General Intangible 9.310; If Partnership has opted into Article 8, Filing 9.312 or Control 9.314 as Investment Property
Proceeds	Perfection of security interest in original collateral 9.315
Promissory Note (Sale)	Attachment 9.309
Securities (a subset of Investment Property)*	Attachment if created by broker or intermediary 9.309; Filing 9.312; Control 9.314
Software (a subset of General Intangibles) that is not part of goods	Filing 9.310(a) unless other statute governs 9.310(b)(3)

* With respect to collateral in which a security interest may be perfected by filing or control, perfection by control is preferable.

** For goods other than goods covered by a certificate of title, possession is always an option to perfect. *See* section 9.313(c) of the Uniform Commercial Code.

End of Document

Ira L. Herman

Table Summarizing State Variations of Methods of Perfection

by Ira L. Herman, Blank Rome LLP

Ira L. Herman is a Partner in the Finance, Restructuring, and Bankruptcy group of Blank Rome LLP.

California, Colorado, District of Columbia, Hawaii, Idaho, Kentucky, Maryland, Massachusetts, Nebraska, North Dakota, Oklahoma, Rhode Island, Texas, Virgin Islands	• A security interest created by a sale of an account that is the rights to payment of winnings in a lottery or other game of chance is perfected when it attaches under non-uniform section 9-309(14).
California	• A security interest in or a claim in or under any policy of insurance (other than a health care insurance receivable), including unearned premiums, may be perfected only by giving written notice to the insurer under section 9-312(b)(4). Non-uniform section 9-310(b)(11) states that it is not necessary to file a financing statement to perfect such a security interest. • A health care insurance receivable may be perfected only as otherwise provided under section 9-312.
Idaho	• Filing is not necessary to perfect a security interest in timber sold by the state of Idaho, pursuant to a non-uniform section 9-310(b)(11).
Louisiana	• A record of mortgage is not effective as a financing statement filed as a fixture filing; a fixture filing in Louisiana is filed in the UCC index, not in the real property records. • A security interest in a collateral mortgage note may be perfected only by the secured party's taking possession under section 9-313, pursuant to non-uniform section 9-312(b)(4). • A security interest in a life insurance policy may be perfected only by control under section 9-314.
Missouri	• Section 9-311 omits the 2010 amendments regarding goods covered by a certificate of title.
New York	• A cooperative organization security interest becomes perfected when the cooperative interest first comes into existence and remains perfected so long as the cooperative interest exists, pursuant to non-uniform section 9-308(h). • Under non-uniform section 9-310(b)(11), filing is not necessary to perfect a security interest in a cooperative interest. • Under non-uniform section 9-312(i), subsections 9-312(a) through (h) do not apply to cooperative interests. Under non-uniform section 9-313(j), subsections 9-313-(a) through (i) do not apply to cooperative interests. Under non-uniform section 9-314(d), subsections 9-314(a) through (c) do not apply to cooperative interests.

North Dakota	• Filing is not necessary to perfect a security interest in agricultural liens created by chapter 35-17, 35-30, or 35-31, pursuant to non-uniform section 9-310(2)(k).
South Dakota	• Filing is not necessary to perfect a security interest subject to South Dakota Codified Laws §§ 49-34-11 to 49-34-11.4, inclusive (covering mortgages or trust deeds executed by public utilities and security interests against personal property of public utilities), pursuant to non-uniform section 9-310(b)(11).
Texas	• Filing is not necessary to perfect a security interest in oil or gas production, pursuant to non-uniform section 9-310(b)(11).
Washington	• Filing is not necessary to perfect the agricultural lien of a handler on orchard crops as provided in RCW 60.11.020(3).

Ira L. Herman

Analyzing Competing Liens and Interests and Certain Bankruptcy Risks

by Ira L. Herman, Blank Rome LLP

Ira L. Herman is a Partner in the Finance, Restructuring, and Bankruptcy group of Blank Rome LLP.

Lien Priorities

Article 9 of the Uniform Commercial Code establishes a system of priorities among creditors with competing interests in a *res*. Generally, a party with a valid and perfected security interest will have priority over unsecured creditors and over lien creditors, who have acquired a non-consensual lien against property subject to a prior security interest by attachment, levy, or the like.

Among secured creditors, the "first in time" to perfect generally has priority. The Uniform Commercial Code employs a "pure race" system such that actual knowledge of an unperfected security interest by a competing lender is not relevant to the inquiry. The most important exception to the "first-in time" rule is the priority provided by the Uniform Commercial Code to a party secured by a purchase money security interest (the "PMSI"). Generally, a PMSI is a security interest taken or retained by a seller of the collateral to secure all or a part of its purchase price, or "for value given, to enable the debtor to acquire rights or use the collateral if the value is in fact so used." The key is to find a direct nexus between the loan proceeds and the collateral. Comment 3 to section 9-103 of the Uniform Commercial Code states:

> The concept of 'purchase-money security interest' requires a close nexus between the acquisition of collateral and the secured obligation. Thus, a security interest does not qualify as a purchase money security interest if the debtor acquires property on unsecured credit and subsequently creates the security interest to secure the purchase price.

Intangible collateral is non-goods collateral and is personal property that cannot be touched. Under Article 9 of the Uniform Commercial Code, the only intangible collateral that can be subject to a PMSI is software purchased for the principal purpose of use in goods that are themselves taken under a PMSI. In other words, the PMSI is permitted in software in an integrated transaction with the acquisition of the related hardware.

For goods other than inventory or livestock that are farm products, Article 9 gives a perfected PMSI priority over a conflicting security interest in the goods and the identifiable cash proceeds, if the PMSI is perfected within twenty days after the debtor receives possession.

In order to get a PMSI in inventory, the secured party must jump through some hoops. The PMSI has priority if:

1. It is perfected when the debtor receives possession of the inventory;
2. The holder of the PMSI sends an authenticated notice to the holder of the conflicting security interest;
3. The competing secured party receives the notice within five years (six months in the case of livestock constituting farm products) before the debtor receives possession; and
4. The notice states that the PMSI holder expects to acquire a PMSI in inventory and describes the inventory. The purchase money priority in inventory attaches to the proceeds of that inventory only to a very limited extent. A prior filer on accounts, for example, will have priority on accounts arising from the sale of inventory unless the creditors agree otherwise.

Contractual and Structural Subordination

The priority rules of Article 9 of the Uniform Commercial Code can be modified contractually, *i.e.,* by a subordination agreement. Intercreditor agreements are crafted to establish priorities as a matter of contract rather than following the Article 9 priority scheme. Intercreditor agreements typically address issues including:

1. The right of a senior lender to block payments by the debtor to a subordinated lender after a default under the senior lenders loan documents;

2. A standstill period during which a junior lender may not exercise remedies;

3. Bankruptcy rights such as with regard to debtor-in-possession financing, cash collateral use, objections to the disposition of the shared collateral, voting rights with regard to a plan of reorganization, etc.

Secured Party vs. Bank Setoff Rights

A depository bank's common law right of setoff has priority over a security interest held by another secured lender, including one who claims the deposit accounts as cash proceeds of an asset-based loan. The depository bank will lose its senior status only if a competing secured creditor takes "control" of the deposit account in question or if the depository bank has agreed to a contractual subordination of its setoff right.

Bankruptcy Risks

A valid, perfected security interest generally will be enforced by the bankruptcy courts. However, the lender with collateral faces various risks that could defeat the lender's senior status, including the automatic stay, subordination, recharacterization, surcharges, avoidance (preferences and fraudulent transfers), and failure to properly perfect ("strong-arm" powers of the trustee under section 544 of the Bankruptcy Code).

Adherence to the technical requirements for perfection is essential. Secured creditors risk avoidance of a security interest that they may think is perfected when they file the financing statement in the wrong jurisdiction. *See* In re Davis, 274 B.R. 825, 828 (Bankr. W.D. Ark. 2002) (a financing statement for farm equipment had to be filed in the county of the debtor's residence). For example, in Kunkel v. Ries (In re Morken), 199 B.R. 940 (Bankr. D. Minn. 1996), the collateral, which was livestock, were expected to be in transit through several states. The secured creditor relied on section 9-103(d)(1) of the Uniform Commercial Code, which allows a security interest to remain perfected for four months after collateral is moved from the state where the financing statement is filed. The bankruptcy court held, however, that because the secured creditor knew at the point that the financing statement would be filed that the collateral would be moved to a state other than the one in which it was perfected, the secured creditor was not entitled to rely on the four-month rule. *Id*. at 962.

Additionally, in the case of Fleet National Bank v. Whipanny Venture I, LLC (In re IT Group, Inc.), 307 B.R. 762 (D. Del. 2004), the creditor similarly failed to perfect a security interest in the proceeds from a contract to sell real property when it filed a financing statement in New Jersey, which was where the property was located. Because the creditor's interest was in a general intangible, however, the creditor was required to file in the state where the debtor's chief executive office was located, which happened to be Colorado. Id. at 766. Since the creditor had not filed a financing statement in Colorado, the security interest was unperfected and avoidable under the trustee's strong-arm powers. Id. at 767.

A security interest is likewise unperfected if the creditor has followed the procedure for perfecting an interest in the wrong type of collateral. For example, a creditor of a car dealership who perfects an interest in vehicles that are inventory must file a financing statement and cannot perfect through the usual process of indicating the interest on the certificate of title. *See* In re Babaeian Transp. Co., 206 B.R. 536, 546 (Bankr. C.D. Cal. 1997) (a secured creditor who failed to file a UCC-1 financing statement had not perfected its security interest in vehicles that were held as inventory). Similarly, a security interest is also unperfected when it is filed under the name of the wrong debtor or when the secured creditor fails to indicate correctly the names of multiple debtors. *See* Official Committee of Unsecured Creditors v. Regions Bank (In re Camtech Precision Manufacturing, Inc.), 443 B.R. 190, 198-99 (Bankr. S.D. Fla. 2011) (a security interest against assets of additional debtors was unperfected where the creditor listed their names only on a non-standard attachment to the financing statement, and neither the names of the additional debtors nor the attachment were referenced on the financing statement). Moreover, a security interest may even be unperfected as a result of a clerk's error in, for

example, failing to properly note the name of the secured creditor on a certificate of title. *See, e.g.,* In re Reaster, 242 B.R. 423, 426 (Bankr. S.D. Ohio 1999) (a secured interest in a mobile home was not perfected where the clerk failed to identify the name of the correct lienholder on the certificate of title, and the error was not minor).

BLANKROME

TAB 3

Subordination and Recharacterization under the topic Bankruptcy Basics

Ira L. Herman

Understanding Subordination

by Ira L. Herman, Blank Rome LLP

Ira L. Herman is a Partner in the Finance, Restructuring, and Bankruptcy group of Blank Rome LLP.

Contractual Subordination

Section 510(a) of the Bankruptcy Code provides that contractual subordination provisions are enforceable in bankruptcy to the same extent as they are under applicable non-bankruptcy law. Both independent subordination agreements executed between creditors and subordination provisions in debtor-creditor agreements are included within the scope of section 510(a).

Statutory Subordination of Securities Claims

Section 510(b) of the Bankruptcy Code works to subordinates claims arising from rescission of a purchase or sale of a security of the debtor or an affiliate of the debtor for damages arising from the purchase or sale of such a security or for reimbursement or contribution. The purpose of such subordination is to prevent the elevation of damage claims arising from an ownership of a security above the level of holders of such a security – in other words, the claim to which the claimant would have been entitled as an owner of the security if not for the misconduct giving rise to the damages. If the security is common stock, the claim is subordinated to the level of common stock. Otherwise, the claim is subordinated to all claims or interests that are senior or equal to the claim or interest represented by the underlying security.

Equitable Subordination

Under section 510(c) of the Bankruptcy Code, a claim may be equitably subordinated "to all or part of another allowed claim," and an interest may be subordinated "to all or part of another allowed interest" if the claimant or interest holder has engaged in some type of inequitable conduct.

Equitable subordination permits a court "to undo or to offset any inequity in the claim position of a creditor that will produce injustice or unfairness to other creditors in terms of estate distributions." In re Vietri Homes, Inc., 58 B.R. 663, 665 (Bankr. D. Del. 1986). Equitable subordination is remedial rather than penal in nature. In re Mobile Steel Co., 563 F.2d 692, 701 (5th Cir. 1977); Diasonics, Inc. v. Ingalls, 121 B.R. 626 (Bankr. N.D. Fla. 1990). Therefore, "a claim . . . should be subordinated only to the extent necessary to offset the harm which the bankrupt and its creditors suffered on account of the inequitable conduct." Mobile Steel, 563 F.2d at 701. If the claim exceeds the extent of the harm, the claim should be subordinated only to that extent. However, this general rule is not always followed, and a court may subordinate an entire claim if the injury to the other creditors is not easily quantified.

In the case of a leveraged buy-out, the court looks to the substance of the transaction as opposed to its form in order to decide whether to equitably subordinate the claims of former shareholders-turned-creditors to those of general unsecured creditors. In re Structurlite Plastics Corp., 224 B.R. 27 (B.A.P. 6th Cir. 1998). The equitable subordination remedy is available not only to trustees and debtors-in-possession but to any creditor seeking to subordinate another creditor's claim to its own.

The widely accepted three-prong standard for equitable subordination is set forth in Benjamin v. Diamond (In re Mobile Steel Co.), 563 F.2d 692, 699-700 (5th Cir. 1977):

> [T]he conditions must be satisfied before exercise of the power of equitable subordination is appropriate:
>
> (i) the claimant must have engaged in some type of inequitable conduct;
>
> (ii) the misconduct must have resulted in injury to the creditors of the bankrupt or conferred an unfair advantage on the claimant; and
>
> (iii) equitable subordination of the claim must not be inconsistent with the provisions of the Bankruptcy Code.

The doctrine most often arises in connection with claims of corporate insiders or those who stood in a fiduciary relationship with the debtor in order to prevent them from converting equity interests into claims or from improving the priority of their claims in anticipation of bankruptcy.

The doctrine also has been applied to non-insider, non-fiduciary claims, but this generally occurs only if that creditor has engaged in very substantial misconduct or "gross misconduct tantamount to 'fraud, overreaching or spoliation or the detriment of others.'" In re Teltronics Services, Inc., 29 B.R. 139, 169 (Bankr. E.D.N.Y. 1983); In re Just For the Fun of It of Tennessee, Inc., 7 B.R. 166, 180 (Bankr. E.D. Tenn. 1980). The "quality of [the] conduct that will be deemed 'inequitable' under [section] 510(c) of the Bankruptcy Code depends on the nature of the legal relationship between the debtor and the party whose claim is subject to attack on equitable subordination grounds." In re Badger Freightways, Inc., 106 B.R. 971, 976 (Bankr. N.D. Ill. 1989).

Where the outside creditor sufficiently controls or dominates the will of the debtor, its operations, or decision-making processes and exercises that control to the detriment of others, that creditor is treated as an insider. For insider status, "[w]hat is required is operating control of the debtor's business, because only in that situation does a creditor assume the fiduciary duty owed by the officers and directors." Badger Freightways, Inc., 106 B.R. at 977. A typical commercial lender, however, owes no fiduciary duties to its customer. A court generally will not find a bank's conduct inequitable where it acted within its authority under its loan agreement with the debtor. Kham & Nate's Shoes No.2. Inc. v. First Bank of Whiting, 908 F.2d 1351, 1356-59 (7th Cir. 1990); In re Heartland Chemicals, 136 B.R. 503 (Bankr. C.D. Ill. 1992).

Some courts have used a broader rule such that subordination may occur where there is either creditor misconduct or the claim is of a type susceptible to subordination. The United States Supreme Court has yet to decide if inequitable conduct *is necessary for equitable subordination.* U.S. v. Noland, 116 S. Ct. 1524 (1996).

Burden of Proof

With respect to burden of proof for equitable subordination, a creditor has the initial burden of establishing the amount and legitimacy of its claim. Pursuant to Federal Rule of Bankruptcy Procedure 3001(f), a proof of claim properly executed and filed by a claimant is *prima facie* evidence of the validity and amount of the claim. The party seeking to equitably subordinate a claim must overcome the claimant's *prima facie* case. Teltronics Services, 29 B.R. at 169 ("[O]bjectant must prove by a preponderance of the evidence that the claimant engaged in such substantial inequitable conduct [such fraud or breach of fiduciary duty], to the detriment of the debtor's other creditor that subordination is warranted."). If the objecting party produces sufficient evidence to overcome the claimant's *prima facie* case, the burden of going forward shifts to the claimant to establish that the challenged transaction is an arm's length transaction.

The burden of proof required to subordinate claims on equitable grounds depends on whether or not the claimant is an insider. When the claimant is an insider or fiduciary, the trustee need only present material evidence of the claimant's inequitable conduct to shift the burden to the claimant to prove the fairness and good faith of such conduct. If the claimant is not an insider of the debtor, the trustee's burden is far greater: he must prove egregious or gross misconduct. In re Fabricators, Inc., 926 F.2d 1458 (5th Cir. 1991); In re Herby's Foods Inc., F.3d 128, 133-34 (5th Cir. 1993); In re Granite Partners, L.P., 210 B.R. 508 (Bankr. S.D.N.Y. 1997) (holding that when a party seeks equitable subordination of non-insider, non-fiduciary claims, the level of pleading and proof is even higher than when subordination of an insider's or fiduciary's claim is sought).

Undercapitalization of Debtor as a Basis for Equitable Subordination

Undercapitalization supports but does not independently justify equitable subordination. As the court in Benjamin v. Diamond (In re Mobile Steel Co.), 563 F.2d 692, 703 (5th Cir. 1977) stated, an adequate amount of capitalization is "what reasonably prudent men with a general background knowledge of the particular type of business and its hazards would determine was reasonable . . . in the light of any special circumstances which existed at the time of the incorporation of the now defunct enterprise."

Ira L. Herman

Understanding Recharacterization

by Ira L. Herman, Blank Rome LLP

Ira L. Herman is a Partner in the Finance, Restructuring, and Bankruptcy group of Blank Rome LLP.

Purported claims are sometimes recharacterized as equity interests. Various circuits have recognized recharacterization under two rationales. The first rationale, which has been adopted by the Third, Fourth, Sixth, and Tenth Circuits, is that courts may recharacterize claims in a bankruptcy case pursuant to the broad equitable powers granted to them by section 105(a) of the Bankruptcy Code. In re SubMicron Sys., 434 F.3d 448, 454 (3d Cir. 2006); In re Dornier Aviation, 453 F.3d 225, 231 (4th Cir. 2006); In re Autostyle Plastics, Inc., 269 F.3d 726,748 (6th Cir. 2001); In re Hedged-Investments Assocs., Inc., 380 F.3d 1292, 1298 (10th Cir. 2004).

Other courts, including the Fifth and Ninth Circuits, have recognized that recharacterization of a purported debt as equity is required under Butner v. United States, 440 U.S. 48, 54 (1979), when applicable non-bankruptcy law would characterize the purported claim as an equity interest. In re Lothian Oil, Inc., 650 F.3d 539, 542-43 (5th Cir. 2011).

Although lawyers can structure a transaction to look like debt, bankruptcy courts have the authority to determine what the transaction really is in reality and are not bound by what it is called or titled. In order to ensure that a transaction is treated as debt by the bankruptcy court, a lender should therefore assess whether the circumstances of a loan would support recharacterization. Factors that courts have considered in recharacterizing purported debts as equity include:

- The intent of the parties;
- The identity between creditors and shareholders;
- The extent of participation in management by the holder of the instrument;
- The ability of the corporation to obtain funds from outside sources;
- The "thinness" of the capital structure in relation to debt;
- The extent to which the advances were used to acquire capital assets;
- The risk involved;
- The formal indicia of the arrangement;
- The relative position of the obligees as to other creditors regarding the payment of interest and principal;
- The voting power of the holder of the instrument;
- The status of the contribution in relation to regular corporate creditors;
- The provision of a fixed rate of interest;
- A contingency on the obligation to repay;

- The source of the interest payments;
- The presence or absence of a sinking fund to provide repayments;
- The presence or absence of a fixed maturity date;
- A provision for redemption by the corporation;
- A provision for redemption at the option of the holder;
- The failure of the debtor to repay on the due date or to seek a postponement; and
- The timing of the advance with reference to the organization of the corporation.

See SubMicron Sys., 434 F.3d at 455 n.8 (listing various multi-factor tests); Dornier Aviation, 453 F.3d at 233-34; Hedged-Inv., 380 F.3d at 1298; Fin Hay Realty Co. v. United States, 398 F.2d 694, 696 (3d Cir. 1968).

Although some of these factors cannot be altered at the front end of a deal – *e.g.*, the identity of creditors with the shareholder and the participation of the creditor in management – other factors can indeed be controlled. As a practical matter, an insider making a loan should:

- Back up the loan with formal documentation, including a standard promissory note;
- Make the loan only on normal business terms, including an interest rate comparable to what could be obtained from a non-insider lender; and
- Avoid terms that are red flags for claim recharacterization, such as:
    - A contingency on the obligation to repay;
    - Redemption provisions; and
    - Provisions granting voting power to the instrument holder.

When a loan complies with the formalities for a valid loan agreement and the advanced funds are treated as a loan in the debtor's business records, courts are typically reluctant to recharacterize the loan as an equity contribution even when the debtor was undercapitalized. In SubMicron Systems, 434 F.3d at 457, for example, the court concluded that an existing lender's loan to an undercapitalized debtor had been properly characterized as a debt when the lending documents called the fundings debt and established a fixed maturity date and interest rate. Although the company was undercapitalized, the court concluded that the loan had been made to the distressed company in an attempt to protect the lender's existing loans.

The court in In re Hedged-Investments Assocs., Inc., 380 F.3d 1292, 1298 (10th Cir. 2004) declined to recharacterize the debt as equity, noting that the transaction documents fulfilled the proper formalities and that the lender had the right to enforce payment of principal and interest. Furthermore, the lender did not have control of management, and the debtor could have secured funds from other lenders at around the time of the transaction. Although the debtor was thinly capitalized, the loan did not have a fixed maturity date, the payment of interest out of a pooled investment account could have been an indication of an equity contribution, and the compliance with formalities and the parties' evident intent that the transaction was to be a loan showed that the transaction had established a debt.

Likewise, in American Twin Ltd. Partnership v. Whitten, 392 F. Supp. 2d 13, 22-23 (D. Mass. 2005), the court concluded that the notes at issue were debt, not equity, emphasizing the compliance with formalities in the issuance of the notes. Although the lender was a minority shareholder, the lender did not control the debtor, and the funds were advanced for operating expenses, which is generally indicative of debt. Furthermore, although the debtor was undercapitalized, its ultimate failure was caused by its poor business model and other similar factors.

Similarly, in Gernsbacher v. Campbell (In re Equipment Equity Holdings, Inc.), 491 B.R. 792, 855-62 (Bankr. N.D. Tex. 2013), the court concluded that although several factors supported characterizing the advance of funds as equity, the balance of factors weighed in favor of the conclusion that the formalized notes represented debt. Despite the undercapitalization of the debtor, the tight correlation between equity interests and the values associated with the notes, and the creditor's control of the majority of the stock of the debtor, the court heavily weighed the formal characterization of the notes as debt and the debtor's business records' treatment of the notes as debt. Moreover, the funds were used to reduce senior debt and to provide working capital, which weighed in favor

of characterizing the funds as a loan. Finally, although the debtor was undercapitalized, there were other causes for the debtor's ultimate financial failure.

On the other hand, when the transaction lacks formalities, especially when the party advancing funds is an insider, courts are more likely to recharacterize the alleged debt as equity. In Fairchild Dornier GMBH v. Official Committee of Unsecured Creditors (In re Official Committee of Unsecured Creditors of Dornier Aviation (North America), Inc.), 453 F.3d 225, 234 (4th Cir. 2006), the Fourth Circuit concluded that an insider transaction that failed to comply with certain formalities of a loan actually constituted an equity contribution. Where the loan lacked a fixed maturity date, the debtor was not required to pay the loan until it became profitable, the debtor had a loan history of unprofitability, the debtor's liabilities after restructuring far exceeded its assets, and the purported creditor assumed the debtor's losses, the transaction represented an equity investment rather than debt. Although the purported creditor argued that transfers of inventory cannot constitute an equity investment, the court concluded that adopting such a position would simply incentivize equity investors to structure their capital contributions as sales of inventory.

Even where the transaction is evidenced by a so-called "promissory note, courts may ignore the name given to the document if the parties do not act like lenders. In Miller v. Dow (In re Lexington Oil & Gas Ltd.), 423 B.R. 353, 366 (Bankr. E.D. Okla. 2010), the court characterized a purported debt as equity, despite the execution of a promissory note, because payment was dependent on the profitability of the debtor. The court stated that in order for a transaction to be debt, there must be a reasonable expectation of repayment that does not depend solely on the success of the borrower's business. *Id.* at 365. In that case, the delay of repayment of any principal or interest for two years was further evidence that the purported lenders were actually equity investors. Finally, the undercapitalization of the debtor and the purported lenders' failure to take prudent actions to protect their rights – for example, providing for payment of accrued interest when the notes were rewritten – was evidence that the transaction was an equity investment.

BLANKROME

TAB 4

Setoff Rights under the topic Identifying and Managing Bankruptcy Risk

Ira L. Herman

Analyzing Setoff Rights

by Ira L. Herman, Blank Rome LLP

Ira L. Herman is a Partner in the Finance, Restructuring, and Bankruptcy group of Blank Rome LLP.

Contracts establishing setoff rights should be drafted to ensure that the setoff rights will be enforceable in bankruptcy. Otherwise, a creditor expecting the protection of a setoff right that would allow it to be paid in full may find itself with only an unsecured claim. *See* sample *Setoff Right* clause.

Under non-bankruptcy law, setoff rights arise when debts are due from and owed to the same persons or entities acting in the same legal capacity. This relationship is referred to as "mutuality." Section 553 of the Bankruptcy Code was enacted to preserve setoff rights in bankruptcy cases. For setoff to be permitted under section 362(d) of the Bankruptcy Code and section 553 of the Bankruptcy Code, three facts must be in evidence:

1. The amount owed by the debtor must be a pre-petition debt;
2. Such debtor's claim against the non-debtor must be a pre-prepetition claim; and
3. There must be "mutuality."

The greatest risk to the enforceability of a setoff right in bankruptcy is that the court will not recognize mutuality. This risk arises when the contract establishing the setoff right involves multiple related entities – for example, a "master netting agreement" unifying setoff rights across multiple contracts with affiliated entities. Such a setoff right may not be enforceable in bankruptcy due to a lack of mutuality. Bankruptcy courts refuse to recognize "synthetic mutuality" – that is, mutuality created by the contract or operation of law. "Synthetic mutuality" is not recognized regardless of whether such alleged mutuality was created by contract or an order effecting the consolidation of multiple debtor estates, or whether the transaction falls within the Bankruptcy Code's safe harbor provisions for swap agreements.

Although section 560 of the Bankruptcy Code and section 561 of the Bankruptcy Code establish safe harbor exceptions to the automatic stay for swap agreements, these safe harbor provisions do not affect the interpretation of section 553 of the Bankruptcy Code. A transaction may fall within a safe harbor exception and nevertheless lack contractual mutuality.

Parties doing business through and with multiple related entities will have to consider the rationale for each of these decisions and rethink their reliance on contractual setoff agreements, including master netting agreements, to manage credit risk. A master netting agreement is likely insufficient to create mutuality regardless of whether a single non-debtor entity seeks to create mutuality *vis-à-vis* multiple debtor entities, or whether a non-debtor and its affiliates attempt to use a master netting agreement to support setoff against a single debtor.

As a practical matter, the following should be noted:

- Do not rely on master netting agreements or similar contract terms to manage customer credit risk. If choosing to rely on contractual netting arrangements, the risk exists of paying the amount owed to a customer's bankrupt affiliate, while receiving only pennies on the dollar from the customer in its bankruptcy case.
- If using derivative contracts to manage certain types of risk, they may not be bankruptcy-proof and may fail to accomplish the intended outcome.

- Instead of relying on contractual setoff rights under a master netting agreement or similar agreement, consider negotiating for liens or cross-collateralization in order to create mutual debt obligations.
- All sales to a customer could be made by a single member of the corporate family to that customer only and not to any of its affiliates, thereby ensuring mutuality. This solution could be implemented through inter-company transfers undertaken by the corporate family, as seller, and by the customer's corporate family, as buyer.
- Consider making the choice to operate through the use of assignments, guarantees, or the like to create mutual debt obligations.

None of these approaches is perfect. The customer may be reluctant to grant liens, as doing so may violate any number of covenants in the customer's credit agreements and may require more complex documentation and the filing of perfection devices, including UCC-1 filing statements, mortgages, or deeds of trust. Additionally, the customer may refuse to incur the cost of implementing and monitoring these arrangements.

Credit managers and others should seriously reconsider their reliance on contractual setoff to manage credit risk. Alternative legal structures are available, but some of these solutions may be difficult to implement and may require the dedication of additional resources.

For more information generally about setoff, *see* *Understanding and Examining Setoff Rights in Bankruptcy Generally*, and *Analyzing the Requirements for Exercising Setoff Rights and Certain Limitations on Setoff Rights*.

BLANKROME

TAB 5

Leases of Commercial Real Property under the topic Identifying and Managing Bankruptcy Risk

Ira L. Herman

Understanding the Landlord's Risk with Regard to the Timely Payment of Rent Prior to Assumption or Rejection

by Ira L. Herman, Blank Rome LLP

Ira L. Herman is a Partner in the Finance, Restructuring, and Bankruptcy group of Blank Rome LLP.

Section 365(d)(3) of the Bankruptcy Code provides that the trustee (or debtor-in-possession, if applicable) "shall timely perform all the obligations of the debtor" arising after the petition is filed and before the lease is assumed or rejected. Section 365(d)(3), by its terms, does not condition the landlord's right to payment on the use of the property by the bankruptcy estate. The trustee or debtor-in-possession is required only to comply with the tenant's lease obligations (*i.e.*, pay rent) in a timely fashion during the post-petition/pre-rejection or assumption period. Notwithstanding the apparently clear language of the statute, issues have arisen, among other things, regarding the amount of the payments due to the landlord during such period and the timing of such payments.

The majority view is that a landlord is entitled to payment of the rent reserved by the lease for the period after the filing of the petition and prior to rejection or assumption of the lease whether or not the debtor has vacated the property. This view is predicated on a plain reading of the statute and on considerations of fairness to the landlord, as the landlord is forced to allow the tenant to occupy its leasehold, whether it is office space or other commercial space, and pay expenses despite continuing default by the tenant. According to this view, if the trustee or debtor-in-possession vacates a leasehold but fails to reject a lease, the estate is liable for rent until the lease is rejected. In many cases, a trustee will seek to avoid the rent claim by asserting that the lease was terminated by the landlord's actions prior to the filing of the petition or by advocating a minority view that payments to landlords must meet the criteria for administrative expenses set out in section 503(b)(1) of the Bankruptcy Code. Thus, many courts have held that non-residential lessors are entitled to immediate payment of rent reserved and not the "actual or necessary" cost of preserving the estate during a pre-assumption or rejection period even if the rent reserved is above or below market.

When a tenant files a voluntary bankruptcy case, payment of post-petition rent is one of the first issues facing the parties with respect to an unexpired lease. *See Sample Clauses Proposed by Landlord During Lease Negotiations*. Debtor/tenants are required to timely perform their post-bankruptcy obligations under their commercial leases. Should a tenant file a bankruptcy petition mid-month, such filing has the effect of splitting the month in two. First, there is the portion of the month elapsing prior to the filing, and, second, there is the portion of the month elapsing while such debtor/tenant and its assets are subject to the jurisdiction of the bankruptcy court. Courts are divided on the issue of the payment of the post-petition date "stub rent" that arises when: (1) there is a mid-monthly period filing; and (2) a lease calls for payment of rent in advance, *i.e.*, on the first day of each consecutive month during the term of a lease, and a bankruptcy filing takes place mid-month. One line of case provides that the landlord is entitled to a full month of rent, even though the chapter 11 debtor rejected and vacated the subject leasehold on the second day of such month. In re Koenig Sporting Goods, Inc., 203 F.3d 986 (6th Cir. 2000).

The "stub rent" issue has been heavily litigated around the country. The two approaches often are referred to as the "billing date" approach (sometimes referred to as the "performance" approach) and the "proration" approach. However, even courts applying the "billing date" approach differ concerning the entitlement of a landlord to the timely payment of "stub rent." The "billing date" focuses on the due day on which the rent falls due. Under this approach, if rent is due on the first of the month and the tenant files later in the month, none of the rent for the affected month is considered a post-petition obligation subject to the "pay as you go" requirement of section 365(d)(3) of the Bankruptcy Code. Thus, courts employing the "billing date" approach will reason that if the rent is due on the first day of the month and a bankruptcy filing occurs mid-month, the landlord is not entitled to the immediate payment of

the "stub rent" pursuant to section 365(d)(3) for the portion of the month elapsing after a bankruptcy has been filed. In contrast, courts employing the "proration" approach will find that the monthly rental obligation is to be allocated on a *per diem* basis for each day of the affected month. Thus, a bankruptcy filing on the fifteenth day of a month would create "stub rent" immediately payable under section 365(d)(3) for the second half of such month. Generally, landlords favor the "proration" approach, and tenants that are attempting to husband their cash prefer the "billing date" approach.

All may not be lost for landlords finding themselves before courts that employ the "billing date" approach. Section 503(b)(1) of the Bankruptcy Code provides for the allowance of administrative expense claims for "the actual, necessary costs and expenses of preserving the [bankruptcy] estate." Some courts have directed a debtor to immediately pay "stub rent," not under the section 365(d)(3) regime, but under the administrative claim section of the Bankruptcy Code, which is section 503(b). *See* Goody's Family Clothing, Inc., 392 B.R. 604 (Bankr. D. Del. 2008). On the other hand, other courts have refused to require the immediate payment of stub rent under the "cost of administration" analysis. In re Sportsman's Warehouse, 436 B.R. 308 (Bankr. D. Del. 2009). Instead, one court imposed significant evidentiary burdens on the landlord and its effort to timely collect the "stub rent" as a cost of administration, effectively defeating the effort.

Generally, administrative expense claims are paid only in successful chapter 11 cases and, absent appropriate circumstances, such claims are not paid until confirmation or consummation of a chapter 11 plan, *i.e.*, the end of the case. From a practical perspective, "appropriate circumstances" generally are instances where a vendor has the leverage of not providing goods or services that are otherwise unavailable to a debtor. Courts that are unsympathetic to landlords may not be willing to view the landlord/tenant relationship as rising to the level of appropriate circumstances to support a landlord's request for an early payment of "stub rent."

Should the trustee or debtor-in-possession assume a lease, all past due rents for the post-petition and pre-petition periods must be paid, including the stub period rent. On the other hand, if the debtor rejects the lease, under section 502(d) of the Bankruptcy Code, claims (the "rejection claims") will be treated as amounts becoming due before the petition date and will therefore be given the status of general unsecured claims.

Finally, a landlord may be able to recover the stub rent as an administrative claim if the landlord can show that the continued occupancy of the space after the filing date provided an actual benefit to the estate and that the stub pay was necessary to preserve the value. Thus, even in the most restrictive sense, a landlord may qualify for administrative expense treatment under section 502(b)(1) of the Bankruptcy Code to allow for recovery of this stub rent.

Although section 365(d)(3) of the Bankruptcy Code requires a tenant to pay all obligations arising after the filing of the petition and prior to assumption or rejection, the tenant may be able to shorten the period during which a post-petition obligation may accrue by requesting that a court authorize the debtor-in-possession or trustee to reject the lease retroactively. Retroactive rejection can be an effective tool in a tenant's arsenal because, if the lease is rejected retroactive to the petition filing date, the landlord loses its right to collect rent under section 365(d)(3). Although there is an issue as to whether the courts may exercise such power in light of the express statutory requirement set out in section 365(d)(3) that the landlord be paid, a number of courts have held that they have the power to order a retroactive rejection if the equities militate in favor of retroactive rejection.

In a 2007 case, the Second Circuit held that the landlord waived its right to object to retroactive rejection but expressly reserved decision on whether a bankruptcy court has equitable authority to order rejection retroactively. Adelphia Business Solutions, Inc., 482 F.3d 602 (2d Cir. 2007). There is a division of authority on the timing of when the rent reserve must be paid to the landlord. Many courts take the view that the rent must be paid as it becomes due, even if the estate is insolvent (*i.e.*, will be unable to pay all administrative claims at the end of the case), as the statute requires timely payment. Courts following this view have expressed a concern about the possible windfall to the trustee or debtor-in-possession if the trustee or debtor-in-possession is able to avoid the statutory timely payment requirement simply by failing to pay rent, thus leaving the landlord to collect the rent as an administrative expense from a possibly insolvent estate at the end of a case.

Other courts take the view that the rent should be paid immediately only if it appears that the estate will have sufficient assets to pay administrative claims in full. According to this view, if an estate may be administratively insolvent so that all post-bankruptcy claims may not be paid in full, the landlord may not be paid its post-petition/pre-rejection rent as scheduled by a lease. Instead, the landlord should only be paid at the conclusion of the case on a *pro rata* basis, with other administrative expenses out of the assets being made available for distribution. Courts adhering to this line of thought generally have relied on the below:

1. Absence of any explicit super-priority language in the statute that would catapult the landlord's claim for rent in front of other administrative expenses; and

2. The availability of a number of effective remedies to the landlord if the trustee or the debtor-in-possession fails to pay post-petition/pre-rejection rent, including a motion to compel payment of rent, a motion to require the bankrupt to surrender the

premises, a motion to lift the automatic stay to allow the landlord to proceed with an eviction action, and a motion to convert the case to chapter 7.

A third view is that rent is payable as specified in a lease, but the landlord may be required to disgorge post-petition/pre-rejection payment of rent if the estate is administratively insolvent at the end of the case.

Ira L. Herman

Examining the Landlord's Risk with Regard to the Payment of Administrative Rent When a Lease Has Been Rejected and the Risk of Lease Re-characterization

by Ira L. Herman, Blank Rome LLP

Ira L. Herman is a Partner in the Finance, Restructuring, and Bankruptcy group of Blank Rome LLP.

Once a tenant actually has vacated the premises and a lease has been rejected, there is a strong trend to lump the rent with the other administrative expenses payable at the conclusion of the case. As a practical matter, where the tenant has extended its time to assume or reject a lease and the tenant remains in possession, courts have been sympathetic to landlord requests for immediate payment of rent. Whatever the view of the presiding court, it is clear that a landlord whose tenant has filed for bankruptcy and defaulted in paying rent in the post-petition/pre-rejection period should immediately move to compel payment and/or move for relief from the automatic stay so that the landlord can commence a state court eviction action. If the landlord allows a post-petition rent claim to accrue, such landlord is proceeding at his, her, or its own peril because a court in such circumstances is apt to treat a claim for post-petition date rent arrearages as an administrative expense at the end of the case on parity with other administrative claimants, at which point there may be insufficient funds to pay the landlord's claim for post-petition rent.

There is a split of authority regarding attorneys' fees incurred by a landlord acting to compel a debtor/tenant to timely pay rent accruing during the post-petition/pre-rejection period. The legal issue that the courts focus on is whether such fees are deemed to be rent or additional rent under the provisions of the lease. In light of the express statutory language requiring a trustee to comply with a debtor's lease obligations and the ability of the trustee or debtor to avoid liability for attorneys' fees by complying with the statute, the better view, at least from the landlord's perspective, will be to allow recovery of such attorneys' fees as an administrative expense.

Another issue arising with respect to the "additional rent" concerns the payment of taxes, common charges, base rent, and similar expenses that may have accrued prior to the filing of the bankruptcy petition but that were billed after the filing. Are these expenses to be treated as post-filing/pre-rejection lease obligations that must be paid in full under section 365(d)(3) of the Bankruptcy Code (based on the "billing" or "performance" date), or are they treated as part of the landlord's pre-petition claim for damages (based on the period to which the charges relate)? Courts historically opted to prorate such charges according to the period to which they related, without regard to the billing date. Notably, the Third and Seventh Circuits are in conflict on the issue. *See* In re Montgomery Ward Holding Corp., 268 F.3d 205 (3d Cir. 2001) (rejecting proration arguments); Handy Andy Home Improvement Centers, Inc., 144 F.3d 1125 (7th Cir. 1998) (accepting proration arguments).

The analysis by so-called "proration" courts focuses on considerations of fairness and specifically on the reason that it would be unfair to permit a landlord to recover pre-petition damages simply because they are billed during the post-petition/pre-rejection period when other creditors are not protected in the same way. Such courts take the view that section 365(d)(3) of the Bankruptcy Code is inapplicable to "stub rent" since the obligation in question arose prior to the petition filing date. The burden is being placed on a landlord under such circumstances to pay unfunded pre-petition operating expenses while additional operating expenses are accruing post-petition, without any assurances that any of the expenses actually will be funded by the payment of amounts due under its lease.

On the other hand, "billing date" courts take a more literal approach to section 365(d)(3) and reason that if a lease requires payment of such charges during the post-petition/pre-rejection period, the debtor or trustee is required to make such payments. This approach

seems more consonant with the purposes of section 365(d)(3) of the Bankruptcy Code, which was adopted to ensure that landlords receive the rent to which they are entitled during the post-filing/pre-rejection period, as they are forced by law (rather than their own independent business decision) to continue to lease space to the bankrupt tenant. Practitioners should note that the billing date approach does not always work in favor of the landlord.

The same issue (billing date vs. proration) will arise with respect to fixed rent if the tenant rejects the lease shortly after the date on which the fixed rent becomes due. Should the landlord receive pre-petition rent for the full month or just a prorated amount calculated on the number of days of the month during which the tenant is in possession? In this situation, courts are more likely to follow the billing date approach.

A related question is what happens if the tenant files immediately after the base rent payment date (*e.g.*, rent due on December 1st and the tenant files on December 2nd). Is the landlord limited to a pre-petition damage claim for that month, or can the landlord recover a *pro rata* portion of the rent for that month as an administrative expense (*i.e.*, from December 2nd through December 31st) rather than pre-petition damages? The landlord cannot seek payment under section 365(d)(3) if the billing date approach applies, even though the tenant continues to occupy the premises. In that situation, some courts have held that the landlord is entitled to make a claim for the *pro rata* portion of the rent for the month in which the filing occurs as an administrative expense under section 503(b)(1) of the Bankruptcy Code.

Since a landlord's claim for post-petition administrative rent generally ends when a lease is rejected, litigation also arises over the timing of rejection. Faced with a landlord's claim for post-petition/pre-rejection rent, a trustee who has failed to promptly reject a lease for unused space will generally argue that rejection occurred when the trustee or debtor first evinced the intention to reject (or when the debtor vacated the premises) or to seek a court order providing for a retroactive rejection date. Some courts permit retroactive rejection while others do not. The landlord will generally argue that rejection only occurs at the end of the 120-day period (210-day if the trustee fails to assume), or when the court issues an order of rejection (if the order is issued earlier than the expiration of the 120-day period).

Lease Re-characterization as a Risk of Bankruptcy With Respect to Real Property

Should an entity file for bankruptcy relief, its capital provider has very different rights when the transaction is determined to be a mortgage loan as opposed to it being a true real property lease. Whether the transaction is a true lease or a mortgage, the capital provider will be stayed from taking enforcement actions by virtue of the automatic stay upon the commencement of a bankruptcy case. If the transaction is determined to be a mortgage, then the creditor will generally not receive any payments during the pendency of the bankruptcy case (other than possible "adequate protection payments, under section 361 of the Bankruptcy Code and section 362 of the Bankruptcy Code, but only if specifically authorized by the bankruptcy court). Ultimately, the creditor will be entitled to receive payments with a present value (as determined by the court) equal to the value of its interest in the collateral. Thus, the amount and timing of the payments and the interest rate on the debt can be rewritten in the bankruptcy case. If the debt exceeds the value of the collateral, the creditor will receive an unsecured claim for the difference, which may result in a payment of only pennies on the dollar for that portion of the claim.

If the transaction is considered a lease for non-residential real property, however, the estate will be required to either assume or reject the lease. If the estate elects to assume the lease, it must cure defaults and provide adequate assurance of future performance of the lease terms. To retain the property, the estate will have to honor its lease obligations, including paying rent during the administration of the bankruptcy case (subject to any exceptions to the general rule contained in section 365 of the Bankruptcy Code). If the estate rejects a lease, the lease is treated as having been breached, and the leasehold must be turned over to the lessor, who may then file an unsecured claim for damages, subject to a statutory cap. The estate does not have the option of delaying payments while the bankruptcy case is pending, nor can it rewrite the payment terms on the lease pursuant to a plan of reorganization, as may be done in the appropriate circumstances with a mortgage. For more information about Executory Contracts and Unexpired Leases, *see* *Understanding What Constitutes an Executory Contract and Unexpired Lease*.

The rules that bankruptcy courts use for distinguishing between a true lease and mortgage transactions will affect the terms and documentation of most deals, as lawyers advise their clients on the optimal ways to protect their interests. Sections365(d)(3) of the Bankruptcy Code and section 365(d)(4) of the Bankruptcy Code apply solely to "true" or "bona fide" leases. The designation of an agreement as a lease is not controlling. Instead, the court generally will look to the parties' intent in order to determine if the agreement is a lease, a financing arrangement, a joint venture agreement, a mortgage, a management agreement, or some other

type of agreement. For example, in In re LeFrak, 223 B.R. 431 (S.D.N.Y. 1998), a debtor-shareholder's 99-year proprietary lease for a cooperative apartment unit was deemed to be not a true lease that needed to be assumed or rejected since the debtor's interest was more in the nature of a deed to real property. This would apply in the non-residential context as well, *e.g.,* commercial office cooperatives. Overall, the question of whether a lease is found to be a true lease will depend on applicable state law.

BLANKROME

TAB 6

Oil and Gas Agreements under the topic Identifying and Managing Bankruptcy Risk

Ira L. Herman

Examining the Status of Rights in Bankruptcy Arising Under Oil and Gas Agreements, Specifically Joint Operating Agreements

by Ira L. Herman, Blank Rome LLP

Ira L. Herman is a Partner in the Finance, Restructuring, and Bankruptcy group of Blank Rome LLP.

The status of rights under oil and gas agreements, including oil and gas leases and joint operating agreements, can be affected by bankruptcy law. A few of the common issues that can arise in an oil and gas bankruptcy case include the treatment of joint operating agreements, oil and gas leases, and farmout agreements. The treatment of oil and gas agreements under the Bankruptcy Code is dependent on the characterization of such agreements under state law. It is therefore crucial to be aware of how the mineral law of the applicable state characterizes your rights. For example, while joint operating agreements almost are always executory contracts, an oil and gas lease may, depending on the governing non-bankruptcy law, constitute either evidence of an interest in real property interest that is subject to assumption or rejection under section 365 of the Bankruptcy Code or an unexpired lease that is subject to assumption or rejection under section 365.

Joint Operating Agreements

Joint operating agreements uniformly are held to be executory contracts and can thus be assumed or rejected under section 365 of the Bankruptcy Code. Wilson v. TXO Prod. Corp. (In re Wilson), 69 B.R. 960, 963 (Bankr. N.D. Tex. 1987). Like any rights created under an executory contract, a party's rights under a joint operating agreement are at risk in the event of a bankruptcy filing. Although the risk of rejection cannot be entirely eviscerated, a party may mitigate that risk by: (1) including a standard provision ensuring that the joint operating agreement is construed as an executory contract and providing for adequate assurance of performance; (2) filing a memorandum of the operating agreement of record to protect any contractual lien rights; (3) negotiating for and preserving offset and recoupment rights; and (4) drafting the operating agreement to protect certain rights as covenants running with the land, which are not subject to rejection in bankruptcy. *See sample Joint Operating Agreement clauses*.

Adequate Assurance

Under section 365(b)(1)(A) of the Bankruptcy Code, a party assuming an operating agreement will be required to provide adequate assurance of future performance under the agreement if there has been a default. To mitigate the risk that the bankruptcy court's determination of adequate assurance will not sufficiently protect the non-debtor's interests, the parties should agree in advance on the nature of adequate assurance by including the following standard provision from the AAPL Model Form:

> If, following the granting of relief under the Bankruptcy Code to any party hereto as debtor thereunder, this agreement should be held to be an executory contract under the Bankruptcy Code, then any remaining party shall be entitled to a determination by debtor or any trustee for debtor within thirty (30) days (inclusive of Saturday, Sunday and legal holidays) from the date an order for relief is entered under the Bankruptcy Code as to the rejection or assumption of this agreement in its entirety. In the event of an assumption, such party seeking determination shall be entitled to adequate assurances as to the future performance of debtor's obligation hereunder and the protection of the interest of all parties. The debtor shall satisfy its obligation to provide adequate assurances by either advancing payments or depositing the debtor's proportionate share of expenses in escrow.

Contractual Lien Rights

An operating agreement also may create contractual lien rights, which are preserved even if the operating agreement is rejected. Operating agreements often grant the operator a contractual, consensual lien on the non-operator's mineral interest to secure the non-operator's obligations under the agreement. If the non-operator files for bankruptcy, it cannot reject the lien even if it rejects the operating agreement. However, the lien is not binding on third parties unless: (1) the operating agreement (or a memorandum of it) is filed of record; (2) constructive notice to the world is given in some other context, such as possession; or (3) the lien claimant is in possession of the collateral. An operator in possession of a property likely is not in possession as the agent of the non-operator so as to give notice of the lien, so it is critical that a party entitled to a contractual lien file a memorandum of the operating agreement of record to ensure that its lien rights will be enforceable in bankruptcy.

Setoff and Recoupment Rights

Even if an operator has failed to perfect its operator's lien, the operator may exercise setoff and recoupment rights against a bankruptcy estate under the terms of the governing operating agreement. Security Pacific Nat'l Bank v. Enstar Petroleum Co. (In re Buttes Resources Co.), 89 B.R. 613, 617 (S.D. Tex. 1988) (operator's claim to production runs is characterized as recoupment, and the stay is lifted to allow effectuation of setoff); Farmers Union Central Exchange, Inc. v. Security Pacific Nat'l Bank (In re Buttes Gas & Oil), 72 B.R. 236, 239 (Bankr. S.D. Tex. 1987) (operator's right to recover costs from production runs is recognized as recoupment). A party entitled to setoff must obtain relief from the stay before exercising its rights, although an "administrative freeze" is available pending relief from the stay. Citizens Bank v. Strumpf, 516 U.S. 16 (1995).

The automatic stay does not stay a recoupment given that recoupment does not involve any action against property of the estate. Rather, recoupment involves a determination of the proper amount of the estate's claim against the party seeking the recoupment. *See, e.g.,* Beaumont v. Dep't of Veteran Affs. (In re Beaumont), 586 F.3d 776, 781 (10th Cir. 2009) ("If the recoupment doctrine applies, then there is no 'debt' or 'claim' here as defined in the Bankruptcy Code, and the [d]efendant has not violated the automatic stay."); Kosadnar v. Met. Life Ins. Co. (In re Kosadnar), 156 F.3d 1011, 1016 (5th Cir. 1998) ("Post-petition recoupment does not violate the automatic stay imposed by the bankruptcy court.").

The recoupment rights of the operator may be superior to a mortgage lien encumbering the estate's interest in the property subject to the recoupment. In one case, a bank intervened in a motion to lift the stay and unsuccessfully argued that its mortgage was prior to the operator's right of recovery. *See* Buttes Resources Co., 89 B.R. at 617. In *Buttes Resources Co.*, the court noted that the claim of the debtor was "subject *ab initio* to reduction for the very expenses that were required to produce the oil." *Id*.

For more information about Setoff, *see* *Understanding and Examining Setoff Rights in Bankruptcy Generally*.

For more information about Recoupment, *see* *Understanding Recoupment*.

Covenants Running with the Land

Operating agreements sometimes contain provisions that may be characterized as covenants running with the land, which cannot be assumed or rejected in bankruptcy. *See* Newco Energy v. Energytec, Inc. (In re Energytec, Inc.), 739 F.3d 215, 224-25 (5th Cir. 2013) (holding that a bankruptcy sale was not free and clear of a party's rights pursuant to covenants running with the land). Thus, from a practical perspective, a party seeking to maximize the chances that its rights under the operating agreement will be preserved even in the event of bankruptcy should: (1) draft the operating agreement to recognize those rights as covenants running with the land and to bind the parties and their assigns; and (2) file the operating agreement of record.

It is important to note that not all rights can be characterized as covenants running with the land. State law universally defines a covenant running with the land as a right that touches and concerns the land. Common elements include whether the right: (1) touches and concerns the land; (2) relates to a thing in existence or specifically binds the parties and their assigns; (3) is intended by the original parties to run with the land; and (4) when the successor to the burden has notice. Inwood N. Homeowners' Ass'n, Inc. v. Harris, 736 S.W.2d 632, 635 (Tex. 1987). Thus, a right that plainly does not concern the land cannot be characterized as a covenant running with the land even if the operating agreement defines it as such.

However, all but the first element can be satisfied by careful drafting and recording of the operating agreement. As a practical matter, the operating agreement should plainly state that the right binds the parties and their assigns, and the explicit characterization of the right as a covenant running with the land in the operating agreement will leave no room for doubt as to the parties'

intent. Recording the operating agreement ensures that any notice element is satisfied. Additionally, where a right is in some way connected to the use of the land – for example, a right to consent before the assignment of the land or a right to receive a fee for certain uses of the land – carefully crafting the definition of the right can improve the chances that it will be construed as touching and concerning the land.

Ira L. Herman

Exploring the Status of Rights in Bankruptcy Arising Under Oil and Gas Agreements, Specifically Oil and Gas Leases and the Safe Harbor Provision for Farmout Agreements

by Ira L. Herman, Blank Rome LLP

Ira L. Herman is a Partner in the Finance, Restructuring, and Bankruptcy group of Blank Rome LLP.

The status of rights under oil and gas agreements, including oil and gas leases and joint operating agreements, can be affected by bankruptcy law. A few of the common issues that can arise in an oil and gas bankruptcy case include the treatment of joint operating agreements, oil and gas leases, and farmout agreements. The treatment of oil and gas agreements under the Bankruptcy Code is dependent on the characterization of such agreements under state law. It is therefore crucial to be aware of how the mineral law of the applicable state characterizes your rights. For example, while joint operating agreements almost are always executory contracts, an oil and gas lease may, depending on the governing non-bankruptcy law, constitute either evidence of an interest in real property interest that is subject to assumption or rejection under section 365 of the Bankruptcy Code or an unexpired lease that is subject to assumption or rejection under section 365.

Oil and Gas Leases

Despite employing the noun "lease" in its description, an oil and gas lease is not necessarily an unexpired lease subject to rejection in bankruptcy and may actually instead be a real property interest. The question of whether an oil and gas lease falls within the definition of either "executory contract" or "unexpired lease," as those terms are used in section 365 of the Bankruptcy Code, is determined by referring to the applicable non-bankruptcy law. Butner v. United States, 440 U.S. 48 (1979). The nature of the property right created by an oil and gas lease varies from state to state. In Texas and Pennsylvania, for example, oil and gas leaseholds are classified as real estate, while in Kansas, a lease is essentially a license to go upon the land in search of oil and is subject to assumption or rejection under section 365 of the Bankruptcy Code. Terry Oilfield Supply Co. v. Am. Sec. Bank, 195 B.R. 66, 70 (S.D. Tex. 1996); Jacobs v. CNG Transmission Corp., 332 F. Supp. 2d 759, 772 (W.D. Pa. 2004). *But see* In re Powell, 482 B.R. 873, 878 (Bankr. M.D. Pa. 2012) (holding that an oil and gas lease is "clearly" a lease of real property within the bankruptcy definition).

If a lease is classified as a real property interest rather than as a lease, a debtor who is a lessor cannot reject the lease and thus deprive the lessee of its expected benefits under the lease. Although a lease that is classified as an executory contract or unexpired lease is subject to rejection, some recent case law has suggested that under section 365(h) of the Bankruptcy Code, which allows a lessee of an unexpired and already commenced lease of real property to retain its rights under the lease that are in or appurtenant to the real property for the balance of the term of the lease, "rejection would not appear to oust [lessees] from their rights to occupy the premises." Powell, 482 B.R. at 879. Although the parties cannot control whether a lease will be characterized as an executory contract or unexpired lease, a lessee can prepare for the risk of rejection in bankruptcy by crafting and defining its rights under the lease so that they will likely be found to be "in and appurtenant to the real property" under section 365(h).

Safe Harbor Provision for Farmout Agreements

Section 541(b)(4) of the Bankruptcy Code provides that mineral rights leases covered by certain types of "farmout" agreements (as defined by the Bankruptcy Code) are not property of the debtor's estate. In the oil and gas industry, a "farmout" is a contractual arrangement by which one party (the farmee) earns all or a portion of the interest in a property owned by another (the farmor) in

exchange for the performance of certain tasks such as, for example, drilling or completing certain wells. In a typical farmout, the farmee drills a well and, upon satisfactory completion, earns a percentage of the acreage and additional rights going forward. Title remains in the name of the farmor pending the farmee's completion of the contractual obligations.

Section 541(b)(4)(A) prevents a debtor-farmor from withholding from its farmee an assignment of an interest if it is otherwise earned. By removing acreage subject to a farmout agreement from the bankruptcy estate, section 541(b)(4) seeks to prevent a windfall to a bankruptcy estate that is a farmor that elects to reject an executory farm-out agreement that otherwise would result in the farmee's earning a percentage of the acreage of a successful well.

As a practical matter, in order to take advantage of the safe harbor, parties to certain types of agreements should ensure that their agreements fall within the Bankruptcy Code's definition of "farmout agreement," a definition that is broader than the standard industry understanding of a farmout agreement. The Bankruptcy Code's definition covers any agreement for the assignment of an interest in an oil and gas lease that includes, as consideration, defined operations upon the party. 11 U.S.C. § 101(21A). A prospective assignee under an agreement for assignment should thus ensure that the agreement falls within the Bankruptcy Code's definition so that a bankruptcy filing by the farmor will not result in a disruption of the farmee's expected rights.

Where the debtor entity is the farmee under an agreement and has promised to sell or has actually sold interests, the situation can be more complicated. If the assignments are not of record, it is unclear whether the interests will nonetheless become property of the estate. Under a broad reading of the phrase "pursuant to a farmout agreement" in section 541(b)(4)(A)(i) of the Bankruptcy Code, the assignment to a third party could arguably be "pursuant to" the farmout agreement, especially if the debtor's ability to perform under the farmout agreement is dependent on the assignment to third parties.

A third party entering into an agreement to purchase interests from a farmee thereby incurs the risk that the farmee will file for bankruptcy relief and reject the agreement to sell the interests despite having already obtained funds from the third party to assist in operations. The rejection damages claim in such a circumstance would only give rise to an unsecured claim against the estate, and the party to whom the debtor promised to sell the interests may receive very little, while the debtor's estate would retain the interests that it acquires under the farmout. Although this risk cannot be eliminated, the third party advancing funds may mitigate the risk by insisting upon a recital that such funds are advanced "pursuant to" the farmout agreement and for the purpose of funding operations under the farmout agreement.

BLANKROME

TAB 7

Lease of Personal Property under the topic Identifying and Managing Bankruptcy Risk

Ira L. Herman

Analyzing Assumption and Rejection of Executory Contracts, Cure Disputes, Equipment Lease Restructuring, and Lease Recharacterization

by Ira L. Herman, Blank Rome LLP

Ira L. Herman is a Partner in the Finance, Restructuring, and Bankruptcy group of Blank Rome LLP.

Assumption and Rejection of Executory Contracts

Equipment leases generally qualify as executory contracts that may be assumed or rejected by the debtor or trustee, unless the transaction evidenced by the documents and called a lease is re-characterized as loan transactions. *See* sample clause regarding an *Equipment Lease*.

The debtor or trustee need not make its assumption/rejection decision until plan confirmation unless the court orders otherwise. However, the debtor or trustee is obligated to continue performing under the terms of the lease if and until it rejects the lease. If the debtor fails to perform its obligations under the lease, that may be grounds for the lessor to seek an order from the bankruptcy court compelling the debtor to make its assumption/rejection decision early. Nevertheless, because the debtor can take months and even years before it is required to assume or reject its leases, it is critical for the lessor to actively monitor the debtor's bankruptcy case in hopes of finding clues that might telegraph the debtor's intentions with respect to some or all of its leases. As a practical matter, the debtor's first day pleadings and any periodic rejection motions that the debtor may file during its bankruptcy case are excellent sources of such information. Speaking with the representatives of the estate, including bankruptcy counsel, also can shed light, among other things, on the possible treatment of particular leases or other contracts.

For more information, *see* *Analyzing and Examining Assumption of Executory Contracts and Unexpired Leases*, and *Analyzing and Examining Rejection of Executory Contracts and Unexpired Leases*.

Cure of Defaults

As a prerequisite to assumption, the estate must cure defaults, compensate the non-debtor party for any pecuniary loss resulting from those defaults, and provide the non-debtor party with adequate assurance that the estate will be able to perform in the future under the lease.

Disputes often arise between the debtor/trustee and the non-debtor concerning the existence and extent of lease defaults. Generally speaking, such disputes are resolved by negotiations among the parties, although a non-debtor party may complain to the bankruptcy court if and when a debtor/trustee refuses to cure or disputes the extent of its cure obligations. As a practical matter, non-debtor parties should be very careful whenever a debtor/trustee seeks to assume its leases because the debtor may understate its cure obligations with the bankruptcy court and then attempt to bind the non-debtor party to such understated cure amounts. In that situation, the non-debtor party must file a objection with the bankruptcy court in order to protect its full cure claim. The bankruptcy court would then fix the amount of such cure claim, unless the parties themselves are able to resolve their dispute.

If, based on the business judgment of the debtor or trustee, continuation of the lease is not beneficial to the estate, then the debtor/trustee may reject the lease. If the debtor/trustee rejects the lease, however, neither the estate (nor the non-debtor party) is obligated to fulfill its respective obligations under the lease. Rejection leaves the non-debtor party with a general unsecured claim against the estate for damages as a result of the rejection or breach, subject to specific provisions of the Bankruptcy Code that may alter the general rule in specified circumstances. To the extent that a non-debtor affiliate has guaranteed a lease, the lessor may pursue any and all claims against the guarantor notwithstanding the bankruptcy.

Equipment Lease Restructuring

Equipment leases can be restructured just like loans. Equipment lease economics change over time. The result of changing economics may make a particular lease unfavorable to a debtor/trustee and, therefore, a likely candidate for rejection. The reasons for a decision to reject a lease tend to be very simple: either the debtor cannot afford to continue paying its current rent obligations under the lease or the debtor can obtain a new lease for similar equipment on more favorable terms elsewhere. In these types of situations, the lessor has two choices – to allow the debtor-lessee to reject the lease and repossess (and redeploy) the equipment, or to agree to restructure the terms of the lease. In a restructuring, the lessor often determines that it is better to agree to forgive and/or defer future rent and modify other contractual lease terms rather than take back the equipment.

A chapter 11 debtor generally implements a restructured lease or restructured lease terms by assuming the underlying lease, as amended by agreement of the parties to reflect the restructured lease terms. Chapter 11 debtors tend to delay actually assuming the amended lease until they have confirmed their reorganization plan and are ready to emerge from chapter 11 (to avoid the unnecessary creation of administrative liabilities), but chapter 11 debtors also may want the benefit of operating under its restructured lease during the bankruptcy case. As a result, lease amendments tend not to become effective until the chapter 11 debtor is set to emerge from chapter 11 and may also sometimes contain specific "snap back" provisions to recapture rent that was deferred or forgiven pursuant to the lease amendment. This mechanism ensures that the lessor does not waive any claims that it might have against the debtor-lessee in the event that the debtor fails to confirm its bankruptcy plan or otherwise emerge from chapter 11.

Lease Recharacterization

As with real property leases, a personal property lease may be recharacterized as a financing agreement rather than a true lease. The legal ramifications of this distinction are many. Leases are entitled to special protections, and lessors are afforded special rights in a bankruptcy case. If a debtor/trustee decides to assume an equipment lease, the debtor/trustee must cure any pre-petition and/or post-petition defaults under the lease. Under section 365(d)(10) of the Bankruptcy Code, after the expiration of an initial 60-day relief period, the debtor is also required to make rent payments to equipment lessors in the amount required under the lease. By contrast, secured creditors only have a secured claim to the extent of the value of its collateral. As a result, if a document denominated as a lease is ever determined to create a security interest rather than a lessee/lessor relationship and the secured party is undersecured (*i.e.*, the amount of the claim is greater than the value of the collateral), the claim will be bifurcated into a secured claim (limited to the value of the collateral) and an unsecured claim for the balance. From there, the debtor/trustee may seek to cram down a plan of reorganization by stripping the lien down to the value of the collateral and paying the claim off over a period of years. Additionally, undersecured creditors are not entitled to interest on the secured component of their claims. For these reasons, disputes often arise concerning the proper legal classification of an equipment finance transaction as either a true lease or disguised financing.

Whether a transaction constitutes a true lease or a disguised financing transaction will be determined not by the provisions of the Bankruptcy Code but instead by applicable state law. Thus, if a bankruptcy court were to determine that a purported lease transaction is actually a secured loan, the court can recharacterize that transaction and the lessor will lose the protections afforded to lessors under the Bankruptcy Code. Rather, the debtor's obligations under the lease will be treated as a typical finance transaction.

Courts generally focus on the intent of the parties in conducting their recharacterization analysis, but often limit their examination to the objective rather than subjective intent of the parties. Courts have applied an economic substance analysis to recharacterize a lease as a disguised financing upon finding that the economic substance of the transaction is not of the type associated with a true lease. These courts have considered several factors when determining the economic substance of an agreement. The courts generally survey all relevant factors, and no one factor is controlling. The factors to be considered are as follows:

- Whether rent payments are calculated to ensure a return on the lessor's investment or are, in fact, payments of principal and interest rather than mere compensation for the use of the property;
- Whether the lessee is required to purchase the property upon the occurrence of a certain event;
- Whether the lease provides the lessee with an option to purchase the assets for nominal or minimal consideration;
- Whether the lessor purchased the property specifically for the lessee's use;
- Whether the lessor obtained credit to purchase the leased property, with the lease term ending when the loan is due; and
- Whether the transaction was structured as a lease instead of a loan to secure tax or other benefits.

In the context of a leveraged lease, contractual equity "squeeze rights" or protections unquestionably improve the lessor's negotiating leverage in a bankruptcy. To the extent the lease debt holder (or its indenture trustee) must obtain the consent of the lease equity (or its owner trustee) to restructure the lease terms, the lease equity (*i.e.*, the owner participant) can insist on a seat at the negotiating table when the lessee and the lease debt seek to restructure the terms of the lease. Participation in the process is crucial for the

lease equity to protect its economic interest in the equipment, as well as for the lease equity to preserve many of the legal rights that it was promised when the lease transaction was consummated. Without "squeeze rights," the lease equity may be kept in the dark when these negotiations take place and would thus have no voice on the new rent or other lease terms. In these situations, the lease equity can raise objections with the bankruptcy court, but these objections are rarely sustained unless the parties have acted in a commercially unreasonable manner or otherwise not in good faith.

Owner-participants that do have equity "squeeze rights" must remember that the lease debt holder ultimately will have the ability to foreclose on the equipment and may even have the right to then release it to the debtor. The owner-participant may suffer substantial adverse tax consequences if the lease debt holder elects to exercise its foreclosure rights. As such, lease equity must carefully balance this risk when negotiating the new terms of the restructured lease or lease amendment with a lessor-debtor and the lease debt holder.

BLANKROME

TAB 8

IP-Related Agreements under the topic Identifying and Managing Bankruptcy Risk

Identifying the Bankruptcy Risks for Licensors and Licensees of Intellectual Property, and Understanding Intellectual Property Terminology

A Lexis Practice Advisor® Practice Note by
Ira L. Herman, Blank Rome LLP

Ira L. Herman

Identifying the Bankruptcy Risks for Licensors and Licensees of IP

Licensors and licensees of intellectual property face several challenges when the other party to a license files for bankruptcy relief. A licensee faces the risk that its licensor may elect to reject the license under section 365 of the Bankruptcy Code, thereby depriving the licensee of the ability to use the intellectual property essential to its business. On the other hand, a licensor faces the risk that a licensee may file for bankruptcy and reject the license in question, thus relieving such licensee of its obligations under the license, including the licensee's obligation to pay licensing fees to the licensor. A licensor may also have to deal with an attempt by a trustee or debtor in possession to assume and assign a non-assignable license agreement in the context of Bankruptcy Code section 363 asset sale.

Purchasers of intellectual property from a debtor-in-possession or bankruptcy trustee also take on bankruptcy ri sk. Although it may seem simplistic, the first thing that a prospective purchaser of a bankruptcy estate's interest in intellectual property needs to know is what the seller is able to convey. Intellectual property including trademarks, trade names, patents, copyrights, and domain names may be treated differently under bankruptcy law than they would be treated outside of the bankruptcy context. Once a prospective purchaser understands the legal interest in the asset in play, the prospective purchaser should then take steps to ascertain whether such property is owned by the debtor entity or is licensed to the debtor entity. If it is determined that the debtor entity is a licensee of the intellectual property in question, the next level of inquiry for the prospective purchaser becomes whether the license is an exclusive license or non-exclusive license.

More often than not, a particular copyright or patent covers a whole bundle of rights. Therefore, during the next phase of the due diligence process, a prospective purchaser should conduct an in-depth review of the terms of the license to determine whether the debtor/licensee has been granted all of the rights that are needed to make use of the intellectual property covered by the relevant copyright or patent. For example, a debtor/licensee may have acquired an exclusive license to exploit a patent to make, use, or sell a particular device. But if the patent in question covers multiple devices, the license may cover only some of these devices. The licensor may have retained rights so that the debtor/licensee does not have a license to use all possible rights available by virtue of the patent in question. Labeling a document "exclusive license" must not be the end of a prospective purchaser's inquiry.

Intellectual Property Definitions

Intellectual Property

What is a right in *intellectual property*? Most simply, it is a legally protected interest in a concept. The legal protection afforded to such property interest is comprised of restrictions placed on the exploitation of such concept by others – in other words, a limitation on use.

Generally, intellectual property rights are transferable, either: (1) by assignment, or (2) by the grant of a license. The universe of interests known as "intellectual property" covers patents, copyrights, trademarks, trade secrets, and domain names. The Bankruptcy Code defines the term *intellectual property* as: (A) trade secret; (B) invention, process, design or plant under title 35 (patent); (C) patent application; (D) plant variety; (E) work of authorship protected under title 17 (copyright); or (F) (semi-conductor chip) mask work protected under chapter 9 of title 17, to the extent protected by applicable non-bankruptcy law. One exclusion from the definition of intellectual property is notable: the Bankruptcy Code's definition of intellectual property does not include trademarks. This omission, and its legal import, is discussed below.

Patents

A patent is a legal monopoly granted by the government on the exploitation of an invention for a limited period of time in exchange for public disclosure and eventual unrestricted public use of the invention. During the term of the patent, the owner may prevent others from making, using, or selling the invention. The subject matter of a patent may be: (a) a new and non-obvious process, machine, manufactured item, or composition of matter (utility patent); (b) a new and non-obvious ornamental design for a manufactured article (design patent); or (c) a new and distinct variety of plant that has been invented or discovered and can be asexually reproduced (plant patent).

Patent rights are granted by a national government in response to an application by the individual inventor(s) or, in some countries but not the United States, by the company employing the inventor(s). A corollary to this rule of patent creation is that patents are territorial.

A patent application must be filed before the invention is publicly disclosed or (in the United States but not all other countries) within a limited time after public disclosure. Foreign applications based on an application in the inventor's home country must be filed within one year of the home country filing date in order to claim the benefit of the home country filing date.

Patent rights do not exist until an application has been approved and granted. The use of the phrase "patent pending" means only that an application has been filed (somewhere, wherever that may be). Unless and until the patent application is granted, the invention may be copied without liability, but if the copying continues after the patent issues, the copier would be liable for patent infringement. In the United States, the term of utility patents applied for since June 8, 1995 is 20 years from the date of application. (Previously, the term was 17 years from the date of issue). The term of design patents is 14 years from the date of issue.

Copyrights

A copyright is the right to control the copying of an original creative work or derivation of such work. The subject matter of a copyright may include the original and creative expressions of an idea in tangible form – for example, writings, photographs, recordings, films, musical notations, source code, art works, sculpture, etc. However, a copyright does not protect an idea itself. Others are free to paraphrase an idea that is copyrighted or create their own expressions of such idea.

A copyright comes into effect automatically upon the creation of a copyrightable work. The Berne Copyright Convention, to which the United States is a party, provides protection for copyright in nearly every country. No registration, publication, or formal notice is required to create a copyright. Nevertheless, copyright owners are well served by routinely including a copyright notice (*e.g.*, © 2014 by [Owner]) on copyrighted material in order to avail themselves of important procedural rights against possible infringers. However, in the United States, copyright owners must register their copyrights as a prerequisite to filing suit for infringement.

The owner of a copyright generally is the individual who created the work. In the United States, a copyrightable work created by an employee in the scope of employment automatically belongs to the employer (and not the individual employee) under the work-for-hire doctrine. Work-for-hire does not apply to independent contractors, who often are required by contract to assign or license the intellectual property subject to the copyright to the *hiring* party.

For works created after January 1, 1978, the term of a copyright is the life of the author, plus 70 years. If under the work-for-hire doctrine the author is a corporation or similar legal entity, the term is the shorter of 95 years from the date of publication or 125 years from the date of creation.

Trademarks

A trademark is a right to keep others from appropriating a distinctive commercial identity. The subject matter of a trademark may include a distinctive symbol (for example, a word, name, symbol, logo, slogan, sound, smell, trade dress, product shape, etc.) used to associate goods or services with a particular source. Trademark rights do not create an absolute monopoly on a particular word or logo, but instead grant only the right to keep others from using the same or a very similar mark on or in association with the same or closely related goods or services, or from otherwise misleading customers into thinking that there is a commercial relationship with the trademark owner. For the forgoing reasons, trademarks are sometimes called “industrial property.”

Common law rights in trademarks arise in the United States and other English law countries when a mark is used to identify and distinguish goods and products produced or sold by one vendor from those produced or sold by another. It is the use of the mark that creates recognition and the right to keep others from appropriating the mark. Thus, in the United States, an applicant for a trademark must use the mark before a federal registration will be issued. Countries outside the English law system typically base trademark rights on filing for registration. By treaty, non-U.S. applicants generally may obtain a U.S. trademark registration without proving that the mark is in commercial use in the United States. The term of a U.S. registration is 10 years; it can be renewed indefinitely, so long as the mark remains in use.

The owner of a trademark is presumed to control the quality of the goods or services sold under the mark – that is why the mark has value. The owner of the mark can either manufacture and sell the goods by itself and/or can grant a license to another party to manufacture and/or sell the goods subject to the mark.

Trade Secrets

As defined in the Uniform Trade Secrets Act, trade secrecy consists of information, including a formula, pattern, compilation, program, device, method, technique, or process, that: (a) derives independent economic value, actual or potential, from not being generally known to, and not being readily ascertainable by proper means by, other persons who can obtain economic value from its disclosure or use; and (b) is the subject of efforts that are reasonable under the circumstances to maintain its secrecy.

If a formula, idea, or invention is not patented, it can be protected only by the owner’s efforts to keep it secret. If the secret is revealed, the owner may have a cause of action against the party who disclosed the secret without authorization. Once disclosed, a trade secret is gone, since it must be information that is secret.

Domain Names

A domain name is an Internet web address or URL – for example, www.uscourts.gov. Domain names are purchased from a provider or a domain name registrar. As a general matter, a domain name can be treated like a trademark, copyright registration, or a patent. Domain names, in many cases, incorporate a trademark or trade name of the domain name registrant. In such cases, trademark protections may attach to the web address.

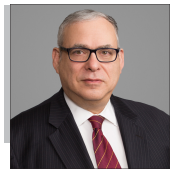
The author would like to express his gratitude to Victoria Guilfoyle, an associate at Blank Rome LLP, for her research and editorial support. The views expressed herein are solely those of the author as of the date this article was written and such views should not be attributed to Blank Rome LLP or to any of its clients.

Ira L. Herman
Blank Rome LLP

BLANKROME

Executory Contract Risks

A Lexis Practice Advisor® Practice Note by
Ira L. Herman, Blank Rome LLP



Ira L. Herman

Executory Contracts Generally

As a general rule, a contract is executory if performance is still due from both parties to the contract, and the failure of either party to perform would constitute a material breach. Courts differ in their interpretation of this definition of "executory contract." The term itself is not defined in the Bankruptcy Code. Section 365(a) of the Bankruptcy Code gives the bankruptcy trustee or debtor-in-possession the power to assume (keep) and the power to reject (disavow) those contracts and leases entered into prior to a bankruptcy filing. The bankruptcy trustee or the debtor-in-possession has the authority to decide whether an executory contract or unexpired lease is advantageous or not, and to assume or reject the agreement. Debtors and trustees may modify obligations under executory contracts and unexpired leases through the use of two tools:

1. The right to assume a contract or lease by curing defaults, notwithstanding a contrary provision in the affected lease or contract providing for termination due to insolvency –and–
2. The right to assign such contract or lease, notwithstanding contractual restrictions on assignment

The benefits of assumption and of assumption and assignment are balanced by the requirements of Section 365 of the Bankruptcy Code for assumption and for assignment and assumption. Under Section 365, a debtor may assume or assume and assign an executory contract or unexpired lease only if it cures any existing defaults and pays damages arising from a breach of the contract or lease. The debtor must also provide adequate assurance of future performance of its obligations under the contract or lease.

Prior to assumption or rejection and after the filing of a bankruptcy case, all executory contracts and unexpired leases remain in existence and enforceable by the debtor or trustee but are not enforceable against the debtor or trustee. Moreover, the Bankruptcy Code provides debtors-in-possession and trustees with the means to compel third parties to continue doing business with them when a bankruptcy filing might otherwise cause a non-debtor party to be reluctant to do so.

For more information about executory contracts and unexpired leases, see Defining Executory Contracts and Unexpired Leases.

Licenses Generally Constitute Executory Contracts under U.S. Bankruptcy Law

A license of intellectual property, in effect on the date of a bankruptcy filing, generally is considered to be an executory contract for the purposes of Section 365 of the Bankruptcy Code. This is so, as most such licenses impose ongoing obligations on both the licensor and licensee, until the license expires or is terminated. The ongoing obligations for a licensee may include accounting for sales or earnings, paying royalties, marking all products sold under the license with a statutory patent notice, sharing technology with the licensor, and reporting

problems with the technology to the licensor. For the licensor, the ongoing obligations may include providing a nonexclusive licensee with notice of patent infringement suits, refraining from licensing the intellectual property subject to the license to third parties at lower royalty rates, approving sublicenses, indemnifying the licensee for losses, defending claims for infringement, and forbearing from suing the licensee for infringement.

Patent licenses generally are executory by their very nature, as they generally follow the pattern described in the preceding paragraph. With respect to patent licenses, the licensor commonly has an ongoing duty to defend infringement claims and to notify the licensee of any infringement proceeding. In re Access Beyond Technologies, Inc., 237 B.R. 32 (Bankr. D. Del. 1999) (patent license is executory because there is "material duty" not to sue each other for infringement covered under the license); Everex Systems, Inc. v. Cadtrax Corp. (In re CFLC, Inc.), 89 F.3d 673 (9th Cir. 1996) (patent license constitutes an executory contract). On the other hand, the licensee of a patent license is likely to have business obligations under the patent license like an ongoing fee payment requirement and an ongoing "most favored nation" clause, under which the licensor agrees to adjust fees downward if it gives a better rate to another licensee.

Copyright licenses often are executory due to their very nature, as the licensor generally will have ongoing obligations under the licensing agreement and the licensee will have obligations, including to pay and account for royalties. In re Qintex Entertainment, Inc., 950 F.2d 1492 (9th Cir. 1991).

Similarly, trademark licenses often are executory, as the licensor generally will have ongoing quality control obligations and the licensee will have payment obligations and continuing nonmonetary obligations under the license. In re Blackstone Potato Chip Co., Inc., 109 B.R. 557, 560 (Bankr. D.R.I. 1990); In re Chipwich, Inc., 54 B.R. 427 (Bankr. S.D.N.Y. 1985).

Assumption of Licenses

As licenses generally are executory contracts subject to Section 365 of the Bankruptcy Code, a trustee or debtor-in-possession may assume or reject an intellectual property license, if applicable non-bankruptcy law would permit assignment. Under Section 365(c)(1) of the Bankruptcy Code, however, the trustee or debtor-in-possession may not assume or assign any executory contract if "applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties."

The term "applicable law" in Section 365(c)(1) refers to state, federal, or other law (such as municipal law) other than the Bankruptcy Code. The purpose of this provision, as articulated by one court, is to prevent a debtor from assigning (over objection by a party-in-interest) contracts of the sort ordinarily made nonassignable by the applicable law. RCI Tech. Corp. v. Sunterra Corp., 361 F.3d 257, 266 (4th Cir. 2004). A non-debtor licensor may always consent by contract to a prospective assignment notwithstanding any applicable anti-assignment statute. In re Supernatural Foods, LLC, 268 B.R. 759, 805 (Bankr. M.D. La. 2001).

Courts generally look to the license in question to determine whether the non-debtor licensor has consented prospectively to an assignment. "[N]othing in federal patent law prevents the assignment of a license where there are express words to show an intent to extend the right to an assignee." In re Hernandez, 285 B.R. 435, 440–41 (Bankr. D. Ariz. 2002) (citing Oliver v. Rumford Chemical Works, 109 U.S. 75, 81–82 (1883)). As the court in Hernandez explained, "[i]n consenting to assignment in such situations, the non-debtor parties to the contracts gave up any interest in the identity of the assignees, thereby effectively removing the contracts from the protections otherwise afforded to them under 'applicable law' and [section] 365(c)(1), to control the identity of assignees." Hernandez, 285 B.R. at 441.

When it comes to assumption (as opposed to assumption and assignment to a third party), there is a split in authority regarding the construction and application of Section 365(c)(1) of the Bankruptcy Code, which states that "[t]he trustee may not assume or assign any executory contract or unexpired lease of the debtor, whether or

not such contract or lease prohibits or restricts such assignment or rights or delegation of duties" if "applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession" and "such party does not consent to the such assumption or assignment." In re Aerobox Composite Structures, LLC, 373 B.R. 135, 140 (Bankr. D.N.M. 2007) (referencing the circuit split). The U.S. Supreme Court has noted that the circuits are split on the issue, but the Court has stated that it is "waiting" for a "suitable" case before addressing the issue. N.C.P. Marketing Group, Inc. v. BG Star Prod. Inc., 129 S.Ct. 1577 (2009) (denying *certiorari*).

Courts have followed three different approaches: the hypothetical test, the actual test, and the literal reading test.

Rule	Circuits	Description
The Majority Rule: "Hypothetical Test"	Third, Fourth, Ninth, and Eleventh Circuits	Under the majority rule, known as the hypothetical test, if applicable non-bankruptcy law precludes assignment of an executory contract to a third party, a debtor-in-possession or trustee may not assume or assign the contract notwithstanding that the debtor-in-possession or trustee may have no intention whatsoever of assigning the contract at issue to a third party. A majority of the circuit courts construing Section 365(c)(1) of the Bankruptcy Code have followed the hypothetical test. See In re Sunterra Corp., 361 F.3d 257 (4th Cir. 2004); City of Jamestown v. James Cable Partners (In re James Cable Partners), 27 F.3d 534, 537 (11th Cir. 1994); In re West Electronics, Inc., 852 F.2d 79 (3d Cir. 1988).
The Minority Rule: "Actual Test"	First and Fifth Circuits	Under the minority rule, known as the actual test, courts focus on whether the non-debtor would actually be forced to accept performance from someone other than the debtor with whom it has contracted. Additionally, several courts have permitted assumption where a debtor-in-possession proposed selling itself to a competitor of the non-debtor licensor entity. Under this construct, the debtor-in-possession or trustee may assume a license agreement that is an executory contract if there is no intent to assign the debtor's interest in the license. See Institut Pasteur v. Cambridge Biotech Corp., 104 F.3d 489, 41 U.S.P.Q.2d 1503 (1st Cir. 1997) (holding that the debtor's proposed sale of stock to the non-debtor licensor's competitor did not constitute a de facto assignment but instead qualified as an assumption of the licenses by the reorganized debtors under new ownership); In re Mirant Corp., 440 F.3d 238, 248-249 (5th Cir. 2006) (rejecting the Third Circuit's hypothetical approach to Bankruptcy Code section 365(c)(1)); see also In re Cardinal Indus., 116 B.R. 964, 982 (Bankr. S.D. Ohio 1990).

The "Literal Reading" Approach	Certain cases in the Bankruptcy Court for the Southern District of New York.	Under the literal reading approach, the statute's use of the word "trustee" does not include the debtor or the debtor-in-possession, and as such, the right of the non-debtor party to object to assignment applies only to the trustee's right to assume or assign, not the debtor-in-possession's right. In re Footstar, 323 B.R. 566, 570-72 (Bankr. S.D.N.Y. 2005); In re Adelphia Commc'ns Corp., 359 B.R. 65, 72 (Bankr. S.D.N.Y. 2007); see also In re Aerobox Composite Structures, LLC, 373 B.R. 135, 138, 140-42 (Bankr. D.N.M. 2007).

Assignment of Licenses

Under Section 365(f) of the Bankruptcy Code, a debtor-in-possession or trustee generally, but not always, is permitted to assign a license agreement. Section 365(c) of the Bankruptcy Code prohibits the debtor from assigning rights under an executory contract if applicable law excuses a party to that agreement from accepting performance from or rendering performance to an entity other than the debtor, and such party does not consent to the assignment or delegation. However, in contrast to the disagreement seen among courts with respect to assumption, courts have been fairly uniform in holding that a nonexclusive patent or copyright license is presumptively not assignable.

Patents

Courts look to federal patent law to determine assignability and have consistently held that the patent license, as a form of personal property, is "not assignable unless expressly made so" in the licensing agreement. The bankruptcy courts have found this rule to apply under Section 365(c) in order to block the assignment of nonexclusive patent licenses without the consent of the patent owner. See Institut Pasteur v. Cambridge Biotech Corp., 104 F.3d 489 (1st Cir. 1997); see also In re Rupari Holding Corp., 2017 Bankr. LEXIS 2341, at *12 (Bankr. D. Del. Aug. 18, 2017) (advance consent to assignment provision in a license agreement did not vitiate application of the Section 365(c)(1) barrier to assignment, as a clause against unreasonable withholding of consent was not the equivalent of a clause expressly allowing assignment without consent and therefore stay relief was granted so licensor could pursue termination of license agreement). The licensee's rights are personal to the licensee and not freely assignable, unless the right to assign is expressly granted in the agreement. On the other hand, assignment of exclusive licenses is generally permitted. Courts view exclusive licenses as conferring a property interest rather than mere personal rights.

Copyrights

Courts generally hold that a nonexclusive copyright license "is personal to the transferee . . . and the licensee cannot assign it to a third party without the consent of the copyright owner." See Seawind v. Creed Taylor, Inc. (In re Creed Taylor, Inc.), 10 B.R. 265, 267–68 (Bankr. S.D.N.Y. 1981) (upholding an anti-assignment clause in an exclusive license to manufacture and distribute sound recordings in part because of the "personal nature of certain licensing arrangements"). Courts are split on whether exclusive licenses are assignable when the agreement is silent. An exclusive license is a transfer of copyright ownership to the licensee. Gardner v. Nike, 279 F.3d 774, 780-81 (9th Cir. 2002) (holding that consent of the licensor is required for assignment). Compare In re Golden Books, 269 B.R. 300, 309 (Bankr. D. Del. 2001) (opining in *dicta* that, except as otherwise provided in the license, the holder of an exclusive license is entitled to all of the rights and protections of the copyright owner and has the right to assign such rights).

Trademarks

Courts generally have permitted the assignment of exclusive trademark licenses, either by finding that they are not analogous to personal service contracts, or because a licensor's interest in the quality of the work bearing the mark can be protected by increased supervision over the license. Nonexclusive trademarks may be non-

assignable under applicable law. However, some courts have prohibited assignment absent consent, regardless of exclusivity. In re N.C.P. Marketing Groups, 337 B.R. 230, 236 (D. Nev. 2005) (finding that, under the Lanham Act, all trademark licenses are personal and non-assignable), *aff'd sub nom*., N.C.P. Marketing Group, Inc. v. BG Star Productions, Inc., 279 Fed. Appx. 561 (9th Cir 2008), cert. denied, 129 S.Ct. 1577 (2009).

Recently, the Eighth Circuit, reversing the decisions of the district and bankruptcy courts, held in a 9-3 *en banc* decision that a trademark license agreement, that was part of a larger integrated purchase agreement, was not an executory contract subject to rejection pursuant to Section 365(a) of the Bankruptcy Code. Lewis Brothers Bakeries Incorporated and Chicago Baking Company v. Interstate Brands Corporation (In re Interstate Bakeries Corporation), No. 11-1850, 2014 U.S. App. LEXIS 10537 (8th Cir. June 6, 2014) (Interstate Bakeries IV). See also In re Exide Tech., 607 F.3d 957 (3d Cir. 2010) (finding trademark license agreement, which was part of a larger integrated contract, was not an executory contract and thus, could not be rejected by the debtor). The Interstate Bakeries IV decision is quite instructive.

In addressing the issue of whether a license agreement is an executory contract, unlike the focus that both the bankruptcy court and the district court placed on the License Agreement standing alone, the Eighth Circuit in Interstate Bakeries IV found that "the proper analysis must consider an integrated agreement that includes both the Asset Purchase Agreement and the License Agreement." Id. The Eighth Circuit concluded that finding otherwise "would run counter to the plain language of both the Asset Purchase Agreement and the License Agreement, which describe the two as one piece, and would ignore the valuable consideration paid for the license." Id. Because the Eighth Circuit found that the agreement it was reviewing was not an executory contract, the court did not have to address the question of whether rejection of a trademark license agreement terminates the licensee's rights to use the trademark, an issue on which courts are divided. Compare Lubrizol Enters., Inc., v. Richmond Metal Finishers, Inc., 756 F.2d 1043 (4th Cir. 1985) (licensee of rejected license could not retain control of its right to use the intellectual property by specific performance), with Sunbeam Prods., Inc. v. Chi. Am. Mfg., LLC, 686 F.3d 372 (7th Cir. 2012) (licensee of rejected trademark license cannot be deprived continued use of the trademark) and In re Tempnology LLC, 559 B.R. 809 (1st Cir. 2016) (same).

Licenses Bundling Trademark and Copyrights or Patents

A court may allow a debtor to retain its rights under a trademark license that is coupled with a license to other intellectual property.

Rejection of Licenses

Section 365(n) of the Bankruptcy Code gives a licensee of intellectual property (as defined in Section 101(35A) of the Bankruptcy Code and does not include trademarks) two options:

1. Treat the rejection as a termination of the contract if the rejection constitutes a breach entitling the licensee to treat the contract as terminated –or–
2. Retain the rights that the licensee held immediately before the bankruptcy commenced

If the licensee chooses the first option, the breach gives the licensee an unsecured claim against the bankruptcy estate. If the licensee chooses the second option, the licensee retains the rights that existed just before the bankruptcy was filed for the duration of the contract, plus any extension to which the licensee may be entitled under applicable non-bankruptcy law. A licensee, selecting option two, must continue to pay royalties due under the contract and waive the right to setoff and the right to assert an administrative expense claim for obligations under the license. See sample Software License clause.

In the case of rejection, the debtor-licensor must provide its licensee with access to the intellectual property that is subject to the license, refrain from interfering with the licensee's exercise of its rights, and, if the license is exclusive, refrain from licensing it to others. A debtor-licensor has no other affirmative duties and is not required

to update, maintain, or improve the intellectual property. How can a licensee protect itself and its investment in a debtor-licensor's intellectual property in the event of rejection? One way in which the licensee can protect its investment is by use of a software escrow.

A software escrow is a deposit of source code of data and other relevant materials with a third-party escrow agent. The reason that a software escrow is so important to a licensee is that the licensee may need access to source code information to continue its use, make updates, and develop intellectual property that it has invested in using the licensor's intellectual property, even though the licensor (for any reason, including a business failure or bankruptcy rejection of the license under Section 365 of the Bankruptcy Code) no longer can or will provide support at agreed-upon levels.

Additionally, a licensee will want a license to enumerate with specificity the post-bankruptcy rights that the licensee may retain upon a rejection of the license, under Section 365, by its licensor. Typically, license fees, renewal fees, and maintenance fees implicitly include royalties for the use of the licensed intellectual property, but the actual amount for royalties is not broken out. If the licensor is not providing maintenance, for example, then there should probably be no continuing obligation for the licensee to pay such maintenance fees. Thus, the licensee will want the license to contain payment and other terms that will apply after a rejection in a bankruptcy case. These bankruptcy specific terms should be designed to reflect the responsibilities of the parties in the event that the licensee elects to retain the licensed software and related source code after a rejection. See sample Source Code Escrow clause.

Section 365(n) of the Bankruptcy Code may be used to avoid the imposition of liquidated damages or other damages and the application of foreign law under a governing law provision in the executory contract. In re EI International, 123 B.R. 64 (Bankr. D. Idaho 1991). In EI International, the debtor had agreed to supply a customized version of its PMAX software to Ontario Hydro, a Canadian public utility corporation. After EI International filed its Chapter 11 case, it rejected its executory contract with Ontario Hydro under Section 365. Ontario Hydro asserted a claim in excess of $3.6 million, mostly to recover for post-petition development costs expended to make the software work as intended. Under the circumstances, the bankruptcy court concluded that Ontario Hydro's claim should be treated like any other claim resulting from a rejected executory contract under Section 365. Therefore, the court reasoned, the liquidated damages provision in the contract was not enforceable because "if liquidated damage clauses were enforceable, there would be no reason for rejection of the contract by a debtor."

Since Ontario Hydro elected to retain the software rather than treat the rejection as a termination, Ontario Hydro was deemed to have waived any right of setoff and any post-petition contract claims. Based on this analysis, the court ruled that Ontario Hydro was only entitled to a pre-petition damage claim limited to actual "out of pocket costs" incurred by Ontario Hydro prior to the Chapter 11 filing. This was so, according to the court, even though the contract in question included an Ontario law choice of law provision, and Ontario Hydro's claim was allowed but only to the extent of $176,752.00.

As a practical matter, if the reasoning of EI International is adopted by other U.S. Bankruptcy Courts, Section 365(n) of the Bankruptcy Code could be used as a strategy for limiting damages and remedial obligations. This strategy, for example, could be useful in connection with a failed software development project in which the licensor is facing significant potential money damages and performance obligations. The ruling in EI International appears to stand for the proposition that U.S. bankruptcy law will apply to contracts with foreign parties when a Title 11 case has been filed in the United States. This implies that Section 365(n) may be used as a vehicle for avoiding the application of foreign law under limited circumstances.

Managing a Licensee's Assumption Risk

A licensee's bankruptcy assumption risk may be managed by including a provision such as the following:

> ***Assumption.*** *Notwithstanding any provision to the contrary, in the event Licensee files for [bankruptcy relief] and elects to assume this Agreement in the bankruptcy case, Licensor hereby consents to such assumption by Licensee provided Licensee agrees to comply with all of the terms and conditions of the License Agreement.*

This provision starts with the well-worn "notwithstanding any provision to the contrary" clause, as most license agreements provide for termination in the event of a bankruptcy filing, even though such *ipso facto* bankruptcy default clauses are unenforceable pursuant to the current version of Section 365(e) of the Bankruptcy Code. The licensor's consent to an assumption occurs only if the licensee makes the decision to assume the license. The provision does not obligate the licensee to assume the license. In most bankruptcy situations, it is likely that the licensee will reject most software licenses; however, there is a contingent risk respecting assumption for which the licensee should seek protection.

The author would like to express his gratitude to Victoria Guilfoyle, an associate at Blank Rome LLP, for her research and editorial support. The views expressed herein are solely those of the author as of the date this article was written and such views should not be attributed to Blank Rome LLP or to any of its clients.

Ira L. Herman
Blank Rome LLP

BLANKROME

Analyzing Legal Considerations Relevant to Patent Infringement in Bankruptcy

A Lexis Practice Advisor® Practice Note by
Ira L. Herman, Blank Rome LLP

Ira L. Herman

There are three sections of the Bankruptcy Code with greatest applicability to intellectual property rights and the enforcement of such rights in bankruptcy cases: section 362 of the Bankruptcy Code (Automatic stay), section 363 of the Bankruptcy Code (Use, sale, or lease of property), and section 365 of the Bankruptcy Code (Executory contracts and unexpired leases). In patent cases in which the debtor is one of multiple defendants, litigation may be stayed with respect to the debtor, but allowed to proceed with respect to the other defendants. If, however, the claims against all of the defendants are "hopelessly intertwined," the entire patent infringement action may be stayed. See, e.g., Int'l Consumer Prods. of N.J., Inc. v. Complete Convenience, LLC, No. 07-325, 2008 U.S. Dist. LEXIS 41532 (D.N.J. May 23, 2008).

Automatic Stay

A key bankruptcy risk under any kind of agreement is that one party will file for bankruptcy implicating the automatic stay. The stay, of course, will prevent the exercise of the non-debtor party's rights, as long as the stay remains in effect. The stay works as an injunction against collection efforts outside of the bankruptcy process. As the name suggests, the stay applies automatically upon the filing of a voluntary or involuntary bankruptcy case, without a need to show the elements ordinarily required for the issuance of an order providing for injunctive relief, including irreparable injury. In addition to collection efforts, the stay prohibits a creditor from taking actions that inevitably would have an adverse effect on property of the estate.

The automatic bankruptcy stay applies to a debtor's property wherever it is located, within or outside the territory of the United States. However, as discussed herein, the stay does not apply to actions on claims arising after commencement of a bankruptcy case.

As the automatic stay is designed to shield debtors and their assets from financial pressure, any exceptions to the automatic stay are read narrowly. Although the stay shields a debtor and its property from collection efforts, it does not extinguish or discharge any debt. The debtor has no greater rights than those that it has outside of bankruptcy.

The automatic stay, however, does not impact pre-petition injunctions related to infringement. A patent holder may be able to seek contempt sanctions for a continuing violation of an injunction while in bankruptcy. At minimum, courts are likely to grant relief from the stay to pursue a contempt charge. A patent holder claiming an ongoing infringement also should seek an administrative claim for damages related to the post-petition infringement of its patent. If infringement continues after a debtor receives a discharge, the holder of the patent may sue for damages.

The automatic stay applies to any suit against the debtor that "could have been commenced before the filing of a bankruptcy petition or that asserts a cause of action that arose before the filing of a bankruptcy petition." Hazelquist v. Guchi Moochie Tackle Co., Inc., 437 F.3d 1178, 1180 (Fed. Cir. 2006). The automatic stay does not, however, generally apply to suits based on post-petition torts, including post-petition patent infringement. "Damages for wrongs done during the bankruptcy proceeding are administrative claims, and thus paid in full most

of the time." In re Mahurkar Double Lumen Hemodialysis Catheter Patent Litig., 140 B.R. 969, 977 (N.D. Ill. 1992); see also Lancaster Composite, Inc. v. Hardcore Composites Operations, LLC, No. 04-1414, 2005 U.S. Dist. LEXIS 47378, at *4 (D. Del. Jan. 14, 2005) (noting that a default judgment had been entered against the debtor regarding post-petition acts of infringement and also pointing out that the official committee of unsecured creditors acknowledged that the automatic stay is not applicable to infringement claims arising post-petition).

For example, in Alloc, Inc. v. Unilin Decor N.V., No. 02-1266, 2006 U.S. Dist. LEXIS 65889 (E.D. Wis. Dec. 15, 2005), the court held that the automatic stay provision of the Bankruptcy Code was inapplicable, where the patent at issue was issued post-petition. Other courts, such as the court in Voice Sys. and Servs., Inc. v. VMX, Inc., 26 U.S.P.Q.2d 1106, 1113 (N.D. Okla. 1992) have allowed patent suits based on post-petition conduct to proceed pursuant to 28 U.S.C. § 959(a), which states that:

> Trustees, receivers or managers of any property, including debtors in possession, may be sued, without leave of the court appointing them, with respect to any of their acts or transactions in carrying on business connected with such property. Such actions shall be subject to the general equity power of such court so far as the same may be necessary to the ends of justice....

Even if an infringement suit against the debtor is allowed to go forward after a bankruptcy filing, the automatic stay may limit the patent holder's ability to enforce a money judgment. For example, in Larami Ltd. v. Yes! Entm't Corp., 244 B.R. 56, 58 (D.N.J. 2000), the court held that while an infringement suit based on post-petition activities was not stayed under section 362(a)(3) of the Bankruptcy Code, "the execution or attachment of a judgment obtained as a result of a post-petition claim would be barred."

A bankruptcy court may terminate the automatic stay under appropriate circumstances. Section 362(d) of the Bankruptcy Code provides several grounds for termination or modification of the stay. Section 362(d)(1) provides for relief from the stay for cause shown, which includes a lack of adequate protection of a non-debtor's interest in property of the bankruptcy estate (i.e., property subject to the automatic stay). A creditor's interest in property is not adequately protected where, for example, the property is susceptible to damage or depreciation and there is an insufficient equity cushion to allow the creditor to retain its secured position.

Section 362(d)(2) provides for stay relief where the debtor's estate does not have any equity in the property and the property is not necessary to an effective reorganization, within a reasonable time. In order for the stay to be lifted under section 362(d)(2), both prongs of the test must be satisfied. In determining whether property is essential for effective reorganization, the court must determine whether an effective reorganization plan is possible. The court need not determine whether a plan is confirmable, only whether the components of the plan are workable.

For more information about the automatic stay, *see* The Automatic Stay.

The author would like to express his gratitude to Victoria Guilfoyle, an associate at Blank Rome LLP, for her research and editorial support. The views expressed herein are solely those of the author as of the date this article was written and such views should not be attributed to Blank Rome LLP or to any of its clients.

Learn more

LEXISNEXIS.COM/PRACTICE-ADVISOR

Ira L. Herman
Blank Rome LLP

BLANKROME

BLANKROME

TAB 9

Settlement Agreements under the topic Identifying and Managing Bankruptcy Risk

Ira L. Herman

Exploring Settlement Agreements in the Context of Bankruptcy

by Ira L. Herman, Blank Rome LLP

Ira L. Herman is a Partner in the Finance, Restructuring, and Bankruptcy group of Blank Rome LLP.

Settlement agreements pose several risks in the context of bankruptcy – most obviously, the risk that the party against whom the claim is asserted will obtain a release in exchange for a promise to pay (for example, through a structured settlement) and then file for bankruptcy and discharge the obligation to make the settlement payments. Although this risk can be mitigated if the releasing party secures the obligation, the lien or security interest may be an avoidable preference if the settling party files for bankruptcy within 90 days. Even when the settlement payment is made upfront, there is a risk that the transfer could be an avoidable preference or even a fraudulent transfer. Although these risks cannot be eliminated, they can be mitigated by careful drafting. *See Settlement Agreement Sample Clause – Anticipating the Risk of the Imposition of the Automatic Stay*; *Settlement Agreement – Anticipating Potential Fraudulent Transfer Challenges Sample Clause*; and *Settlement Agreement – Anticipating Potential Preferential Transfer Claims Sample Clause.*

Bankruptcy Court Approval of Settlements

If the party asserting a claim files for bankruptcy relief, any settlement agreement will be subject to approval by a bankruptcy judge, who will determine if such settlement is fair to such debtor's estate and creditors. On motion by the debtor-in-possession or trustee, and after notice and a hearing, a court may approve a compromise or settlement. The court must decide whether "the compromise is fair, reasonable, and in the best interest of the estate." As the Third Circuit has noted, "[u]nder the 'fair and equitable' standard, [courts look] to the fairness of the settlement to the other persons, i.e., the parties who did not settle." Will v. Northwestern Univ. (In re Nutraquest, Inc.), 434 F.3d 639, 645 (3d Cir. 2006). Furthermore, "[i]n the final analysis, the court does not have to be convinced that the settlement is the best possible compromise. Rather, the court must conclude that the settlement is within the reasonable range of litigation possibilities." In re Penn Cent. Transp. Co., 596 F.2d 1102, 1114 (3d Cir. 1979); In re World Health Alternatives, Inc., 344 B.R. 291, 296 (Bankr. D. Del. 2006). The debtors carry the burden of persuading the court that the compromise falls within the reasonable range of litigation possibilities. In re A & C Properties, 784 F.2d 1377, 1381 (9th Cir. 1986). Therefore, litigants must be aware of the very real possibility that their mutually agreed-upon settlement terms might be rejected by a bankruptcy court.

When considering the best interests of the estate, a bankruptcy court must "assess and balance the value of the claim that is being compromised against the value to the estate of the acceptance of the compromise proposal." Jeffrey v. Desmond, 70 F.3d 183, 185 (1st Cir. 1995). In striking this balance, courts typically should consider the following factors: (l) the probability of success in litigation; (2) the likely difficulties in collection; (3) the complexity of the litigation involved, and the expense, inconvenience, and delay necessarily attending it; and (4) the paramount interest of creditors. *See* Protective Comm. for Indep. Stockholders of TMT Trailer Ferry, Inc. v. Anderson, 390 U.S. 414, 424 (1968).

Discharge

When parties settle before a bankruptcy filing, the primary risk with respect to settlement agreements is that the party required to make one or more payments under the agreement in exchange for a release will obtain a discharge of its payment obligation. The recipient of the payments, i.e., the releasing party, may then be in a situation in which it will not receive the full amount of the settlement and also cannot assert its original claim against the bankruptcy estate. This risk arises most frequently when the settlement is a structured settlement providing for payments over time.

As a practical matter, if the paying party is not financially sound, one way for the releasing party to counter this risk is to draft a settlement agreement that grants a security interest in collateral sufficient to cover the amount of the structured settlement. The security interest must then be perfected in accordance with applicable non-bankruptcy law. If the paying party later files for bankruptcy, the releasing party will have a secured claim against the estate and will then be paid in full (assuming the value of the collateral is sufficient to cover the amount of the claim). The releasor that secured a payment stream by taking collateral remains subject to the risk that the transfer of the collateral will be subject to attack as a preferential transfer.

If the underlying claim giving rise to the settlement would be a non-dischargeable obligation under section 523(a) of the Bankruptcy Code (for example, for fraud), the releasing party should seek provisions in a settlement agreement that clearly state the basis for the agreement and thus preserve the non-dischargeable character of the claim – or, better yet, agree to the entry of a stipulated judgment. If, for example, the underlying claim is one based on fraud, willful and malicious injury, or defalcation in a fiduciary capacity (to name a few common categories of non-dischargeable debt), the settlement agreement can explicitly state the grounds of the debt being paid in language that tracks the elements of non-dischargeability under section 523(a). Courts generally enforce post-petition settlement provisions setting forth the non-dischargeability of the debt in bankruptcy but hold that pre-petition waivers of dischargeability are unenforceable. *See* Lichtenstein v. Barbanel, 161 F. App'x 461, 468 (6th Cir. 2005); Saler v. Saler (In re Saler), 205 B.R. 737 (Bankr. E.D. Pa. 1997).

A pre-petition stipulation as to the facts giving rise to the underlying claim may, however, be enforceable, particularly if it is entered by a court as part of a consent judgment. *See* Klingman v. Levinson, 831 F.2d 1292, 1296 n.3 (7th Cir. 1987) (determining that consent judgment proved that debt was non-dischargeable where parties stipulated to facts establishing the elements of section 523(a)(4) and stating, "For public policy reasons, a debtor may not contract away the right to a discharge . . . [but] a debtor may stipulate to the underlying facts that the bankruptcy court must examine to determine whether a debt is dischargeable."). The issue preclusive effect of such a stipulation is determined by applicable collateral estoppel law. A consent judgment in federal court does not have issue preclusive effect; the collateral estoppel effect of such a consent judgment in state court is determined pursuant to state law. *See* Bay Area Factors v. Calvert (In re Calvert), 105 F.3d 315, 317 (6th Cir. 1997) (holding that the collateral estoppel effect of a state-court default judgment in a non-dischargeability action was based on applicable state law). The stipulation must include a specific admission of the elements for one of the non-dischargeability grounds in section 523 of the Bankruptcy Code. A bare assertion that a claim is based on "allegations of fraud," together with an agreement that the debt is non-dischargeable, is not sufficient without actual admissions of the facts.

Many settling defendants will be unwilling to stipulate that the settlement amount is based on non-dischargeable grounds because such a stipulation would amount to an admission, for example, of a fraud, defalcation, or willful and malicious injury. The releasing party may instead seek to include a provision that preserves its original claims, including the issue of non-dischargeability, in the event that a bankruptcy or other insolvency proceeding is filed and it does not receive or is not allowed to retain the full amount of the settlement payment.

If the releasing party fails to include provisions protecting the non-dischargeable character of the debt, the obligation may be transformed into a mere contractual obligation dischargeable in bankruptcy. This would be true particularly if the settlement involves the entry of a judgment converting an unliquidated claim into a fixed debt obligation, without a clarification that the claim is subject to non-dischargeability. *See* In re Cybersight LLC, No. 04-112, 2004 U.S. Dist. LEXIS 24426 (D. Del. Nov. 18, 2004).

Usually, however, a settlement agreement will not be interpreted as rendering the settlement obligation dischargeable. Following the Supreme Court's ruling in Archer v. Warner, 538 U.S. 314 (2003), courts are required to look behind the settlement to the underlying cause of action to determine dischargeability as long as the terms of the settlement agreement do not direct otherwise. A releasing party should make sure that no language in the settlement agreement explicitly or implicitly renders the settlement obligation dischargeable. The paying party should bargain for a stipulation that the execution of a promissory note extinguishes the underlying cause of action and, if possible, that the debt created by the promissory note is dischargeable, thereby increasing the possibility that the settlement obligation will be dischargeable in the event of a bankruptcy filing.

Avoidance

Even when the settlement amount will be paid all at once, the party receiving the payment risks avoidance of the payment in bankruptcy, either as a fraudulent transfer or (more likely) as a preferential transfer. When the entire settlement amount is paid at once, the releasing party receives the entire amount agreed to under the settlement agreement. If, however, the payment is made less than 90 days before the paying party files for bankruptcy relief, the releasing party may be required to turn over the settlement payment to the estate since the amount received (the entirety of the settlement amount) is almost certainly greater than the amount that the releasing party would have received on account of its claim in a chapter 7 distribution. Similarly, if the releasing party takes a security interest in the prospective debtor's property to secure a structured settlement, the security interest will likely be subject to avoidance as a preference if the other party files for bankruptcy less than 90 days after the perfection of the security interest.

As a practical matter, one way to mitigate this risk is to arrange for the payment (and/or the attachment and perfection of the security interest) to be made as soon as possible in order to lessen the likelihood that the paying party will need to file for bankruptcy within 90 days. Of course, if the settlement payment itself precipitates the filing, requiring an earlier payment may not help. If the payment of the settlement is likely to result in insolvency, the releasing party may choose to defer payment by 90 days while taking a security interest in non-cash assets.

Although the security interest itself could be subject to avoidance as a preference for up to 90 days after perfection, both the security interest and subsequent payments will, after the 90-day window has passed, be protected from avoidance, since payments on a secured obligation are not avoidable preferences. Securing the obligations under the settlement agreement can therefore reduce the risk of avoidance of payments in a deferred or structured settlement.

With a structured settlement, if the paying party's debts are primarily commercial, the settlement payments may also be protected against avoidance if the total amount of the payments during any 90 day period falls below the threshold for an avoidance action set forth in section 547(c)(9) of the Bankruptcy Code. This safe harbor is available only in the case of smaller settlements.

Additionally, if possible, the releasing party can require settlement payments to be made by a third party. If the funds used to pay the settlement would not have been property of a debtor's bankruptcy estate, the transfer should not be avoidable as a preference. Similarly, the settlement may be structured so that a third party lends money to the debtor to make the settlement payments. Such earmarked funds are not considered part of the bankruptcy estate, and the transfer of the funds is therefore not an avoidable preference. On the other hand, where the paying party has sufficient influence over another entity to make third-party payment or earmarking feasible, there may be a risk that the entities will be substantively consolidated in bankruptcy. In that event, the transfer would be of funds of the consolidated estate and would be subject to avoidance as a preference. Third party payment should therefore be used in conjunction with other protective provisions.

Finally, the releasing party may include in the settlement agreement a provision delaying the release of claims until 90 days after payment, the time at which the payment would be protected from avoidance, assuming that the debtor is not an insider of the releasing party. Although it is possible that such a provision may be regarded as an *ipso facto* clause under section 365(d) of the Bankruptcy Code, the provision likely would protect the releasing party against the worst-case scenario in which the releasing party is required to turn over a settlement payment while being simultaneously barred from asserting its claims against the debtor.

BLANKROME

TAB 10

Escrow Agreements under the topic Identifying and Managing Bankruptcy Risk

Ira L. Herman

Analyzing Escrow Agreements in the Bankruptcy Context

by Ira L. Herman, Blank Rome LLP

Ira L. Herman is a Partner in the Finance, Restructuring, and Bankruptcy group of Blank Rome LLP.

Generally, the use of an escrow agreement in connection with any transaction raises two legal questions in the bankruptcy context. First, is the escrow agreement an executory contract that the trustee may reject under section 365(a) of the Bankruptcy Code? Second, are the escrowed funds property of the bankruptcy estate, pursuant to section 541(a)(1) of the Bankruptcy Code, if one of the parties to the escrow files for bankruptcy relief?

Whether property in escrow when a case is filed under the Bankruptcy Code constitutes "property of the estate" is a mixed question of state and federal law. To determine whether an escrow is property of the estate, courts initially consider applicable non-bankruptcy law, *i.e.*, state law. Specifically, a bankruptcy court will seek to determine whether the estate holds a legal or equitable interest in such property or whether the estate's equitable interest is contingent upon the occurrence of future events or conditions. The nature and circumstances of the escrow arrangement often control. Factors considered by various courts include whether the debtor entity initiated or agreed to the creation of the escrow, whether the debtor entity exercises any degree of control over the escrow, the source of the funds that have funded the escrow, the beneficiary of the escrow, and finally, the purpose of the escrow.

After determining the nature of an estate's interest in an escrow, courts consider whether the escrow constitutes "property of the estate." The definition of the term "property of the estate" employed by section 105 of the Bankruptcy Code is very broad in scope, as it encompasses conditional, future, speculative, and equitable interests of a debtor in the property in question. It is settled law, however, that property of the estate can be no greater in scope than the property interests of the debtor as they existed on the petition date. Pursuant to section 541(d) of the Bankruptcy Code, "property in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest . . . becomes property of the estate . . . only to the extent of the debtor's legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold." Accordingly, if, as of the commencement of the case, the debtor has only a contingent right to receive the escrowed property, then only that contingent interest is property of the estate.

Courts in several jurisdictions have held escrows into which an entity puts its property pre-petition in the escrow account, or from which such entity is entitled to payment after satisfying certain conditions to be outside of the bankruptcy estate, with only the estate's contingent right to recover the funds upon satisfying the escrow conditions being considered property of the estate.

See sample *Escrow Agreement* clause.

Escrow Agreement as Payment Mechanism

When parties to an escrow intend the account to be the source of payment, they presumably agree that the amount to be paid will be paid out of the account at closing. The payment could be the price for a parcel of real property or payment on account of a settlement agreement, etc.

When a bankruptcy trustee argued that an escrow agreement was an executory contract and could be rejected by the trustee, the Eighth Circuit held that the escrow agreement was not an executory contract because: (1) the agreement was more than a contract; it was a way to convey property, and the ultimate grantee acquired an interest in the property when the funds were deposited in escrow, and (2) alternatively, even if the escrow agreement were a contract, it was not executory with performance remaining due on both sides at the time of the bankruptcy petition because payment of money was all that remained to be done. In re Newcomb, 744 F.2d 621 (8th Cir. 1984).

Escrow Account as Security

When parties intend an escrow agreement to create a security interest related to the purchaser's payment obligation under a credit sales contract, the escrow agreement still is not an executory contract. In *In re Cedar Rapids Meats*, the debtor entity established an escrow account to secure its obligation to pay workers' compensation claims. Ultimately, the bankruptcy court followed the reasoning of *In re Newcomb* and concluded that the escrow agreement was not an executory contract. In re Cedar Rapids Meats, Inc., 121 B.R. 562 (Bankr. N.D. Iowa 1990). As an additional rationale, the bankruptcy court in *Cedar Rapids* stated that even if the escrow agreement were an executory contract, rejection of the escrow agreement was not appropriate because it would fail the test of benefiting the unsecured creditors. The unsecured creditors would not have benefited because the escrow funds were not property of the estate or, alternatively, if the funds were property of the estate, they were subject to a perfected security interest.

Automatic Stay

The automatic stay will serve to deny access to an escrow if it is determined that the escrow is property of the estate under section 541 of the Bankruptcy Code. For further information about the impact of the automatic stay generally, *see Understanding and Examining the Automatic Stay*.

Voidable Transfers

There is a risk a transfer of property to an escrow account prior to the commencement of a bankruptcy case will be avoided as a preference, under section 547 of the Bankruptcy Code, or as a fraudulent transfer under section 544 of the Bankruptcy Code and section 548 of the Bankruptcy Code. For further information about the avoidance actions available to a trustee or debtor-in-possession, including preferences and fraudulent transfers, *see Understanding and Examining Preferences*, and *Understanding and Examining Fraudulent Transfers*.

BLANKROME

TAB 11

Employment Contracts under the topic Identifying and Managing Bankruptcy Risk

Ira L. Herman

Examining Severance

by Ira L. Herman, Blank Rome LLP

Ira L. Herman is a Partner in the Finance, Restructuring, and Bankruptcy group of Blank Rome LLP.

If a debtor-in-possession enters into an employment agreement, an employee's claims for compensation and severance payable under the agreement generally are entitled to administrative expense priority treatment. Where the debtor enters into an employment agreement before filing for bankruptcy relief and the employee continues to work for the debtor during the administration of the debtor's case before being terminated, the priority of the employee's severance claim is more difficult to determine. This is because severance claims do not fit neatly into the pre-petition/post-petition paradigm underpinning the administrative priority determination, due to the fact that unlike ordinary wages, severance pay can be "earned" at different times during a term of the employee's employment.

Several courts that have faced the issue have subscribed to the view that severance pay is compensation for the hardship that all employees, regardless of their length of service, suffer when they are terminated, and that severance, therefore, is earned when an employee is dismissed. However, this approach has been largely discredited. Instead, most courts will carefully examine the particular type of severance payment involved to determine whether the employee's claim should qualify for administrative priority. *See, e.g.*, In re Majestic Capital, Ltd., 463 B.R. 289, 294-95 (Bankr. S.D.N.Y. 2012) (rejecting severance where the claimant was "indisputably an insider, and his claim satisfied neither requirement of section 503(c)(2) of the Bankruptcy Code"); In re Forum Health, 427 B.R. 650, 655 (Bankr. N.D. Ohio 2010) (rejecting severance for a former CEO where "[d]ebtors' severance program, although generally applicable to all full-time non-union employees, is not generally applicable to all full-time employees."); In re Dana Corp., 351 B.R. 96, 102 (Bankr. S.D.N.Y. 2006) (rejecting proposed compensation plans for certain executives given that the plans did not meet the requirements of section 503(c)(2) of the Bankruptcy Code); In re Phones for All, Inc., 249 B.R. 426, 429 (Bankr. N.D. Tex. 2000) *aff'd*, 262 B.R. 914 (N.D. Tex. 2001) *aff'd*, In re Phones For All, Inc., 288 F.3d 730 (5th Cir. 2002) (denying administrative priority for severance payments); *see generally* Straus-Duparquet, Inc. v. Local Union No. 3 Int'l Bhd. of Elec. Workers, A F of L, CIO, 386 F.2d 649, 651 (2d Cir. 1967) ("Since severance pay is compensation for termination of employment and since the employment of these claimants was terminated as an incident of the administration of the bankrupt's estate, severance pay was an expense of administration and is entitled to priority as such an expense.").

There are two general types of severance pay. The first consists of a payment to the employee at termination, based upon the length of his or her employment. Most courts find that "length of service" severance does not qualify for administrative expense priority because the severance pay was earned prior to the bankruptcy filing. Other courts have adopted a less draconian approach and will prorate the severance claim into pre-petition and post-petition amounts corresponding to the duration of the employee's service during both periods. These courts reason that the latter qualifies for administrative priority, while the former may qualify at least in part as a priority pre-petition unsecured claim. *See, e.g.*, In re Roth Am., Inc., 975 F.2d 949, 957 (3d Cir. 1992); Lines v. System Bd. of Adjustment No. 94 Bhd. of Ry. (In re Health Maintenance Found.), 680 F.2d 619, 621 (9th Cir. 1982); In re Mammoth Mart, Inc., 536 F.2d 950 (1st Cir. 1976); In re Public Ledger, 161 F.2d 762 (3d Cir. 1947).

The second general type of severance is a payment at termination *in lieu* of advance notice of termination. This kind of severance payment generally is viewed as compensating a terminated employee for being deprived of advance notice of her termination. As such, most courts take the view that this type of severance is "earned" on the termination date. *See* Public Ledger, 161 F.2d at 771–73; In re Phones for All, Inc., 262 B.R. 914, 916 (N.D. Tex. 2001) *aff'd*, In re Phones for All, Inc., 288 F.3d 730 (5th Cir. 2002) ("When an agreement provides for severance in lieu of notice, the full claim for severance pay is accorded administrative priority, if the employee was terminated post-petition."). Accordingly, these courts hold that "termination *in lieu* of notice" severance qualifies for treatment

as an administrative priority claim. *See, e.g.*, Teamsters Local No. 310 v. Ingrum (In re Tucson Yellow Cab Co.), 789 F.2d 701, 704 (9th Cir. 1986).

Other severance packages may not fit neatly into either category and may have characteristics of both. For example, many companies struggling to restructure their operations and avoid bankruptcy retain crisis managers and other workout professionals under employment agreements with severance provisions entitling the employee to severance if he or she is terminated at any time after executing the agreement. Courts confronted with hybrid severance arrangements have sometimes struggled to articulate a rational standard to apply to the employee's request that the claim be accorded priority status. *See, e.g.*, Matson v. Alarcon, 651 F.3d 404, 409 (4th Cir. 2011) ("[A]n employee 'earns' the full amount of 'severance pay' on the date the employee becomes entitled to receive such compensation, subject to satisfaction of the contingencies provided in the applicable severance compensation plan."); In re Plymouth Rubber Co., Inc., 336 B.R. 16, 21 (Bankr. D. Mass. 2005) (allowing administrative priority for a severance plan where, although the amount was related to pre-petition service, the consideration was "to forego other employment opportunities post-bankruptcy in consideration of post-petition services"). A majority of courts find that severance payable under a pre-bankruptcy employment agreement does not qualify for administrative claim treatment.

The Priority Status of Severance Claims Is Limited to One Year of Benefits

Section 502(b)(7) of the Bankruptcy Code limits total severance claims to a single year of compensation, measured from the date of the bankruptcy filing or the date of termination, whichever is earlier. Thus, for example, an executive who otherwise is entitled to 24 months of severance benefits would lose at least 12 months of benefits the moment that his or her employer files its bankruptcy petition. If the executive was terminated before the filing date, any severance benefits that she received prior to the filing date count against the one-year cap, potentially wiping out additional months of the remaining severance claim or even wiping out such claim in its entirety.

No Rank-and-File Severance, No Priority Insider Severance Claims Allowed

The Bankruptcy Code prohibits administrative priority for severance claims of "insiders," including senior executives, if the debtor does not provide a severance program for its rank-and-file employees. Thus, for example, if a collective bargaining agreement does not include severance benefits for unionized workers, the courts will disallow any administrative priority for executive severance claims. Instead, such claims will be treated like all other general unsecured claims.

Other Limits on Administrative Priority Status for Executive Severance

Even if rank-and-file employees are entitled to severance (thus, permitting administrative priority for executive severance claims), the Bankruptcy Code limits such claims to ten times the amount of the mean severance pay received by non-management employees during the same calendar year. Thus, if hourly employees received severance benefits during a calendar year say, for example, for an average of four weeks or less of benefits, the portion of the executives' severance claim otherwise entitled to administrative priority status will be reduced to a relatively small portion of the total claim.

Limits on Executive Retention Payments

The Bankruptcy Code permits administrative priority for retention incentive payments owed to insiders (*i.e.*, payments designed to induce the insider to remain with the company for a specified period of time). In practice, however, pure retention payments have been largely eliminated because the statute imposes near-impossible prerequisites and severe limits on such payments, even if the prerequisites are somehow met. Thus, pre-petition retention agreements with executives often are replaced after a chapter 11 filing by an incentive program primarily designed to reward executives for achieving specified performance goals, not for simply remaining with a debtor.

Assumption and Rejection Risk

If an executive is fired before a debtor files its bankruptcy petition, his or her employment agreement may no longer be amenable to assumption. Instead, his or her agreement would almost certainly be subject to immediate rejection.

For more information, *see* *Analyzing and Examining Assumption of Executory Contracts and Unexpired Leases*, and *Analyzing and Examining Rejection of Executory Contracts and Unexpired Leases*.

Avoidance Risk

Any severance payments received by an executive prior to a bankruptcy filing could constitute an avoidable preferential transfer under section 547 of the Bankruptcy Code. There also is a fraudulent conveyance risk under section 548 of the Bankruptcy Code that

should not be disregarded.

For more information on preferential transfers generally, *see* *Understanding and Examining Preferences by Trey A. Monsour, K&L Gates LLP*.

For more information on fraudulent transfers generally, *see* *Understanding and Examining Fraudulent Transfers by Trey A. Monsour, K&L Gates LLP*.

About Blank Rome

With over 600 attorneys serving clients around the globe, Blank Rome represents businesses and organizations ranging from Fortune 500 companies to start-up entities. Founded in 1946, Blank Rome advises clients on all aspects of their businesses, including commercial and corporate litigation; consumer finance; corporate, M&A, and securities; environmental, energy, and natural resources; finance, restructuring, and bankruptcy; government contracts; insurance coverage; intellectual property and technology; labor and employment; maritime and international trade; matrimonial; products liability, mass torts, and insurance; political law and policy; real estate; tax, benefits, and private client; and white collar defense and investigations. Blank Rome also represents pro bono clients in a wide variety of cases and matters. For additional information, visit www.blankrome.com.

OFFICES

Cincinnati, OH
1700 PNC Center
201 East Fifth Street
Cincinnati, OH 45202
v: +1.513.362.8700
f: +1.513.362.8787

Fort Lauderdale, FL
500 East Broward Boulevard
Suite 2100
Fort Lauderdale, FL 33394
v: +1.954.512.1800
f: +1.954.512.1818

Houston, TX
717 Texas Avenue
Suite 1400
Houston, TX 77002-2727
v: +1.713.228.6601
f: +1.713.228.6605

Los Angeles, CA
2029 Century Park East
6th Floor
Los Angeles, CA 90067
v: +1.424.239.3400
f: +1.424.239.3434

New York, NY
The Chrysler Building
405 Lexington Avenue
New York, NY 10174-0208
v: +1.212.885.5000
f: +1.212.885.5001

Philadelphia, PA
One Logan Square
130 North 18th Street
Philadelphia, PA 19103-6998
v: +1.215.569.5500
f: +1.215.569.5555

Pittsburgh, PA
Union Trust Building
501 Grant Street
Suite 850
Pittsburgh, PA 15219
v: +1.412.932.2800
f: +1.412.932.2777

Princeton, NJ
301 Carnegie Center
3rd Floor
Princeton, NJ 08540
v: +1.609.750.7700
f: +1.609.750.7701

San Francisco, CA
555 California Street
Suite 4925
San Francisco, CA 94104
v: +1.415.986.2144
f: +1.415.659.1950

Shanghai, Blank Rome LLP
Shanghai Representative Office, USA
45F, Two ifc
8 Century Avenue, Pudong
Shanghai 200120; China
v: +86.21.2089.3200
f: +86.21.2089.3232

Tampa, FL
Fifth Third Center
201 East Kennedy Boulevard
Suite 520
Tampa, FL 33602
v: +1.813.255.2300
f: +1.813.830.7444

Washington, DC
1825 Eye Street NW
Washington, DC 20006
v: +1.202.420.2200
f: +1.202.420.2201

Wilmington, DE
1201 Market Street
Suite 800
Wilmington, DE 19801
v: +1.302.425.6400
f: +1.302.425.6464