2007 DUCK LUNCH SEMINAR

BANKRUPTCY CASES AND ISSUES OF INTEREST (WE TAKE QUESTIONS AND SUGGESTIONS TOO)

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I. LIEN ISSUES

In Re Equinox Oil Company, Inc., 300 F.3d 614 (5th Cir. 2002)

Equinox Oil Company, Inc. ("Equinox") and Alma Energy Corp. ("Alma") had common ownership and the companies' Chapter 11 proceedings were subsequently consolidated. Equinox operated the oil and gas leases that were owned by Alma. Several banks ("Bank Group") loaned over $106 million to Equinox and Alma. The Bank Group secured these loans by mortgages and other security rights in all the assets of Alma. In the course of operating the leases, Equinox incurred unpaid debts to numerous service providers. These service providers filed liens pursuant to Louisiana's Oil Well Lien Act ("LOWLA") against the property securing the Bank Group mortgages. The mortgages and related financing statements were filed by the Bank Group in the public records prior to the effective date any of the LOWLA liens. In September of 1998, a blowout occurred at a well on an Alma lease causing property damage and an oil spill. Equinox notified its insurer, National Union, of the accident. Numerous companies ("Remediation Creditors") provided services and equipment to Equinox to stop the blowout and clean up the spill. National Union subsequently paid Equinox over $700,000 in partial settlement of the insurance claim related to the clean up. Two separate adversary proceedings resulted. In one adversary proceeding, the bankruptcy court and the district court agreed that the Bank Group's mortgage primed the LOWLA liens. In the other, the bankruptcy court determined that the insurance proceeds were not property of the bankruptcy estate. The district court reversed.

The Fifth Circuit easily disposed of the first issue relating to the priority of competing liens. According to the Court: "LOWLA makes it clear that mortgages that are effective as to this persons before the privilege is established are superior in rank and priority to the liens. LA.R.R. 9:4870(b)(2)."

The remaining issue related to whether the proceeds from Equinox's insurance policy was property of Equinox's bankruptcy estate. The Remediation Creditors had contended that the proceeds of the policy should be excluded from the estate and instead paid directly to them because the well-control policy covered Equinox for the cost of the work they did. The Fifth Circuit did not agree. The Court noted that the central question when determining whether insurance proceeds associated with an insurance policy are estate property is whether, in the absence of the bankruptcy proceeding, the proceeds of the policy would belong to the debtor when the insurer pays a claim. The Court then examined the well-control policy at issue, pointing out that the policy named the debtor as the assured and under the terms of the policy, the insurer agreed "to reimburse the Assured" for all expenses incurred in relation to any well blowouts, including the costs to extinguish fires and costs associated with regaining control of the well. Bases upon these factors, the Court found that "the policy provides coverage for losses of the bankrupt corporation itself and provides for payment of those losses to Equinox." The Court analogized the well-control policy to a standard fire policy which is designed to reimburse the insured for repairs to his structure after a fire. Because the Court found that the Remediation Creditors had no rights under the policy to claim its proceeds, the district court was affirmed.

In Re Grace-Cajun Oil Co. No. 3 v. Federal Deposit Insurance Corporation, 882 F. 2d 1008 (5th Cir. 1989)

Grace-Cajun was a party to an unrecorded operating agreement with Delta Energy Resources, Inc. ("Delta"), covering a lease and wells drilled thereupon. Subsequently, Grace-Cajun was assigned an interest in the lease and a group of non-operating investors, also received assignments. The assignments were recorded. Subsequently Delta refinanced its indebtedness to M Bank, and pledged its share of production from the lease. The recorded security interest instrument contained a provision that it was subject to the operating agreement.

Delta failed to pay operating costs, went into default with M Bank, and filed Chapter 11 the face of a number of liens. During the Chapter 11 Grace-Cajun paid over to M Bank the production revenues attributable to Delta's share. It also paid the Delta share of operating costs. Grace-Cajun filed suit against M Bank seeking recovery of costs attributable to the share of Delta. Summary judgment was rendered in favor of M Bank. Grace-Cajun appealed.

On appeal the fifth circuit reversed. The security instrument was a pledge. Delta could only pledge what it had. As co-lessor it was not entitled to share in production without paying the costs of production. Therefore, M Bank's rights were so limited.[1]

The Court mentions that the pledge agreement has expressly made subject to the operating agreement, but does not examine the question whether the operating agreement thereby granted primary lien rights to the interest owners. The court instead carves out an equitable exception to the public records doctrine. "The unrecorded instrument may bind if the third party knows of it and know that his transfer intends that he be bound by it."[2]

The court is careful to note that it is not suggesting the M Bank became personally liable upon execution of the security agreement. However, upon enforcement, it did become liable for costs, to the extent it received production, and its share of further production was burdened with the costs obligation.

<u>In re Equinox Oil Co., Inc.</u>, 2001 WL 649806 (E.D. La.)

During the course of an adversary proceeding in bankruptcy court, a dispute arose as to the priority of competing liens on oil and gas leases owned and operated by the debtor. The bankruptcy court ruled that Bankr Group was entitled to priority over M&M Creditors, who consequently appealed.

In this case, Bankr Group loaned money to the debtor in excess of $106 million, secured by mortgages and other security interest in all the assets of the debtor, including the debtor's mineral leases. The debtor also incurred debt from trade creditors, M&M creditors, who perfected liens pursuant to the Louisiana Oil Well Lien Act ("***LOWLA***"). The parties did not dispute that Bank Group held prior perfected security interests over M&M creditors. M&M creditors argued that the bankruptcy court erred by not granting priority to their perfected LOWLA liens because the express terms of the mortgage to Bank Group allowed such lines as "Permitted Encumbrances." The district court affirmed the district court.

The district court began its discussion with a review of <u>Grace-Cajun</u>. According to the district court, <u>Grace-Cajun</u> involved co-lessees, and under Louisiana law, "a co-lessee is not entitled to share in the proceeds of production from an oil and gas well until he pays his costs of drilling and completing the well. This rule rests on the principle of unjust enrichment." In <u>Grace-Cajun</u>, the bank's rights to the proceeds were

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[1] The court mentions that M Bank did not become owner of the lease or leased property, but that the transaction confected by the security agreement was a pledge. We do not understand the significance of such a distinction. If the transfer had been of its interest in the lease, and the court is correct about the obligation of a co-lessor to pay its share of costs as a precondition to receiving production, the distinction seems to be one without a difference.

[2] 882 F. 2d 1008, 1012.

derived from solely from Delta's collateral mortgage, and Delta could not pledge any right greater than it owned. Thus, by paying Delta's share of the costs, Grace-Cajun acquired a "right of prior claim."

The district court then distinguished Grace-Cajun from the case at bar. First, the district court reasoned that the Louisiana law of accession was not applicable. When two statutes conflict, the more specific statute prevails over the more general statute. According to the district court, LOWLA was more specific, and thus the provisions of LOWLA take priority over the general law of Louisiana accession found in the Civil Code. Under La. Rev. Stat. §9:4870(B)(3) a pre-existing mortgage is given priority treatment over a mechanic and materialman's lien. Accordingly, the bankruptcy court did not err in ruling that Bank Group was entitled to priority treatment.

Second, the district court found that Grace-Cajun was distinguishable from the case at bar because Grace-Cajun involved co-lessees whereas in the instant case M&M creditors did not have an ownership interest over the subject leases. The district court stated that Grace-Cajun was careful to point out that the right to receive proceeds is not automatically burdened with the obligation to pay for the costs of the well, such obligations depends on the source of the right. Thus, reasoned the district court, Grace-Cajun was more concerned with the relationship of the parties than with the ranking of privileges.

Lastly, Grace-Cajun was decided before the 1997 revisions to LOWLA. Therefore, the district court concluded that the bankruptcy court was correct in granting priority to the pre-exisint security interests of Bankr Group because express statutory provisions governed the relationship between Bank Group and M&M creditors and Grace-Cajun was distinguishable.

In Re Century Offshore Management Corporation, 119 F.3d 409 (6th Cir. 1997)

Interpreting Louisiana law, the Sixth Circuit dealt with the ranking of lien interests of working interest owners and the perfected security interests of a third party lender.

The interest owners were parties to an operating agreement that was not recorded in the parish where the mineral leases were located. The operating agreement provided for reciprocal lien rights in form of the working interest owners arising in the event of non-payment of the applicable share of operating costs by any interest owner (including the operator). The reciprocal lien extended to the non-paying party's interest in production revenues.

Subsequently the operator (Century Offshore) obtained financing from BMO financial Bank of Montreal. The financing was secured by a perfected security interest upon Century Offshore's interest in the well covered by the operating agreement.

The BMO mortgage was expressly subject to certain "encumbrances" including the operating agreement.

Century Offshore defaulted as a result of decreased production due to damages caused by Hurricane Andrew.

Liens were filed and Century Offshore subsequently filed Chapter 11. After the Chapter 11 filing, lienholders sued the non-operating owners on account of the failure to pay by Century Offshore. By adversary proceeding BMO sought judgment ranking its lien. Upon being sued by lienholders the non-operating owners intervened in the BMO adversary, seeking judgment declaring that the reciprocal liens arising under the operating agreement ranked in priority over the BMO security interest.

The bankruptcy and District Court concluded that the BMO interest was superior on the basis of the Public Rewards Doctrine and the Louisiana jurisprudence which allows parties to rely upon the public records even in the face of a recorded document refers to an unrecorded interest.[3]

The Court of appeals distinguished the Public Records Statutes and the related jurisprudence. Also, the Court declined to follow the federal Fifth Circuit jurisprudence argued by the non-operating owners, Grace-Cajun Oil Co. No. 3 v. Federal Deposit Inc., Corp.[4] The Court held that the mortgage instrument contained a provision subordinating the lender's lien status to the lien rights existing under the operating agreement, which constituted a contractual reordering of priorities and was therefore enforceable.

The consequence was that the non-operating owners, whose interests were subject to the lienholders' claims have a primary interest in the operator's interest, and could utilize the operator's interests in production revenue to satisfy the lien claims that were determined by the amount of the lienholders' claims. By subordinating to the non-operators' lien rights, BMO, in effect subordinated to all lien rights arising under oil and gas lien law relating to the rights under operating agreements.

Gardes Directional Drilling v. U.S. Turnkey Exploration Co., etal, 98 F. 3d 860 (5^{th} Cir. 1996)

Providers of services on offshore platform and facilities to farmout operator were not paid and filed timely notices of lien under La. R.S. 9:4861, et seq. and subsequently instituted suit in state court for recognition of liens. The action was removed to federal court under 28 U.S.C.A. §1331 (on the basis of 43 U.S.C.A. §1331-1356).

Subsequently the owners instituted an interpleader action. After filing the interpleader, the owners effectuated removal of the platform and structures on the basis of a salvage bid that provided a credit of $43,000 against the $400,000 cost to remove for the value of the liened property. The removal was performed pursuant to an order from the United States Mineral Management Service (MMS).

Owners were able to obtain a release of lien rights in return for the posting of $43,000 bond, though the lien claims amounted to in excess of $1.68 million. The providers were not noticed of the disposal of the removed structure and facilities (they were advised of the removal, but not the disposal). Everybody thereafter sued everybody. In particular the providers sued the owners personally.

The district court granted summary judgment to the owners. The providers appealed.

On the question of applicable substantive law, the court holds that Louisiana law applied pursuant to the directive of 43 U.S.C.A. §1333(a). There is no conflict between federal and state law. Owners argued that the MMS order conflicted with state lien law. The court concluded that there was no conflict. While the MMS order required removal of the property it did not require disposal. Removal would not necessarily interfere with the existence of the lien rights held by the providers, and therefore notice of removal was not proper notice of disposal.

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[3] Cardinal Federal Savings Bank v. Corporate Tower Partners, 564 So. 2d 1282, 1288 (La. App. 3 Cir. 1990); Judice-Henry-May Agency, Inc., v. Franklin, 376 So. 2d 991, 992 (La. App.1 Cir. 1980)

[4] 882 F.2d 1008 (5^{th} Cir. 1989)

Because Louisiana law applied, and provided the mechanism for obtaining the right to dispose of the liened property (bond in amount of claims, etc.), the owners had violated the applicable state law to the detriment of the providers.

Under Article 2315 of the Louisiana Civil Code, the actions of the owners damaged the providers' lien claims. Remand was ordered requiring trial of the issue of the fair value of the liened property-which would constitute the measure of damages.

Phillips Petroleum Company v. Best Oilfield Services, Inc., 48 F.3d 913 (5th Cir. 1995)

After the driller (Best) performed the drilling and removed its rig, owner was notified of the filing of a lien. The owner paid the lien and, took an assignment of all lien rights and recorded two liens.

The driller opposed the liens on the ground of prescription, improper description and confusion. On the prescription argument the court distinguished between the fuel supplier lien (180 day period begins to run with last delivery of fuel to the well) and the barge and crew boat services liens (180 day period begins to run on completion of services performed in connection with the drilling or operation of the well).

On the confusion question the court distinguished the obtaining a lien on the lease hold (owned by the lien holder/leasehold owner) from the lien rights upon the drilling rig. The owner did not own the rig and therefore the liens (other than the fuel supplier's, which had prescribed) attached.

In the Matter of Senior-G & A Operating Co., Inc., 957 F. 2d 1290 (5th Cir. 1992)

Lender's Production Payment Loan Agreement constituted a security interest in the working interest and lease hold interest of the borrower (operator) and not a royalty interest. Because the lien interest gave the lender the right to seize the operator's interest and to operate the well, its rights were inconsistent with the passive nature of a royalty interest (or production payment interest).

This case, decided before *Hardford Underwriters,*[5] concluded that the Trustee could surcharge the secured creditor for a pro-rata share of working interest costs. However, because there had been a transfer of the bulk of the operator's interest to a third party, subject to the security interest of the lender, the surcharge would be limited to a share equal to the share retained by the operator. The extent of the lender's rights vis a vis the third party purchaser was not before the court and therefore could not be ordered or dealt with.

II. EXECUTORY CONTRACT/UNEXPIRED LEASES ISSUES

In Re Texaco, 254 BR 536 (Bankr. S.D.N.Y. 2000)

In a case that determines the ultimate result of the Texaco bankruptcy as its confirmed plan related to its delegations under oil gas and mineral leases, the bankruptcy court, some twelve years after confirmation, concludes that Texaco did not discharge its post-petition obligations under these agreements.

Municipality lessors (Lafourche Basin Levee Basin District, etc.) brought suit against Texaco in state court against Texaco for cancellation of leases and for claims arising out of the operation of the leased property (for clean up, restoration, etc.). Texaco filed a motion in bankruptcy court to "bar" the claims on

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[5] 530 U.S. 1, 120 S.Ct. 1942, 147 L.Ed.2d 1 (2000).

the ground that the claims, if any, should have been brought in the bankruptcy court prior to confirmation, and had been discharged by the order of confirmation. In support of its argument Texaco pointed to an order of the bankruptcy court, entered without opposition, stating that some 25,000 of Texaco's leases were not subject to assumption under §365 of the bankruptcy code. The list of leases attached to the order included the leases that were included in the state court suit.

Texaco argued that because the leases were not subject to assumption, any right arising out of the contracts, whether or not contingent or unmatured as of the confirmation order, constituted a claim subject to discharge. Because the grounds of liability arose under the contracts the lessors were barred from asserting the claims by the discharge injunction.

The court performs an exhaustive analysis of the Texaco bankruptcy case proceedings, and concludes that the order upon which Texaco based its argument could not be enforced on the grounds of improper notice, constitutional due process, and, it seems to this writer, trickery.

The opinion is a refreshing dose of realism about "mega" Chapter 11 cases. According to the court, the full thrust of Texaco's approach to mineral leases was to spread the word that the leases, unless rejected were to be assumed. Yet, by means of "classification" and an enigmatic footnote in a form of notice, this published intention to assume resulted in an order (not noticed to anyone) stating the leases, in Louisiana[6] were not subject to assumption.

The importance of the opinion lies in its answer to the argument of Texaco that its non-assumption generated a discharge of all obligations under the leases. First, if a contract is subject to assumption, then taking no action (assuming rejection will not be statutorily imposed) causes the contract to pass through bankruptcy unaffected. In effect, the contract exists as though there was no bankruptcy (this is a conclusion with which the fifth circuit agrees). Second, and to this writer, more importantly, this "pass through" effect applies to contracts that are not technically subject to assumption under §365.

In short, whether an executory contract or unexpired lease is assumed under Section 365 or not, and whether or not a particular contract or lease is technically assumable under Section 365, does not matter in the context of this controversy. In either event, if the debtor continues to operate under and derive all of the economic benefits of the contract or lease then the debtor retains all of its obligations and burdens and the contract or lease passes through the bankruptcy unaffected by it, just the same as if the contract or lease had been assumed under Section 365.[7]

Therefore, though perhaps there could be the discharge of the pre-bankruptcy claims existing under the contract, for pre-petition royalties for example, if a reorganized debtor continues to reap the benefits of the contract it must bear the obligations, at least those that arise after confirmation.

The court concludes, that the grounds of cancellation and remediation claims arose after confirmation and (again, importantly) that the plugging and abandonment obligations arising where they actually accrue, are not discharged by the confirmation order.

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[6] Except for State of Louisiana and Plaquemine Parish leases. The question of whether there leases could be assumed was separately decided.

[7] 254 BR 536, 558.

Finally, (the purpose of this discussion), the court concludes that Louisiana oil and gas leases are executory contracts, that he agrees with the decision of Judge John V. Parker in Texaco Inc., etal. v. Louisiana Land and Exploration Co., etal.,[8] wherein the court decided that oil, gas and mineral leases are executory contracts subject to assumption and rejection under §365.[9] Therefore, the conclusion of the Middle District Court constituted law of the case as to the assumability of mineral leases in Louisiana. As such, Texaco has deemed to have assumed all that had not been rejected.

Texaco v. Louisiana Land and Exploration, 136 B.R. 658 (M.D. La. 1992)

Louisiana mineral lease is an executory contract - some performance is due, and assumption creates a net benefit to the estate. Court rejects Countryman definition as too narrow in scope, at least for this type of contract.

In re WRT Energy Corporation, 202 B.R. 579 (Bankr. W.D. La. 1996)

Debtor filed Chapter 11. Shortly thereafter, certain lessors filed motions to compel assumption or rejection of the debtor's Louisiana mineral leases. Debtor opposed the motions, as did the unsecured creditors' committee, on the ground that the mineral leases were neither executory contracts nor unexpired leases. The court began its analysis by observing that, in Louisiana, oil and gas are not owned by any person until reduced to possession. Furthermore, a mineral lease is a contract by which the lessee is granted the right to explore for and produce minerals on the lessor's land in exchange, generally, for a percentage of the proceeds.

After discussing the conflicting authority within the Fifth Circuit on the issue, the court announced its preference for the Countryman definition as the proper test by which to determine whether a contract is executory. The court then found that although both parties still owed obligations, the obligations of the lessor to deliver the premises, to refrain from disturbing the lessee's possession, and to perform in good faith, were passive rather than active, and that they were not substantial enough to make the contract executory.

The court next considered whether a mineral lease was an unexpired lease within the meaning of § 365. The court found that a mineral lease vested the lessee with real rights, whereas a lease of real property in Louisiana created only personal rights. Characterizing the mineral lease as a transfer of an interest in real property, rather than a lease, the court held that the mineral lease was not an unexpired lease. Since the contract was neither executory nor a lease, it could neither be assumed nor rejected, and the court denied the motions to compel.

Most cases in the Fifth Circuit have relied upon the Countryman definition. However, nationwide that definition is drawing increased criticism, as more courts realize its inferiority as an analytical tool. For example, here the court determined that both parties still owed obligations, but that the contract was not executory because the lessor's obligations weren't substantial. Accordingly, if the contract was not executory, it could neither be assumed nor rejected. If the debtor in possession doesn't assume, then the estate isn't liable on the contract. Since there can be no rejection, the lessors won't have a claim for breach,

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[8] 136 BR 658 (M.D. La 1992)

[9] The State of Louisiana had opposed assumption on the basis of §365 (c)(1), but had argued that the leases were subject to section 365. The leases dealt with by Judge Parker had been carved out of any assumption or "not subject to assumption" listing.

even if the debtor in possession doesn't perform. As long as the lease is productive, the debtor will undoubtedly perform.

But what about when the well runs dry? Suppose the debtor just packed up and left, without cleaning up, and without plugging the well? By that time, the debtor's plan may have been confirmed, which means that the debtor's pre-petition obligations under the lease will have been discharged. There are no post-petition obligations, because the contract was not assumable. A finding that this contract is not executory is a finding that the debtor can walk off without cleaning up the site, and the lessors will have no legal recourse to recover their clean-up expenses. Countryman leads to this result because it illogically dictates that the lessor's duty to perform, or lack thereof, should dictate whether the lessee has anything left to do under the contract. The WRT case pointed out that one of the cases it criticized was a pre-Code case. One might respond by saying that Countryman's definition is also pre-Code, and that it was designed to remedy pre-Code problems that no longer exist. Now Countryman's definition is the problem, as this case illustrates.

In re WRT Energy Corporation, 169 F.3d 306 (5th Cir. 1999)

Debtor Gulfport Energy Corp. (GEC), formerly known as WRT Energy, was a sublessee of an oil, gas, and mineral lease. Duck Lake Acquisition Partners (DLAP), the sublessor, filed a proof of claim in GEC’s chapter 11 for $318,377, representing unpaid prepetition royalties due from production under the sublease. DLAP argued that the claim was secured by a lessor’s privilege under La. Rev. Stat. Ann. § 31:46, which provides:

> The lessor of a mineral lease has, for the payment of his rent, and other obligations of the lease, a right of pledge on all equipment, machinery, and other property of the lessee on or attached to the property leased. The right also extends to property of others on or attached to the property leased by their express or implied consent in connection with or contemplation of operations on the lease or land unitized therewith.

DLAP argued that it sought payment for “other obligations” than rent, namely production royalties. GEC sought to avoid DLAP’s claim pursuant to § 545(2)-(4):

> The trustee may avoid the fixing of a statutory lien on property of the debtor to the extent that such lien . . .
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> . . .
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> (2) is not perfected or enforceable at the time of the commencement of the case against a bona fide purchaser that purchases such property at the time of the commencement of the case, whether or not such a purchaser exists;
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> (3) is for rent; or
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> (4) is a lien of distress for rent.

The bankruptcy court granted the § 545(3) objection to DLAP’s claim, reasoning that “rent” meant the same thing under both federal and Louisiana law and that Louisiana law specifically defined royalty payments as rent in La. Rev. Stat. Ann. Art. 31:123.

DLAP argued on appeal that § 545 was inapplicable in this case because its lien enhanced the value of the debtor’s property, or so said Collier’s. Notwithstanding the commentator’s opinion, the Fifth Circuit summarily rejected this argument because there was nothing in the statute that limited avoidance of liens for rent to those that did not add value to the underlying property.

DLAP's primary argument on appeal was that the nature of their lien was neither rent nor royalty but "other obligations," to which § 545 was inapplicable. GEC (or probably the Fifth Circuit) replied that "if it walks like a duck, ..." The sublease specifically termed the interest a royalty so the argument that it was something else did not hold much water.

Notice the irony. The royalty obligation, arising out of an oil, gas and mineral lease is "rent" despite the prior holding that the lease itself is not a lease or executory contract subject to assumption or rejection (that is, it is not a lease). Conclusion here, which strikes this writer as the unforeseen consequence of not requiring the lessor to perform in order to hold the lease, is that the lessor retains the lease free of lease obligations. The result would not hold under the Texaco court view.

Stewart Title Guaranty Co., 83 F.3d 735 (5th Cir. 1996)

Lessee of an office (housing a Texas "abstract plant"), under the lease contract retained, upon termination of the lease (for any reason) reproduction rights, allowing it to copy all papers, etc. relating to matters filed in certain county courthouses. Lessee files bankruptcy. Trustee rejects lease agreement, but moves the bankruptcy court for authority to sell reproduction rights.

After outbidding the successor to the lessor, a third party's offer was accepted by the trustee and approved by the bankruptcy court. Subsequently, the lessor refused access to the purchaser so that reproduction rights could not be exercised, and in response the purchaser instituted an action in state court asserting a claim for breach of lease and requiring specific performance. The lessor removed the proceeding to U.S. District Court.

Upon cross-motions for summary judgment, the district court determined that the trustee's rejection of the lease agreement excused the lessor from performance under the lease, and thereby rendered the reproduction rights unenforceable. The purchaser appealed.

On appeal the Fifth Circuit, assuming without saying why that the district court had jurisdiction, reversed.

The court found that under Texas state law, the lease agreement contained severable contractual provisions, and was in effect two contracts. Therefore, according to the court, the rejection by the estate (trustee) had effected only a rejection of the unexpired lease contractual provisions.

Somewhat problematically, the court's analysis of § 365 of the Bankruptcy Code retreats from its state law severability analysis. Under state law, the overall agreement was, in fact, two separate contracts. However, the court concludes its § 365 analysis in terms of executory contracts (unfulfilled versus the executed (fulfilled) parts of the contract). The holding of the court is that the reproduction rights were enforceable because the rejection only affected the executory, unfulfilled portions of the contract; because the reproduction rights portion was executed, § 365 does not apply and rejection has no effect.

These writers (the judge, anyway) have, for some years, railed against the executory/ non-executory definition as controlling line of cases. This is one of them. The ultimate conclusion (assuming jurisdiction), that the reproduction rights are enforceable, is correct. The analysis is unnecessary. The court could have very cleanly arrived at its decision by continuing its state law analysis to its logical conclusion, as follows.

Because there were two severable contracts under state law, the trustee's rejection, which was only directed to the unexpired lease contract, only affected its objection on the unexpired lease. Because the reproduction rights were granted by a separate contract (and there were material obligations still owing, just none of sufficient materiality so that breach by the lessee would excuse the lessor from performance of the acts necessary to make the material available for reproduction), why not call this severable contract an executory contract (it had not been performed) subject to assumption, because the cost of assumption was zero, while the reproduction rights had value on the open market. Using this analysis, the trustee's request for authority to sell was tantamount to an assumption and assignment, perfectly acceptable given the state law referred to by the court. Note that the court's § 365 analysis obviates the necessity of resorting to the severable contracts state law inquiry. Had the court continued the inquiry through its logical consequences rather than focus upon the definition of "executory contract," the way to the correct decision would have been better marked.

Matter of Murexco Petroleum, Inc., 15 F.3d 60 (5th Cir. 1994)

In Murexco the Fifth Circuit beats a retreat from the cogent analysis found in the Matter of Continental Airlines, 981 F.2d 1450 (5th Cir. 1993), into the confusing (but familiar) muddle that emanates from focus upon the definition of "executoriness." Though deemed of utmost importance to the court, the facts need no extensive recitation. In a two-stage Asset Purchase Agreement ("APA"), Murexco and a third party agreed that Murexco would sell, at a first closing, all of its proven undeveloped and possible mineral reserves, along with its operating rights under all of its oil and gas well operating agreements. By an accompanying Letter Agreement, the purchaser was to be contract operator for Murexco until it became "operator of record." After the closing, the purchaser became the contract operator, but, it appears, had not become operator of record as of Murexco's bankruptcy filing.

After the bankruptcy petition, the Murexco trustee moved to reject the Letter Agreement, apparently hoping to somehow reject (or rescind or avoid) the sale of the operating rights.

The bankruptcy court had authorized rejection, and one supposes, avoidance or dissolution or rescission of the operating rights sale, because as quoted by the court, the bankruptcy court held that the "portion of the [APA] that created the contract operator rights [sic] is determined to be an executory contract, and is hereby rejected. Murexco . . . retains its rights as operator under the joint Operating Agreement." 15 F.3d at 62.

The district court reversed, finding that because neither the APA nor the Letter Agreement were executory, rejection was not available. The district court opinion focused, in great detail, upon the terms of the Letter Agreement and the effect of the sale closing. Basically the court found that HarCor had completed the sale of the operating rights and had become contract operator. Under the terms of the agreement, all Murexco had to do was use its best efforts to obtain necessary consents from other interest owners for HarCor becoming operator of record. Under the terms of the contract, however, failure to obtain such consents (or to use best efforts) did not constitute a default or cause question as to the validity of the overall agreement. Any remaining obligation upon Murexco under the APA was subject to such a "best efforts" clause as well.

The Fifth Circuit affirmed, focusing exclusively upon the question of whether the Letter Agreement was executory as of the date of bankruptcy. This focus ran the court's attention to the question of whether Murexco owed any obligation as of bankruptcy, the beach of which would be so material as to excuse the performance of the purchaser. Interpreting the agreements in accord with the district court, the Fifth Circuit concluded that breach of the obligations subject to the "best efforts" clauses would not constitute a material breach of the contract, thereby excusing the performance of the purchaser. Because of this finding, the Letter Agreement and APA were found to be non-executory, and rejection was denied.

Why all this fuss, and what facts were left undiscussed by the court's focus? First of all, is it clear that the court is ordering the trustee of Murexco to perform its obligations under the best efforts clauses? Not to these writers it's not. If the trustee is not going to perform (and why should he, after the court has concluded that these obligations are of no moment?), isn't this a breach? If the failure to perform is a breach and, pursuant to § 365(a)(1), rejection is a breach, isn't the court authorizing rejection, unless these obligations are ordered performed?

Let us recast the focus. The closing was completed and HarCor became owner of the operating rights, the reserves, and became contract operator. Presumably the agreement was properly made of record (§ 541(b)(4) was not passed until October 24, 1992), or the trustee would have been seeking to avoid the transfer under § 544. Forget about the definition of executoriness for a moment and focus upon the consequence of rejection, as previously explained by this Court in In re Continental Airlines, "[s]ignificantly, § 365(a)(1) speaks only in terms of 'breach.' The statute does not invalidate the contract, or treat the contract as if it did not exist. To assert that a contract effectively does not exist as of the date of rejection is inconsistent with deeming the same contract breached." 981 F.2d 1450, 1459 (5th Cir. 1993).

If the focus is upon rejection as breach, then clearly, regardless of the executoriness of the contract, rejection has no consequence on the non-debtor other than the consequences that flow from a garden variety breach of contract by the debtor: a claim and, perhaps, a question as to whether the non-debtor, on the basis of the nature of the bundle of rights acquired by the contract, has acquired such an interest to be able to force performance by the trustee, in full, of all obligations under the contract. Looking at the contracts at issue, the court's opinion clearly shows that rejection, if properly seen, is in fact what is being ordered (unless the opinion is in fact compelling the trustee to use his best efforts to complete performance of the remaining obligations).

As has been argued, the consequences flowing from rejection do not include invalidation, rescission, or avoidance of the contract. These consequences flow only from some particular bankruptcy avoidance power, which, when focused upon the non-breaching party's right in and to the thing (?) of the contract, can be used, if applicable, to strip away, or avoid that right. Here the court is saying, HarCor has perfected ownership of the operating rights (though as a result of its focus on the executoriness of the contract the court fails to mention whether this ownership interest was recorded, or whether the contract operation Letter Agreement was recorded so as to forestall avoidance under § 544), and Murexco has remaining obligations, though not material. As Murexco has already received the benefit of the agreement (the sale price) shouldn't rejection of the remaining obligation be authorized as a matter of course?

Actually not. The cost benefit analysis still comes into play -- does it cost Murexco more paying a claim from rejection in bankruptcy dollars than it does to perform the best efforts obligations? That's all that need be asked. If the answer is yes, rejection denied; if the answer is no, rejection should be granted.

The mistaken adherence to the definition of executoriness as grounds for the decision is a cause of the perpetuation of the rejection-as-avoidance school of consequences. In fact, the essence of the problem raised by the court's analysis is the implication that had the court found the agreement to be an executory contract, Harcor's rights as contract operator and as owner of the operating rights would have been avoided and would have evaporated, on the basis of rejection of the contract by the trustee.

If the actual consequences of rejection are grappled with, held to the light (and kept there), cases such as Murexco will cease to exist (a few of these per court, with rejection summarily granted or denied based upon the cost/benefit analysis, without accommodation by the bankruptcy court of grandiose schemes of avoidance by rejection -- I breach I win, you lose everything -- should put these wasteful cases to bed for good).

III. USE, SALE, OR LEASE OF ASSETS

In re Torch Offshore, Inc., 327 B.R. 254 (E.D. La. 2005)

Debtor filed for Chapter 11 relief, but repeatedly expressed its intention to sell all or most of the assets of the bankruptcy estate, due to the poor prospect of it being able to reorganize successfully. It filed a 363(b) motion to sell all or most of its assets to a potential buyer for $92 million. This would divest Debtor of virtually all of its operating assets. The bankruptcy court approved the sale and the assets sold for approximately $85 million. The unsecured creditors committee objected, arguing that the sale was a virtual sub rosa plan of reorganization. The bankruptcy court overruled the objection, perceiving that the unsecured creditors would receive no payments under either the sales or through a reorganization plan.

11 U.S.C. § 363(b) provides that "[t]he trustee, after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate. Under In re Continental Air Lines, Inc., 780 F.2d 1223 (5th Cir.1986), if the sale is outside the ordinary course of business, the first step is for the debtor in possession to demonstrate that there are "business justifications" for the proposed transaction:

> the proportionate value of the asset to the estate as a whole, the amount of elapsed time since the filing, the likelihood that a plan of reorganization will be proposed and confirmed in the near future, the effect of the proposed disposition on future plans of reorganization, the proceeds to be obtained from the disposition vis-a-vis any appraisals of the property, which of the alternatives of use, sale or lease the proposal envisions and, most importantly perhaps, whether the asset is increasing or decreasing in value. This list is not intended to be exclusive, but merely to provide guidance to the bankruptcy judge.

Continental, 780 F.2d at 1226.

In addition, the sale cannot violate or be incompatible with the provisions of Chapter 11 and may not constitute a sub rosa plan of reorganization.

> The district court found sound business justifications for the asset sales.
>
> The auctions occurred approximately six months after the filing of the bankruptcy petition, and during these six months the debtor explored whether it could reorganize its business or had to liquidate its operating assets. No plan of reorganization has been proposed, and there is no indication that a sale of the debtor's assets pursuant to any such plan would result in a greater value to the estate than the proceeds realized by the auctions. The Committee points out that the assets were recently appraised at $228 million, but this is not an indication of market value because no firm was willing to offer this amount at the well advertised twelve-hour-long auctions, during which the debtor received almost 100 bids. Most importantly, the undisputed evidence before the bankruptcy court indicated that maintaining the vessels was costing the debtor an exorbitant amount of money, and the condition of the vessels was deteriorating over time.

In re Torch Offshore, Inc., 327 B.R. at 258.

The district court also found that the committee failed to specify what protections were being lost as a result of the sale. Therefore, it found that the sales approved by the bankruptcy court did not exceed the scope of § 363(b). The district court also affirmed the bankruptcy court's ruling that the compromise entered into by the lienholder of the vessel and debtor, whereby debtor would avoid foreclosure on the vessels if it made an aggregate bid of $18.36 million for the vessels, subject to better offers at an auction sale, was fair and equitable.

> The GECC motion to lift the stay, if granted, would have resulted in a sale of the GECC collateral by the marshal, a sale without the more extensive publication and marketing efforts that were attendant to the sale ultimately approved by the bankruptcy court. The fairness of the GECC bid was tested through the auction process, and was the highest bid for the vessels at issue. As detailed above, the sales approved by the bankruptcy court do not exceed the scope of § 363(b).

Id. at 361-62.

IV. AVOIDANCE ISSUES

Preferential Transfers

In re Enron Corp, 316 B.R. 251 (Bankr. S.D. Tex. 2004)

Former officer of debtor received a prepetition payment of $1.5 million shortly before the filing of Debtor's Chapter 11 case. Employment-related issues committee brought an adversary proceeding against the officer to recover the payment, alleging that it was an avoidable preference under sections 547 and 550 and a fraudulent transfer under sections 548, 544(b) and 550. The officer moved to postpone the proceedings against him due to the fact that he was the subject of an ongoing criminal investigation. Officer argued that, if he responded to the discovery or further issue in the proceeding, he would jeopardize his Fifth Amendment privilege against self-incrimination by creating the possibility that his responses would aid in the prosecution against him. The committee agreed to postpone discovery on issues in the complaint relating to the actual intent to hinder, delay, or defraud Debtor's creditors, but argued that going forward with its constructive fraud claim would not create a possibility that officer's responses would aid a prosecution of him. The court agreed that "receiving an avoidable transfer in this situation is not a criminal act, but, in fact, is more in the nature of a strict liability civil action. [Officer] need not have done anything wrong, either civilly or criminally, to be found liable on the transfers." In re Enron, 316 B.R. at 253.

Use of IRS Reachback Period

In re Emergency Monitoring Technologies, Inc., 347 B.R. 17 (Bankr. W.D. Pa. 2006)

Trustee survives motion to dismiss section 544(b) complaint, on the basis that notwithstanding that the alleged avoidable transfer took place outside the applicable state law statute of limitations, it is conceivable that the trustee could utilize the power of the IRS to avoid the transactions under the 10 year limitations period provided by 26 U.S.C. section 6502(a)(1), as the trustee could access the avoidance rights of the IRS under section 544(b), citing In re Porras, 312 B.R. 81 (Bankr. S.D. Tex. 2004) (Note: the court points out the possible availability of such as action though the IRS claim arose after the transaction, using applicable state law—the result is probably different in Louisiana).

Swap Agreement Defense

<u>In re National Gas Distributors, L.L.C.</u>, 369 B.R. 884 (Bankr. E.D. N.C. 2007)

The chapter 11 trustee brought an adversary proceeding against the former customer of the debtor, which was a natural gas distributor, seeking to avoid allegedly fraudulent transfers. The former customer moved to dismiss based upon the affirmative defense that it and the debtor had entered into a swap agreement. Under 11 U.S.C. §546(g), 548(c), and 548(d)(2), participants of "swap agreement" have an absolute defense to fraudulent transfer actions. Thus, the issue before the bankruptcy court was whether the debtor and the former customer entered into a swap agreement.

Section 101(53B) of the Bankruptcy Code defines swap agreement. According to the legislative history of this section, traditional supply agreements cannot be treated as swap agreements. According to the bankruptcy court, the legislative history suggests that Congress was focused protecting financial instruments that are regularly the subject of trading and did not contemplate the application of 11 U.S.C. §101(53B) to simple contracts between a single end-user and a supplier.

In this case, the parties entered into a base contract, wherein the debtor agreed to supply and the former customer agreed to buy natural gas. Then, each month, the parties would negotiate a price per unit and the total number of units of natural gas to be transferred. The court found that this agreement was a simply supply agreement because the agreement was in the nature of the kind of contract Congress sought to exclude from the definition of swap agreement. Thus, the bankruptcy court denied the former customer's motion to dismiss.

V. IMPUTATION OF FRAUD

<u>Tummell Carroll v. Quinlivan</u> (<u>In re Quinlivan</u>), 434 F.3d 314 (5th Cir. 2005)

The Fifth Circuit held that if a partner or agent acting as a formal partner or formal agent of the debtor incurs a debt by fraud, that debt is not dischargeable under 523(a)(2)(A) even if the debtor is innocent had no knowledge of the fraud. In early 1993, the president of Worldwide Floral, Inc. ("WFI"), contacted a law firm to request legal services for WFI and Worldwide Floral Exchange ("WFE"). The debtor served as the vice-president of WFE. WFI's president made numerous misrepresentations in order to induce the law firm into a contingent-fee legal services contract, such as, (1) that he was a wealthy investor, (2) that he was familiar with commercial litigation and how expensive it was, and (3) that he was financing the business of the prospective clients. In addition, WFI's president misrepresented that the bank he wished to sue had wrongfully terminated a Visa/Mastercard merchant account that had been established for WFI and WFE, that the bank wrongfully had placed WFI and WFE on a list of "terminated" merchants, that this action by the bank was causing prospective clients to sustain losses of $10,000 to $20,000 per day, and that efforts by the prospective clients to obtain replacement financing from "unregulated" lenders had resulted in associated additional losses to the prospective clients of approximately $200,000. The WFI's president did not disclose the fact that information used to obtain the merchant account contained false or misleading information. WFI's president and the debtor (in his individual capacity and as vice-president of WFE) signed a retainer agreement with the law firm for representation on a contingency-fee basis.

The law firm filed suit against the bank on behalf of the debtor in his individual capacity, WFE, and WFI in a Texas state court. During a hearing in state court, the law firm discovered the merchant account application contained false information.

WFI’s president and the debtor subsequently informed the law firm that they no logner wished to pursue their claims against the bank. Pursuant to their contract, the law firm gave the parties notice that, because they had decided to withdraw their claims, they owed the law firm for legal services rendered on an hourly basis. After the parties failed to pay the invoiced charges, the law firm sued the debtor, WFI’s president, WFI and WFE for breach of contract and sued WFI’s president for fraud.

The state court, on summary judgment, rendered judgment against the debtor and awarded the law firm $45,222.20 plus six percent pre-judgment interest and reasonable attorney fees. The state court's summary judgment decision contained no findings that the debtor incurred the debt in question under false pretenses.

The debtor and his spouse subsequently filed a chapter 7 petition. The debtor failed to list as a liability the law firm’s judgment, which was in excess of fifty percent of the total value of creditors' claims against the debtor. The law firm learned of the bankruptcy case a few years later, when the debtor and his wife sought to reopen the case in order to obtain a discharge of their debt to the law firm because the judgment had impressed a lien on real estate that the debtor had inherited after his bankruptcy discharge.

The law firm sought to have the judgment held nondischargeable. The bankruptcy court found that, because the debtor did not engage in fraudulent behavior himself, section 523(a)(2)(A) did not bar discharge of the law firm’s debt. The bankruptcy court also held that the debtor’s failure to list the law firm’s judgment, in violation of § 523(a)(2)(A), was due to inadvertence. Therefore, the debt remained dischargeable.

On appeal, the Fifth Circuit remanded. “Holding the debtor accountable for his partner's fraud effectuates important state law policies regarding imputed liability,” noted the court, and as a result, when determining whether the debt is dischargeable, the culpability of the indebted partner is irrelevant. “Even if the partner is innocent of wrongdoing and had no knowledge or reason to know of the fraud, the debt is not dischargeable under § 523(a)(2)(A).” Because the bankruptcy court had not made a proper determination of whether an agency relationship existed between the debtor and WFI’s president, the case was remanded to the bankruptcy court.

On remand to the district court, the court found that under Texas law, an agency relationship did exist. WFI’s president had actual authority to negotiate the contract on the debtor’s behalf.

VI. DEEPENING INSOLVENCY

<u>In re Vartec Telecom, Inc.</u>, 335 B.R. 631, (Bankr.N.D.Tex. 2005)

Unsecured creditors committee of Chapter 11 debtor-telecommunications provider and its debtor-subsidiaries brought an adversary proceeding against one of debtor’s secured creditors, asserting claims for fraudulent transfers, preferences, avoidance of secured creditor's prepetition security interests, avoidance of secured creditor's replacement liens and super-priority protections, disgorgement, disallowance of secured creditor's claims, equitable marshaling of assets, equitable subordination of claims, deepening insolvency, and turnover. The secured creditor moved to dismiss the deepening insolvency claim pursuant to Rule 12(b)(6) of the Federal Rules of Civil Procedure made applicable to bankruptcy proceedings by Bankruptcy Rule 7012. The secured creditor argued the plaintiffs had failed to state a claim upon which relief could be granted, as Texas law did not allow an independent claim for deepening insolvency. The bankruptcy court agreed and held that deepening insolvency was not considered a separate cause of action under Texas law.

The theory of deepening insolvency has been defined by the Bankruptcy Court for the Northern District of New York as "the 'fraudulent prolongation of a corporation's life beyond insolvency,' resulting in damage to the corporation caused by increased debt." Kittay v. Atlantic Bank of New York (In re Global Service Group, LLC), 316 B.R. 451, 456 (Bankr.S.D.N.Y.2004), noted the bankruptcy court. Its origin had been traced as a theory of recovery in New York to a case a quarter of a century earlier, Bloor v. Dansker (In re Investors Funding Corp. of New York Sec. Litig.), 523 F.Supp. 533 (S.D.N.Y.1980), where the plaintiff alleged that the debtor's insiders had embarked on a scheme to loot the corporate debtor. "Relying on a false picture of the debtor's financial well-being, they induced creditors and shareholders to invest more funds in the company. Thereafter, they misappropriated a portion of the funds that were raised." Id. at 536.

The bankruptcy court explained that the theory of deepening insolvency, in summary, was a theory used to recover damages in actions for breach of fiduciary duty alleging that officers or directors deepened the insolvency of the corporation and reduced or eliminated any return for creditors. The action quickly morphed from a breach of statutory duty claim to a form of common law tort liability, and expanded to include lawyers, accountants, bankers, and other financial and insolvency professionals.

The first question asked by the bankruptcy court was, if deepening insolvency exists as a separate tort, is it considered based in state law or federal bankruptcy law? It noted the absence of the words "deepening insolvency" from the Bankruptcy Code or elsewhere from any other federal law. The courts that have had considered the theory of deepening insolvency had to consider, in the absence of any state law recognizing deepening insolvency, how their respective state courts would rule when adopting a new cause of action, and based their decisions using three guiding principles: (1) the soundness of the theory; (2) its growing acceptance among the courts and (3) the remedial theme under state law (citing Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 349-52 (3d Cir.2001).

The bankruptcy court noted that many courts either have treated a claim of deepening insolvency as a separate duty owed to a corporation, a theory of damages, or have raised questions about its viability. See Limor v. Buerger (In re Del-Met Corp.), 322 B.R. 781, 813-815 (Bankr.M.D.Tenn.2005) (treated separate duty owed to a corporation, not as a separate cause of action); Kittay v. Atlantic Bank of New York (In re Global Service Group, LLC), 316 B.R. 451, 457-459 (Bankr.S.D.N.Y.2004) (same); Alberts v. Tuft (In re Greater Southeast Community Hospital Corp.), 333 B.R. 506, 517-18 (Bankr.D.Dist.Col. 2005); Bondi v. Bank of America Corp. (In re Parmalat), 383 F.Supp.2d 587 (S.D.N.Y.2005); Schacht v. Brown, 711 F.2d 1343, 1350 (7th Cir.1983) (treating deepening insolvency as a theory of damages); Hannover Corp. of America v. Beckner, 211 B.R. 849, 854 (M.D.La.1997) (same); Allard v. Arthur Andersen & Co. (USA), 924 F.Supp. 488, 494 (S.D.N.Y.1996) (same); Drabkin v. L & L Constr. Assocs., Inc. (In re Latin Inv. Corp.), 168 B.R. 1, 6 (Bankr.D.C.1993) (same); Florida Dep't of Ins. v. Chase Bank of Texas Nat'l Ass'n, 274 F.3d 924, 935-36 (5th Cir.2001) (questioning whether Texas would recognize the cause of action); Askanase v. Fatjo, 1996 WL 33373364, at *28 (S.D.Tex. Apr. 1, 1996) (rejecting trustee's "deepening insolvency" argument because the insolvent debtor was not damaged by false financial statements since the shareholders had already lost all of their equity and the complaint did not allege that any creditor was injured); Feltman v. Prudential Bache Sec., 122 B.R. 466, 473-74 (S.D.Fla.1990) (rejecting argument that insolvent corporation was harmed by artificial extension of its life where complaint alleged that corporation was a sham, without a corporate identity and served as a conduit for stolen money).

The bankruptcy court then turned to its next question: would the Supreme Court of Texas recognize the theory of deepening insolvency as a tort? It pointed out the Fifth Circuit's mention in Florida Dep't of Ins. v. Chase Bank that no Texas court has recognized the theory of "deepening insolvency" and questioned its viability. In the absence of any guidance from the Texas Supreme Court, it would look to: (i) decisions of the Texas Supreme Court in analogous cases; (ii) the rationales and analyses underlying Texas Supreme

Court decisions on related issues; (iii) dicta by the Texas Supreme Court; (iv) lower state court decisions; (v) the general rule on the question; (vi) the rulings of courts of other states to which Texas courts look when formulating substantive law; and (vii) other available sources, such as treatises and legal commentaries. (citing Centennial Ins. Co. v. Ryder Truck Rental, Inc., 149 F.3d 378, 382 (5th Cir.1998).

While Texas courts adhere to the principle that a remedy is provided for every wrong (see Payant v. Corpus Christi Plaza Hotel Co., 149 S.W.2d 665-667 (Tex.Civ.App-El Paso 1941, writ dism'd)), the bankruptcy court recognized the Supreme Court of Texas's reluctance to recognize a new tort (see Trevino v. Ortega, 969 S.W.2d 950, 951 (Tex.1998)), and its adverseness to "creating a tort that would lead to duplicative litigation, encouraging inefficient relitigation of issues better handled within the context of the core cause of action." (see Trevino at 952).

The bankruptcy court thus viewed "deepening insolvency" as nothing more than a measure of damages, not as a cognizable cause of action. It distinguished between a condition being harmful and actually being a tort. A tort consists of a duty, a breach, and damages. The mere act of driving a company deeper into insolvency, therefore, cannot give rise to a cognizable claim without a duty and corresponding breach of that duty. In order for a plaintiff to assert a valid claim for damages under a theory of deepening insolvency, the plaintiff must show that the defendant had committed some other tort. Considering deepening insolvency as separate claim would be substantially duplicating torts already established under Texas law.

> Much like the little old lady in the fast food commercials, the Court looks at the bottom of the deepening insolvency hamburger bun and is forced to ask "where's the tort?" If Texas courts were to apply the theory of deepening insolvency as a tort separate and apart from torts already existing under Texas law, does a cause of action for "deepening insolvency" fit the definition of a tort? As Judge Bernstein in Global Service Group indicates, and as commentators have recently addressed, asking this question usually results in leaving what is before a court to be simply a measure of damages or a breach of tort that has already been established.
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> In re Vartec, 335 B.R. at 645.

VII. AUTOMATIC STAY

Brown v. Chesnut (In re Chesnut), 422 F.3d 298 (5th Cir. 2005)

Creditor in chapter 13 case foreclosed on real property that the creditor believed was not property of the bankruptcy estate but rather was the separate property of the debtor's non-filing spouse. The debtor's non-filing spouse was named in the deed as the sole purchaser of the property. The non-filing spouse also attend the closing alone without her husband and signed all of the relevant legal documents alone, including the real estate lien note, the deed of trust, the title policy, and the warranty deed. The warranty deed recited that the property in question was the "sole and separate property and estate" of the non-filing spouse. When the non-filing spouse defaulted on her loan obligation, the creditor initiated foreclosure proceedings.

The debtor subsequently filed an individual chapter 13 petition for and faxed a copy of the petition to the creditor, which was reviewed by the creditor's attorney, and which, according to the Fifth Circuit, placed the creditor on notice that the debtor was claiming that the property in question was community.

The creditor nonetheless foreclosed on the property. The bankruptcy court, without deciding whether the property in question was community found that the creditor willfully violated the automatic stay. The bankruptcy court found that the creditor's belief that the property was not part of the estate was not sufficient to obviate compliance with the relief from stay procedures of section 362(d), and assessed the creditor a fine and attorney fees. The district court reversed, finding that the property in question was the separate property of the non-filing spouse and, because the debtor had no interest in the property in question, there had been no violation of the automatic stay when it foreclosed on the property.

The Fifth Circuit reversed, finding that a willful violation of the stay occurs when a creditor, with knowledge of the stay, and without permission of the bankruptcy court, forecloses on an asset to which the debtor has only an "arguable claim of right" (defined by the court as "arguable property.") In the present case, the property in question was arguable property – it was not clearly part of the debtor's bankruptcy estate at the time of foreclosure, but neither was it clearly not part of his estate.

> Whether an asset is property of the estate is a legal determination which frequently entails complex analyses involving a number of legal elements and a variety of facts…. These questions concerning the characterization of the Eastland property as separate or community property can only be answered with finality through the judicial process, which was not initiated here until after the foreclosure of the Eastland property. Regardless of whether the Eastland property is ultimately held to have been Mrs. Chesnut's separate property or the Chesnuts' community property, at the time that Brown foreclosed on the Eastland property, it was uncertain whether it was property of Mr. Chesnut's estate and, therefore, was arguable property.

Thus, it was sufficient to conclude that the creditor willfully violated the automatic stay.

VIII. DOCUMENT PRODUCTION/ATTORNEY CLIENT PRIVILEGE

In the Matter of Toms Foods, Inc., 345 B.R. 745 (Bankr.M.D.Ga. 2006)

Responsible officer of corporate chapter 11 debtor moved for an order authorizing a 2004 examination of debtor's major shareholder corporation, and for production of documents. The responsible officer alleged that officers of the debtor had removed documents from the debtor's corporate offices and contended that these documents were property of the debtor's estate. Officers moved for a protective order, alleging that the attorney-client privilege protecting the documents belonged to third parties and not to the Debtor. The documents in dispute consisted of ten e-mails sent by Ron Devin, former CEO, president, and director of the Debtor. The e-mails were sent to an attorney who served on the board of directors. Nine of the e –mails were also sent to other individuals. Five of the e-mails were sent by blind copy to other individuals. The other individuals who received the blind copy were three of the debtor's directors, six officers of the debtor, four persons associated with the major shareholder corporation of the debtor, and one person who owned 20% of holding company of the debtor. Four of the e-mails were marked attorney client privilege.

The court held that the attorney client privilege did not apply because the CEO was asking for business rather than legal advice. "Any privilege resulting from communications between corporate officers and corporate attorneys concerning matters within the scope of the corporation's affairs and the officer's duties belongs to the corporation and not to the officer…" In re Grand Jury Subpoenas, 144 F.3d 653 (10th Cir.), cert denied 525 U.S. 966, 119 S.Ct. 412 (1998). Further, the e-mails were widely distributed by blind copy, not only to corporate officers and directors, but to persons affiliated with another corporate entity distinct from the debtor, and the substance of these e-mails concerned matters within the debtor's business affairs. Thus, the documents were not protected by attorney-client privilege and had to be turned over.

Official Committee of Asbestos Claimants of G-1 Holding. Inc. v. Heyman, 342 B.R. 416 (S.D. N.Y. 2006)

The committee was appointed to pursue avoidance and breach of fiduciary duty actions against certain insiders of the debtor arising out of the spin off of a subsidiary to the shareholders of the parent (ultimately the debtor). The primary defendant was Heyman, owner of some 96% of the parent shares, who received, therefore the bulk of the subsidiary stock.

Discovery disputes arose over the question whether the committee held the attorney client privilege for purposes of waiver to avoid claims of privilege by the Debtor, the subsidiary and/or the individual defendants. Noting that in matters involving bankruptcy jurisdiction, it may be possible to use federal conflicts principles, the court noted no significant difference between federal and New York law, and resorted to New York law.

The committee argued that Weintraub[10] provided the committee the right to waive the privilege. The court nixes this approach. First, the committee held no managerial control over the debtor, who held possession of the estate. Second, other decisions recognizing the placement of the privilege in parties other than the debtor in possession (where there is not trustee) have done so upon special facts, such as court recognition of expanded examiner powers (In re Boileau, 736 F.2d 503 (9th Cir. 1984)). Second, the committee did not stand, in its capacity as plaintiff, in the shoes of a trustee further than the court grant of standing to act as plaintiff. The committee creditors had no responsibility to run the affairs of the estate, and the committee in fact represented only one class of creditor, the asbestosis claimants. Therefore, "the Committee owes a duty only to its constituent creditors."[11] In fact, says the court, the committee owes no general duty to the estate.

Essentially the court concludes that despite the appointment of the committee to bring the actions (the opinion does not state what was to be done with proceeds of recovery), which carries within the grant standing derived from the debtor in possession, the litigation standing is insufficient to shift managerial control over the estate or to shift the inherent duty of the committee/plaintiff so that the attorney client privilege is held in the plaintiff.

The case also contains a good discussion of the exception to attorney client privilege set forth in Garner v. Wolfinbarger, 430 F.2d 1093 (5th Cir. 1970), which provides for the prospect of an exception to the attorney client privilege in situations involving shareholder derivative actions (and has been expanded to areas of breach of fiduciary litigation). On the basis of the interest held by the committee, the court approved an exception as to the privilege claimed by the debtor, but held back from extending the ruling to the claims made by the subsidiary, whose shares were spun off. According to the court there was dual representation under a management services contract, and on the basis of the record before the court, there was no ground for concluding that the dual representation by in house counsel was problematic.

[10] Commodity Futures Trading Commission v. Weintraub, 471 U.S. 343, 105 S.Ct. 1986, 85 L.Ed.2d 372 (1985).

[11] 342 B.R. at p. 423.

IX. SUBORDINATION OF AND DEFENSES TO PURCHASED CLAIMS

Enron Corp. v. Springfield Associates, L.L.C., 06-CIV-7828 (S.D. N.Y. 2007)

The United States District Court for the Southern District of New York was recently asked whether equitable subordination under 11 U.S.C. §510(c) and disallowance of claims under 11 U.S.C. §502(d) can be applied, as a matter of law, to claims held by a transferee to the same extent they would be applied to claims if they were still held by the transferor based on alleged acts or omissions of the transferor? According to the court in its 53-page opinion, the answer is: it depends on whether the transferee is an assignee or a purchaser.

Prior to Enron's December 2, 2001 chapter 11 bankruptcy petition, Enron was a borrower under a short-term credit agreement by syndicate banks, including Citibank. The total liability under these agreements was more than $1.7 billion. Accordingly, on the petition date, Citibank and other syndicate banks held claims against Enron. At various time post-petition, Citibank and other syndicate banks transferred, directly or indirectly, some portion of their claims to other entities, including Springfield Associates, L.P. ("Springfield"). Springfield indirectly acquired a claim of approximately $5.0 million arising from a short-term credit agreement that Citibank held as of the petition date. Springfield did not engage in any inequitable conduct.

On September 24, 2004, Enron filed an action in the bankruptcy court against Citibank and other claims transferors seeking, *inter alia*, 1) equitable subordination of the transferors' claims under 11 U.S.C. §510(c), and 2) disallowance of the transferors' claims under 11 U.S.C. §502(d). On January 10, 2005, Enron filed a series of adversary proceedings against each of the transferee's, including Springfield, in which Enron asserted two causes of action: 1) equitable subordination of the transferors' claims under 11 U.S.C. §510(c), and 2) disallowance of the transferors' claims under 11 U.S.C. §502(d). On April 1, 2005, Springfield and certain other transferees moved to dismiss both causes of action. However, the bankruptcy court denied the motions to dismiss. The court held that the claim in the hands of Springfield, the transferee, could be subordinated and/or disallowed based solely on the conduct of Citibank, the transferor. Accordingly, Springfield moved for leave to file an interlocutory appeal with the district court.

The Court asked whether equitable subordination and disallowance are attributes of the claimant that travel with the claim, or are personal disabilities of the claimant. According to the court, equitable subordination is a personal disability that does not inhere to the claim. Enron, at *29. Citing the legislative history of section 510(c), the court stated that Congress did not intend section 510(c) to be applied to a transferee that has not acted inequitably merely because that claim was transferred by a bad actor. *Id*. at *31. Moreover, Second Circuit jurisprudence provides that equitable subordination is appropriate, *inter alia*, when the subordinate claimant has engaged in inequitable conduct that injures competing claims. *Id*. at *33. Thus, the appropriate focus of section 510(c) is on the claimant, not the claim. Likewise, the court held that disallowance is a personal disability because the plain language of section 502(d) focuses on the claimant as opposed to the claim. *Id*. at *38-39.

Because the court held that equitable subordination under section 510(c) and disallowance under section 502(d) are personal disabilities of the individual claimants, whether equitable subordination and disallowance can be applied to a transferee depends on the nature of transfer, assignment or sale. Under Second Circuit jurisprudence, an assignee stands in the shoes of the assignor and subject to all equities against the assignor. *Id*. at *21, citing Citibank, N.A. v. Tele/Resources, Inc., 724 F.2d 266, 269 (2d Cir. 1983). In other words, an assignee is exposed to liability for conduct of the assignor. By contrast, a purchaser does not stand in the shoes of the seller, i.e., a purchaser is not necessarily exposed to the liability of the seller. Enron at *21, citing N.Y. U.C.C. §8-202(d). Therefore, because equitable subordination and disallowance are personal disabilities of the claimant, they travel with the claim only when the claim is assigned. Enron, at *22.

The district court also took aim at the bankruptcy court's broad application of assignment law to all transfers. By doing so, the district court stated, the bankruptcy court ignored the distinction between assignments and sales and never addressed whether section 510(c) and 502(d) were personal disabilities. *Id*. at *36.

The court went on to recognize that not every purchaser of a claim will automatically be exempt from equitable subordination. *Id*. at *37. The court suggested that bad faith purchasers or purchasers with actual notice of inequitable conduct may be subject to equitable subordination. *Id*. The court also recognized that not every assignee will be subject to equitable subordination. *Id*. The court suggested that an assignee qualifying as a holder in due course may be exempt from equitable subordination. *Id*. Also, the doctrine of third party latent equities may apply as an exception to the assignment law's application, depending on which state law governs. *Id*. at *37-38.

Enron alternatively argued that equitable subordination and disallowance are fixed as of the petition date. Thus, if a claim is tainted by inequitable conduct on the petition date, then it will forever be tainted, even in the hands of any transferee. The court began its analysis with Sexton v. Dreyfus, 219 U.S. 339 (1911), and United Stats v. Marxen, 307 U.S. 200 (1939). In these two cases the Supreme Court held that rights among competing claims to the bankruptcy estate are generally fixed as of the petition date. However, according to the district court, Sexton and Marxen do not apply to equitable subordination. *Enron*, at *25-26. First, court action is perquisite to the application of section 510(c) because the statute states "after notice and a hearing, the court may" equitably subordinate a claim. *Id*. at *26. Second, the doctrine is permissive because the statute uses the word "may." *Id*. Third, equitable subordination can be based on post-petition conduct. *Id*., citing Citicorp Venture Capital, Ltd. v. Committee of Creditors Holding Unsecured Claims, 160 F.3d 982, 991 (3d Cir. 1998); In re Lemco Gypsum, Inc., 911 F.2d 1553, 1558 (11th Cir. 1990). Fourth, because the test for equitable subordination under Mobile Steel,[12] dictates that equitable subordination is not available to creditors who suffered no injury, creditors who acquire their claims post-petition and after the alleged misconduct may not be entitled to that remedy. Enron, at *26-27, citing In re W.T. Grant Co., 4 B.R. 53, 78 (Bankr. S.D. N.Y. 1980). Thus, equitable subordination is not fixed as of the petition date. Likewise, the district court held that disallowance is not fixed as of the petition date. First, like equitable subordination, court action is required under section 502(d). Enron, at *27. Second, section 502(d) is contingent upon the refusal or failure to return the avoidable transfer by the recipient of that avoidable transfer. *Id*. at 27-28. Third, disallowance can be applied to post-petition receipt of an avoidable transfer. *Id*. at 28.

X. LIQUIDATION TRUSTEES—SUITS AGAINST

In re WRT Energy Corp., 2007 WL 2893426 (Bankr. W.D. La.)

Is the Barton doctrine viable in the Fifth Circuit? If so, is the Barton doctrine applicable to the trustee of a liquidating trust? Does the bankruptcy court have post-confirmation jurisdiction over a liquidating trust?

In 1997, the bankruptcy court confirmed a chapter 11 plan which provided for the creation of a "Liquidation Entity" as a representative of the debtor's estate for the purpose of pursuing potential causes of

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action. The confirmed chapter 11 plan also provided for the execution of a "Trust Agreement." Although the confirmation order did not appoint a trustee of the liquidation entity, the trust agreement named a trustee. Over the next few years, the trustee of the liquidation entity brought multiple claims against various parties. Eventually, the trustee collected over $17 million through its activities. However, the liquidating entity only produced a net return of $19,000 after costs and expenses were offset. Consequently, several trust beneficiaries filed a complaint in the United States District Court, Western District of Texas, alleging multiple causes of action, including breach of fiduciary duty, breach of contract, and gross negligence. The trustee objected in the bankruptcy court arguing that the trust beneficiaries did not seek court approval pursuant to the Barton doctrine.

The Barton doctrine provides that a court appointed trustee cannot be sued for actions taken in the trustee's official capacity unless leave if first obtained from the court that appointed the trustee.[13] The beneficiaries first argued that the Fifth Circuit has never expressly adopted the Barton doctrine. The bankruptcy court disagreed. The bankruptcy noted that the Fifth Circuit itself has never expressly applied Barton, lower courts in the circuit have recognized and applied the doctrine to bankruptcy trustees.[14] Accordingly, the bankruptcy court recognized the viability of the Barton doctrine in the Fifth Circuit.

The bankruptcy court also concluded that the Barton doctrine applies to liquidating trustees. The bankruptcy court was persuaded by In re Crown Vantage, Inc.,[15] in which the Ninth Circuit reasoned that the Barton doctrine applies to liquidating trustees who represent the estate because they are the functional equivalent of a trustee appointed under the Code. Thus, the bankruptcy court held that the Barton doctrine applied to the trustee of the liquidating entity.

However, the bankruptcy ultimately concluded that it did not have post-confirmation jurisdiction over the claims against the trustee. According to the bankruptcy court, the claims against the trustee did not have the requisite nexus to the chapter 11 plan so as to justify post-confirmation jurisdiction because the plan had been substantially consummated, confirmed over 10 years ago, and the trust terminated in 2000. Moreover, the claims against the trustee arose post-confirmation. Thus, without subject matter jurisdiction, the bankruptcy court could not apply the Barton doctrine.

XI. SARBANES –OXLEY AND BANKRUPTCY PRIORITIES

Official Committee of Unsecured Creditors of WorldCom, Inc. v. S.E.C., 467 F.3d 73 (2d Cir. 2006)

Official creditors' committee appealed plan proposed by the SEC to distribute civil penalty settlement funds of $750 million to only certain groups of interest holder, while it excluded groups that had made net profit from sales and purchases of the of the debtor's securities during the fraudulent period, and those that had already recovered more than the average recovery by general creditors in the chapter 11 proceeding. The committee had nonparty standing to appeal from the district court's decision and order approving the SEC's "fair fund" plan for distribution. Although not a party to the SEC's action against the

[13] Barton v. Barbour, 104 U.S. 126 (1881).

[14] *See*, *e.g.*, In re Coastal Plains, Inc., 362 B.R. 102 (Bankr. N.D. Tex. 2005); Telpro, Inc. v. Litzler, 2002 WL 31553971 (N.D. Tex.).

[15] 421 F.3d 963 (9th Cir. 2005).

debtor and never sought to intervene, the committee's interest in the allocation of the settlement funds provided it with a basis for nonparty standing to appeal.

The distribution plan was fair and proper. Once the district court is satisfied that the plan is fair and reasonable, its review is at an end, regardless of whether the plan violates the Bankruptcy Code's priority scheme. Prior to Sarbanes-Oxley, civil penalties obtained by the SEC in securities actions were paid to the U.S. Treasury and were not available to distribution to injured investors. However, the Fair Fund Provision of the Sarbanes-Oxley Act (15 U.S.C. §7246(a)) now provides the SEC with flexibility to distribute, at its discretion, the recovery to defrauded investors. The SEC's primary purpose is not to compensate investors, but to ensure that those guilty of fraud are not unjustly enriched. Further, the SEC remains the decision-maker on whether to distribute civil penalties to victims at all. The exclusions reflected the SEC's reasonable choices for equitably distributing limited funds, and the court should defer to its experience and expertise in determining how to distribute the funds.