Class Materials

Bankruptcy

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Shawmut Bank Connecticut N.A. Investments, Inc. v. First Fidelity Bank (In re Secured Equipment Trust of Eastern Air Lines, Inc.)

38 F.3d 86 (2d Cir. 1994)

ALTIMARI, Circuit Judge: Appellants appeal from a judgment entered in the United States District Court for the Southern District of New York (Sprizzo, J.) affirming a final order of the United States Bankruptcy Court for the Southern District of New York (Lifland, J.) dismissing an involuntary bankruptcy petition appellants filed against the Secured Equipment Trust of Eastern Air Lines, Inc. (the "Trust"). The Trust was created as part of a secured financing by Eastern Air Lines, Inc. ("Eastern"), and subsequent to Eastern's filing of a voluntary petition for relief under Chapter 11 of the United States Bankruptcy Code (the "Bankruptcy Code" or the "Code"), creditors of the Trust filed an involuntary bankruptcy petition against the Trust. The bankruptcy court dismissed the petition on the grounds that the Trust was not eligible for bankruptcy protection. The eligibility determination turned on the bankruptcy court's finding that the Trust did not constitute a "business trust" within the meaning of the Bankruptcy Code. See 11 USC § 101(9)(A)(v). The district court agreed. On appeal, appellants challenge the bankruptcy court's interpretation of "business trust," claiming that the Trust clearly falls within the Code's use of that term. For the reasons discussed below, we reject appellants' arguments, and affirm the judgment of the district court upholding the bankruptcy court's dismissal of appellants' petition.

Eastern, seeking to raise $500 million in financing, created the Trust to facilitate its ability to secure the financing with a lien on a portion of its fleet of aircraft. The Trust was created pursuant to a document entitled "Secured Equipment Indenture and Lease Agreement Between First Fidelity Bank, Indenture Trustee and Eastern Air Lines, Inc." as amended by subsequent supplemental indentures (the "Indenture"). The mechanics of the transaction involved the Trust's sale of $500 million in Trust certificates to investors, the Trust's purchase of a portion of Eastern's fleet (the "Collateral Pool") with the proceeds of the sale, and the lease of the fleet back to Eastern in exchange for rental payments designed to equal the amount of principle, premium, and interest on the certificates. Although the transaction was called a sale/leaseback, there is no dispute that it was a secured financing.

The Trust certificates were sold in three series as follows: First Priority Secured Equipment Certificates in principal amount of $200 million due November 15, 1993 and bearing interest of 11 3/4 %; Second Priority Secured Equipment Certificates in principal amount of $200 million due November 15, 1996 and bearing interest of 12 3/4 %; and Third Priority Secured Equipment Certificates in principle amount of $100 million due November 15, 2001 and bearing interest of 13 3/4 %. The affairs of the Trust as a whole were to be administered by a "Collateral Trustee," and each series of certificates was to be represented by its own "Series Trustee." First Fidelity Bank was appointed Collateral Trustee, and Midlantic National Bank, United Jersey Bank, and First Jersey National Bank (ultimately replaced by Shawmut Bank) were respectively appointed First, Second, and Third Series Trustees.

Pursuant to the Indenture, the Collateral Trustee is responsible for collecting the lease payments and distributing them in accordance with the priorities set forth in the Indenture. The Indenture further provides that any rental payments in excess of amounts due under the Indenture be returned to Eastern, and upon payment in full by Eastern, title to the Collateral Pool would be reconveyed to Eastern and the Trust dissolved. Upon a default by Eastern, the Indenture allows the Collateral Trustee to take possession of the Collateral Pool and hold, sell, keep, or lease its components in order to enforce the Indenture.

On March 9, 1989, Eastern filed a voluntary petition for relief under Chapter 11 of the Bankruptcy Code. Eastern subsequently stopped making timely rental payments to the Trust. Each of the Series Trustees filed separate secured proofs of claim in Eastern's bankruptcy for principal, premiums, interest, fees and expenses owed to the Secured Equipment Trust Certificateholders. On January 23, 1991, Eastern's Chapter 11 Trustee entered into a stipulation with the Collateral Trustee pursuant to which Eastern returned certain aircraft to the Trust, and turned over $230 million in proceeds resulting from Eastern's sale and lease of Collateral Pool equipment.

Because Eastern defaulted on its rental obligations, the Collateral Trustee, pursuant to powers enumerated in the Indenture, began actively managing, maintaining, marketing, leasing, and selling certain Collateral Pool equipment. The Collateral Trustee retained counsel, accountants, and an aviation consultant to assist in the stewardship of the entrusted property. The Collateral Trustee projects that the liquidation of the remaining Collateral Pool will take several years to complete.

On March 28, 1991, three holders of Second and/or Third Priority Secured Equipment Certificates, LNC Investment Inc., Charter National Life Insurance Co., and Magten Asset Management Corporation, filed an involuntary Chapter 11 petition against the Trust in the Bankruptcy Court for the District of New Jersey. These certificateholders hold $54.2 million in aggregate principal amount of Trust certificates. The Resolution Trust Corp., a holder of $35.5 million in aggregate principle amount of Trust certificates, subsequently joined the petition. The Collateral Trustee moved to dismiss or transfer the case, and the case was ultimately transferred to the Southern District of New York (Lifland, J.).

After a ruling, appeal, and remand not relevant to the issue on appeal, the Collateral Trustee renewed its motion to dismiss the petition, and the Second Series Trustee, United Jersey Bank, joined the petition (collectively "appellees"). Both claimed that the Trust is not an eligible debtor under the Bankruptcy Code. The petitioning certificateholders and the Third Series Trustee, Shawmut Bank, opposed the motion, claiming that the Trust is a "business trust" eligible for Chapter 11 relief. The bankruptcy court granted the motion to dismiss the petition, finding that the Trust failed to exhibit the elements of a business trust. The district court affirmed the bankruptcy court's decision without opinion.

The petitioning certificateholders and Shawmut (collectively "petitioners") now appeal.

The sole issue on appeal is whether the trust in question is a "business trust" within the meaning of the Bankruptcy Code, thereby making it eligible for bankruptcy protection. Notably, we have never before had to expressly address the definition of "business trust" under the Bankruptcy Code. Furthermore, although many other courts have been called on to make this type of determination, none have been presented with a trust that was created in order to secure the payment of certificates issued in connection with a secured financing. As such, we are faced with an issue of first impression for this and any appellate court.

Under the Bankruptcy Code, only a "person" may be an involuntary debtor. 11 USC § 303(a). The term "person" has been defined to include "corporation," 11 USC § 101(41), and "corporation" has been further defined to include "business trust," 11 USC § 101(9)(A)(v). "Business trust" itself, however, is not defined in either the Code or its legislative history. ***

Clearly, most courts agree that a basic distinction between a business trust and other trusts is that business trusts are created for the purpose of carrying on some kind of business, whereas the purpose of a non-business trust is to protect and preserve the res. Furthermore, while a trust must engage in business-like activities to qualify as a business trust, such activity, without more, does not necessarily demonstrate that a trust is a business trust. *** Ultimately, each decision is based on a very fact specific analysis of the trust at issue.

Petitioners, who bear the ultimate burden of establishing that the alleged debtor is an eligible debtor under the Bankruptcy Code, originally claimed that the activities carried on by the Trust demonstrate that it is a business trust. Specifically, they pointed to the fact that ever since Eastern has been in bankruptcy, the Collateral Trustee has carried on the business of leasing and selling the Collateral Pool property. In so doing, the Collateral Trustee has hired accountants, attorneys, and marketing personnel.

The bankruptcy court rejected these arguments and ultimately concluded that because the Trust was established merely to "secure the payment of the Secured Equipment Certificates" and not to generate a profit or to liquidate the final affairs of a company originally established to generate a profit, it was not a business trust.***

On appeal, petitioners abide by their original arguments, and additionally claim that the bankruptcy court applied an improper test in determining whether the Trust constitutes a business trust. They claim that there are more types of business trusts than the categories the bankruptcy court set forth. Specifically, they cite to three cases wherein the trusts at issue were found to be business trusts yet they were not established to generate a profit or to liquidate a corporation. See *The 65 Sec. Plan*, 831 F.Supp. at 1017-18; *In re Affiliated Food Stores, Inc. Group Benefit Trust*, 134 B.R. 215, 217-18 (Bankr. N.D. Tex. 1991); *In re Michigan Real Estate Ins. Trust*, 87 B.R. 447, 449 (E.D. Mich. 1988). These three cases focus on the benefits the trust provided to its beneficiaries, without specifically limiting those benefits to profits. For example, in *In re Affiliated* a self-funded employee benefit plan that provided and maintained health benefits for employees of member stores was deemed a business trust even though it did not operate to generate a profit.

Appellees point out that these cases represent only one side of a split in authority, and that several cases have found these types of trusts ineligible for bankruptcy relief.

Regardless of our view on the above controversy, we do not read the bankruptcy court's opinion as foreclosing the possibility that trusts not established to generate a profit may still be considered business trusts. Instead of the narrow interpretation of the bankruptcy court's opinion espoused by petitioners, we interpret the court's reference to trusts that seek profits or carry on the final affairs of a company as merely examples of what the court also refers to as trusts that "transact business for the benefit of investors."

Furthermore, regardless of whether generating a profit is a necessary element of a business trust, petitioners cannot dispute that many courts have found the presence or absence of a profit motive influential in their determination of whether the trust at issue was a business trust. As most corporations are established to generate a profit, we too find this factor relevant to our determination of whether the Trust is a business trust. We do not, however, foreclose the possibility that a Trust that was not specifically established to generate a profit may still be considered a business trust.

In this case, it is clear that the Trust was not established to generate a profit. Assuming arguendo that the interest the certificateholders are entitled to constitutes profit, a point contested by petitioners, the Trust was not established to generate such interest. Rather, it was established merely to secure the repayment of the certificateholders' loans to Eastern. As such, its purpose was to preserve the interest that the certificateholders had already been guaranteed, not to generate it. Notably, any payments in excess of amounts due under the Indenture were to be returned to Eastern.

In any event, aside from the absence of a profit-generating purpose, we still do not believe that the Trust was established to "transact business" as that phrase is commonly interpreted. The Indenture makes it clear that the Trust was not established to run a business enterprise, but was merely created to serve as a vehicle to facilitate a secured financing by Eastern. By placing title to the Collateral Pool in one party—the Collateral Trustee—the Trust enabled numerous lenders to receive the benefit of a security interest without the need for multiple security agreements and filings, which would drastically increase transaction costs. Any business activities that the Trust is currently engaged in are incidental to the Trust's sole responsibility of protecting the certificateholders' security interest. Accordingly, keeping in mind that our "inquiry must focus on the trust documents and the totality of the circumstances, not solely on whether the trust engages in a business," we find that the Trust is not eligible for bankruptcy protection.

None of the cases cited by petitioners convince us otherwise. The liquidating trust cases that petitioners rely on all involve trusts that were established to carry on the final affairs of a corporation. The Trust was clearly not established for such a purpose; any liquidation that it is conducting is part of its effort to enforce the certificateholders' security interest.

We are also unpersuaded by petitioners' claim that the Trust should be considered a business trust because if it is not petitioners will have no other forum to adjudicate their claims. First, we question whether the availability of another forum is a relevant factor to consider in determining whether a trust is a business trust within the meaning of the Bankruptcy Code. More importantly, however, we are unconvinced that petitioners have no other forum to adjudicate their claims. Although petitioners may have no forum in which to seek redress from the Trust for a decline in the value of the Collateral Pool, because the petitioners are actually secured creditors of Eastern, their deficiency claims can be dealt with in Eastern's bankruptcy. In fact, each Series Trustee has already filed a proof of claim on behalf of the certificateholders it represents in Eastern's bankruptcy.

Furthermore, the petitioners can assert any claims they may have concerning the Trustees' management of the Trust or distributions thereunder in federal or state court.

We have examined petitioners' remaining contentions and find them without merit. In sum, after reviewing the specific facts giving rise to the trust at issue, we believe that it is not a "business trust" within the meaning of the Bankruptcy Code.

Based on the foregoing, the judgment of the district court affirming the bankruptcy court's dismissal of appellants' involuntary bankruptcy petition filed against the Trust is affirmed.

KEARSE, Circuit Judge, dissenting: I respectfully dissent from the majority's conclusion that the Secured Equipment Trust of Eastern Airlines, Inc. (the "Trust"), is not a "business trust" within the meaning of the Bankruptcy Code, see 11 USC § 101(9)(A)(v). Thus, I would reverse the decision of the district court that the Trust is not a "person" within the meaning of the Code, see id. § 101(41) (defining person to include corporation); id. § 101(9) (defining corporation to include business trust), and hence cannot be subjected to involuntary bankruptcy proceedings, see 11 USC § 303(a).

The Trust is an entity in which investors purchased certificates evidencing their respective shares of beneficial ownership. The certificateholders expected to earn a profitable return on their investments. Pursuant to the terms of the Trust Indenture, which provided that it was to be governed by New York law, the Trustee (sometimes referred to as "Collateral Trustee") used the capital raised through the sale of the certificates to purchase aircraft from Eastern Airlines, Inc. ("Eastern"); the Trustee leased the aircraft back to Eastern at rates designed to ensure the certificateholders their agreed rate of return.

The Indenture also gave the Trustee considerable powers to deal with the equipment in the event that Eastern defaulted. These included the power to take the aircraft, airframes, engines, or any parts thereof, into the Trustee's possession, the power to sell any or all of this equipment at public or private sale for cash or on credit, and the power to lease any or all of the equipment to others. As events unfolded, the Trustee in fact had to engage in such activities. As of January 24, 1991, the Trust had taken possession of 67 commercial jet aircraft and 165 engines. The Trustee undertook an extensive marketing program for the lease and/or sale of these assets and arranged for their maintenance, repair, insurance, and storage pending such lease or sale. Two years after taking possession of these assets, the Trustee was still managing a fleet of 47 commercial jet aircraft. As the bankruptcy court observed in its April 16, 1993 ruling,

> [s]ince January 24, 1991, the Collateral Trustee, in accordance with its rights and powers under the Indenture, has actively managed, maintained, marketed, leased and sold certain Collateral Pool equipment.

In re Secured Equipment Trust, 153 B.R. 409, 411 (Bkrtcy. S.D.N.Y. 1993). In my view, the Trustee was operating a business, and the Trust would be a business trust under New York law, which defines such an entity as "any association operating a business under a written instrument or declaration of trust, the beneficial interest under which is divided into shares represented by certificates." *N.Y. General Associations Law*, § 2.2.

Such an entity appears to be among those Congress meant the Bankruptcy Code to encompass in its definition of "corporation" [101(9)] as including "business trust[s]" ***. Although the Code contains no definition of the term "business trust," the legislative history of the term is informative. Prior to the enactment of the Code, the Bankruptcy Act of 1898, as amended (the "Act"), defined corporation to include the same groups eventually listed in § 101(9)(A) of the Code. Instead of using the term "business trust" in haec verba, however, the Act defined corporation to include "any business conducted by a trustee or trustees wherein beneficial interest or ownership is evidenced by certificate or other written instrument." 11 USC § 1(8) (1976). In enacting the Code in 1978, Congress replaced this language with the term "business trust," and in describing the Code's definition of "corporation," the reports of the Judiciary Committees of both the Senate and the House of Representatives stated that "[t]he definition of 'corporation' ... is similar to the definition in current law, section 1(8)." S. Rep. No. 989, 95th Cong., 2d Sess. 22, reprinted in 1978 U.S. Code Cong. & Admin. News ("USCCAN") 5787, 5808; H.R. Rep. No. 595, 95th Cong., 2d Sess. 309, reprinted in 1978 USCC.A.N. 5963, 6266. Thus, the legislative history reveals that the Code's use of the term "business trust" was intended to include an entity that conducts business through a trustee and issues certificates or other written instruments to evidence beneficial interest or ownership in the entity. Had Congress intended the Code's use of the term "business trust" to be more restrictive than the descriptive language that the term replaced in the Act, I would have expected the legislative history to contain some statement to that effect, and I doubt that Congress would have called the two provisions "similar." Given this history, the Trust at issue here meets the criteria to be considered a business trust under the federal bankruptcy laws.

I find the majority's reasons for concluding that the Trust is not a business trust unpersuasive. Though the majority argues that the Trust was formed only to "preserve" the assets securing the investors' loans to Eastern, this Trust plainly is not a typical trust for the simple preservation of assets. The Trust was the vehicle through which financial institutions that agreed to make collateralized loans to Eastern agreed to have the money transferred and the aircraft collateral held, and it is plain from the indenture documents that neither the loans nor the interest payable to the certificateholders existed independent of the Trust. The Trust was established in order to enter into the purchase-and-leaseback transactions that would generate the rental income that created the certificateholders' profits.

And though the majority seems to rely most heavily on the fact that any excess profits generated by the purchase-and-leaseback would be payable to Eastern, the Trust plainly was no eleemosynary entity. Its operations were intended to generate a return on certificateholders' investment in the Trust, and while the amount of that return was contractually limited, the certificateholders were still to receive their agreed profit. I fail to see why the agreed profit limitation should remove the Trust from the Code definition of corporation.

In sum, I would conclude that a trust whose beneficial owners' interests are reflected by investment certificates, and which was engaged in the purchase and leaseback of equipment and thereafter engaged in the sale and lease of that equipment to others when the original seller/lessee failed to make payments on its lease, is properly viewed as a business trust within the meaning of § 101(9)(A)(v). Accordingly, I would reverse the decision of the district court.

In re LTV Steel Co.

274 Bankr. 278 (Bankr. N.D. Oh. 2001)

Bodoh, Bankruptcy Judge. This cause is before the Court on the emergency motion of Abbey National Treasury Services PLC ("Abbey National") for modification of an interim order entered by the Court on December 29, 2000. That order permitted LTV Steel Company, Inc., Debtor and Debtor-in-Possession in these jointly administered proceedings ("Debtor"), to use cash assets that are claimed to be cash collateral in which Abbey National has an interest. A hearing was held on this matter on January 18, 2001. Richard M. Cieri, Esq. and Bruce Bennett, Esq. appeared on behalf of Debtor. Thomas D. Lambros, Esq., David Spears, Esq. and Lindsee P. Granfield, Esq. appeared on behalf of Abbey National. This is a core proceeding over which the Court has jurisdiction pursuant to 28 USC § 157(b)(2)(M) and (O). The following constitutes the Court's findings of fact and conclusions of law pursuant to Fed. R. Bankr. P. 7052.

Debtor is one of the largest manufacturers of wholly-integrated steel products in the United States. Debtor mainly produces flat rolled steel products, hot and cold rolled sheet metal, mechanical and structural tubular products, and bimetallic wire. Debtor currently employs approximately 17,500 people in various capacities, and Debtor is also responsible for providing medical coverage and other benefits to approximately 100,000 retirees and their dependents. Debtor and 48 of its subsidiaries filed voluntary petitions for relief under Chapter 11 of Title 11, United States Code, on December 29, 2000. These cases are jointly administered.

This is not the first occasion on which Debtor has filed for relief under the Bankruptcy Code. Debtor previously filed a voluntary Chapter 11 petition in the Bankruptcy Court for the Southern District of New York on July 17, 1986. Debtor successfully emerged from Chapter 11 on June 28, 1993. Indeed, the current controversy stems from a series of financial transactions that Debtor executed after its previous reorganization. The transactions in question are known as asset-backed securitization or structured financing ("ABS"), and are generally designed to permit a debtor to borrow funds at a reduced cost in exchange for a lender securing the loan with assets that are transferred from the borrower to another entity. By structuring the transactions in this manner, the lender hopes to ensure that its collateral will be excluded from the borrower's bankruptcy estate in the event that the borrower files a bankruptcy petition.

Abbey National is a large financial institution located in the United Kingdom. Debtor and Abbey National entered into an ABS transaction in October 1994. To effectuate this agreement, Debtor created a wholly-owned subsidiary known as LTV Sales Finance Co. ("Sales Finance"). Debtor then entered into an agreement with Sales Finance which purports to sell all of Debtor's right and interest in its accounts receivables ("receivables") to Sales Finance on a continuing basis. Abbey National then agreed to loan Two Hundred Seventy Million Dollars ($270,000,000.00) to Sales Finance in exchange for Sales Finance granting Abbey National a security interest in the receivables. On the date Debtor's petition was filed, Chase Manhattan Bank ("Chase Manhattan") was Abbey National's agent for this credit facility.

In 1998, Debtor entered into another ABS financing arrangement. To that end, Debtor created LTV Steel Products, LLC ("Steel Products"), another wholly-owned subsidiary. Debtor entered into an agreement with Steel Products which purports to sell all of Debtor's right, title and interest in its inventory to Steel Products on a continuing basis. Chase Manhattan and several other banking institutions then agreed to loan Thirty Million Dollars ($30,000,000.00) to Steel Products in exchange for a security interest in Steel Products' inventory. Abbey National is not involved in this ABS facility, and it had no interest in pre-petition inventory allegedly owned by Steel Products.

Neither Sales Finance nor Steel Products is a debtor in this proceeding. Nevertheless, Debtor filed a motion with the Court on December 29, 2000 seeking an interim order permitting it to use cash collateral. This cash collateral consisted of the receivables and inventory that are ostensibly owned by Sales Finance and Steel Products. Debtors stated to the Court that it would be forced to shut it doors and cease operations if it did not receive authorization to use this cash collateral. A hearing was held on Debtor's cash collateral motion on December 29, 2000 as part of the first day hearings.

Abbey National was not present at the cash collateral hearing. However, the Court notes that Abbey National had actual notice of the hearing, first, in the form of an e-mail sent by a Chase Manhattan employee to Abbey National on December 28, 2000, and second, in the form of a telephone call made from a Chase Manhattan employee to Abbey National on December 29, 2000. Furthermore, it is clear that Debtor had given advance notice of its intention to file for bankruptcy protection to Chase Manhattan, Abbey National's agent, in the week prior to December 29, 2000. Chase Manhattan was present at the December 29, 2000 hearing.

On December 29, 2000, Debtor and Chase Manhattan reached an agreement regarding an interim order permitting Debtor to use the cash collateral. Chase Manhattan did not formally consent to the entry of this order, as it could not secure Abbey National's consent to the form of the order, but Chase Manhattan did negotiate some of the terms of the order and did not raise an objection to its entry by the Court. The Court determined that entry of the interim order was necessary to permit Debtor to continue business operations, that the interests of Abbey National and all other creditors who had an interest in the cash collateral were adequately protected by the order, and that entry of the order was in the best interests of the estate and creditors of the estate. Accordingly, the Court entered the order tendered by Debtor, the relevant provisions of which are summarized below:

1. Recognition that there is a dispute between Debtor and the secured lenders of Sales Finance and Steel Products as to whether the transactions between Debtor and those entities were true sales or disguised financing vehicles;

2. An order requiring the secured lenders to turn over to Debtor the cash proceeds of the inventory and receivables which are to be used to provide working capital for Debtor;

3. Recognition that in the event the Court determines these transactions to be true sales, the secured lenders whose cash collateral was used will be entitled to administrative expense claims against the estate;

4. Adequate protection was provided to the secured lenders in the form of senior liens on the inventory and receivables and weekly interest payments to the lenders at pre-petition non-default rates.

It is this order that Abbey National seeks to modify. Specifically, Abbey National asks the Court to modify the interim cash collateral order *nunc pro tunc* to include the following provisions:

a. The Debtors shall transfer to Sales Finance all receivables created on or after December 29, 2000 and not previously sold to Sales Finance and that would have been sold to Sales Finance were it not for the occurrence of a Liquidation Event;

b. Steel Products would continue to purchase Inventory from the Inventory Sellers and Sales Finance would continue to purchase Receivables from the Receivables Sellers, each on the same basis and on the same terms as existed prior to the Petition Date;

c. The respective Collection Accounts would be administered by the Collateral Agent in the same manner as was administered prior to the Petition Date. Therefore, notwithstanding the occurrence of any Termination Date, collection on account of the Receivables would not be required to be applied to principal payments or amortization payments (other than any payments required in connection with the maintenance by the borrowers of their respective borrowing bases);

d. Steel Products and the Collateral Agent under the Inventory Facility would continue to automatically release all liens against the Receivables purchased by Sales Finance from Steel Products;

e. All minimum borrowing base and collateral value requirements set forth in the Receivables Facility and the Inventory Facility will continue in full force and effect;

f. In all other respects, the Receivables Facility and the Inventory Facility will continue to operate as required after the occurrence of a Liquidation Event including without limitation, the reimbursement of all expenses of each Receivables Lender and Inventory Lender.

(Abbey National's Emergency Motion to Modify Interim Order at 14-16).

Abbey National argues that the interim cash collateral order should be modified because *** there is no basis for the Court to determine that the receivables which are Abbey National's collateral are property of Debtor's estate ***.

*** Abbey National's next argument is that the receivables which constitute its collateral are not property of Debtor's estate, and thus this Court lacked jurisdiction to enter the interim order. We shall construe this as an argument that the interim order is void pursuant to Rule 60(b)(4).

Section 541(a) of the Bankruptcy Code provides that upon the filing of a bankruptcy petition an estate is created consisting of "all legal or equitable interests of the debtor in property as of the commencement of the case." § 541(a)(1). The estate created by the filing of a Chapter 11 petition is very broad, and property may be included in Debtor's estate even if Debtor does not have a possessory interest in that property. *United States v. Whiting Pools, Inc.*, 462 U.S. 198, 204, 205-06 (1983).

Abbey National contends that the interim order is flawed because, on its face, the transaction between Debtor and Sales Finance is characterized as a true sale. Therefore, Abbey National argues, since Debtor sold its interests in the receivables to Sales Finance, Debtor no longer has an interest in the receivables and they are not property of the estate. However, Abbey National has admitted to the Court, both in its pleadings and in oral argument, that the ultimate issue of whether Debtor actually sold the receivables to Sales Finance is a fact-intensive issue that cannot be resolved without extensive discovery and an evidentiary hearing.

We find Abbey National's argument for "emergency" relief to be not well taken for several reasons. First, Abbey National's position in this regard is circular: we cannot permit Debtor to use cash collateral because it is not property of the estate, but we cannot determine if it is property of the estate until we hold an evidentiary hearing. We fail to see how we can conclude that the receivables are not property of Debtor's estate until an evidentiary hearing on that issue has been held. Because the determination of this issue must await further discovery, we decline to grant Abbey National relief from the interim order.

Furthermore, there seems to be an element of sophistry to suggest that Debtor does not retain at least an *equitable* interest in the property that is subject to the interim order. Debtor's business requires it to purchase, melt, mold and cast various metal products. To suggest that Debtor lacks some ownership interest in products that it creates with its own labor, as well as the proceeds to be derived from that labor, is difficult to accept. Accordingly, the Court concludes that Debtor has at least some equitable interest in the inventory and receivables, and that this interest is property of the Debtor's estate. This equitable interest is sufficient to support the entry of the interim cash collateral order.

Finally, it is readily apparent that granting Abbey National relief from the interim cash collateral order would be highly inequitable. The Court is satisfied that the entry of the interim order was necessary to enable Debtor to keep its doors open and continue to meet its obligations to its employees, retirees, customers and creditors. Allowing Abbey National to modify the order would allow Abbey National to enforce its state law rights as a secured lender to look to the collateral in satisfaction of this debt. This circumstance would put an immediate end to Debtor's business, would put thousands of people out of work, would deprive 100,000 retirees of needed medical benefits, and would have more far reaching economic effects on the geographic areas where Debtor does business. However, maintaining the current status quo permits Debtor to remain in business while it searches for substitute financing, and adequately protects and preserves Abbey National's rights. The equities of this situation highly favor Debtor. As a result, the Court declines to exercise its discretion to modify the interim order pursuant to Rule 60(b)(4). ***

For the reasons stated above, the Court concludes that Abbey National's motion seeking to modify the Court's interim order permitting the use of cash collateral on December 29, 2000 is properly characterized as a motion seeking relief from judgment pursuant to Fed. R. Civ. P. 60(b). Furthermore, the Court finds that Abbey National has failed to establish that modification of the interim order is warranted. Accordingly, Abbey National's emergency motion is overruled.

An appropriate order shall enter.

Ohio v. Kovacs

469 U.S. 274 (1985)

Justice WHITE delivered the opinion of the Court: Petitioner State of Ohio obtained an injunction ordering respondent William Kovacs to clean up a hazardous waste site. A receiver was subsequently appointed. Still later, Kovacs filed a petition for bankruptcy. The question before us is whether, in the circumstances present here, Kovacs' obligation under the injunction is a "debt" or "liability on a claim" subject to discharge under the Bankruptcy Code.

I

Kovacs was the chief executive officer and stockholder of Chem-Dyne Corp., which with other business entities operated an industrial and hazardous waste disposal site in Hamilton, Ohio. In 1976, the State sued Kovacs and the business entities in state court for polluting public waters, maintaining a nuisance, and causing fish kills, all in violation of state environmental laws. In 1979, both in his individual capacity and on behalf of Chem-Dyne, Kovacs signed a stipulation and judgment entry settling the lawsuit. Among other things, the stipulation enjoined the defendants from causing further pollution of the air or public waters, forbade bringing additional industrial wastes onto the site, required the defendants to remove specified wastes from the property, and ordered the payment of $75,000 to compensate the State for injury to wildlife.

Kovacs and the other defendants failed to comply with their obligations under the injunction. The State then obtained the appointment in state court of a receiver, who was directed to take possession of all property and other assets of Kovacs and the corporate defendants and to implement the judgment entry by cleaning up the Chem-Dyne site. The receiver took possession of the site but had not completed his tasks when Kovacs filed a personal bankruptcy petition.[1]

Seeking to develop a basis for requiring part of Kovacs' postbankruptcy income to be applied to the unfinished task of the receivership, the State then filed a motion in state court to discover Kovacs' current income and assets. Kovacs requested that the Bankruptcy Court stay those proceedings, which it did. The State also filed a complaint in the Bankruptcy Court seeking a declaration that Kovacs' obligation under the stipulation and judgment order to clean up the Chem-Dyne site was not dischargeable in bankruptcy because it was not a "debt," a liability on a "claim," within the meaning of the Bankruptcy Code. In addition, the complaint sought an injunction against the bankruptcy trustee to restrain him from pursuing any action to recover assets of Kovacs in the hands of the receiver. The Bankruptcy Court ruled against Ohio, as did the District Court. The Court of Appeals for the Sixth Circuit affirmed, holding that Ohio essentially sought from Kovacs only a monetary payment and that such a required payment was a liability on a claim that was dischargeable under the bankruptcy statute. We granted certiorari to determine the dischargeability of Kovacs' obligation under the affirmative injunction entered against him. ***

[1] Kovacs originally filed a reorganization petition under Chapter 11 of the Bankruptcy Code, 11 USC § 1101 *et seq.*, but converted the petition to a liquidation bankruptcy under Chapter 7. See 11 USC § 1112.

III

Except for the nine kinds of debts saved from discharge by 11 USC § 523(a), a discharge in bankruptcy discharges the debtor from all debts that arose before bankruptcy. § 727(b). It is not claimed here that Kovacs' obligation under the injunction fell within any of the categories of debts excepted from discharge by § 523. Rather, the State submits that the obligation to clean up the Chem-Dyne site is not a debt at all within the meaning of the bankruptcy law.

For bankruptcy purposes, a debt is a liability on a claim. § 101(11). A claim is defined by § 101(4) as follows:

> "(4) 'claim' means—
>
> > "(A) right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured; or
> >
> > "(B) right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured."

The provision at issue here is § 101(4)(B). For the purposes of that section, there is little doubt that the State had the right to an equitable remedy under state law and that the right has been reduced to judgment in the form of an injunction ordering the cleanup. The State argues, however, that the injunction it has secured is not a claim against Kovacs for bankruptcy purposes because (1) Kovacs' default was a breach of the statute, not a breach of an ordinary commercial contract which concededly would give rise to a claim; and (2) Kovacs' breach of his obligation under the injunction did not give rise to a right to payment within the meaning of § 101(4)(B). We are not persuaded by either submission.

There is no indication in the language of the statute that the right to performance cannot be a claim unless it arises from a contractual arrangement. The State resorted to the courts to enforce its environmental laws against Kovacs and secured a negative order to cease polluting, an affirmative order to clean up the site, and an order to pay a sum of money to recompense the State for damage done to the fish population. Each order was one to remedy an alleged breach of Ohio law; and if Kovacs' obligation to pay $75,000 to the State is a debt dischargeable in bankruptcy, which the State freely concedes, it makes little sense to assert that because the cleanup order was entered to remedy a statutory violation, it cannot likewise constitute a claim for bankruptcy purposes. ***

The courts below also found little substance in the submission that the cleanup obligation did not give rise to a right to payment that renders the order dischargeable under § 727. The definition of "claim" in H.R. 8200 as originally drafted would have deemed a right to an equitable remedy for breach of performance a claim even if it did not give rise to a right to payment. The initial Senate definition of claim was narrower, and a compromise version, § 101(4), was finally adopted. In that version, the key phrases "equitable remedy," "breach of performance," and "right to payment" are not defined. See 11 USC § 101. Nor are the differences between the successive versions explained. The legislative history offers only a statement by the sponsors of the Bankruptcy Reform Act with respect to the scope of the provision:

> "Section 101(4)(B) ... is intended to cause the liquidation or estimation of contingent rights of payment for which there may be an alternative equitable remedy with the result that the equitable remedy will be susceptible to being discharged in bankruptcy. For example, in some States, a judgment for specific performance may be satisfied by an alternative right to payment in the event performance is refused; in that event, the creditor entitled to specific performance would have a 'claim' for purposes of a proceeding under title 11."[8]

We think the rulings of the courts below were wholly consistent with the statute and its legislative history, sparse as it is. The Bankruptcy Court ruled as follows, *In re Kovacs,* 29 B.R., at 818:

> "There is no suggestion by plaintiff that defendant can render performance under the affirmative obligation other than by the payment of money. We therefore conclude that plaintiff has a claim against defendant within the meaning of 11 USC § 101(4), and that defendant owes plaintiff a debt within the meaning of 11 USC § 101(11). Furthermore, we have concluded that that debt is dischargeable."

The District Court affirmed ***. The Court of Appeals also affirmed, rejecting the State's insistence that it had no right to, and was not attempting to enforce, an alternative right to payment:

> "Ohio does not suggest that Kovacs is capable of personally cleaning up the environmental damage he may have caused. Ohio claims there is no alternative right to payment, but when Kovacs failed to perform, state law gave a state receiver total control over all Kovacs' assets. Ohio later used state law to try and discover Kovacs' post-petition income and employment status in an apparent attempt to levy on his future earnings. In reality, the only type of performance in which Ohio is now interested is a money payment to effectuate the Chem-Dyne cleanup.
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> * * *
>
> "The impact of its attempt to realize upon Kovacs' income or property cannot be concealed by legerdemain or linguistic gymnastics. Kovacs cannot personally clean up the waste he wrongfully released into Ohio waters. He cannot perform the affirmative obligations properly imposed upon him by the State court except by paying money or transferring over his own financial resources. The State of Ohio has acknowledged this by its steadfast pursuit of payment as an alternative to personal performance." 717 F.2d, at 987- 988.

As we understand it, the Court of Appeals held that, in the circumstances, the cleanup duty had been reduced to a monetary obligation.

We do not disturb this judgment. The injunction surely obliged Kovacs to clean up the site. But when he failed to do so, rather than prosecute Kovacs under the environmental laws or bring civil or criminal contempt proceedings, the State secured the appointment

[8] 124 Cong.Rec. 32393 (1978) (remarks of Rep. Edwards); see also *id.,* at 33992 (remarks of Sen. DeConcini).

of a receiver, who was ordered to take possession of all of Kovacs' nonexempt assets as well as the assets of the corporate defendants and to comply with the injunction entered against Kovacs. As wise as this course may have been, it dispossessed Kovacs, removed his authority over the site, and divested him of assets that might have been used by him to clean up the property. Furthermore, when the bankruptcy trustee sought to recover Kovacs' assets from the receiver, the latter sought an injunction against such action. Although Kovacs had been ordered to "cooperate" with the receiver, he was disabled by the receivership from personally taking charge of and carrying out the removal of wastes from the property. What the receiver wanted from Kovacs after bankruptcy was the money to defray cleanup costs. At oral argument in this Court, the State's counsel conceded that after the receiver was appointed, the only performance sought from Kovacs was the payment of money. Had Kovacs furnished the necessary funds, either before or after bankruptcy, there seems little doubt that the receiver and the State would have been satisfied. On the facts before it, and with the receiver in control of the site,[10] we cannot fault the Court of Appeals for concluding that the cleanup order had been converted into an obligation to pay money, an obligation that was dischargeable in bankruptcy.

IV

It is well to emphasize what we have not decided. First, we do not suggest that Kovacs' discharge will shield him from prosecution for having violated the environmental laws of Ohio or for criminal contempt for not performing his obligations under the injunction prior to bankruptcy. Second, had a fine or monetary penalty for violation of state law been imposed on Kovacs prior to bankruptcy, § 523(a)(7) forecloses any suggestion that his obligation to pay the fine or penalty would be discharged in bankruptcy. Third, we do not address what the legal consequences would have been had Kovacs taken bankruptcy before a receiver had been appointed and a trustee had been designated with the usual duties of a bankruptcy trustee. Fourth, we do not hold that the injunction against bringing further toxic wastes on the premises or against any conduct that will contribute to the pollution of the site or the State's waters is dischargeable in bankruptcy; we here address, as did the Court of Appeals, only the affirmative duty to clean up the site and the duty to pay money to that end. Finally, we do not question that anyone in possession of the site—whether it is Kovacs or another in the event the receivership is liquidated and the trustee abandons the property, or a vendee from the receiver or the bankruptcy trustee—must comply with the environmental laws of the State of Ohio. Plainly, that person or firm may not maintain a nuisance, pollute the waters of the State, or refuse to remove the source of such conditions. As the case comes to us, however, Kovacs has been dispossessed and the State seeks to enforce his cleanup obligation by a money judgment.

The judgment of the Court of Appeals is

Affirmed.

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[10] We were advised at oral argument that the receiver at that time was still in possession of the site, although he was contemplating terminating the receivership. We were also advised that it was difficult to tell exactly who owned the property at 500 Ford Boulevard and that although the trustee did not formally abandon the property, he did not seek to take possession of it.

Justice O'CONNOR, concurring: I join the Court's opinion and agree with its holding that the cleanup order has been reduced to a monetary obligation dischargeable as a "claim" under § 727 of the Bankruptcy Code. I write separately to address the petitioner's concern that the Court's action will impede States in enforcing their environmental laws.

To say that Kovacs' obligation in these circumstances is a claim dischargeable in bankruptcy does not wholly excuse the obligation or leave the State without any recourse against Kovacs' assets to enforce the order. Because "Congress has generally left the determination of property rights in the assets of a bankrupt's estate to state law," *Butner v. United States,* 440 U.S. 48, 54 (1979), the classification of Ohio's interest as either a lien on the property itself, a perfected security interest, or merely an unsecured claim depends on Ohio law. That classification—a question not before us—generally determines the priority of the State's claim to the assets of the estate relative to other creditors. Cf. 11 USC § 545 (trustee may avoid statutory liens only in specified circumstances). Thus, a State may protect its interest in the enforcement of its environmental laws by giving cleanup judgments the status of statutory liens or secured claims.

The Court's holding that the cleanup order was a "claim" within the meaning of § 101(4) also avoids potentially adverse consequences for a State's enforcement of its order when the debtor is a corporation, rather than an individual. In a Chapter 7 proceeding under the Bankruptcy Code, a corporate debtor transfers its property to a trustee for distribution among the creditors who hold cognizable claims, and then generally dissolves under state law. Because the corporation usually ceases to exist, it has no postbankruptcy earnings that could be utilized by the State to fulfill the cleanup order. The State's only recourse in such a situation may well be its "claim" to the prebankruptcy assets.

For both these reasons, the Court's holding today cannot be viewed as hostile to state enforcement of environmental laws.

Epstein v. Official Committee of Unsecured Creditors (In re Piper Aircraft Corp.)

58 F.3d 1573 (11th Cir. 1995)

BLACK, Circuit Judge: This is an appeal by David G. Epstein, as the Legal Representative for the Piper future claimants (Future Claimants), from the district court's order of June 6, 1994, affirming the order of the bankruptcy court entered on December 6, 1993. The sole issue on appeal is whether the class of Future Claimants, as defined by the bankruptcy court, holds claims against the estate of Piper Aircraft Corporation (Piper), within the meaning of § 101(5) of the Bankruptcy Code. After review of the relevant provisions, policies and goals of the Bankruptcy Code and the applicable case law, we hold that the Future Claimants do not have claims as defined by § 101(5) and thus affirm the opinion of the district court. ***

Piper has been manufacturing and distributing general aviation aircraft and spare parts throughout the United States and abroad since 1937. Approximately 50,000 to 60,000 Piper aircraft still are operational in the United States. Although Piper has been a named defendant in several lawsuits based on its manufacture, design, sale, distribution and support of its aircraft and parts, it has never acknowledged that its products are harmful or defective.

On July 1, 1991, Piper filed a voluntary petition under Chapter 11 of Bankruptcy Code in the United States Bankruptcy Court for the Southern District of Florida. Piper's plan of reorganization contemplated finding a purchaser of substantially all of its assets or obtaining investments from outside sources, with the proceeds of such transactions serving to fund distributions to creditors. On April 8, 1993, Piper and Pilatus Aircraft Limited signed a letter of intent pursuant to which Pilatus would purchase Piper's assets. The letter of intent required Piper to seek the appointment of a legal representative to represent the interests of future claimants by arranging a set-aside of monies generated by the sale to pay off future product liability claims.

On May 19, 1993, the bankruptcy court appointed Appellant Epstein as the legal representative for the Future Claimants. The Court defined the class of Future Claimants to include:

> All persons, whether known or unknown, born or unborn, who may, after the date of confirmation of Piper's Chapter 11 plan of reorganization, assert a claim or claims for personal injury, property damages, wrongful death, damages, contribution and/or indemnification, based in whole or in part upon events occurring or arising after the Confirmation Date, including claims based on the law of product liability, against Piper or its successor arising out of or relating to aircraft or parts manufactured and sold, designed, distributed or supported by Piper prior to the Confirmation Date.

This Order expressly stated that the court was making no finding on whether the Future Claimants could hold claims against Piper under § 101(5) of the Code.

On July 12, 1993, Epstein filed a proof of claim on behalf of the Future Claimants in the approximate amount of $100,000,000. The claim was based on statistical assumptions regarding the number of persons likely to suffer, after the confirmation of a reorganization plan, personal injury or property damage caused by Piper's pre-confirmation manufacture, sale, design, distribution or support of aircraft and spare parts. The Official Committee of Unsecured Creditors (Official Committee), and later Piper, objected to the claim on the ground that the Future Claimants do not hold § 101(5) claims against Piper. ***

Under the Bankruptcy Code, only parties that hold preconfirmation claims have a legal right to participate in a Chapter 11 bankruptcy case and share in payments pursuant to a Chapter 11 plan. 11 USCA. §§ 101(10), 501, 502. In order to determine if the Future Claimants have such a right to participate, we first must address the statutory definition of the term "claim." The Bankruptcy Code defines claim as

> (A) right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured; or (B) right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured.

11 USCA. § 101(5). The legislative history of the Code suggests that Congress intended to define the term claim very broadly under § 101(5), so that "all legal obligations of the debtor, no matter how remote or contingent, will be able to be dealt with in the bankruptcy case." H.R. Rep. No. 595, 95th Cong., 2d Sess. 309 (1978), reprinted in 1978 USCC.A.N. 5787, 5963, 6266.

Since the enactment of § 101(5), courts have developed several tests to determine whether certain parties hold claims pursuant to that section: the accrued state law claim test,[2] the conduct test, and the prepetition relationship test. The bankruptcy court and district court adopted the prepetition relationship test in determining that the Future Claimants did not hold claims pursuant to § 101(5).

Epstein primarily challenges the district court's application of the prepetition relationship test. He argues that the conduct test, which some courts have adopted in mass tort cases,[3] is more consistent with the text, history, and policies of the Code.[4] Under the conduct test, a right to payment arises when the conduct giving rise to the alleged liability occurred. See A.H. Robins, 839 F.2d at 199. Epstein's position is that any right to payment arising out of the prepetition conduct of Piper, no matter how remote, should be deemed a claim and provided for, pursuant to § 101(5), in this case. He argues that the relevant conduct giving rise to the alleged liability was Piper's prepetition manufacture, design, sale and distribution of allegedly defective aircraft. Specifically, he contends that, because Piper performed these acts prepetition, the potential victims, although not yet identifiable, hold claims under § 101(5) of the Code.

The Official Committee and Piper dispute the breadth of the definition of claim asserted by Epstein, arguing that the scope of claim cannot extend so far as to include unidentified, and presently unidentifiable, individuals with no discernible prepetition relationship to Piper. Recognizing, as Appellees do, that the conduct test may define claim too broadly in certain circumstances, several courts have recognized "claims" only for those individuals with some type of prepetition relationship with the debtor. See In re Jensen, 995 F.2d 925, 929-31 (9th Cir. 1993); In re Chateaugay Corp., 944 F.2d 997, 1003-04 (2d Cir. 1991). The prepetition relationship test, as adopted by the bankruptcy court and district court, requires "some prepetition relationship, such as contact, expo-

[2] The accrued state law claim theory states that there is no claim for bankruptcy purposes until a claim has accrued under state law. The most notable case adopting this approach is the Third Circuit's decision in In re: M. Frenville Co., 744 F.2d 332 (3d Cir. 1984). This test since has been rejected by a majority of courts as imposing too narrow an interpretation on the term claim. See e.g., Grady v. A.H. Robins Co., 839 F.2d 198, 201 (4th Cir. 1986). We agree with these courts and decline to employ the state law claim theory.

[3] See, e.g., A.H. Robins Co., 839 F.2d at 203 (Dalkon Shield).

[4] Epstein claims that the prepetition relationship test, by requiring identifiability of claimants, eliminates the words "contingent," "unmatured," "unliquidated," and "disputed" from the statute. He further argues that requiring a prepetition relationship is contrary to the Congressional objective that bankruptcy permit a complete settlement of the affairs of the debtor and a complete discharge and fresh start, as the claims of those persons whose injuries become manifest after the petition is filed could prove a drain on the reorganized debtor's assets for years to come.

sure, impact, or privity, between the debtor's prepetition conduct and the claimant" in order for the claimant to hold a § 101(5) claim.

Upon examination of the various theories, we agree with Appellees that the district court utilized the proper test in deciding that the Future Claimants did not hold a claim under § 101(5). Epstein's interpretation of "claim" and application of the conduct test would enable anyone to hold a claim against Piper by virtue of their potential future exposure to any aircraft in the existing fleet. Even the conduct test cases, on which Epstein relies, do not compel the result he seeks. In fact, the conduct test cases recognize that focusing solely on prepetition conduct, as Epstein espouses, would stretch the scope of § 101(5). Accordingly, the courts applying the conduct test also presume some prepetition relationship between the debtor's conduct and the claimant. See A.H. Robins, 839 F.2d at 203.

While acknowledging that the district court's test is more consistent with the purposes of the Bankruptcy Code than is the conduct test supported by Epstein, we find that the test as set forth by the district court unnecessarily restricts the class of claimants to those who could be identified prior to the filing of the petition. Those claimants having contact with the debtor's product post-petition but prior to confirmation also could be identified, during the course of the bankruptcy proceeding, as potential victims, who might have claims arising out of debtor's prepetition conduct.

We therefore modify the test used by the district court and adopt what we will call the "Piper test" in determining the scope of the term claim under § 101(5):

> an individual has a § 101(5) claim against a debtor manufacturer if (i) events occurring before confirmation create a relationship, such as contact, exposure, impact, or privity, between the claimant and the debtor's product; and (ii) the basis for liability is the debtor's prepetition conduct in designing, manufacturing and selling the allegedly defective or dangerous product. The debtor's prepetition conduct gives rise to a claim to be administered in a case only if there is a relationship established before confirmation between an identifiable claimant or group of claimants and that prepetition conduct.[5]

In the instant case, it is clear that the Future Claimants fail the minimum requirements of the Piper test. There is no preconfirmation exposure to a specific identifiable defective product or any other preconfirmation relationship between Piper and the broadly defined class of Future Claimants. As there is no preconfirmation connection established between Piper and the Future Claimants, the Future Claimants do not hold a § 101(5) claim arising out of Piper's prepetition design, manufacture, sale, and distribution of allegedly defective aircraft.

For the foregoing reasons, we hold that the Future Claimants do not meet the threshold requirements of the Piper test and, as a result, do not hold claims as defined in § 101(5) of the Bankruptcy Code. ***

[5] This modified test was set forth by the bankruptcy court in a related case, In re: Piper Aircraft Corp., 169 B.R. 766 (Bankr. S.D. Fla. 1994). By changing the focal point of the relationship from the petition date to the confirmation date, the test now encompasses those with injuries occurring post-petition but pre-confirmation, consistent with the policies underlying the Bankruptcy Code.

Moore v. Bay

284 U.S. 4 (1931)

Mr. Justice HOLMES delivered the opinion of the court: The bankrupt executed a mortgage of automobiles, furniture, showroom, and shop equipment that is admitted to be bad as against creditors who were such at the date of the mortgage, and those who became such between the date of the mortgage and that on which it was recorded, there having been a failure to observe the requirements of the Civil Code of California, § 3440. The question raised is whether the mortgage is void also as against those who gave the bankrupt credit at a later date, after the mortgage was on record. The Circuit Court of Appeals affirmed an order of the District Judge giving the mortgage priority over the last creditors. Whether the court was right must be decided by the Bankruptcy Act, since it is superior to all state laws upon the subject. Globe Bank v. Martin, 236 U. S. 288, 298

The trustee in bankruptcy gets the title to all property which has been transferred by the bankrupt in fraud of creditors or which prior to the petition he could by any means have transferred, or which might have been levied upon and sold under judicial process against him. Act of July 1, 1898, c. 541, § 70. By section 67a, claims which for want of record or for other reasons would not have been valid liens as against the claims of the creditors of the bankrupt shall not be liens against his estate. The rights of the trustee by subrogation are to be enforced for the benefit of the estate. The Circuit Courts of Appeal seem generally to agree, as the language of the Bankruptcy Act appears to us to imply very plainly, that what thus is recovered for the benefit of the estate is to be distributed in 'dividends of an equal per centum * * * on all allowed claims, except such as have priority or are secured.' Bankruptcy Act, § 65.

Decree reversed.

In re W.R. Grace & Co.

281 B.R. 852 (Bankr. D. Del. 2002)

WOLIN, District Judge: This matter has been opened before the Court upon the parties' application for an *in limine* ruling on the choice of law and the legal standards to be applied at trial to determine the solvency of the debtor, defendant W.R. Grace & Co. in this fraudulent conveyance adversary proceeding. The Court has reviewed the submissions and heard the oral arguments of counsel. For the reasons set forth below, the Court will grant an *in limine* ruling and hold that there is no conflict between the laws of the various jurisdictions proposed and the Court will apply the Uniform Fraudulent Transfer Act ("UFTA") to the proceedings. The Court will further grant an *in limine* ruling and hold that, subject to certain conditions and findings identified in this Opinion, an asbestos claim filed after the transfer date may be considered in determining the debtor's solvency in this case under section 5 of the UFTA.

BACKGROUND

These adversary proceedings involve allegations of fraudulent conveyance, including the conveyance of a former division of the debtor W.R. Grace-Conn to the entity now known as Sealed Air Corporation in March 1998. *** The complaint invokes the authority of 11 USC § 544(b) which permits an action to avoid a transfer of an interest that would be avoidable under applicable law by a creditor. Plaintiffs do not base their claim upon the fraudulent transfer section of the bankruptcy code, 11 USC § 548. Instead, the complaint stakes its claim on other "applicable law," including without limitation the UFTA, which is in force in the majority of the states. It will be relevant to the discussion to follow to note, therefore, that the claims at bar are state-law causes of action authorized and incorporated into the bankruptcy proceeding by Title 11.

1. Choice of Law

The parties have spent little of their energies arguing the correct choice of law. Plaintiffs argue that New Jersey law controls; defendant Sealed Air argues that Delaware law should govern. However, no party has advanced any material difference between the law of the potential fora. Both have enacted versions of the UFTA that are identical in relevant part.

Applying basic choice of law principles, plaintiff makes the stronger case that New Jersey law should be applied were there any true conflict. That is the state where Sealed Air is located. W.R. Grace has its offices in Florida, but no party has urged that Florida law should apply. The Court notes that Florida too has enacted the UFTA. Delaware's only contact with this matter is that it is the state of incorporation of the transferee and the subsidiary that is the subject of this fraudulent transfer action. The state of incorporation may be an important contact where the issue is internal corporate governance, but that is not the situation here.

Therefore, for the record, the Court finds that New Jersey law is most properly applied to this matter. Because there is no true conflict of laws, the Court will rely on the UFTA and treat as persuasive authorities from each of the UFTA jurisdictions.

2. The UFTA

a. The Statutory Language

At the outset, there appears to be some confusion in the arguments of counsel regarding which section or sections of the UFTA are at play here in light of the Court's limitation of the issue to constructive fraudulent conveyance. Section 4(a)(1) states that a transfer is fraudulent "if the debtor made the transfer or incurred the obligation ... with actual intent to hinder, delay or defraud any creditor of the debtor." This is obviously the definition of actual fraud, not constructive fraud, and to avoid premature expenditure of resources on this branch of the case the Court barred discovery into the parties' intent.

There are two sections of the UFTA that arguably may be considered "constructive fraudulent transfer" provisions, section 4(a)(2) and section 5(a). Each involves a two-element test. The first element is common to both; the debtor did not receive reasonably equivalent value in the accused transaction. The second element deals generally with the debtor's insolvency, but varies between the two sections. Section 4(a)(2) provides that a transfer is fraudulent if the debtor does not "receiv[e] a reasonably equivalent value" and the debtor

> (i) was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; or
>
> (ii) intended to incur, or believed or reasonably should have believed that he [or she] would incur, debts beyond his [or her] ability to pay as they became due.

In section 5, in contrast, the second, insolvency element is stated more simply. A transfer is fraudulent under section 5 if reasonably equivalent value is lacking "and the debtor was insolvent at that time or the debtor became insolvent as a result of the transfer or obligation." Insolvency is defined elsewhere by reference to a strict balance sheet test; a debtor is insolvent if its debts exceed its assets. UFTA § 2.

Plaintiffs believe that the Court's limitation of the September 30 trial to "constructive fraudulent conveyance" means that only section 5 is at issue now. Defendants, by relying on the wording of section 4 in arguing their position on standards, impliedly take the position that both section 4(a)(2) and section 5 fall within the generic term "constructive fraudulent conveyance." As an abstract proposition, the Court agrees. Sections 4(a) and 5 have important differences both in scope and effect and these differences are important to this Opinion. However, both protect creditors from transfers that diminish the value of the debtor's remaining estate, regardless of any truly fraudulent intent. "Constructive" fraudulent conveyance comfortably covers this concept under either section.

But plaintiffs have focused their argument on the definition of insolvency in section 5. For reasons that will appear *infra,* the Court believes that the section 5 definition is the broader of the two. Moreover, if plaintiffs choose to aim solely at section 5 alone, that is the section on which defendants must defend. Therefore, the Court will focus on the standard of insolvency under section 5 in this Opinion, addressing section 4(a)(2) primarily by way of contrast to the broader section.

The essential dispute is this. Defendants contend that the liabilities that should be considered to determine the debtor's solvency on the transaction date are those that were known on that date or those that the debtor reasonably should have known about at that time. Plaintiffs argue that section 5 insolvency is determined by the actual liabilities of the debtor, net of assets. What the debtor may have known about those liabilities on the transfer date, reasonably or otherwise, is not at issue, plaintiffs contend.

The importance of this issue stems from the mass toxic tort nature of the debtor's primary liability. Obviously, by 1998, the harmful nature of asbestos in general and W.R. Grace's asbestos liability in particular were nationally known and had been so for decades. Under defendants theory, W.R. Grace's liabilities in 1998 would include then-existing asbestos claims and a reasonable estimate of claims in the future. Reasonableness, it is argued, would turn on the legitimacy of the method by which the 1998 claiming rate was extrapolated to the future.

Setting aside for the moment the question of extrapolation and its reasonableness, defendants have represented repeatedly that W.R. Grace experienced a substantial increase in asbestos claims after 1998, and that it was this spike in claims that eventually drove the company into bankruptcy. Whether the alleged increase can realistically be characterized as a "spike" need not be accepted as proven truth at this point. According to plaintiffs' figures, the debtor averaged about 31,500 claims per year from 1995 through 1998. In 2000, W.R. Grace received about 48,700 claims, an increase but not one of exponential proportions. It is true that, from 1996 to 1999, claims appear to have steadily declined. However, plaintiffs represent that at least some of that decline is attributable to stand-still agreements, "moritoria," in place from 1997 to 1999 with the leading firms representing claimants. According to plaintiffs, the moritoria prevented the filing of new claims until they began to expire in 2000. This, plaintiffs contend, explains the perceived increase in claims in that year.

The significance of these allegations will be explored later in this Opinion. It suffices now to note that many of the asbestos claims presently pending against W.R. Grace were not formally asserted against the company until after the allegedly fraudulent transfer in 1998. Determining the standard for proving insolvency under section 5 will determine to what extent the post-1998 claims should be considered in calculating W.R. Grace's solvency on the transaction date. The difference in result, depending on which theory is adopted, may be dramatic.

Looking first at the letter of the statute, it is apparent that defendants' position fits neatly with the terms of section 4(a)(2)(ii). If the question is whether the debtor "reasonably should have believed that he [or she] would incur, debts beyond his [or her] ability to pay as they became due," UFTA § 4(a)(2)(ii), then the reasonableness of W.R. Grace's March 1998 estimation of future asbestos claims would be central to the solvency calculation. Likewise the analysis of whether the debtor was undercapitalized following the transfer turns on reasonableness, although no party has raised the undercapitalization prong of section 4(a)(2)(i).

Section 5 makes no mention of the debtors knowledge or reasonableness of estimation in relation to its own insolvency. As framed by the statute, the only question is whether the debtor was insolvent on the transfer date or became insolvent. To the extent defendants would have the Court read reasonable estimation of liabilities into section 5, such an argument would be contrary to one of the most fundamental and universally accepted notions of statutory construction. Section 4 explicitly invokes reasonableness. Section 5 does not. If one limits one's consideration to the literal terms of the statute, the omission of reasonableness from the solvency prong of section 5 must be given effect. The clear implication of the text of the two sections is that solvency under section 5 is to be based upon the objective reality of whether "the debtor was insolvent at that time" and not by reference to what the debtor may have reasonably estimated its liabilities to be.

The question then becomes whether the case law, by way of interpretation, judicial gloss, or policy, would lead to a different result. Relevant case law applying the UFTA context is not plentiful and particularly not in the mass tort context. Therefore, the Court must be guided also by cases interpreting other, similarly worded statutes. The insolvency element of the Bankruptcy Code's constructive fraudulent conveyance section, 11 USC § 548(a)(1)(B)(ii)(I), is very close to the parallel provision in section 5 of the UFTA. Definitional sections, importantly the definitions of "insolvency," "debt" and "claim" are also the same. Making due allowance for differences of purpose and context, the Court will be guided by whatever case law exists interpreting these statutes.

b. The Probability Discount Rule

Defendants rely on a line of cases dealing with contingent liabilities (and assets), many of which contain language that, facially, supports defendants' position. Chief among these cases is *R.M.L., Inc.,* 92 F.3d 139 (3d Cir. 1996), in which Judge Cowen wrote:

> a court looks at the circumstances as they appeared to the debtor and determines whether the debtor's belief that a future event would occur was reasonable. The less reasonable a debtor's belief, the more a court is justified in reducing the assets (or raising liabilities) to reflect the debtor's true financial condition at the time of the alleged transfers.

Id. at 156. In *R.M.L.,* the debtor claimed it was solvent on the transfer date because it had a commitment for a loan that would have saved the company had the funds actually become available. Following the transfer, the loan failed to close and the debtor filed for bankruptcy.

The issue was whether the payment of fees for the loan commitment by the debtor was a fraudulent transfer under the Bankruptcy Code. The lower court, as affirmed by the Court of Appeals, found that the proper measure for valuing contingent assets (or liabilities) was to discount them to present value as of the transfer date by the probability that the contingency will not come to pass and that the asset (or liability) will not be realized.

R.M.L. drew on *In re Xonics Photochemical, Inc.,* 841 F.2d 198 (7th Cir. 1988). While *Xonics* is in fact a case about standing, Judge Posner discussed the question of valuing contingent liabilities for insolvency purposes. The debtor-in-possession argued that when it guaranteed the debt of a corporate affiliate the entire amount of that debt became countable as a liability, although the affiliate did not default on the debt until some time after the accused transaction.

Judge Posner wrote:

> The proposition is absurd; it would mean that every individual or firm that had contingent liabilities greater than his or its net assets was insolvent— something

> no one believes. Every firm that is being sued or that may be sued, every individual who has signed an accommodation note, every bank that has issued a letter of credit, has a contingent liability.

Id. at 199.

Judge Easterbrook seconded this proposition in *Covey v. Commercial Nat'l Bank of Peoria,* 960 F.2d 657, 660 (7th Cir. 1992), writing that "[d]iscounting a contingent liability by the probability of occurrence is good economics and therefore good law, for solvency, the key to § 548(a)(2), is an economic term." It is plain from *R.M.L.* and other cases cited by defendants that the appropriate discount factor is derived from the reasonable foreseeability (as of the transfer date) of the contingency coming to pass.

Defendants read *R.M.L.* differently and point out that the Court of Appeals affirmed the finding below that the loan upon which debtor had placed its hopes had little or no chance of closing as of the transaction date. From this defendants argue that *R.M.L.* stands for the proposition that a finding of insolvency under the UFTA rests on the reasonableness of the debtor's estimation of its own solvency, both with respect to contingent future events *and* then existing financial circumstances.

This is simply not correct. What the lower court held was that, on the transaction date, the debtor was unable to meet certain conditions of closing the loan and, therefore, that the credits carried on its books which depended upon the loan should be ignored. The Third Circuit held that "The bankruptcy court correctly determined that a debtor's creative accounting practices, which have the effect of grossly overstating its financial condition, cannot be the basis of a court's solvency analysis." One may search in vain for any statement that, had the debtor's perception of its solvency on the transaction date been wrong but reasonable, it should have been found to be solvent. On the contrary, the clear thrust of the opinion is that the debtor was insolvent on the transaction date regardless of what it may have thought, reasonably or otherwise.

Only after this finding, did the *R.M.L.* court go on to treat the loan closing as a supposed contingent event. It is not clear that the court needed to do so. However, as noted, the court applied the probability discount rule to the loan closing, and affirmed the essence of the lower court's ruling that because of the prior insolvency of the debtor the probability was zero.

While this Court believes that the contingent event analysis of *R.M.L.* is, at best, a holding in the alternative, it is the branch of the opinion that is most frequently cited, including by defendants here. It is from this branch that the language regarding reasonableness and foreseeability comes. The Court of Appeals said that "a court looks at the circumstances as they appeared to the debtor and determines whether the debtor's belief that a *future* event would occur was reasonable." 92 F.3d at 156 (emphasis added). The panel plainly was not talking about already existing facts and whether the debtor's understanding of them with respect to its solvency was reasonable.

c. The Post-1998 Claims and "Claims" Under the UFTA

For the probability discount rule to apply in this case, however, the Court must find that the post-1998 asbestos claims against W.R. Grace represented a contingent future liability on the date of the transfer. Stating the question more broadly, the Court must first determine whether, and only then how, the post-1998 claims are to be counted as "debts" in the solvency analysis.

The statute defines a debt as a "liability on a claim." UFTA § 1(5). A claim is treated very broadly, as "a right to payment, whether or not the right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured." UFTA § 1(3). Thus the initial question is whether the post-1998 claimants possessed a "right to payment," *i.e.* a "claim" for UFTA solvency purposes, on the transaction date even though they did not assert their claims until later. If so, only then must the Court consider the implication of the defendants' argument that any such claim was contingent as of March 1998.

In re M. Frenville Co., 744 F.2d 332 (3d Cir.), *cert. denied,* 469 U.S. 1160, 105 S.Ct. 911, 83 L.Ed.2d 925 (1985), is the controlling case for what may be considered a claim under the identical language in the Bankruptcy Code, 11 USC § 101(5) (codified at 101(4) when *Frenville* was decided). *** By reference to first principles of bankruptcy law, the *Frenville* court concluded that, in the absence of a federal pronouncement on this point, state law must control when a "right to payment" arises. *** *Frenville* has proved a remarkably unpopular decision and no other Circuit Court of Appeals has followed it. It is widely read to posit an accrual test for bankruptcy claims, as distinguished from a conduct test under which only the conduct giving rise to liability must have occurred to give rise to a claim under the Code. *Frenville* remains the law of this Circuit ***.

There is little case law applying the rationale of *Frenville* in the mass tort context. *** This Court, however, does not believe that looking to accrual for state statute of limitations purposes makes sense when determining the existence of a "right to payment" for solvency purposes under the fraudulent conveyance statute. *** We assume, without deciding, that under certain circumstances a cause of action may withstand a motion to dismiss for failure to state a claim though the action has not "accrued" within the meaning of the relevant statute of limitations and, thus, a cause of action may "exist" before it has "accrued." ***

The Third Circuit's *Schweitzer* opinion, 758 F.2d 936, discussed when a right to payment arises for personal injury due to asbestos exposure ***. *** [C]iting general principles of tort law, the *Schweitzer* panel found that exposure to asbestos was not enough, and that no tort liability arose until the claimant "suffered identifiable, compensable injury." *Id.* at 942.

It is far from clear that all states actually subscribe to the manifestation rule applied *** by the *Schweitzer* court. New Jersey, for example, recognizes a cause of action for medical monitoring based upon simple exposure to toxic materials, *see Ayers v. Jackson Township,* 525 A.2d 287 (1987), at least under specially defined conditions. *See Theer v. Philip Carey Co.,* 628 A.2d 724 (1993). Moreover, the amount of compensable physical harm needed to give rise to a claim will clearly vary from state to state. For example, pleural thickening alone without a showing of functional impairment is sufficient in New Jersey to open up the full panoply of tort remedies for asbestos exposure. *See Mauro v. Raymark Indus., Inc.,* 561 A.2d 257 (1989). *Schweitzer's* rejection of "subclinical injury" as sufficient to establish a *** claim can not directly control in the face of contrary state-law authority, given the rule of *Frenville.*

To continue in rendering this *in limine* opinion, the Court must engage in some reasonable assumptions ahead of the proven facts. It is reasonable to conclude that of the tens of thousands of persons making claims for asbestos personal injury against W.R. Grace after the 1998 transfer date, substantial numbers of them had viable claims against the company prior to that time. Asbestos had not been manufactured or employed in industry for many years prior to 1998 and any person with a post-1998 claim must have been exposed long before the transfer date. That such exposure would lead to long-term, serious, health effects with long latency periods has been common knowledge for twenty to perhaps thirty years.

It may be, under some states' law, that this exposure is enough. However, it must also follow that many, and no doubt a substantial majority, of these persons had some physical manifestation of their exposure, whether they knew it at that time or not. Exposure and physical manifestation doubtless gave the affected person a claim under the laws of most states.

Therefore, and for the reasons stated thus far, these persons had a "right to payment" and thus a claim for purposes of the solvency analysis of the UFTA on the transfer date. To recognize this does not contradict the rule defendants reiterate that solvency must be determined as of the transaction date. It cannot matter that the claimants themselves may have been unaware of their own claim in 1998. The assumption of *Schweitzer,* 758 F.2d at 942, quoted *supra* at 861, is intuitively correct—a cause of action may exist before its owner is aware of it. The UFTA states that a claim is a claim "whether or not the right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured." This expansive language must negate any residual inference that a right to payment must be known and asserted to be a claim.

The Court cannot accept defendants' contention that the post-1998 claims were contingent and thus subject to discounting by the reasonable probability that the contingency would not arise. Third Circuit has defined a contingent claim as one "which the debtor will be called upon to pay only upon the occurrence or happening of an extrinsic event." *Frenville,* 744 F.2d at 336 n. 7. The easy example is the surety case, *see, e.g., Xonics,* in which the obligation is complete, but it is triggered by the default of the third-party guarantee. *R.M.L.* is another; the company collapsed upon the refusal of a bank to close a loan transaction, making certain previously booked credits worthless.

An illustrative counter-example appears in *Grady v. A.H. Robins Co.,* 839 F.2d 198 (4th Cir. 1988), a leading case of those declining to follow *Frenville.* In *Grady,* the panel held that exposure alone gave rise to a claim under the Bankruptcy Code, even though manifestation of injury and thus a state cause of action did not yet exist. The claim was a contingent one, however, and that contingency was the manifestation of a compensable injury. Of course, in this case the Court makes its *in limine* ruling on the assumption either that manifestation had already occurred with respect to the post-1998 claimants or that the relevant state's law does not require manifestation in latent toxic tort cases.

It is difficult to discern what extrinsic event was left to occur as of 1998, to make W.R. Grace liable for asbestos injuries to the post-1998 claimants. *Ex hypothesi,* these persons were already exposed to and injured by W.R. Grace's products. To say that the act of making the claim was the extrinsic event stretches the meaning of that phrase too far; the formal claim is not extrinsic to the underlying liability, nor is it an event creating liability where none existed before. To hold that the making of a formal claim was the contingency upon which W.R. Grace's insolvency was balanced is to hold, in effect, that unknown claims are always contingent.

For the reasons already set forth, the Court rejects the proposition that unknown claims are necessarily contingent. *** At oral argument, the debtor's counsel posited a number of other supposed contingencies upon which, it was argued, claims depend before they become non-contingent, existing claims. These include the gamut of claimant behavior variables, such as delaying a claim past the statute of limitation, claiming against a more solvent target, and simply failing to sustain the burden of proof. Counsel maintained that these complexities mandate the conclusion that any post-1998 claim was contingent on the transfer date.

But just because claims are defeasible through later acts or omissions of the claimants does not mean they were never claims in the sense of being a "right to payment." Moreover, no one suggests that each claim, be it prepost-1998, must be counted at face value without further analysis. As counsel are well aware, large numbers of asbestos tort claims are routinely analyzed and their value estimated by experts on the basis of epidemiology and statistics. The behavioral variables raised by counsel are typically taken into account in this process. That the Court must place a value on the post-1998 claims does not mean that they are not claims nor does it mean that they were merely contingent claims on the transfer date.

Defendants cite language from a number of cases which roundly condemn the use of hindsight in insolvency calculations and endorse reasonable foreseeability of liability as the proper measure. *** The balance of defendants' cases concern truly contingent liabilities. In *R.M.L.,* 92 F.3d 139, a loan failed to close. *Xonics,* 841 F.2d 198, and *Covey,* 960 F.2d 657, involved guarantees by debtors that were triggered by a later default. Judge Easterbrook applied this line of authority in the field of toxic torts, in the following hypothetical

> To disregard the probability that the firm will not be called on to pay is to regard all firms as insolvent all of the time, for all firms face some (remote) contingencies exceeding the value of their assets. A firm's product might prove dangerous, maiming hundreds of customers; all of an air carrier's planes might fall out of the sky, or one of an electric utility's nuclear stations melt down, creating stupendous liabilities; all of an insurer's policyholders might die in the same year, generating obligations that exceed its assets. The probability of such occurrences is low, however, and it therefore makes sense to treat the firms as solvent.

Id. at 659.

This passage proves the rule in this case. W.R. Grace's product had *already* proven dangerous on the transfer date affecting tens of thousands, not hundreds. The post-1998 increase in the claiming rate was not an airplane falling out of the sky nor a melt down in a reactor. Every element of liability was already present and had been for many years. Nor is this akin to all of an insurer's policyholders dying in one year. W.R. Grace's asbestos claimants, pre- and post-transfer, are not all dead, thankfully. But the Court has taken as a working assumption that many, and perhaps all, of the post-1998 claimants had suffered a legally cognizable injury as of the transfer date.

Defendants' argument only works if one accepts their premise that the post-1998 asbestos claimants represented a contingent liability on the transfer date. The Court rejects this. The liability may have been unknown and the best estimates may have erred in projecting who would come forward with a claim of asbestos injury. This does not mean that liability for such claims was contingent. ***

3. The Policy Arguments

Defendants deprecate the approach adopted by the Court, claiming that the claiming rate for asbestos claimants will always fluctuate and that the real liability of the debtor will never be known until approximately 2050 when all asbestos claimants are expected to cease. There are two answers to this point. First, is that the issue must be decided now because it is now that the plaintiffs seek to reach the transferred asset. In any event, to hold that the Court is not bound by the debtor's own reasonable estimation of its solvency does not mean that no-one can make such an estimation. The Court will undertake this burden to the best of its ability, just as it must for unliquidated claims in the bankruptcy-in-chief under 11 USC § 502(c).

Second, the logic of the situation demonstrates that the problem posed by the complexities of the situation is not as acute as defendants suggest. The Court need not determine the exact value of the post-1998 claims. All that must be determined is whether they exceeded the debtor's assets. If the debtor is found to be insolvent, a post-judgment fluctuation in the claiming rate can only make the debtor more insolvent. If the debtor is found to be solvent, plaintiffs will have failed to sustain their burden at time of trial. Defendants will be protected from future fluctuations by the *res judicata* effect of the Court's verdict.

Defendants characterize the view adopted by the Court as a strict liability test, inequitable and unsettling to commercial expectations. In fact, the equities run the other way. The assumed facts in this Opinion picture W.R. Grace sitting in unwitting comfort on the surface at ground zero. The company has debts, very substantial debts, including debts that the company knows it can only estimate, but it reasonably believes it is solvent. The truth, however, is that a subterranean cavern of liability lies just beneath the company's feet. It is at this moment, so plaintiffs allege, that W.R. Grace chooses to transfer away its most profitable division for far less than the division was worth.

This Court does not posit a regime in which any transaction is at the peril of the transferor's insolvency. The rule is that an entity with creditors gives away its assets for less than fair value at the peril that it may be insolvent. The fundamental inquiry in a constructive fraudulent conveyance action is whether the transfer diminished the transferor's estate. If the transferor is solvent, it may diminish its estate without interference from the law. If the transferor is not solvent, the diminishment unfairly harms the transferor's creditors. This is true regardless of the transferor's intent and regardless of whether the transferor knew or should have known of its insolvency.

It is the purpose of the fraudulent conveyance statute to prevent this result. The settled commercial expectations that should be protected are those of the existing creditors, not those of less-than-full-value transferees. Creditors size up the financial responsibility of prospective debtors on the assumption that they will not simply give their assets away, or at least that there will be enough left over for the prospective debtor to satisfy prior liabilities. These considerations have only more force with respect to tort creditors whose choice of debtor is involuntary.

At the hearing, plaintiffs advanced a variant on their earlier argument. Conceding, apparently *arguendo,* that post-transfer information should only be considered to the extent it was reasonable for the debtor to know of that information on the transfer date, plaintiffs posit that the amount of post-transfer asbestos claims was not only unknown, but unknowable. This is, of course, consistent with the defendants' arguments regarding the complexity of estimating the future claiming rate of asbestos injuries.

Where later information is unknowable, plaintiffs argue that the burden of guessing wrong should be placed upon the debtor and its transferee. Defendants' response to this argument can be deduced from their established position. Defendants would contend that the more imponderable the complexities of future asbestos claims, the less likely it is that plaintiffs can sustain their burden of showing that the debtor's date-of-transfer estimate was unreasonable.

Accepting plaintiffs' argument would represent a holding in the alternative by this Court, but the thrust of this argument is consistent with what the Court has said already. Assuming for the moment that it matters that the future claiming rate is unknowable, it is still the case that these unknown post- transfer claims are existing "rights to payment" on the transfer date. The asbestos mass tort problem is characterized by long latency periods and tens of thousands of claims being raised, year in and year out. This distinguishes the case at bar from the typical reported case concerned with financial contingencies and unknowns.

Therefore, the Court agrees with plaintiffs' contention raised at oral argument. It is consistent with the fundamental purpose of the fraudulent conveyance statute already discussed. There is no unfairness to a debtor or to a less-than-fair-value transferee in placing the burden of a wrong solvency estimate upon them where there exists a historically unknowable mass tort liability that may impair the debtor's ability to meet its obligations.

Defendants take an ill-considered detour into the issue of whether transferee paid equivalent value to argue that their expectations in exploiting a legal tax avoidance device in the transaction should be protected. Here, where the creditors are alleged to be personal injury victims, this argument rings particularly hollow. Such creditors have their debtor forced upon them; plainly the commercial expectations involved in corporate tax-avoidance must take second place. Conversely, the purposes of the fraudulent conveyance statute to prevent debtors placing assets beyond the reach of their creditors is only more acute where the creditors are personal injury claimants.

Here the subterranean cavern opened and W.R. Grace was swallowed up. Plaintiffs argue and their point is a good one that they should not be the party burdened with W.R. Grace's failure to accurately calculate its actual, then-existing, asbestos liability. Fairness places this burden on the debtor and its transferee (who could, presumably, return the asset or make up the difference to provide fair value). The law is the same—contingent liabilities are to be reduced by the reasonably probability of the contingency, but mere errors in the debtor's calculation of its solvency are to be corrected to reflect the evidence. ***

However, this Court agrees *** that mass torts, and particularly mature mass torts like personal injury from asbestos exposure, raise considerations with respect to timing that require careful consideration from the courts. The reality is that asbestos, similar to tobacco, has been a societal scourge for more than a generation. W.R. Grace knew it had a serous and open-ended asbestos liability problem for years before the transaction at issue here. Moreover, the asset transferred away is alleged to have been a substantial part of the company's portfolio.

That W.R. Grace's asbestos may already have injured so many people as to make the company insolvent on the transaction date is hardly an intuitively surprising proposition. Nor, in light of this historical context, can the growing realization of W.R. Grace's true liability be deemed a distinct occurrence subject to discount as an extrinsic, intervening contingency. Finally, it is not too much to expect that firms with well-established legacies of mass-tort liability should realize that transfers for less than equivalent value may harm their tort claimant-creditors should prognostications of future claims be inaccurate. These firms are in a special position with respect to such creditors. Transactions, including legitimate tax-avoidance transactions, must take the reality of the companies' existing liability and the inherent difficulty in defining that liability's scope into consideration.

CONCLUSION

*** Subject to the caveats identified above regarding state law and compensable injury, post-1998 claims should be included in the solvency analysis of W.R. Grace for this constructive fraudulent conveyance proceeding. ***

In re Metrocraft Publishing Services, Inc.

39 B.R. 567 (Bankr. N.D. Ga. 1984)

W. HOMER DRAKE, Bankruptcy Judge: This case is before the Court on the application by the above-named debtor for approval of its disclosure statement in accordance with § 1125 of the Bankruptcy Code. An objection to the disclosure statement was filed by the Creditors' Committee ("Committee"). Following a hearing on May 1, 1984, this matter was taken under advisement. As set forth below, the disclosure statement contains a number of deficiencies which must be corrected before the Court will approve the disclosure statement for distribution to creditors.

Section 1125(b) of the Bankruptcy Code states as follows:

> An acceptance or rejection of a plan may not be solicited after the commencement of the case under this title from a holder of a claim or interest with respect to such claim or interest, unless, at the time of or before such solicitation, there is transmitted to such holder the plan or a summary of the plan, and a written disclosure statement approved, after notice and a hearing, by the court as containing adequate information. The court may approve a disclosure statement without a valuation of the debtor or an appraisal of the debtor's assets.

"Adequate information" is defined in § 1125(a)(1) of the Bankruptcy Code to mean

> information of a kind, and in sufficient detail, as far as is reasonably practicable in light of the nature and history of the debtor and the condition of the debtor's books and records, that would enable a hypothetical reasonable investor typical of the holders of claims or interests of the relevant class to make an informed judgment about the plan.

Case law under § 1125 of the Bankruptcy Code has produced a list of factors disclosure of which may be mandatory, under the facts and circumstances of a particular case, to meet the statutory requirement of adequate information. Disclosure of all factors is not necessary in every case. Conversely, the list is not exhaustive, and a case may arise in which disclosure of all these enumerated factors is still not sufficient to provide adequate information for the creditors to evaluate the plan. Nevertheless, these factors provide a useful starting point for the Court's analysis of the adequacy of the disclosure statement. The Court will address the Committee's objections with an eye toward these enumerated factors as they pertain to this debtor's business and the proposed Chapter 11 plan of reorganization. ***

Relevant factors for evaluating the adequacy of a disclosure statement may include: (1) the events which led to the filing of a bankruptcy petition; (2) a description of the available assets and their value; (3) the anticipated future of the company; (4) the source of information stated in the disclosure statement; (5) a disclaimer; (6) the present condition of the debtor while in Chapter 11; (7) the scheduled claims; (8) the estimated return to creditors under a Chapter 7 liquidation; (9) the accounting method utilized to produce financial information and the name of the accountants responsible for such information; (10) the future management of the debtor; (11) the Chapter 11 plan or a summary thereof; (12) the estimated administrative expenses, including attorneys' and accountants' fees; (13) the collectibility of accounts receivable; (14) financial information, data, valuations or projections relevant to the creditors' decision to accept or reject the Chapter 11 plan; (15) information relevant to the risks posed to creditors under the plan; (16) the actual or projected realizable value from recovery of preferential or otherwise voidable transfers; (17) litigation likely to arise in a nonbankruptcy context; (18) tax attributes of the debtor; and (19) the relationship of the debtor with affiliates. ***

The disclosure statement describes the business of the debtor, Metrocraft Publishing Services, Inc. ("Metrocraft"), in the following terms:

Metrocraft is a medium size commercial web printing company with its place of business at 1833 Lawrenceville Highway, Decatur, Georgia. Metrocraft offers to its customers a full spectrum of services from composition and typesetting to complete web offset press. These services[,] including camera ready preparations and sheet fed presses, are offered as separate services as well as a completely integrated package.

A separate entity, Metropolitan Advertising Associated ("MAA") was created to act as a sales organization to increase Metrocraft's business and, ultimately, to act as a broker to place business with other printers. The disclosure statement indicates that:

In January, 1983, MAA supplied all of its business to Metrocraft. By February MAA was brokering some business, and by March MAA was brokering 80% of its business. The combined business of Metrocraft and the MAA brokering brought in some 26 million impressions, or $650,000.00 gross sales for the quarter ending March 31, 1983.

The disclosure statement points out that two experienced printing sales and marketing individuals left MAA during July, 1983 thereby causing a loss in sales momentum. Efforts to regain sales momentum have not been entirely successful. After filing the Chapter 11 petition, Metrocraft has concentrated on cutting variable operating costs, primarily in the area of payroll.

The only claim deemed unimpaired under the plan is the claim held by Stone Mountain Industrial Park, Inc., lessor of Metrocraft's business premises. In general, secured creditors and creditors holding claims under leases with Metrocraft will realize almost full satisfaction of their indebtedness under the plan. The plan does, however, restructure certain contractual payment provisions. The Chapter 11 plan allocates a total of $48,000.00, plus nominal interest, to be distributed to all unsecured claimants. Neither the plan nor the disclosure statement suggests the percentage at which unsecured creditors will be paid under the plan.

The Committee legitimately desires more information before an intelligent decision can be rendered as to the acceptability of the Chapter 11 plan. The Court categorizes the Committee's objections according to the criteria set forth above under which such objections arise:

(2) A Description of the Available Assets and their Value. The Committee notes that the disclosure statement fails to give the actual or projected realizable value from machinery, fixtures and equipment originally scheduled in the amount of $354,499.92. The Court agrees that creditors are entitled to such information or an explanation why such information has not been presented.

(7) The Scheduled Claims. The Committee raises a number of objections relating to the disclosure of claims. First, the Committee points out that the plan proposes to pay claims held by Compugraphic Corporation, Rockwell International Corporation and General Electric Credit Corporation, yet these claims are not scheduled. It is imperative that creditors be informed of the nature of these claims, the principal amount due on these claims and the monthly payments specified in the agreements under which these claims arise. Second, the Committee strongly desires to know the amount of unsecured claims so that some calculation can be made as to the percentage at which such claims shall be paid under the proposed pro rata distribution of $48,000.00. The debtor argues that the amount of unsecured claims is subject to the Court's determination of which claims are allowable. In addition, the debtor asserts that certain claims may be offset by preferential transfers. The Court concludes that the debtor cannot avoid all disclosure regarding unsecured claims simply because their exact amount cannot be determined at this time. Some discussion of the nature of unsecured claims, their approximate value and the approximate amount by which such claims may be subject to setoff for settlement purposes shall be disclosed to creditors. Third, the Committee objects that the disclosure statement fails to indicate the sums to be paid to other creditors, both on a monthly basis and in total amount. The Court agrees that disclosure in this regard is necessary to evaluate, inter alia, the debtor's cash flow and the amount of money being diverted to creditors which might be available to pay unsecured claims. Fourth, the Chapter 11 plan provides for payment of wage priority claims notwithstanding the fact that no such claims have been scheduled. The debtor argues that no disbursements are intended to be made to priority wage claimants, but that the wage priority provision was included in the plan to assure that the plan complies with the Bankruptcy Code. Rather than force creditors to ponder the discrepancy between the schedule and the plan, a short statement explaining why the wage priority provision is in the plan shall be provided to eliminate any confusion.

(8) The Estimated Return to Creditors Under a Chapter 7 Liquidation. The Committee asserts that the disclosure statement should reveal the estimated return to creditors under a Chapter 7 liquidation as an alternative to the Chapter 11 reorganization. The debtor argues that the projected balance sheet shows that the debtor would be insolvent by the amount of $42,500.00 after subtracting from asset value the amount of secured claims, estimated administrative claims and unsecured claims in the reduced amount of $48,000.00. However, as the Committee's first objection illustrates, the debtor has not provided a valuation regarding the machinery and equipment. Absent a valuation of the assets with some factual basis, and absent a concise statement addressing the prospects of a Chapter 7 liquidation, the disclosure statement does not provide adequate information as required by the Bankruptcy Code.

(13) The Collectibility of Accounts Receivable. The debtor's Schedules list the amount of accounts receivable at $117,232.16. Related to the question of the value of assets is the question of the collectibility of these accounts receivable. The debtor's accounting records should enable the debtor to offer at least a historical analysis as to the collectibility of the outstanding accounts. Absent such disclosure, the statement of the amount of accounts receivable is nothing but raw data with little significance.

(16) The Actual or Projected Realizable Value from Recovery of Preferential or Otherwise Voidable Transfers. The debtor acknowledges that the bankruptcy estate may have claims for preferential transfers, but no light is shed on the nature of these preferential transfers or their approximate amount. Admittedly, the precise amount of such preferential transfers cannot be stated prior to this Court's determination on such claims. Nevertheless, the debtor is not excused from discussing the amount of preferences in approximate terms and setting forth what steps have been taken toward settling or litigating these claims.

(17) Litigation Likely to Arise in a Nonbankruptcy Context. The debtor's Statement of Financial Affairs shows that a lawsuit has been filed against the debtor by Covington News, but the claim of Covington News is not discussed in the disclosure statement or provided for in the Chapter 11 plan. The creditors are entitled to information regarding the claim by Covington News. In addition, there is a possibility that the debtor may have claims against former principals. The debtor shall indicate what progress has been made or is expected to be made in furtherance of these claims.

(18) Tax Attributes of the Debtor. The disclosure statement makes no mention of net operating loss carry-overs which would seemingly be available to reduce the debtor's tax liability in the future. The Court will not impose upon the debtor the obligation to render a lengthy analysis of the law under the Internal Revenue Code. But, if such tax attributes are available for the debtor's use, they should be described so that creditors may evaluate the actual after-tax position of the debtor. If such tax attributes are not available to the debtor, a brief explanation of the reasons leading to that conclusion is sufficient.

(19) The Relationship of the Debtor with Affiliates. The Committee contends that the disclosure statement does not illuminate the relationship between the debtor and MAA and any potential claims that may exist between the debtor and MAA. Although the debtor makes reference to MAA at page 5 of the disclosure statement, the exact relationship of the two entities is not clearly set forth, and no discussion is made as to potential liability running to and from the entities. The Court concludes that this relationship and the possible claims shall be disclosed.

In accordance with the foregoing, approval of the debtor's disclosure statement shall be and is hereby DENIED. The debtor shall have thirty (30) days to file an amended disclosure statement which conforms with the directives stated herein.

IT IS SO ORDERED.

Century Glove, Inc. v. First American Bank

860 F.2d 94 (3d Cir. 1988)

JAMES HUNTER, III, Circuit Judge: Century Glove, Inc. ("Century Glove"), a debtor seeking reorganization under the federal bankruptcy laws, seeks review of a district court order dismissing sanctions imposed on its creditors. Century Glove claims that one of its creditors, First American Bank ("FAB"), unlawfully solicited the votes of other creditors, in violation of 11 USC § 1125. The bankruptcy court agreed, imposing sanctions against FAB and invalidating another creditor's rejection of Century Glove's plan. On appeal, the district court reversed, holding FAB's action lawful. Century Glove now appeals to this court. We will affirm the order of the district court.

I.

Century Glove filed its petition seeking reorganization in bankruptcy on November 14, 1985. On August 1, 1986, Century Glove filed its reorganization plan, along with a draft of the disclosure statement to be presented along with the plan. Arguing that Century Glove's largest claimed assets are speculative lawsuits (including one against FAB), FAB presented a copy of an alternative plan to the unsecured creditors' committee. FAB advised that it would seek court approval to present its plan as soon as possible. The committee ultimately rejected the plan in favor of that of the debtor. On December 2, 1986, the bankruptcy court approved Century Glove's disclosure statement. A copy of the plan, the statement, and a sample ballot were then sent to Century Glove's creditors entitled to vote on the plan's acceptance.

Between December 12 and December 17, 1986, an attorney for FAB, John M. Bloxom, telephoned attorneys representing several of Century Glove's creditors. Among these creditors were Latham Four Partnerships ("Latham Four") and Bankers Trust New York Corporation ("BTNY"). Bloxom sought to find out what these creditors thought of the proposed reorganization, and to convince them to vote against the plan. He said that, while there was no other plan approved for presentation, and thus no other plan "on the table," FAB had drafted a plan and had tried to file it. The creditors' attorneys then asked for a copy of the plan, which FAB provided. The copies were marked "draft" and covering letters stated that they were submitted to the creditors for their comments. The draft did not contain certain information necessary for a proper disclosure statement, such as who would manage Century Glove after reorganization.

With a copy of its draft plan, FAB also sent to Latham Four a copy of a letter written to the unsecured creditors' committee by its counsel. In the letter, dated August 26, 1986, counsel questioned the committee's endorsement of the Century Glove plan, arguing that the lawsuits which Century Glove claims as assets are too speculative. As stated, the committee endorsed the plan anyway. Upset with this decision, one of its members sent a copy of the letter to a former officer of Century Glove. The officer then sent a copy, unsolicited, to FAB. Uncertain whether the letter was protected by an attorney-client privilege, FAB asked the committee member whether he had disclosed the letter voluntarily. He said that he had, and furnished a second copy directly to FAB. FAB attached this letter to a motion before the bankruptcy court seeking to have the committee replaced. The bankruptcy court later held the letter a privileged communication.

BTNY had made a preliminary decision on September 12, 1986, to reject Century Glove's plan. It reaffirmed this decision on December 15, when it received a copy of the plan and disclosure. Counsel for BTNY spoke with Bloxom the next day, December 16, 1986, and Bloxom mailed a letter confirming the call, but by mistake Bloxom did not send a draft of the alternate plan until December 17. On that day, counsel for BTNY prepared its ballot rejecting Century Glove's plan, and informed Bloxom of its vote.

After receiving the several rejections, Century Glove petitioned the bankruptcy court to designate, or invalidate, the votes of FAB, Latham Four and BTNY. Century Glove argued that FAB had acted in bad faith in procuring these rejections.

II.

The bankruptcy court held that FAB had violated 11 USC § 1125(b), which allows solicitation of acceptance or rejections only after an approved disclosure statement has been provided the creditor. ***

The bankruptcy court also concluded that FAB had violated "the spirit of § 1121(b), since FAB was apparently seeking approval of a plan which was not yet filed and which it could not file...."[2] This "impropriety" was "heightened" by the absence from the FAB plan of such information as "who will manage the debtor." The bankruptcy court also found "improper" the disclosure by FAB of the August 26, 1986 letter to the creditors' committee. The court found that FAB's "machinations" in procuring a second copy of the letter showed that it was "obviously wary" that the letter might be privileged.

The bankruptcy court held invalid Latham Four's vote. It allowed the vote of BTNY, however, finding that the creditor had proved it had not relied on FAB's statements in deciding to reject Century Glove's plan. The court declined to bar FAB from participating further in the reorganization, finding such a sanction "too harsh," but instead, ordered FAB to pay for "all costs incurred by [Century Glove] in prosecuting" its motions. The amount of these damages was not specified. Both parties appealed the decision to the district court.

In a decision dated January 5, 1988, the district court affirmed the bankruptcy court rulings allowing BTNY's vote, but reversed the designation of Latham Four and the imposition of money sanctions against FAB. The district court disagreed that § 1125(b) requires approval for all materials accompanying a solicitation, and found such a reading in conflict with the bankruptcy code's policy of fostering free negotiation among creditors. The district court held that merely supplying additional information does not constitute "bad faith" or a violation of the bankruptcy rules. Therefore, the court concluded, the bankruptcy court had erred in finding that FAB had improperly solicited rejections of the Century Glove plan.

The district court next considered whether FAB had improperly sought acceptance of its own plan. The court found that, in order to facilitate negotiations, communications between creditors should not easily be read as solicitations. Because Bloxom did not make a "specific request for an official vote," In re Synder, 51 B.R. 432, 437 (Bankr. D. Utah 1985), FAB's action "may only be fairly characterized as part of FAB's negotiations." Because FAB did not unlawfully solicit rejections, and did not solicit acceptances, the designation and sanction orders of the bankruptcy court were reversed. Century Glove appeals to this court.

[2] The parties do not dispute that 11 USC § 1121(b), which provides the debtor the exclusive right to file a plan for a limited period of time, applied at all times relevant to this action.

III.

*** Section 1125(b) bars certain solicitation activities, regardless of the intent of the actor. Whether that provision is violated is not a matter left to the discretion of the bankruptcy court, but is a matter of fact and law. Section 1126(e), on the other hand, is not simply a remedy for § 1125(b) violations. It grants the bankruptcy court discretion to sanction any conduct that taints the voting process, whether it violates a specific provision or is in "bad faith." Thus, the bankruptcy court also considered several "improprieties" unrelated to the § 1125(b) decision in deciding whether the designate votes. Further, § 1126(e) grants a limited discretion: the bankruptcy court may designate a vote or not. The section does not give the court discretion to impose other remedies, such as the payment of costs. Thus, determining whether the bankruptcy court acted properly in imposing costs does not determine whether it acted properly in designating (or not) certain votes. We therefore find the bankruptcy court's order imposing costs and designating one vote separate decisions. We review each for finality. ***

FAB argues that the district court's decision to allow the votes is not final. To be effective, a reorganization plan usually must be approved by the vote of each class of creditors, 11 USC § 1129(A)(8), and always by at least one class of creditors, id. at § 1129(a)(10). The bankruptcy court has yet to divide the creditors into classes or tally their votes. Because the voting has not yet been conducted, Century Glove's plan might be defeated or upheld whether or not the contested rejections are counted. Therefore, FAB argues, the district court's order is not yet final. We agree. ***

We therefore hold that the district court's decision reversing the designation of Latham Four's vote and permitting the votes of the other creditors is not subject to review at this time. However, the decision holding that FAB did not violate 11 USC § 1125(b) and reversing the imposition of costs does present a separate and final order. We will review the merits of that decision.[6]

IV.

Century Glove argues that the district court erred in holding FAB did not improperly solicit rejections of Century Glove's reorganization plan. ***

Section 1125(b) states, in pertinent part, that:

> An acceptance or rejection of a plan may not be solicited after the commencement of the case under this title from a holder of a claim or interest with respect to such claim or interest, unless, at the time of or before such solicitation, there is transmitted to such holder the plan or summary of the plan, and a written disclosure

[6] We recognize that the district court did not appear to separate the two decisions, reversing the designation of the vote because FAB had not violated § 1125(b). The district court did not consider the other grounds for designation mentioned by the bankruptcy court, such as FAB's use of a privileged communication and the absence of certain information from FAB's draft plan. We do not consider or decide whether these findings have merit, or, assuming such merit, whether they provide the bankruptcy court the discretion to designate votes. Also, because it was not contested below, we do not determine whether the bankruptcy court has the power to award costs for violations of § 1125(b).

> statement approved, after notice and a hearing, by the court as containing adequate information.

There is no question that, at the time of FAB's solicitations, the solicitees had received a summary of the plan and a court-approved statement disclosing adequate information. Also, the bankruptcy court's factual conclusion that FAB was seeking rejections of Century Glove's plan is not clearly erroneous, and so must be assumed. Century Glove argues that FAB also was required to get court approval before it could disclose additional materials in seeking rejections.

Century Glove's interpretation of the section cannot stand. Century Glove argues, and the bankruptcy court assumed, that only approved statements may be communicated to creditors. The statute, however, never limits the facts which a creditor may receive, but only the time when a creditor may be solicited. Congress was concerned not that creditors' votes were based on misinformation, but that they were based on no information at all. See H.R. 95-595, at pp. 225-25, 95th Cong., 2d Sess., 124 Cong. Rec. ___, reprinted in, 1978 USCC.A.A.N. 5963, 6185 (House Report). Rather than limiting the information available to a creditor, § 1125 seeks to guarantee a minimum amount of information to the creditor asked for its vote. See S.R. 95-989, at pp. 121, 95th Cong., 2d Sess., 124 Cong.Rec. ___, reprinted in, 1978 USCC.A.A.N. 5787, 5907 ("A plan is necessarily predicated on knowledge of the assets and liabilities being dealt with and on factually supported expectations as to the future course of the business....") (Senate Report). The provision sets a floor, not a ceiling. Thus, we find that § 1125 does not on its face empower the bankruptcy court to require that all communications between creditors be approved by the court.

As the district court pointed out, allowing a bankruptcy court to regulate communications between creditors conflicts with the language of the statute. A creditor may receive information from sources other than the disclosure statement. Section 1125 itself defines "typical investor" of a particular class in part, as one having "such ability to obtain such information from sources other than the disclosure required by this section...." 11 USC § 1125(a)(2)(C). In enacting the bankruptcy code, Congress contemplated that the creditors would be in active negotiations with the debtor over the plan. The necessity of "adequate information" was intended to help creditors in their negotiations. Allowing the bankruptcy court to regulate communications between creditors under the guise of "adequate information" undercuts the very purpose of the statutory requirement.

Lastly, Century Glove's reading of § 1125 creates procedural difficulties. Century Glove provides this court no means to distinguish predictably between mere interpretations of the approved information, and additional information requiring separate approvals. Therefore, to be safe, the creditor must seek prior court approval for every communication with another creditor (or refrain from communication), whether soliciting a rejection or an acceptance. Congress can hardly have intended such a result. It would multiply hearings, hence expense and delay, at a time when efficiency is greatly needed. We also note that, as expressed in the House Report, Congress evidently contemplated a single hearing on the adequacy of the disclosure statement.

Century Glove argues that two additional instances show that FAB violated § 1125(b). First, it claims that FAB's draft plan contained material misrepresentations, mostly omissions. Second, it claims that FAB improperly disclosed to Latham Four a letter the bankruptcy court later found privileged. The bankruptcy court found both “improper” in support of its finding under § 1125(b), and Century Glove argues that the bankruptcy court’s decision can be affirmed on these grounds. The problem with the argument is that it rests on an erroneous interpretation of the law. Once adequate information has been provided a creditor, § 1125(b) does not limit communication between creditors. It is not an antifraud device. Thus, the bankruptcy court erred in holding that FAB had violated § 1125(b) by communicating with other materials. The district court therefore properly reversed the bankruptcy court on this issue.

V.

Though FAB was not limited in its solicitation of rejections, § 1125 did prevent FAB from soliciting acceptances of its own plan. The bankruptcy court held that, “since FAB was apparently seeking approval of a plan which was not yet filed,” FAB violated § 1125. The court also found that FAB’s actions violated the spirit of § 1121, which provides the debtor with a limited, exclusive right to present a plan. Reversing, the district court held that solicitations barred by § 1125(b) include only the “specific request for an official vote,” and not discussions of and negotiations over a plan leading up to its presentation. In re Snyder, 51 B.R. 432, 437 (Bankr. D. Utah 1985). Because Bloxom explained that he was sending the draft only for discussion purposes, the district court found that the transmittal “may only be fairly characterized as part of FAB’s negotiations.” We exercise plenary review over the proper interpretation of the legal term “solicitation.”

We agree with the district court that “solicitation” must be read narrowly. A broad reading of § 1125 can seriously inhibit free creditor negotiations. All parties agree that FAB is not barred from honestly negotiating with other creditors about its unfiled plan. “Solicitations with respect to a plan do not involve mere requests for opinions.” Senate Report, 1978 USCC.A.A.N. at 5907. The purpose of negotiations between creditors is to reach a compromise over the terms of a tentative plan. The purpose of compromise is to win acceptance for the plan. We find no principled, predictable difference between negotiation and solicitation of future acceptances. We therefore reject any definition of solicitation which might cause creditors to limit their negotiations.[9]

A narrow definition of “solicitation” does not offend the language or policy of 11 USC § 1121(b). The section provides only that the debtor temporarily has the exclusive right to file a plan (and thus have it voted on). It does not state that the debtor has a right to have its plan considered exclusively. A right of exclusive consideration is not warranted in the policy of the section. Congress believed that debtors often delay confirmation of a plan, while creditors want quick confirmation. Therefore, unlimited exclusivity gave a debtor “undue bargaining leverage,” because it could use the threat of delay to force unfair concessions. House Report, 1978 USCC.A.A.N. at 6191. On the other hand, Congress evidently felt that creditors might not seek the plan fairest to the debtor. Therefore, Con-

[9] Barring negotiations also would provide an unwarranted boon for the debtor: creditors wholly unable to be sure that an alternative plan can be agreed are more likely to vote for the debtor’s proposal rather than risk unknown delay.

gress allowed a limited period of exclusivity, giving the debtor "adequate time to negotiate a settlement, without unduly delaying creditors." Id. Section 1121 allows a debtor the threat of limited delay to offset the creditors' voting power of approval. FAB did nothing to reduce Century's threat of limited delay, and so did not offend the balance of bargaining powers created by § 1121 or the "spirit" of the law.

On the contrary, Century Glove's reading of § 1121(b) would in fact give the debtor powers not contemplated by Congress. The ability of a creditor to compare the debtor's proposals against other possibilities is a powerful tool by which to judge the reasonableness of the proposals. A broad exclusivity provision, holding that only the debtor's plan may be "on the table," takes this tool from creditors. Other creditors will not have comparisons with which to judge the proposals of the debtor's plan, to the benefit of the debtor proposing a reorganization plan. The history of § 1121 gives no indication that Congress intended to benefit the debtor in this way. The legislative history counsels a narrow reading of the section, one which FAB's actions do not violate.

We recognize that § 1125(b) bars the untimely solicitation of an "acceptance or rejection," indicating that the same definition applies to both. A narrow definition might allow a debtor to send materials seeking to prepare support for the plan, "for the consideration of the creditors," without adequate information approved by the court. Though such preparatory materials may undermine the purpose of adequate disclosure, the potential harm is limited in several ways. First, a creditor still must receive adequate information before casting a final vote, giving the creditor a chance to reconsider its preliminary decision. The harm is further limited by free and open negotiations between creditors. Last, because they are not "solicitations," pre-disclosure communications may still be subject to the stricter limitations of the securities laws. 11 USC § 1125(e). Where, as here, the creditors are counselled and already have received disclosure about the debtor's business, there seems little need for additional procedural formalities.

Therefore, we hold that a party does not solicit acceptances when it presents a draft plan for the consideration of another creditor, but does not request that creditor's vote. Applying this definition, FAB did not solicit acceptances of its plan. Century Glove does not dispute that FAB never asked for a vote, and clearly stated that the plan was not yet available for approval. Bloxom communicated with lawyers for the creditors, and there is no suggestion by Century that these lawyers did not understand the limitations. Also as Century argues, FAB never sent its plan to Hartford Insurance because Hartford firmly opposed Century's plan. Contrary to Century's conclusion, though, this fact argues that FAB sent copies of its plan because it was interested in obtaining rejections, not acceptances. (An opponent of Century's plan would be an ideal person to solicit for acceptances.) These undisputed facts require a finding that FAB did not "solicit" acceptances within the meaning of § 1125(b).

VI.

We hold that the district court correctly determined that Century Glove failed to show that FAB violated 11 USC § 1125 by soliciting acceptances or improperly soliciting rejections. We therefore will affirm the district court's order reversing the imposition of costs against FAB. We do not decide, however, whether the circumstances merit designation of the votes of any creditors.

In re Allegheny International, Inc.

118 B.R. 282 (Bankr. W.D. Pa. 1990)

JOSEPH L. COSETTI, Chief Judge: *** For the motions to designate, we take up the saga, beginning on December 29, 1989, when the debtor filed the instant plan of reorganization. The court conducted several days of hearings on the disclosure statement in January 1990. The court approved the debtor's disclosure statement on February 5, 1990, setting the last day to ballot on the debtor's plan as March 30, 1990, at 5:00 P.M.

However, on January 24, 1990, near the conclusion of the hearings on the debtor's disclosure statement, Japonica filed its plan of reorganization (the "Japonica plan") and disclosure statement which mirrored and utilized in large part the debtor's material and organization. The court was urged by Japonica not to approve the debtor's disclosure statement until Japonica's disclosure statement could be approved and a joint ballot distributed. Japonica requested an extraordinary reduction in the time the rules provided for confirmation. The court feared additional delay and denied the request. The court set separate schedules for confirmation of the plans and promised Japonica an opportunity for creditors to vote on the Japonica plan before any order of confirmation would be issued.

The Japonica plan offered cash equivalent to $6.42 per share with holdbacks, as compared to the debtor's proposed stock plan which offered $7.00 per share. Under the Japonica plan, Japonica would acquire control of the debtor. Although Japonica had indicated its interest in acquiring control of the debtor as early as July 1989, Japonica held no interest as a creditor or equity holder of the debtor until immediately prior to the filing of its proposed plan and disclosure statement. To qualify as a party in interest authorized to file a plan, Japonica purchased public subordinated debentures of the debtor with a face value of $10,000 for $2,712. At that time, the court was unaware that the purchase of claims would be the tactic used by Japonica to gain control.

On February 23, 1990, Japonica began purchasing claims of the secured bank lenders, Class 2.AI.2. This occurred after the debtor's disclosure statement was approved and the debtor's plan balloting had commenced. This was also after Japonica had proposed a plan and disclosure statement and had become a proponent of a plan. The purchase of the following claims gave Japonica control of approximately 27% of the claims in Class 2.AI.2:

NAME OF BANK	DATE	FACE AMOUNT	PRICE PAID	%
Canadian Imperial Bank of Commerce ("CIBC")	2/23/90	$12,614,800	$10,121,543.25	80.24%
Israel Discount Bank of New York	2/23/90	2,803,289	2,247,005.25	80.16%
The Northern Trust Company	2/26/90	5,606,578	4,498,462.50	80.24%
Harris Trust and Savings Bank	2/26/90	11,213,154	8,966,925.00	79.97%
NCNB National Bank of North Carolina	3/13/90	8,409,868	6,747,237.00	80.23%
First National Bank of Boston	3/23/90	9,811,511	8,339,784.35	85%

On or about March 26, 1990, Japonica purchased the claim of Continental Bank, N.A. ("Continental"), with a face amount of $12,614,800, for $11,984,060, or 95% of the face amount. Following the purchase of the claim of Continental, Japonica held 33.87% of the claims in Class 2.AI.2, enabling Japonica to block an affirmative vote by that class on the debtor's plan of reorganization. 11 USC § 1126(c). After achieving its blocking position, Japonica purchased the claim of Bank of Hawaii, with a face amount of $2,242,630, for $1,838,956.60, or 82% of the face amount. Under the terms of the assignments by the aforementioned banks, Japonica caused the votes of the claims it purchased to be voted against the debtor's plan.

In addition to purchasing the claims for cash, Japonica agreed to indemnify the assigning banks for all expenses and liability arising from certain lawsuits against the members of Class 2.AI.2. At least some of the assigning banks would not sell their claims unless Japonica agreed to assume such liability. For example, CIBC would not have sold its claim at any price unless Japonica agreed to assume the expenses and liability arising from those lawsuits. The most notable of those lawsuits is an adversary action in this court, at Adversary No. 88-186, in which the Official Committee of Unsecured Creditors of Allegheny International, Inc. (the "Creditors' Committee") has sued the secured bank lenders under theories of preference, fraudulent conveyance, equitable subordination, and lender liability.

Japonica also purchased claims from senior unsecured creditors in Class 4.AI.2. Japonica purchased the claims of Swiss Volksbank and certain other holders of Swiss Franc notes, with a face amount of $21,793,590, for $14,383,769.40, or 66% of the face amount. Japonica caused the votes of these claims to be voted against the debtor's plan. Although Japonica purchased less than 1/3 of the claims in Class 4.AI.2, its negative votes were sufficient to defeat the debtor's plan in that class because of the large number of claims in Class 4.AI.2 that did not vote. It should be noted that Swiss Volksbank was a member of the Creditors' Committee and the Creditors' Committee had recommended a favorable vote on the debtor's plan. It should also be noted that the Creditors' Committee, on behalf of all these unsecured creditors, is a plaintiff in the bank litigation. Unsecured creditors, such as the holders of the Swiss Franc notes, have interests adverse to the interests of the secured bank lenders and would benefit from a favorable result in the litigation. Therefore, Japonica has purchased claims which constitute a blocking position in two classes whose interests are diametrically opposed in the bank litigation. ***

In the case at bar, Japonica, by acquiring a blocking position, has defeated the debtor's plan and can defeat any other plan and thereby obstruct a "fair and feasible reorganization." Japonica *** bought a blocking position after the debtor proposed its plan of reorganization. *** In the instant case, Japonica's interest is to take over and control the debtor. Section 1126(e) and its predecessor were intended to enable the court to disqualify the votes of parties who engage in such conduct.

*** The overriding fact that causes this court to reach this conclusion is that Japonica chose to buy claims which gave it unique control over the debtor and the process. With one minor exception, Japonica purchased its claims—and became a creditor—after the debtor's disclosure statement was approved. Japonica knew what it was getting into when it purchased its claims. Japonica is a voluntary claimant. If Japonica was unsatisfied by the proposed distribution, it had the option of not becoming a creditor. Japonica could have proposed its plan without buying these claims.

Japonica's actions with respect to the purchase of claims were in bad faith. Notwithstanding Japonica's allegedly longstanding interest in the debtor, Japonica filed its plan of reorganization at the eleventh hour. Notwithstanding Japonica's allegedly longstanding interest in the debtor, Japonica did not purchase significant claims until the voting period on the debtor's plan. Japonica was also at this time a proponent of a plan. The particular claims that Japonica purchased, and the manner in which they were purchased, can be used to determine their intent. Japonica purchased a clear blocking position in Class 2.AI.2, the secured bank lenders. Because that class was the most senior class, a negative vote in that class made confirmation extremely difficult, if not impossible. Japonica paid approximately 80% of the face amount for the first five claims in Class 2.AI.2. As Japonica approached ownership of 33% in amount of this class, it paid 85% of the face amount for the next claim, that of First National Bank of Boston. It then purchased the claim of Continental Bank for 95% of the face amount. This gave Japonica 33.87% of the amount of Class 2.AI.2 claims. Thereafter, Japonica purchased one more bank claim, but only for 82% of the face amount. If Japonica purchased bank claims solely for economic purposes, it would not have paid 95% of the face amount and then returned to an 82% purchase. Instead, it purchased almost exactly the amount required to block the plan of reorganization.

Lederman was a bankruptcy lawyer who clearly understood the significance of 33 1/3 % of a class. The court finds from these facts Japonica's purpose was control and was in bad faith. Japonica recited to the court that it wanted to provide cash to creditors. Japonica's plan proposes to pay cash to creditors, but with a portion held back pending resolution of unresolved claims. Because the court believed this recitation, the court granted additional time to Japonica for its plan. However, the court was misled. Japonica's purpose was control and so we find.

Similarly, Japonica purchased only enough claims in Class 4.AI.2 to block an affirmative vote by that class. That class follows Class 2.AI.2 in priority. Thus, Japonica purchased a blocking position in the two highest classes which were impaired, ensuring that the debtor could not confirm its plan of reorganization. Again, we note that the two classes in which Japonica purchased claims have directly opposite interests with respect to the bank litigation. The court is hard pressed to characterize Japonica's actions as merely furthering their own economic interests.

Votes must be designated when the court determines that the "creditor has cast his vote with an 'ulterior purpose' aimed at gaining some advantage to which he would not otherwise be entitled in his position." In re Gilbert, 104 B.R. at 216; see also Insinger Machine Co. v. Federal Support Co. (In re Federal Support Co.), 859 F.2d 17 (4th Cir. 1988).

In In re MacLeod, 63 B.R. at 656, the bankruptcy court designated the votes of dissenting creditors who were competitors because the court concluded that those votes were cast for the "ulterior purpose of destroying or injuring debtor in its business so that the interests of the competing business ... could be furthered." Although the debtor and Japonica are not engaged in competing businesses, the court finds *In re MacLeod* analogous to the case sub judice. Japonica and the debtor were proponents of competing plans of reorganization. Japonica's stated purpose was to take over the debtor. To do so, it was necessary for Japonica to block confirmation of the debtor's plan of reorganization. Thus, the court concludes that Japonica's actions were for an ulterior motive.

Under chapter 11, creditors and interest holders vote for or against a plan of reorganization, after adequate disclosure, if such vote is in their best economic interests. If, as in the instant case, an outsider to the process can purchase a blocking position, those creditors and interest holders are disenfranchised. If competing plans of reorganization are pending, the court must consider the preferences of the creditors and interest holders. If a plan proponent, such as Japonica, can purchase a blocking position, the votes of the other creditors and interest holders are rendered meaningless. Moreover, Japonica, who chose to become a creditor, should not have veto control over the reorganization process. The court does not believe that such a result was intended by Congress. Therefore, for all of the reasons stated above, the court designates the votes of Japonica pursuant to 11 USC § 1126(e) in Class 2.AI.2 and Class 4.AI.2. ***

Local Loan Co. v. Hunt

292 U.S. 234 (1934)

Mr. Justice SUTHERLAND delivered the opinion of the Court: On September 17, 1930, respondent borrowed from petitioner the sum of $300, and as security for its payment executed an assignment of a portion of his wages thereafter to be earned. On March 3, 1931, respondent filed a voluntary petition in bankruptcy in a federal District Court in Illinois, including in his schedule of liabilities the foregoing loan, which constituted a provable claim against the estate. Respondent was adjudicated a bankrupt; and, on October 10, 1932, an order was entered discharging him from all provable debts and claims. On October 18, 1932, petitioner brought an action in the municipal court of Chicago against respondent's employer to enforce the assignment in respect of wages earned after the adjudication. Thereupon, respondent commenced this proceeding in the court which had adjudicated his bankruptcy and ordered his discharge, praying that petitioner be enjoined from further prosecuting said action or attempting to enforce its claim therein made against respondent under the wage assignment. The bankruptcy court, upon consideration, entered a decree in accordance with the prayer; and this decree on appeal was affirmed by the court below.

Challenging this decree, petitioner contends that *** the rule is that an assignment of future wages constitutes an enforceable lien; but that, in any event, the highest court of the state of Illinois has so decided, and by that decision this court is bound. ***

Whether an assignment of future earned wages constitutes a lien within the meaning of section 67d of the Bankruptcy Act,[2] is a matter upon which the decisions of the state and federal courts are not in complete accord; although by far the larger number of cases and the greater weight of authority are in the negative. *** The lower federal courts which have had occasion to consider the question concur in the view that the lien has no existence or is ineffective as against an adjudication and discharge in bankruptcy. Judge Bellinger, in Re West (D.C.) 128 F. 205, 206, sucsinctly stated the ground of his ruling in accordance with that view as follows:

> The discharge in bankruptcy operated to discharge these obligations as of the date of the adjudication, so that the obligations were discharged before the wages intended as security were in existence. The law does not continue an obligation in order that there may be a lien, but only does so because there is one. The effect of the discharge upon the prospective liens was the same as though the debts had been paid before the assigned wages were earned. The wages earned after the adjudication became the property of the bankrupt clear of the claims of all creditors.

*** The earning power of an individual is the power to create property; but it is not translated into property within the meaning of the Bankruptcy Act until it has brought earnings into existence. An adjudication of bankruptcy, followed by a discharge, releases a

[2] "Liens given or accepted in good faith and not in contemplation of or in fraud upon the provisions of this title, and for a present consideration, which have been recorded according to law, if record thereof was necessary in order to impart notice, shall, to the extent of such present consideration only, not be affected by anything herein." USC title 11, § 107(d), 11 USCA § 107(d).

debtor from all previously incurred debts, with certain exceptions not pertinent here; and it logically cannot be supposed that the act nevertheless intended to keep such debts alive for the purpose of permitting the creation of an enforceable lien upon a subject not existent when the bankruptcy became effective or even arising from, or connected with, preexisting property, but brought into being solely as the fruit of the subsequent labor of the bankrupt.

Third. To the foregoing array of authority petitioner opposes the decisions of the Supreme Court of Illinois ***. Undoubtedly, these cases hold, as petitioner asserts, that in Illinois an assignment of future wages creates a lien effective from the date of the assignment, which is not invalidated by the assignor's discharge in bankruptcy. The contention is that even if the general rule be otherwise, this court is bound to follow the Illinois decisions, since the question of the existence of a lien depends upon Illinois law.

We find it unnecessary to consider whether this contention would in a different case find support in section 34 of the Judiciary Act of 1789 *** since we are of opinion that it is precluded here by the clear and unmistakable policy of the Bankruptcy Act. It is important to bear in mind that the present case is one not within the jurisdiction of a state court, but is a dependent suit brought to vindicate decrees of a federal court of bankruptcy entered in the exercise of a jurisdiction essentially federal and exclusive in character. And it is that situation to which we address ourselves, and to which our decision is confined.

One of the primary purposes of the Bankruptcy Act is to "relieve the honest debtor from the weight of oppressive indebtedness, and permit him to start afresh free from the obligations and responsibilities consequent upon business misfortunes." Williams v. U.S. Fidelity & Guaranty Co., 236 U.S. 549, 554, 555. This purpose of the act has been again and again emphasized by the courts as being of public as well as private interest, in that it gives to the honest but unfortunate debtor who surrenders for distribution the property which he owns at the time of bankruptcy, a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of pre-existing debt. The various provisions of the Bankruptcy Act were adopted in the light of that view and are to be construed when reasonably possible in harmony with it so as to effectuate the general purpose and policy of the act. Local rules subversive of that result cannot be accepted as controlling the action of a federal court.

When a person assigns future wages, he, in effect, pledges his future earning power. The power of the individual to earn a living for himself and those dependent upon him is in the nature of a personal liberty quite as much if not more than it is a property right. To preserve its free exercise is of the utmost importance, not only because it is a fundamental private necessity, but because it is a matter of great public concern. From the viewpoint of the wage-earner there is little difference between not earning at all and earning wholly for a creditor. Pauperism may be the necessary result of either. The amount of the indebtedness, or the proportion of wages assigned, may here be small, but the principle, once established, will equally apply where both are very great. The new opportunity in life and the clear field for future effort, which it is the purpose of the Bankruptcy Act to afford the emancipated debtor, would be of little value to the wage-earner if he were obliged to face the necessity of devoting the whole or a considerable portion of his earnings for an indefinite time in the future to the payment of indebtedness incurred prior to his bankruptcy. Confining our determination to the case in hand, and leaving prospective liens upon other forms of acquisitions to be dealt with as they may arise, we reject the Illinois decisions as to the effect of an assignment of wages earned after bankruptcy as being destructive of the purpose and spirit of the Bankruptcy Act.

Decree affirmed.