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Valuation Litigation

The Burden of Considering Your Burden of Proof

By Samuel H. Israel, Joshua T. Klein and Brian R. Isen

On May 14, 2012, the United States Court of Appeals for the Third Circuit issued its opinion in the case of *In re Heritage Highgate, Inc.*, 679 F.3d 132 (3d Cir. 2012), concerning the lien of a junior secured creditor and the creditor's treatment under the debtor's Chapter 11 plan of reorganization. The Third Circuit addressed the use of lien stripping under a plan of reorganization and the relevant time and standards for valuation of the creditor's collateral.

While this decision is a must read for bankruptcy practitioners dealing with multiple levels of secured debt in formulating Plans of Reorganization, it provides equally important lessons to bankruptcy litigators addressing the shifting burdens of proof required in valuation litigation under Section 506(a) of the Bankruptcy Code. This article addresses those lessons and pitfalls to avoid in trying these types of disputes in bankruptcy court.

Case Background

Since 2005, the debtor owned and developed a mixed use residential subdivision in Lehigh County, PA, planned for 411 units (the Project). A total of 101 units had been constructed and delivered when in January 2009, with the continued

continued on page 7

Dewey & Leboeuf Partner Contribution Settlement Agreements Seek to Avoid the Long And Winding Road of Law Firm Bankruptcies

By Steven B. Smith and Joy L. Monahan

The anticipated long and winding road of the Dewey & Leboeuf LLP bankruptcy case was cut short on Oct. 9, 2012, less than five weeks into the case, when the United States Bankruptcy Court for the Southern District of New York (the Honorable Judge Martin Glenn presiding) issued its Memorandum Opinion and Order granting Dewey's motion seeking an order: 1) approving certain partner contribution settlement agreements and mutual releases for participating partners; and 2) denying the motion filed by an ad-hoc committee of retired partners of Lebouef Lamb to appoint an independent examiner. This article explores the process by which the key parties-in-interest in the case successfully negotiated the Partner Contribution Settlements or PCPs, the rationale behind Bankruptcy Judge Glenn's approval of the PCPs, as well as some of the issues that the United States District Court for the Southern District of New York is currently considering on appeal.

Background

The Dewey & Leboeuf LLP (Dewey) bankruptcy case, reported to be the largest law firm failure in U.S. history, garnered national attention when it filed on May 28, 2012. At the time of its filing, Dewey owed its creditors at least $315 million, and the law firm sought Chapter 11 protection after its lenders refused to extend a $100 million credit line to keep the firm operating during the midst of an exodus of partners in large numbers and public concern about the firm's financial health. Shortly after the filing, the Office of the United States Trustee appointed both an official committee of unsecured creditors (the Committee), as well as an official committee of former partners (the FPC).

continued on page 2

In This Issue

Dewey Bankruptcy

continued from page 1

In addition to the two official committees, an ad-hoc committee of LeBoeuf 1990 pension plan retirees (the Ad-Hoc Committee) organized and appeared early in the case as well. Following on the heels of other large law firm failures such as Coudert Brothers, Heller Ehrman LLP, Howrey LLP, and Brobeck, Phleger and Harrison, among others, counsel for Dewey recognized that it could take years of contested and costly litigation for creditors and trustees to investigate and ultimately pursue preferences or "claw-back" payments made to former partners as a source of money to make creditors whole. Therefore, from the outset of the filing, Dewey's attorneys immediately sought to formulate a settlement plan with its former partners to avoid years of potential litigation, curb high administration expenses and secure a pool of funds for creditor recovery.

The goal was to settle these claims at the front end of the case in order to allow former partners to move on with their lives, while providing an early payoff to creditors. After four months of what the bankruptcy court referred to as "arms-length" negotiations between Dewey, on the one hand, and its creditors, former partners, and secured lenders, on the other hand, the parties negotiated the PCPs — a series of structured settlements — requiring former partners to pay portions of their compensation from 2011 and 2012 in exchange for receiving general releases from estate claims and causes of action that could be asserted against them. Forms of the agreement were circulated to individual former partners so that they were given the opportunity to review and provide comments to facilitate broad participation in the settlement process.

Ultimately, more than 400 of the 670 former partners agreed to contribute funds on a sliding scale based on their respective potential liability exposure in exchange for a release from the estate. Individual payments ranged from $5,000 to $3.5 million, for a total of $71.5 million, which constituted approximately 80% of the aggregate of all partner contribution amounts sought under the PCPs. Since it is alleged that three of Dewey's senior managers played a more integral role in the downfall of the firm, the PCPs explicitly excluded Chairman Steven Davis, Executive Director Stephen DiCarmine and Chief Financial Officer Joel Sanders from participating and obtaining releases, on the one hand, while preserving Dewey's claim and right to investigate and pursue claims and causes of action against these three individuals for the benefit of the estate, on the other hand. The PCPs also do not release any direct claims held by third parties or by any non-settling partner against those participating partners or Dewey's insurance policies.

The PCPs Are Fair and Equitable

In order to determine whether the PCPs were "fair and equitable," the bankruptcy court balanced the following interrelated factors from the Second Circuit case of *Motorola, Inc. v. Official Comm. of Unsecured Creditors* (*In re Iridium Operating LLC*), 478 F.3d 452 (2d Cir. 2007): 1) the balance between the litgation's possibility of success and the settlement's future benefits; 2) the likelihood of complex and protracted litigation; 3) the paramount interests of the creditors; 4) whether other parties-in-interest supported the settlement; 5) the competency

continued on page 6

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Losing Bidder Has Standing to Seek Reimbursement of Fees and Expenses

By Michael L. Cook

A New York bankruptcy court recently held that a losing acquiror in a competing Chapter 11 plan fight had "standing" to seek reimbursement of its legal fees and expenses as a "substantial contribution" to the reorganization case. *In re S & Y Enterprises, LLC, et al.*, 2012 Bankr. LEXIS 4622, at * 4-*5 (Bankr. E.D.N.Y., Sept. 28, 2012). Nevertheless, the losing acquiror failed to recover because, in the court's view, it failed to satisfy the statutory requirements for reimbursement with the requisite "preponderance of the evidence." *Id.* According to the court, Bankruptcy Code (Code) § 503(b)(3)(D) permits an entity in a reorganization case "to seek … to recover its 'actual, necessary expenses' in making a substantial contribution" only if it proves that its "contributions are of such consequence to the bankruptcy process and the parties as a whole that the debtor's estate, rather than the entity should bear the reasonable cause of those contributions . …" *Id.* at *2. The losing acquiror failed this test, reasoned the court, in a close call, at best.

Relevance

S&Y deals with an asset acquiror who had no contractual expense reimbursement rights. On the facts stated by the court, the acquiror never asked for such a provision when making its offer to the debtors. More significant, however, was the court's granting the acquiror standing to seek reimbursement while imposing, at the same time, a virtually impossible obstacle to recovery.

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Facts

Each of the two debtors in *S&Y* was a single asset real estate entity with properties in New York City. They had initially agreed to sell their properties to acquiror A for $20 million plus a 25% interest in the acquiring entity. A intended to develop the properties into "an upscale retail property." *Id.* at *6. Because of "increased construction costs and zoning issues," A later reduced the purchase the price "from $20 million to $16.5 million." *Id.* at *6. When a lender and another entity objected to the debtors' proposed reorganization plan based on the proposed asset sale to A, a new potential acquiror, B, offered to buy the property for $21 million, plus a 35% equity interest. After further litigation, A increased its offer to $21.9 million with a waiver of its claims based on the debtors' rejection of the original sale agreement. Despite B's objection, the court eventually confirmed a new reorganization plan based on A's higher bid.

A court should thus "strictly limit … compensation to extraordinary creditor actions which lead directly to tangible benefits to the creditors, debor or estate."

B later applied to the court, seeking "allowance of an administrative expense for making a substantial contribution in" the two debtor cases. According to B's papers, it "contributed to the success of the … reorganization by causing [A], the successful purchaser, to increase its offer for the Debtors' properties, by drafting and defending the Debtors' … plans and disclosure statements, which were ultimately not confirmed, by participating in motion practice and negotiations, and by paying the counsel fees and expenses of the Debtors' principals … ." *Id.* at *3.

Applicable Standards for a Substantial Contribution Award

Bankuptcy Code § 503(b)(3)(D) enables recovery of the "actual, necessary expenses" incurred by "a creditor, an indenture trustee, an equity security holder, or a committee representing creditors or equity security holders … in *making a substantial contribution* in a case" under Chapter 11 (emphasis added). These expenses may include "reasonable compensation for professional services rendered by an attorney of … an entity whose expense is allowable" under § 503(b)(3)(D). Code § 503(b)(4).

The substantial contribution provision "is intended to promote meaningful … participation in the reorganization process, but not to encourage mushrooming administrative expenses." *In re Alert Holdings Inc.*, 157 B.R. 753, 757 (Bankr. S.D.N.Y. 1993). According to the court in *S&Y*, "[p]ayment from the debtor's estate of a creditor's or other entity's counsel fees and expenses based on a substantial contribution … should be the exception, not the rule, because any allowed administrative expense diminishes the assets … available for the debtor's plan of reorganization." *Id.* at *12. A court should thus "strictly limit … compensation to extraordinary creditor actions which lead directly to tangible benefits to the creditors, debtor or estate." *Id.*, quoting *In re Best Prods. Co.*, 173 B.R. 862, 866 (Bankr. S.D.N.Y. 1994).

Standing to Seek Substantial Contribution Award

Bankruptcy Code § 503(b)(3)(D) enables certain prospective applicants, "including … a creditor, an indenture trustee, an equity security holder, or a committee representing creditors or equity security

continued on page 4

Losing Bidder

continued from page 3

holders" to seek a substantial contribution award. Because this list is nonexclusive, lower courts are split as to whether standing is limited to creditors. *See, e.g., In re Bethlehem Steel Corp.*, 2003 WL 21738964, at *8 (S.D.N.Y. July 28, 2003) (third-party plan funder "was not a creditor, and thus could not have applied for reimbursement"); *In re Innkeepers USA Trust*, Case No. 10-13800, Transcr. 71-72 (Bankr. S.D.N.Y. Aug. 2, 2011) (although bidder "was an active and positive participant in the debtor's auction and plan process," it was not a creditor and thus "not a party eligible to submit a substantial contribution claim. … "). Other courts, however, do not require creditor status in this context. *In re Frog and Peach Ltd.*, 38 B.R. 307, 310 (Bankr. N.D. Ga. 1984) (no "outright bar against an administrative claim by a meritorious, non-creditor claimant which has directly conferred a benefit upon the debtor and whose claim is outside the literal categories defined by … § 503(b)."); *In re Amfesco Industries, Inc.*, 1988 WL 141524, *4 (E.D.N.Y. Dec. 21, 1988) (acquiring investor had standing to seek substantial contribution award despite its not being "a 'creditor' in the traditional sense"), citing *Frog and Peach*, 38 B.R. at 309-10).

The *S&Y* court found the list of prospective applicants in Code § 503(b) to be "illustrative, not exclusive." 2012 Bankr. LEXIS 4622, at *17-18. According to the court, "a substantial contribution in a Chapter 11 case may come from many quarters, and that sometimes, an applicant's efforts in advancing a debtor's reorganization are of such a nature and extent that the reasonable costs of those efforts should be shifted from the applicant to the estate. … But § 503 does not open that door too wide, and the inquiry in each situation should be case-specific and fact-intensive." *Id.* at *18.

Losing Acquiror Has Standing

The Debtor and A argued that "an unsuccessful bidder for estate assets [who] is not a creditor lacks standing" to seek a substantial contribution award. *Id.* at *19. Moreover, they argued that B "could have sought a break-up fee expense reimbursement or other bid protection terms at the outset of its involvement … ," but did not do so. *Id.* Rejecting these arguments as to B's lack of standing, the court held that B had standing to apply for a "substantial contribution" award "to recover the counsel fees and expenses that it paid on behalf of itself and [the debtors' principals]," reasoning that the Code's list of "prospective applicants" is "illustrative, not an exclusive, list." *Id.* at *20. Moreover, Congress could not draft "a comprehensive list" of eligible applicants because of "the wide range of entities and enterprises that may merit" a substantial contribution award. *Id.*

Standard for Substantial Contribution Award

The applicant for a substantial contribution award has the burden of proving by "a preponderance of the evidence" that it is entitled to extraordinary relief. *In re Drexel Burnham Lambert Grp. Inc.*, 134 B.R. 482, 489 (Bankr. S.D.N.Y. 1991). Moreover, the burden "is exceedingly difficult since the general presumption is that the [applicant] is acting in its own interest." *In re Villa Luisa*, 354 B.R. 345, 348 (Bankr. S.D.N.Y. 2006). Thus, one court held, in the context of a bankruptcy auction that a substantial contribution award to an unsuccessful bidder was not warranted:

> [W]hen a creditor is pursuing its own economic self-interest, as by definition it does as a bidder at a bankruptcy auction, then that creditor cannot establish the requisite 'direct benefit' which the case law requires in order to grant a creditor a [substantial contribution] award.

In re Pub. Serv. Co. of N.H., 160 B.R. 404, 452 (Bankr. D.N.H. 1993).

Courts have focused on "process as much as on contribution, on the movant's substantial contribution in the case — that is, the entire Chapter 11 case." *In re Bayou Grp., LLC*, 431 B.R. 549, 561 (Bankr. S.D.N.Y. 2010):

> The majority of cases allowing creditors' substantial contribution claims under sections 503(b)(3)(D) and (b)(4) have … found that the creditor played a leadership role that normally would be expected of an estate-compensated professional but not so performed; most have, … involved a creditor who actively facilitated the negotiation and successful confirmation of the Chapter 11 plan or, in a opposing a plan, brought about the confirmation of a more favorable plan.

Bayou, 431 B.R. at 562. Relying on these few precedents, the *S&Y* court applied them narrowly to B's claim.

B's Arguments

B argued that its efforts resulted in a $4.5 million higher bid from A; "provided a greater ownership interest in" the reorganized entity for the debtor's principals; enhanced the debtors' "negotiating leverage" with A; formulated and defended a new reorganization plan on the debtors' behalf; participated in "extensive discovery" to show that it "was a 'real' bidder and that the second amended plans were viable"; and participated in motion practice and discovery. 2012 Bankr. LEXIS 4622, at *28. Arguing that "it effectively acted as co-counsel to the Debtors," that its services were "essential" and that "self-interest [did] not preclude" an award, B sought "counsel fees and expenses" of "more than $1 million." *Id.* at *28-*29.

Court's Reasoning: Indirect Benefit Not a Substantial Contribution

Despite acknowledging B's standing to seek reimbursement, the court denied its application. First,

continued on page 5

Losing Bidder

continued from page 4

B's activities were "principally in furtherance of its efforts to acquire the Debtors' properties … and to advance [its] own interests, not the interests of the bankruptcy estate or the parties as a whole." *Id*. at *32. Second, despite causing A to increase its purchase price, the court found this activity led to "an indirect benefit," which was "not enough." *Id*. at *32-*33. Finally, although the reorganization was successful in the sale of the debtors' properties, B's "efforts were directed toward its own objectives, not the entire bankruptcy process." *Id*. at 33.

Nor could B be compensated for its legal fees incurred on behalf of the debtors' principals. First, there was no evidence that the principals "played a role in the bankruptcy process that yielded a direct and significant benefit to the bankruptcy estate or the parties as a whole." *Id*. at *38. Nor did B show that the principals "would have been unable to retain counsel or participate in these … cases if it had not paid these sums." *Id*.

Comments

1. The *S&Y* court summarily dismissed the tangible benefit conferred by B on the debtors' estate and all creditors: causing A to increase "its offer for the … properties by $4.5 million … ." *Id*. at *28. According to the court, "the primary objective of [B's] activities was to advance [its own] interest, not the interest of the bankruptcy estate or the parties as a whole." *Id*. at *32. As shown below, however, the court's analysis is unfairly narrow in view of applicable case law.

2. B was no mere bidder at an auction. When A, the only apparent buyer, unilaterally reduced its original bid, B stepped up with a $4.5 million higher bid, causing A to top B's offer by another $900,000. B also did the work to amend the debtors' original reorganization plan and disclosure statement, effectively inducing A to return with an even higher offer for the debtors' assets. In the end, it was only because of B's effort that creditors realized $21.9 million rather than the reduced $16.5 million offer from A.

3. Significantly missing from the *S&Y* court's decision was any mention of important appellate decisions authorizing "substantial contribution" awards on similar or even less favorable facts. *See, e.g., In re DP Partners Ltd. Partnership*, 106 F.3d 667, 673 (5th Cir. 1997) ("Thus, the phrase 'substantial contribution … means a contribution that is 'considerable in amount, value or worth.' The benefits, if any, conferred upon an estate are not diminished by selfish or shrewd motivations. We therefore hold that a creditor's motive in taking actions that benefit the estate has little relevance in the determination whether the creditor has incurred actual and necessary expenses in making a substantial contribution to a case … . At a minimum, the court should weigh the cost of the claimed fees and expenses against the benefits conferred upon the estate which flow directly from those actions"; party discovered fraudulent transfers, and caused amendment of reorganization plan; " … participation in the confirmation fight resulted in a least a $3,000,000 benefit to all creditors of the estate."); *In re Celotex*, 227 F.3d 1336, 1339 (11th Cir. 2000) (adopting the Fifth Circuit's holding in *DP Partners* that motive "has little relevance" in determining whether a party made substantial contribution; " … it is difficult to imagine a circumstance in which a creditor will not be motivated by self-interest in a bankruptcy [case]. To impose an altruism requirement on the ability to obtain" an award "would effectively render the section meaningless … ."; applicant "played a significant role in the successful negotiation of a consensual plan …"; "a large portion of credit for achievement of the plan was attributable to [him] because of his credibility and the experience … that he brought to the process"; without his "efforts a reorganization plan may not have been achieved"; " … a substantial contribution has been demonstrated."); *In re Cellular 101, Inc.*, 377 F.3d 1092, 1097 (9th Cir. 2004) (creditors "substantially contributed to the reorganization. [They] formulated and presented the only reorganization plan that … resulted in the payment to creditors of 100% of the creditors' allowed claims with funds remaining for the equity security holders. … [A] creditor need not provide the funds used in the reorganization in order to 'substantially contribute' to the plan."); *In re Roberts*, 93 B.R. 442, 445 (D. So. Cir. 1988) (affirmed bankruptcy court's "substantial contribution" award to unsecured creditor whose "efforts to secure interest payments for all unsecured creditors was continuous throughout the pendency of" case; creditor "was protecting the interests of all unsecured creditors rather than just its own interests"; its "efforts may have resulted in as much as an additional … $75,000 … in interest payments to the unsecured creditors."). *See also In re 9085 E. Mineral Office Bldg., Ltd.*, 119 B.R. 246, 249-50 (Bankr. D. Colo. 1990) (held, substantial contribution when, due to applicant's efforts, all creditors received superior payout to that proposed by debtor).

4. An appellate court in *S&Y* could easily reach a different result from the one reached by the bankruptcy court. The Second Circuit has yet to weigh in on Code § 503(b)(3)(D), but if $3 million is enough for the Fifth Circuit in *DP Partners, supra*, $4.5 million should be "substantial," even in New York. If that is not a "substantial contribution" in a relatively small real estate case, nothing will ever be.

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Dewey Bankruptcy

continued from page 2

and experience of counsel and the bankruptcy court judge supporting and reviewing the settlement; 6) the nature and breadth of releases to be obtained by officers and directors, and 7) the extent to which the settlement was the product of arm's-length bargaining.

Applying the business judgment standard to its Rule 9019 analysis, rather than the heightened scrutiny of the entire fairness doctrine advocated by the FPC, the bankruptcy court addressed each of the foregoing *Iridium* factors and ultimately concluded as follows: 1) the PCPs "would avoid the costs of expensive and time-consuming litigation, conserve the Debtor's resources to pursue claims against those most likely to have mismanaged the firm, and minimize the risk of expending the Debtor's liability insurance policy on unnecessary defense costs" while bringing roughly $70 million into the estate for the benefit of creditors; 2) the secured lenders, the Committee (despite the fact that the settlement would result in only a "twenty cent plan" for its constituents) and a majority of former partners each favored the settlements; 3) Dewey's legal and financial advisors had been actively engaged in prior large law firm bankruptcies; 4) the releases exchanged by Dewey and the participating partners — of claims held by the estate against the participating partners and claims held by participating partners against the estate — were reasonable and necessary to accomplish the purposes of the PCPs and, importantly, did not include any third-party non-debtor releases; and 5) the PCPs were developed by independent professionals and were negotiated with partners at arms' length. The bankruptcy court therefore concluded that application of the *Iridium* factors mandated a finding that the PCPs were both fair and equitable and, as a result, approved the 9019 motion.

The Denial of the Examiner Motion

While many practitioners reviewing the bankruptcy court's opinion will focus on the court's analysis and ultimate approval of the PCPs, the court's denial of the motion to appoint an independent examiner to evaluate the merits of the PCPs, filed by the Ad-Hoc Committee and supported by the FPC, is noteworthy as well. The bankruptcy court first analyzed whether, pursuant to section 1104(c)(2) of the Bankruptcy Code, Dewey had fixed, liquidated, unsecured debts, other than debts for goods, services or taxes, or owing to insiders, that exceeded $5 million.

While the foregoing condition is usually satisfied in many large Chapter 11 cases where there is outstanding unsecured funded debt, the bankruptcy court found that the Ad-Hoc Committee and the FPC were unable to meet their burden at trial to prove that Dewey had satisfied this condition given the unique facts and circumstances of the case.

Thereafter, the bankruptcy court concluded that even assuming the satisfaction of the $5 million condition in section 1104(c)(2), the appointment of an examiner was neither mandatory nor in the best interests of the estate, finding that: 1) it was in its discretion to determine if the appointment of an examiner was required under the facts of the case; 2) the examiner motion was filed for an improper purpose as a clear litigation tactic to derail approval of the PCPs; and 3) the expense of an examiner and the delay required to complete the examiner investigation and report would only add needless expense and delays and given the precarious financial situation, would cause this case to convert to a case under Chapter 7 as well as result in a possible administrative insolvency.

Judge Glenn joins Delaware bankruptcy court Judges Christopher L. Sontchi (*In re Visteon Corp.*, Case No. 09-11786 (Bankr. D. Del. May 12, 2010)) and Kevin S. Carey (*In re Spansion, Inc.*, 426 B.R. 114, 128 (Bankr. D. Del. 2010)), among others, who also agree that the appointment of an examiner is not mandatory, notwithstanding the language in section 1104(c)(2) which, on its face, appears to mandate such appointment in cases where the $5 million unsecured debt threshold is satisfied.

The Appeal

Both the FPC and the Ad-Hoc Committee have appealed the bankruptcy court's order approving the PCPs, and have raised the following issues presented on appeal, among others: 1) whether the bankruptcy court erred when it found that the PCPs were not related-party transactions that would trigger the applicability of the entire fairness doctrine to the court's analysis of the PCPs under Bankruptcy Rule 9019; 2) whether the bankruptcy court erred by approving the PCPs notwithstanding Dewey's admitted failure to investigate tort claims against released partners; 3) whether the bankruptcy court erred when it denied the motion to appoint an examiner under section 1104(c)(1) or (2), and (4) whether the bankruptcy court erred to the extent it approved the 9019 motion outside of and prior to a plan of liquidation.

Conclusion

The approval of the PCPs has generated quite a bit of attention primarily because it was constructed at the front end of the bankruptcy and approved within a few months after the bankruptcy filing. Indeed, as noted by the bankruptcy court, there was also a significant amount of cooperation between the former partners, the secured lenders and the creditors to reach a consensus in a relatively short time, in order to avoid the tortured and twisted trail traveled by other fallen firms. Depending upon its success, the PCP architecture constructed in the Dewey case could provide a potential model for future law firm bankruptcies. Needless to say, all eyes are on the district court as it considers the following question: "Dewey" or don't we affirm the partner contribution settlements?

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Burden of Proof

continued from page 1

collapse of the residential real estate market and the debtor in default and facing foreclosure, a bankruptcy was filed with the intent to reorganize under Chapter 11, complete the Project, and distribute the net proceeds to creditors. The debtor financed the Project though a bank loan that was secured by a first-priority lien on substantially all of the debtor's assets (the Senior Secured Debt). To raise additional working capital for the Project, in 2008 the debtor entered into prepetition loan agreements with a group of individuals and trusts (the Subordinate Lenders) and granted to each a second lien on substantially all of the debtor's assets.

The debtor initially filed a plan of reorganization that incorporated a "waterfall" for payment to secured and unsecured creditors through net revenues generated from build-out of the Project and sale of the residential housing units. As originally proposed on June 9, 2009, the debtor's plan would first pay the Senior Secured Lenders in full, then pay the Subordinate Lenders in full starting in 2012, and then starting in 2013 pay the unsecured creditors on a pro rata basis the balance of the plan proceeds projected to result in an unsecured dividend of approximately 20% before the build out was to be completed in 2013. The payment waterfall and timing were based upon projections of cash flows produced by the debtor and attached to the plan as an exhibit (the Projections).

On Sept. 4, 2009, the Official Committee of Unsecured Creditors (Committee) filed its motion to determine the value of the secured claims of the Subordinate Lenders pursuant to Bankruptcy Code § 506(a) and Rule 3012 of the Federal Rules of Bankruptcy Procedure (the Motion). In conjunction with the Motion, the Committee objected to the proposed treatment of the Subordinate Secured Claim under the plan. Citing Bankruptcy Code §§ 506(a) and (d), as well as the Motion, the Committee took the position that the Subordinate Debt was wholly unsecured, and that it violated the absolute priority rule for the Subordinate Lenders to have their claims paid before the commencement of payments to other unsecured creditors. The plan was then modified to provide that the treatment for the Subordinate Debt would be determined by the bankruptcy court's decision on the Committee's Motion, which the Committee and the Subordinate Lenders agreed would occur after confirmation of the plan. The Subordinate Lenders did not object, and the plan was confirmed on April 1, 2010.

In connection with the hearing on the Motion, the Committee and the Subordinate Lenders stipulated that based on an appraisal from 2009 (the Appraisal), which was submitted in connection with a contested cash collateral hearing, adjusted to account for the units sold during the period while the debtor was in Chapter 11, the total fair market value of the Project as of the Confirmation Date was $9,362,264.15 (the Confirmation Date Value). The Confirmation Date Value was based on the $15 million fair market value established by the Appraisal, minus the per lot Appraisal values attributed to each Project phase, multiplied by the number of lot sales since the date of the Appraisal to the Confirmation Date.

In the Courts

In bankruptcy court, the Subordinate Lenders argued that in valuing their claim for distribution purposed, the Projections should control over the Confirmation Date Value established by the Appraisal, and that since the Projections showed sufficient cash flow to pay in full the Subordinate Debt with a residual for payment on account of unsecured claims, the Subordinate Lenders should retain the full benefit of their liens on the Project. Rejecting this position, the bankruptcy court concluded that the security interests of the Subordinate Lenders should be limited to the fair market value of the Project as of the effective date of the plan, and that the Appraisal, not the Projections, was the only true determinant of value presented for that that purpose.

As a result of the ruling, the claims of the Subordinate Lenders would be treated as wholly unsecured, included with all other unsecured creditors for purposes of the distribution under the Plan, and paid pro rata with the other unsecured creditors after payment in full of the Senior Secured Debt. The district court affirmed the Order of the bankruptcy court, and the Subordinate Lenders took the case to the court of appeals.

First, the Third Circuit determined that the fair market value of collateral is the appropriate standard where a Chapter 11 plan of reorganization provides for a debtor to retain such collateral in order to generate income and make payments to creditors. The court rejected the contention of the Subordinate Lenders that a market based on a "wait-and-see" approach to valuation of the Project should be utilized using the plan projections presented by the debtor to establish feasibility. The court then clearly indicated that the time for valuation under § 506(a) is at the time of confirmation of a Chapter 11 plan of reorganization. The court held that the bankruptcy court correctly concluded that the Subordinate Debt was wholly unsecured because: 1) the plan called for retention of ownership of the Project; 2) the discounted fair market value of the Project as of the plan confirmation date best approximated how secure the claims of the Bank Lenders and the Subordinate Lenders were; and 3) the stipulated Appraisal accurately calculated the fair market value of the Project.

continued on page 8

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Burden of Proof

continued from page 7

In its ruling, the court also "clarified" the burden of proof with respect to collateral valuations in the § 506(a) context. Observing that neither the Bankruptcy Code nor the Federal Rules of Bankruptcy Procedure allocates the burden of proof in such proceedings and acknowledging that as a result "courts have arrived at divergent formulations," the Third Circuit adopted a burden-shifting framework. Under the Third Circuit's ruling, the filing of the Secured Claim is *prima facie* evidence of its validity. The initial burden then is on the challenger of the secured claim to first establish with "sufficient evidence" that the value of the collateral is insufficient. Once the initial burden is met, the burden shifts to the secured creditor asserting the claim to "demonstrate by a preponderance of the evidence both the extent of its lien and the value of the collateral securing its claim."

Lessons Learned

As noted above, the Third Circuit took the occasion in *Heritage Highgate* to request supplemental briefing and then write on an issue that was not addressed by the bankruptcy court or district court — the burden of proof in valuation disputes under Section 506(a). The shifting burden approach adopted by the court has provided clarity to the bar; however, it also raises strategic questions that need to be addressed with the client as early as possible in the litigation.

The most significant strategic decision that needs to be addressed is whether and when to obtain a valuation expert. While the obvious answer might seem to be that both sides should obtain experts as soon as possible, financial constraints might play a role in the decision. For example, the secured creditor's burden is initially met simply by filing a proof of claim in the amount of the secured claim; thus it need not obtain an expert opinion at the beginning of the case.

The burden then shifts to the challenger to produce "sufficient evidence" to challenge the value of the collateral. While the court did not indicate what is meant by the words "sufficient evidence," it would appear that anything less than an expert opinion on value would fall short of meeting this burden.

Once the challenger produces such sufficient evidence (presumably, through the submission of an expert opinion), the burden shifts back to the secured creditor to prove by a preponderance of evidence that the value of the collateral exceeds the debt. The creditor must then decide whether to obtain a rebuttal expert opinion in order to meet its ultimate burden of proof.

While, here again, the obvious choice would be to obtain a rebuttal opinion, cost might be a factor to your client. In the absence of obtaining a rebuttal report, then, is all lost for the challenger? Maybe not, depending upon the strength of the secured creditor's expert opinion.

For example, § 506(a) provides that the "proposed disposition and use of the collateral is of paramount importance to the valuation question." 11 U.S.C. § 506(a). Thus, an initial inquiry should be made as to whether the challenger's expert opinion addressed the proposed disposition and use of the collateral. In *Associates Commercial Corp. v. Rash*, 117 S.Ct. 1879 (1997), the Supreme Court rejected a foreclosure valuation where the Chapter 13 debtor intended to use the collateral to generate an income stream, noting that the foreclosure valuation standard in that instance did not take into consideration the proposed "disposition and use" of the collateral.

Thus, if a challenger's expert opinion on the collateral value fails to take into consideration the proposed disposition and use of the collateral, the secured creditor might be able to avoid submitting a competing opinion, attack the expert opinion on cross examination at trial and then argue that the challenger failed to meet its initial burden under § 506(a). While this might be a viable and cost-effective strategy, it is extremely risky and, indeed, proved ultimately fatal to the Subordinate Lenders in *Heritage Highgate,* who employed such a strategy.

As noted above, the Subordinate Lenders in *Heritage Highgate* decided against submitting a competing expert valuation opinion at trial. Instead, they challenged the Appraisal submitted by the Committee as based on a methodology that, they argued, did not take into consideration the proposed disposition and use of the collateral. The Subordinate Lenders advanced the novel theory that, because the residential subdivision was to be completed over the next several years, the valuation as of the Plan confirmation date did not take into consideration the proposed disposition and use and, instead, the valuation should be predicated on a "wait-and-see" approach based on projections as to future sales. The Third Circuit rejected the theory and concluded that the challenger's appraisal was based on a proper valuation standard. Accordingly, because the Subordinate Lenders' attack on the Committee's expert opinion methodology failed, they were left with no way to meet their burden of proof as to the value of the collateral secured by its lien.

Conclusion

Ultimately, the *Heritage Highgate* decision may serve as a reminder to bankruptcy litigators to begin thinking about burdens of proof early and often during the course of a valuation dispute, or anticipated valuation dispute, under § 506(a) as well as other sections of the Bankruptcy Code. Strategic decisions will need to be made and discussions held with cost-sensitive clients with those burdens of proof in mind.