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## To Possess Or Not To Possess: What are the lessons to take away from *Kemp v. Countrywide*?

By Scott B. Lepene and Kristen M. Senk

*To possess or not to possess, that is the question.*

Arguably as complex as a Shakespearian play, what constitutes possession of a negotiable instrument can create significant issues. However, a simple solution exists—require actual possession.

In the April edition of the of the ABI Journal, David Pisciotta and Oscar Pinkas, of the law firm SNR Denton US LLP, published an article entitled *Lien on Me: Kemp v. Countrywide: Problem of Possession*. In *Lien on Me*, Messrs. Pisciotta and Pinkas argued that the U.S. Bankruptcy Court for the District of New Jersey in *Kemp v. Countrywide* wrongfully determined that actual possession of a negotiable instrument is required to enforce a note under the Uniform Commercial Code (UCC). More specifically, *Lien on Me* suggests that the *Kemp* decision could detrimentally affect properly transferred mortgages against mortgagors. While *Lien on Me* is well written and provides for some thought-provoking considerations, we disagree with its conclusion and analysis of *Kemp*. This article serves as a rebuttal to *Lien on Me* and will demonstrate why the *Kemp* holding correctly interprets the “possession” requirement under the UCC.

### The *Kemp* Case

The relevant facts of *Kemp* are quite simple. John Kemp executed a note and mortgage in favor of Countrywide Home Loan, Inc. (Countrywide).<sup>1</sup> Countrywide assigned the mortgage and associated note to Bank of New York as Trustee (Bank of New York).<sup>2</sup> Through a Pooling and Service Agreement, Countrywide Home Loans Servicing (Countrywide Servicing) became the master servicer of the debtor’s loan.<sup>3</sup>

Countrywide never transferred possession of the note to Bank of New York.<sup>4</sup> Rather, the *Kemp* Court determined that either Countrywide or Countrywide Servicing retained possession of the note.<sup>5</sup>

The debtor eventually filed a voluntary petition for relief under Chapter 13 of the Bankruptcy Code.<sup>6</sup> Countrywide Servicing, on behalf of Bank of New York, filed a proof of claim, claiming that it was the servicer for the loan.<sup>7</sup> The debtor sought to expunge the proof of claim.<sup>8</sup>

The Court ultimately denied the proof of claim, finding that Bank of New York did not qualify as a party entitled to enforce the instrument under the New Jersey UCC.<sup>9</sup>

Under UCC § 3-301, a party is entitled to enforce a note if the party is: (1) the holder of the instrument, (2) a nonholder in possession of the instrument who has the rights of a holder, or (3) a person not in possession of the instrument who is entitled to enforce the instrument pursuant to §§ 3-309 or 3-418.<sup>10</sup> Only the first two qualifiers were potentially applicable in *Kemp*, and they both turned on whether Bank of New York came into possession of the note.

## To Possess Or Not To Possess: What are the lessons to take away from *Kemp v. Countrywide*? (continued from page 1)

As to the first qualifier—a holder of the instrument—the *Kemp* Court correctly found that Bank of New York was not entitled to enforce the note as a holder of the note.<sup>11</sup> A “holder” is defined as “the person in possession if the instrument is payable to bearer or, in the case of an instrument payable to an identified person, if the identified person is in possession.”<sup>12</sup> Bank of New York was not a holder for two reasons. First, the note was not endorsed to Bank of New York.<sup>13</sup> An endorsement must be on the instrument itself or “so firmly affixed to the instrument as to become an extension or part of it,” and no such endorsement existed on the note at issue.<sup>14</sup> Second, Bank of New York was not in actual possession of the note.<sup>15</sup>

As to the second statutory qualifier—a nonholder in possession of the instrument who has the rights of a holder—Bank of New York did not qualify for the same reason that it did not qualify for the first category. Bank of New York was not in possession of the note. Accordingly, the Court disallowed Bank of New York’s proof of claim.

### *Kemp* and Actual Possession

The *Kemp* decision rightfully interpreted the UCC and as a result, Bank of New York was not entitled to enforce the note. As stated above, a “holder” is a person in possession of a bearer instrument or an instrument payable to the person in possession of the instrument.<sup>16</sup> Clearly, Bank of New York had neither and therefore could not enforce the note.

In *Lien on Me*, the authors suggest that the *Kemp* Court failed to appropriately consider Bank of New York’s constructive possession of the note through its alleged agent, Countywide or Countrywide Servicing. Moreover, they argued that such possession should be given appropriate treatment when the UCC is silent and ambiguous. However, there is nothing silent in the UCC when it pertains to the requirements for a “holder” of a note. As reflected in *Kemp*, a “holder” eligible to enforce a note must be (i) in possession of it, or (ii) the endorsee of the note. *Kemp* correctly determined that Bank of New York could not enforce the note because “the maker of the note must have certainty regarding the party who is entitled to enforce the note.”<sup>17</sup> Without an endorsement of the note to Bank of New York, and Bank of New York’s failure to maintain actual possession of the note, a lack of certainty regarding the enforceability of the note existed.

*Black’s Law Dictionary* defines possession as “[t]he fact of having or holding property in one’s power; the exercise of dominion over property. . . .”<sup>18</sup> Given the ambiguity and the issues surrounding possession, the *Kemp* Court’s decision

establishes an objective mechanism for resolving this ambiguity. Additionally, applying the *Kemp* standard will provide parties with the appropriate framework to determine who has the right to enforce a note. Without such a standard, a slippery slope may ensue, where courts will implement a more subjective standard in gauging the parties’ intent to a note’s enforceability. As a result, such a standard would lead to a reliance on ambiguous standards that could subject the maker of the note to multiple claims for payment on the note.

The UCC allows a person to enforce an instrument even if that person does not have actual possession in only one situation. Under UCC § 3-309, a person not in possession of an instrument may enforce the instrument if the instrument was lost, stolen, or destroyed and other requirements are met. One such requirement is that the person was in possession of the instrument before it was lost, stolen, or destroyed.

The reason for the possession requirement for lost, stolen, or destroyed instruments is the same for the possession requirement in cases like *Kemp*. It protects the maker by ensuring that the maker pays the person actually entitled to enforce the note. The maker is discharged from its obligation to pay the note only if the maker pays a person actually entitled to enforce the note.<sup>19</sup> To ensure that the maker is not subjected to multiple obligations on a single note, a clear rule, such as *actual* possession, is crucial. Without actual possession, it may be unclear to whom the maker or subsequent transferees intended to give the right to enforce the instrument. For example, what constitutes constructive possession? Must the person attempting to enforce the note have the right to control the person possessing the note? Must the person attempting to enforce the note have full and unfettered access to the note? The responses to these questions would undoubtedly vary. Conversely, actual possession is actual possession and provides a uniform standard that allows for the parties to the note to plan accordingly.

Therefore, the *Kemp* Court got it right. The Court interpreted the word “possession” in the UCC by its plain meaning and in a way that is easy for both courts and parties to apply.

<sup>1</sup> *Kemp*, 440 B.R. 624, 627 (2010).

<sup>2</sup> *Id.*

<sup>3</sup> *Id.*

<sup>4</sup> *Id.*

<sup>5</sup> *Id.* at 629.

<sup>6</sup> *Id.* at 626.

<sup>7</sup> *Id.*

<sup>8</sup> *Id.*

<sup>9</sup> *Id.* The *Kemp* Court applied New Jersey’s version of the UCC. However, for purposes of this article, we will refer only to the UCC.

<sup>10</sup> *Id.* at 630.

<sup>11</sup> *Id.* at 631.

<sup>12</sup> *Id.* citing § 1-201.

<sup>13</sup> *Id.* at 630.

<sup>14</sup> *Id.* at 631 citing UCC Commentary.

<sup>15</sup> *Id.* at 630.

<sup>16</sup> UCC § 3-301.

<sup>17</sup> *Kemp*, 440 B.R. at 631, citing *Adams v. Madison Realty & Dev. Inc.*

<sup>18</sup> *Black’s Law Dictionary* 1281 (9th ed. 2009).

<sup>19</sup> UCC § 3-602.

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## *Iqbal* and the Pleading of Affirmative Defenses

By Mark A. Phillips

Since it was announced on May 18, 2009, the Supreme Court's decision in *Ashcroft v. Iqbal*<sup>1</sup> has generally been regarded as "good news" for defendants,<sup>2</sup> imposing heightened pleading requirements on plaintiffs in all federal civil cases and creating a new standard for the dismissal of complaints that requires trial courts to assess the "plausibility" of the claims alleged. In their enthusiastic embrace of the Court's holding, few in the defense bar appear to have considered that the pleading requirements and dismissal criterion articulated in *Iqbal* and its precursor, *Bell Atlantic Corp. v. Twombly*,<sup>3</sup> might be no less applicable to the assertion of affirmative defenses and the determination of motions to strike those defenses pursuant to Federal Rule of Civil Procedure 12(f).

To be sure, *Twombly* and *Iqbal* provide no indication that this result was intended by the Court. The analysis in both decisions focuses almost exclusively on the requirements imposed by Federal Rule of Civil Procedure 8(a)(2) for pleadings stating a claim for relief. Neither decision contains any reference to affirmative defenses or the requirements of Federal Rule of Civil Procedure 8(c). Yet within months of the issuance of *Twombly* in May 2007, courts began finding that the requirements it sets forth regarding the factual allegations needed to state a claim for relief were "equally applicable" to the pleading of affirmative defenses.<sup>4</sup> Since then, the district courts have been divided on the issue,<sup>5</sup> with a significant number, if not the majority, extending the holdings of *Iqbal* and *Twombly* to strike affirmative defenses that are not supported by sufficient factual allegations or are deemed "implausible" based on the facts alleged. In many cases, this result has been predicated on pre-*Twombly* case law in the relevant district or circuit concerning the pleading standards applicable to affirmative defenses. In other instances, the extension of *Iqbal* to affirmative defenses would appear directly contrary to established precedent in the applicable circuit and has given rise to contradictory opinions among judicial officers within the same district.

The likelihood that this issue will be conclusively resolved at any point in the near future appears remote. The most frequently cited guidance from the Supreme Court with respect to the pleading of affirmative defenses is a two-sentence passage from the Court's 1971 decision in *Blonder-Tongue Labs., Inc. v. Univ. of Ill. Found.* Citing Rule

8(c), the Court notes that an affirmative defense must be pleaded in a responsive pleading in order "to give the opposing party notice" of its assertion and "a chance to argue" why the imposition of the defense "would be inappropriate."<sup>6</sup> The rule itself offers no greater clarity as to how a defense must be pleaded, providing merely that "a party must affirmatively state any avoidance or affirmative defense" in responding to a pleading.

Absent a clear directive as to the extent of the "notice" required or when the assertion of a defense should be found to be "inappropriate," the lower courts had developed and applied widely divergent standards for the pleading of affirmative defenses. In certain circuits, the courts found that the rules governing the pleading of claims by plaintiffs applied equally to affirmative defenses and required that a defendant allege facts supporting each element of a defense.<sup>7</sup> By contrast, others courts of appeals viewed the conclusory assertion of an affirmative defense, e.g., "plaintiff's claims are barred by the doctrine of res judicata," as sufficient because it provided the plaintiff with "fair notice" that the defense would be at issue in the action.<sup>8</sup> This split in prior law foreshadows a conflict regarding the extension of *Iqbal* that may remain unresolved for years, offering fertile ground for motion practice in the district courts and new grounds for appeals by dissatisfied litigants.

How exactly the *Iqbal* standard translates to the pleading of affirmative defenses and the determination of motions to strike alleged defenses as "insufficient" pursuant to Rule 12(f) is, in some respects, less than clear. *Iqbal* holds that, to survive a motion to dismiss made pursuant to Federal Rule of Civil Procedure 12(b)(6), "a complaint must contain sufficient factual matter, accepted as true, to 'state a claim to relief that is plausible on its face.'"<sup>9</sup> This standard requires a two-prong analysis by the court in deciding the motion. First, it is to consider whether the complaint contains well-pleaded factual allegations or simply "[t]hreadbare recitals of the elements of a cause of action, supported by mere conclusory statements" that are not entitled to the assumption that they are true. Second, even if the complaint contains well-pleaded factual allegations, the court must determine whether that "factual content . . . allows the court to draw the reasonable inference that the defendant is liable for the misconduct alleged." This plausibility analysis is "a context-specific task that requires the reviewing court to draw upon its judicial experience and common sense" and necessitates that the court be able to infer from the pleading's factual allegations "more than the mere possibility of misconduct. . . ."<sup>10</sup>

Under this test, the mere recitation of one or more of the defenses enumerated in Rule 8(c) without the allegation of at least some factual predicate plainly would be deemed insufficient. Indeed, most of the decisions applying *Iqbal* and *Twombly* to strike defenses have done so where the defendant has offered nothing more than "threadbare" and conclusory recitals, unsupported by factual allegations, of its alleged defenses. However, the nature and extent of factual pleading required of a defendant in support of its

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defenses remains an open question. In one of the few reported decisions extending *Iqbal* to the pleading of affirmative defenses, the district court suggests that “[a] minimal statement of only ultimate facts should suffice” to satisfy *Iqbal*’s “heightened pleading standard” and refers the parties to Form 30 appended to the Federal Rules of Civil Procedure as exemplifying the appropriate mode of pleading.<sup>11</sup> Yet, another court applying the *Iqbal* standard to affirmative defenses has concluded that the “bare recitation” of a failure to state a claim defense, even though seemingly approved by this form, is insufficient without allegations explaining the deficiencies in the plaintiff’s stated claims.<sup>12</sup> Those decisions applying the *Iqbal* standard to answers where a modicum of facts are alleged suggest that what one court may consider the allegation of an “ultimate fact” another may deem to be a little more than “a legal conclusion couched as a factual allegation” that is unworthy of acceptance as true under the test.

Moreover, the pleading of “only ultimate facts” may leave a court unable to assess the plausibility of an affirmative defense under the second prong of the *Iqbal* standard. In *HCRI TRS Acquirer, LLC v. Iwer*, an action on a guaranty, the defendants asserted a defense of economic duress by alleging, “[t]hat the Defendants executed the Guaranties and consents attached to Plaintiff’s Complaint only as a result of economic duress caused by the control of Progressive [the primary obligor] or its agents.” In striking the defense, the court noted that these allegations failed to identify who created the economic duress, when it was created, or how the alleged “control” of Progressive by the plaintiff might have caused duress sufficient to satisfy the required elements of such claim. It found that, in the absence of such allegations, the defense did not “fit” with the defendants’ admission in their answer that the underlying loan agreement had been amended four times over the course of almost three years and therefore was not “plausible.”<sup>13</sup>

This result can be contrasted with the court’s refusal to strike a “good faith” defense in another guaranty case, *Bank of Montreal v. SK Foods, LLC*. In that action, the defendant guarantor offered “a litany of allegations” regarding the plaintiff’s conduct in support of its assertion that the plaintiff had breached the implied covenant of good faith and fair dealing by assuring that it was unable to collect the underlying debt from the bankrupted

borrowers. Although the court found the conduct alleged “equally consistent with lawful behavior” and “somewhat implausible,” it concluded that striking the defense at the outset of the litigation would be “inappropriate” in the absence of a fully developed record from which it could determine whether the plaintiff was “honest and prudent” in its dealings with the borrowers.<sup>14</sup>

The level of detail required in pleading operative facts to state a “plausible” affirmative defense will obviously vary with the nature of the defense alleged. For certain defenses, the pleading burden may be relatively insubstantial. To assert a statute of limitations defense, for example, it would appear sufficient to allege “facts” regarding the applicable limitations period and either its commencement or expiration date, allowing the court to infer that the plaintiff’s claim was filed after the period had expired. By contrast, the assertion of an equitable estoppel defense would require more detailed factual allegations regarding each element of estoppel, showing: (1) words, conduct, or acquiescence by the plaintiff that induces reliance; (2) willfulness or negligence on the part of the plaintiff with regard to its acts, conduct, or acquiescence; and (3) detrimental reliance on the part of the defendant.<sup>15</sup> Those allegations must be sufficient to allow the court to conclude that the defendant could plausibly – not just conceivably – prevail with respect to the defense. In short, the factual pleading required of a defendant in support of many affirmative defenses becomes no different than that required of a plaintiff to show that it has a plausible claim for relief.

The implications of extending *Iqbal* to the pleading of affirmative defenses will undoubtedly become clearer as more district courts consider challenges to defendants’ pleadings. In those jurisdictions where defendants previously have been required to support the assertion of affirmative defenses with a “short and plain statement of facts” alleging the necessary elements of each defense, the impact on pleading practices may be marginal. In those that have regarded the mere recitation of the defense as sufficient, the effect on those practices would obviously be far more profound.

Whether the application of *Iqbal* to affirmative defenses will ultimately become the universal or even majority rule remains, however, an open question. A significant number of courts have rejected the extension of *Iqbal* precisely because the Supreme Court’s analysis was limited to the requirements for pleadings stating a claim for relief under Rule 8(a)(2). That rule requires that a claim be stated in a manner “showing that the pleader is entitled to relief.” As several courts have pointed out, neither Federal Rule of Civil Procedure 8(b)(1)(A) or Rule 8(c) requires that a defendant “show” anything by its pleading; rather, they provide only that the pleader “state in short and plain terms its defenses to each claim” and “affirmatively state any avoidance or affirmative defense.” This reading of Rule 8 rejects any equivalency between the pleading standards imposed on plaintiffs with those applicable to defendants, refusing to read into the word “state” any requirement that the pleader must “show” that it is “plausibly” entitled to judgment. To paraphrase one court, what is “sauce for the goose” may not necessarily be “sauce for the gander” under the applicable rules.<sup>16</sup>

What appears certain is that, until this issue is definitively resolved in each circuit, the potential that a district court might apply *Iqbal* to a defendant's pleading of affirmative defenses will alter pre-trial strategy and practice. Upon service of an answer, plaintiffs must consider whether the filing of a motion to strike under Rule 12(f) is warranted based on the insufficiency of the defendant's pleading of its affirmative defenses under the *Iqbal* standard and the issues at stake. Prior decisions by the district or magistrate judge assigned to the case will need to be examined to determine the receptivity of that judicial officer to such motions, particularly in those districts where there have been conflicting decisions on the extension of *Iqbal*. Ultimately, counsel will need to determine whether it is more cost-effective to have the court strike an insufficiently pleaded or "implausible" defense – with the possibility, if not the likelihood, that the court will grant the defendant leave to replead – or to pursue discovery on the defense through deposition and contention interrogatories with an eye toward eventually filing a motion for partial summary judgment. In other words, the decision for plaintiff's counsel becomes much like that confronted by defendant's counsel in determining whether to file a motion to dismiss. Particularly in those districts where the application of *Iqbal* to affirmative defenses becomes established, the motion to strike – previously "disfavored" and discouraged as a litigation tactic because of its potential to delay proceedings unnecessarily – may become as accepted and prevalent in its use as motions to dismiss under Rule 12(b)(6).

This, of course, assumes that defendants will not adjust their practice with respect to the pleading of affirmative defenses to reflect the possible application of *Iqbal*. Especially in those jurisdictions where the unadorned assertion of defenses has been the judicially-accepted norm, defense counsel must consider the adoption of fact-based pleading of defenses if they wish to preempt the filing of motions to strike predicated on the extension of *Iqbal*. In doing so, counsel will be required to examine the legal and factual grounds for asserting a defense more closely at the outset of an action, tempering the all too frequent practice of alleging a "laundry list" of affirmative defenses based on the fear that to do otherwise may result in waiver of an otherwise viable defense.

As some courts have pointed out in rejecting the extension of *Iqbal*, defendants are at a disadvantage in terms of the limited time they have in which to investigate and identify factual support for their defenses before they are required to file an answer. This concern can be addressed, however, through more frequent use by defendants of the amendment procedures provided under Federal Rule of Civil Procedure 15(a) and the inclusion in scheduling orders of extended periods for amendment of pleadings without the necessity of obtaining leave. Simply stated, there should be no reason why a defendant cannot ascertain a "plausible" factual basis for each of its affirmative defenses before they are asserted. The only question is whether they are required to plead those facts under Rule 8 and, by extension, *Iqbal*.

<sup>1</sup> 129 S.Ct. 1937 (2009).

<sup>2</sup> See, e.g., Yuri Mikulka, *Ashcroft v. Iqbal: A New Defense Tool for Corporate Defendants*, IN-HOUSE LITIGATOR (ABA), Fall 2009, at 1, available at <http://www.abanet.org/litigation/committees/corporate/archive.html#8>.

<sup>3</sup> 550 U.S. 544 (2007).

<sup>4</sup> See, e.g., *Home Mgmt. Solutions, Inc. v. Prescient, Inc.*, No. 07-20608-CIV, 2007 WL 2412834, at \*3 (S.D. Fla. August 21, 2007).

<sup>5</sup> See *HCRI TRS Acquirer, LLC v. Iwer*, 708 F.Supp.2d 687, 690-91 (N.D. Ohio 2010) (summarizing legal arguments and surveying decisions). See also Brian Robinson and Alithea Sullivan, *District Courts Consider Whether to Extend Twombly to Affirmative Defenses*, ANTI-TRUST NEWS & NOTES (Vinson & Elkins LLP), March 2010, at 2-4 (surveying decisions), available at [http://velaw.cn/uploadedFiles/VEsite/Resources/AntitrustNewsNotes\\_2010\\_03](http://velaw.cn/uploadedFiles/VEsite/Resources/AntitrustNewsNotes_2010_03).

<sup>6</sup> 402 U.S. 313, 350 (1971).

<sup>7</sup> See, e.g., *Heller Financial, Inc. v. Midwhay Powder Co., Inc.*, 883 F.2d 1286, 1294-95 (7th Cir. 1989).

<sup>8</sup> See, e.g., *Davis v. Sun Oil Co.*, 148 F.3d 606, 612 (6th Cir. 1998).

<sup>9</sup> *Iqbal*, 129 S.Ct. at 1949 (quoting *Twombly*, 550 U.S. at 570).

<sup>10</sup> *Id.* at 1249-50.

<sup>11</sup> *Hayne v. Green Ford Sales, Inc.*, 263 F.R.D. 647, 651 (D. Kan. 2009).

<sup>12</sup> *Fogel v. Linnemann (In re Mission Bay Ski & Bike, Inc.)*, Nos. 07 B 20820, 08 A 55, 2009 WL 2913438, at \*5 (Bkrcty. N.D. Ill. Sept. 9, 2009).

<sup>13</sup> *HCRI TRS Acquirer*, 708 F.Supp.2d at 692.

<sup>14</sup> *Bank of Montreal v. SK Foods, LLC*, No. 09 C 3479, 2009 WL 3824668, at \*3-4 (N.D. Ill. Nov. 13, 2009). The same court did not hesitate, however, in striking a defense of mutual mistake based, in part, on its finding that the alleged mistake as to the identity of the intended guarantor was "wholly implausible" in light of the undisputed credit documents. *Id.* at \*3.

<sup>15</sup> *Home Mgmt. Solutions*, 2007 WL 2412834, at \*4 (quoting *Savoury v. U.S. Attorney Gen.*, 449 F.3d 1307, 1319 (11th Cir. 2006)).

<sup>16</sup> *Kaufman v. Prudential Ins. Co. of Am.*, No. 09-10239, 2009 WL 2449872 (D. Mass. Aug. 6, 2009).

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# The Perils of Sell-Side 363 Sale Engagements: Protecting Your Success Fee in Underwater Situations

By Stuart A. Laven, Jr.

I am not an investment banker, so I've never had the benefit of really knowing what goes on in the head of one when deciding whether to take a particularly risky sell-side 363 sale engagement. But I have been through a few of these situations as an observer (or an attorney for one party or another), and, over time, I've seen something of a theme emerge: investment bankers underestimating—or completely overlooking—the risk of forfeiting a success fee if the assets simply do not yield enough money at auction to satisfy the senior secured debt.

Underwater section 363 sales transact all the time, sometimes with and sometimes without the senior lender's outright consent. And in many of these deals, the investment banker gets its success fee at closing (albeit a small one) without a hitch. But this does not mean that an iron-clad engagement letter with the debtor-seller is all that's needed to ensure payment in an underwater, minimum-fee scenario.

The bottom line is this: if the secured lender has not clearly and expressly bound itself to pay a success fee from the proceeds of the sale of its collateral, the success fee is in real jeopardy if the sale price is less than the secured debt. With certain limited exceptions, the magic wand of bankruptcy does not change the fact that a perfected first lienholder has a first property right in its collateral—one that's absolutely senior to the debtor's interest in the collateral. This means that if you cut a deal with the debtor, but neglect to sign up the secured creditor, you are at risk. Plain and simple.

So what precautions should (or can) be taken? Consider the following (and in doing so, bear in mind that the hypothetical client we are talking about is a mid-market, privately held company operating as a Chapter 11 debtor-in-possession and selling its assets in a Bankruptcy Code section 363 sale):

## The Red Herring of Bankruptcy Fee Orders and Administrative Priority

Before we can tackle strategies, a little background on exactly what the Bankruptcy Code does and does not do for estate professionals is worth outlining. (Caveat: this may be a bit pedestrian for ultra-experienced Chapter 11 practitioners—bear with me.)

At the most basic level, a professional working for a debtor-in-possession in Chapter 11 bankruptcy will need at

least two court orders before any kind of compensation can be paid: (i) an order under Bankruptcy Code section 330 permitting the debtor to use its cash to pay the professional<sup>1</sup> and (ii) an order under Bankruptcy Code section 327 permitting the debtor to retain the professional in the first place.<sup>2</sup>

The thing is, even if you have both of these orders, you don't necessarily have any right to be paid from the proceeds of the sale of fully encumbered collateral. True, a section 330 fee order will elevate the *debtor's* obligation to pay the professional fees to “administrative expense” status. But administrative expenses, while senior to almost all *unsecured* claims against the Chapter 11 debtor, are nonetheless junior to *secured* claims.<sup>3</sup>

How can this be possible? It's actually a matter of constitutional law; in particular, the takings clause of the Fifth Amendment. The Fifth Amendment prohibits the federal government from “taking” individual property without due process.<sup>4</sup> A perfected security interest is a form of an interest in property—the property pledged as collateral in the security agreement or mortgage—that belongs to the holder of the security interest. To make a potentially very long story short, bankruptcy courts are therefore constitutionally barred from forcibly “taking” collateral away from a secured lender for someone else's benefit, absent fair compensation to the secured lender.

## Privity of Contract: The Lender Needs to Sign

So how can you best protect your success fee in an underwater sale? Have the secured lender sign your engagement letter (otherwise known as pressing the “Easy Button”). Or, more precisely, have the lender sign an engagement letter that specifically obligates the lender to set aside (carve out) the fee, even if the ultimate sale price is less than the secured debt.

If the lender is a party to the engagement letter, then the engaged investment banker will have the right to enforce the terms of the letter against the lender directly (because the investment banker and the lender are, as a matter of contract law, in “privity” with one another<sup>5</sup>).

For sure, there is a bit of ice breaking involved in making this kind of rock-hard demand on an institutional lender who may otherwise be content to sit back and see what happens at its borrower's auction. But the time to find out that the lender is unwilling to carve out for a success fee is sooner rather than later. There is no shame in forcing the lender to show its true colors by requiring a crystal clear sign-off on your success fee *before* you make a substantial investment of manpower and resources in a patently risky engagement.

But what if you get pushback from the lender? This may be an invitation to negotiate terms and, depending on your need to take the engagement and your internal valuation of the asset, an opportunity to ensure a reasonable, minimum fee while preserving some modicum of upside. The key in this kind of negotiation is having reliable intelligence on the lender's view of the world; that is, intelligence on the lender's valuation of the asset and, to some extent, the internal pressures and

objectives facing the special asset officers responsible for the asset (e.g., fiscal year-end/quarter-end portfolio quotas).

If the lender's expectations are extraordinarily low, it may be reluctant to commit to carving out a guaranteed minimum success fee without some kind of corresponding floor on the sale price that triggers the carve-out. The question then becomes whether you are willing to take on some level of success fee exposure in the event of a truly rock-bottom sale.

**Cash Collateral Carve-Outs: Devil's in the Details**

Is it safe to rely on a DIP financing/cash collateral budget for your success fee (and avoid an awkward confrontation with the lender over an engagement letter sign-off)? Generally, the answer is "no."

A DIP/cash collateral "budget" is a cash-flow forecast conceived with a singular purpose: to keep the Chapter 11 debtor on a short leash while it is operating. A liquidation event, like a 363 sale, will typically terminate the budget. So, while there should be a line item in the budget for the investment banker's monthly/weekly retainers (make sure it's there!) pending sale, a reserve for a success fee won't show up anywhere as a mechanical matter.

In many cases, a material question arises as to what happens to professional fee carve-outs in DIP/cash collateral budgets after there has been some kind of DIP default. The key here is to scrutinize the DIP/cash collateral order itself, as there is always some potential for the debtor to continue operations and conduct a sale *after* a DIP default.

**Fairness and The 506(c) Surcharge: Last Ditch Efforts**

Bankruptcy Code section 506(c) gives the debtor-in-possession the right to "surcharge" otherwise fully liened assets to pay the "reasonable, necessary costs and

expenses of preserving, or disposing" of the collateral.<sup>6</sup> So this means that an investment banker can comfortably rely on 506(c) as a fall-back to guaranty a success fee in an underwater sale, right? Wrong.

Section 506(c) presents two huge problems for the fee-starved investment banker: (i) the statute only gives the debtor, not the investment banker, standing to request the surcharge and (ii) the agreed success fee may not be the same as what is considered "reasonable" or "necessary" under the statute.

On the issue of standing, the liquidating post-363 sale Chapter 11 debtor may simply have no interest or ability to prosecute a 506(c) claim for a jilted investment banker. On the question of reasonableness/necessity, it is safe to say that this can be a very expensive and time-consuming issue to litigate.

**In Summary**

In a perennially competitive environment, it is pretty difficult to turn away a potential engagement simply because of the prospect of an underwater transaction. But without the senior lender signing off, your success fee will be in real peril. Ultimately, the savvy investment banker will recognize that, in these situations, the debtor-client is talking the talk, but only the senior lender can walk the walk. If the lender doesn't clearly and unequivocally communicate its desire to pay you to shop the asset, then don't shop it (or, at least, watch your back very carefully).

<sup>1</sup> 11 U.S.C § 330

<sup>2</sup> 11U.S.C. § 327

<sup>3</sup> 11 U.S.C. § 507

<sup>4</sup> U.S. Const. Amend.

<sup>5</sup> "Privity of contract is that connection or relationship which exists between two or more contracting parties; it is essential to the maintenance of an action on any contract that there should subsist a privity between the plaintiff and defendant in respect to the matter sued upon." *Sumitomo Corp. of Amer. v. M/V Saint Venture*, 683 F.Supp. 1361 (M.D. Fla. 1988) (citing *Black's Law Dictionary* (1957)).

<sup>6</sup> 11 U.S.C. § 506(c)

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**News About Us**

- Six members of the Business Reorganization Practice Group were named 2012 Best Lawyers®: Jon B. Abels, Wendy D. Brewer, David H. Kleiman, Raymond H. Lemisch, Mark A. Phillips and William E. Schonberg.
- Five members of the Business Reorganization Practice Group were named 2012 Super Lawyers: Jon B. Abels, Wendy D. Brewer, Samuel D. Hodson, David H. Kleiman and William E. Schonberg.
- Two members of the Business Reorganization Practice Group were named Super Lawyers Rising Stars: Stuart A. Laven, Jr., and Scott B. Lepene.
- Caroline Richardson was selected to participate in the 2011-2012 United Way of Central Indiana's Leadership United training series. She was accepted into the Executive Women's Leadership Series.

- Krista Taggart was appointed to the Indianapolis Bar Association's Pro Bono Standing Committee.
- Wendy D. Brewer and Samuel D. Hodson presented "Asset Protection" at the Indiana Continuing Legal Education Forum on November 2.
- Matthew J. Samsa is publishing a chapter on Assignments for the Benefit of Creditors in the ThompsonWest publication *Strategic Alternatives for Distressed Businesses 2012* due out early this year.
- Jon B. Abels, Wendy D. Brewer and Samuel D. Hodson presented on "Tax Issues in Chapter 11 Bankruptcy Cases" at the ICLEF Annual Bankruptcy Institute on December 11, 2011.
- Scott B. Lepene was Co-Chair of the CMBA Bankruptcy & Commercial Law Section and the Turnaround Management Associations's seminar, *Renewal Public and Private: The Changing Landscape of Workouts and Restructurings* on November 17, 2011. At the same seminar, Stuart A. Laven, Jr. spoke on a panel entitled, "Bankruptcy Alternatives: Receivership and Other Remedies" and Mark A. Phillips spoke on a panel entitled, "Stern V. Marshall: Navigating the New Limitations on Bankruptcy Court."

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## Get to Know Wendy D. Brewer



**Wendy D. Brewer**

*Vice-Chair, Business Reorganization Practice Group*

**What Wendy wants you to know about the current business reorganization industry:**

The question about whether there will be a wave of municipal bankruptcies has been a hot topic in the business reorganization industry for the past several months. Bankruptcy attorneys across the nation started dusting off their copies of Chapter 9, and states started revisiting their own laws on the issue. A municipality cannot file a bankruptcy, unless the state where it exists allows it to do so. About 50% of states currently allow municipalities to file bankruptcy, but generally only with the approval of a state board or agency. The rise in the discussion about municipal bankruptcies and the threat of unfunded pension liabilities has led to discussion about whether Congress might enact Bankruptcy Code provisions enabling states to file for bankruptcy protection. While the likelihood of a state bankruptcy code provision is still theory, we are starting to see some significant municipal filings. In November, Jefferson County, Alabama (home to Birmingham) filed the largest municipal bankruptcy in history after failed attempts to refinance \$3.1 billion in sewer bonds. Jefferson County is the twelfth entity to file a Chapter 9 bankruptcy in 2011.

**When Wendy isn't practicing law she is:**

Living in Fishers, Indiana with her husband Ken, a local meteorologist, and their two children, Emily and Matt. When she isn't at a scout meeting, swimming, basketball, or choir for the kids, she enjoys volunteering in the community. She currently serves on the board of Partners in Housing Development Corporation, an agency that develops and manages supportive affordable housing for the formerly homeless and special needs populations in Indianapolis, and recently finished a term of board service with Happy Hollow Children's Camp, an agency that provides a residential summer camp experience for economically disadvantaged children in the greater Indianapolis area. She has also served for several years as the United Way campaign coordinator for her office and on the selection and planning committee for the Mayor's Celebration of Diversity Awards Luncheon.

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