Case No. 12-60021

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

In re: Loop 76, LLC, Debtor. Wells Fargo Bank, N.A., Appellant, vs. Loop 76, LLC, Appellee.	BAP No. 11-1094 Bk. Case No. 2:09-bk-16799-RJH

APPEAL FROM THE BANKRUPTCY APPELLATE
PANEL OF THE NINTH CIRCUIT

AMICUS CURIAE BRIEF OF THE AMERICAN, ALASKA, ARIZONA, CALIFORNIA, COLORADO, IDAHO, MONTANA, NEVADA, OREGON, UTAH, WASHINGTON, AND WYOMING BANKERS ASSOCIATIONS IN SUPPORT OF APPELLANT'S REQUEST FOR REVERSAL

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Statement of Identity and Interest of Amicus Curiae

The American Bankers Association, Alaska Bankers Association, Arizona Bankers Association, California Bankers Association, Colorado Bankers Association, Idaho Bankers Association, Montana Bankers Association, Nevada Bankers Association, Oregon Bankers Association, Utah Bankers Association, Washington Bankers Association and Wyoming Bankers Association (the "Associations") are non-profit federal or statewide banking trade associations.

The instant appeal now concerns the classification of unsecured debt in a Chapter 11 plan that disregards the state laws concerning debtor/creditor and distorts the law of reorganization.[1]

Introduction

Appellant's opening brief has addressed how the decisions below diverted from this and other Circuits' rulings regarding the proper application of Chapter 11 plan structure. This amicus brief addresses specifically the troubling practical effect of the lower courts' decision that the mere existence of a third-party guarantee of an unsecured claim against a bankrupt estate can be a *per se* justification for its separate classification. This supposedly simple theory for an

[1] Pursuant to Federal Rule of Appellate Procedure 29(c)(5), no party's counsel authored the brief in whole or in party, and neither a party nor a party's counsel contributed money that was intended to fund preparing or submitting the brief. No person has contributed money that was intended to fund preparing or submitting the brief.

unsecured class division contradicts historical bankruptcy policy, drowns plan classification in an interpretive swamp with no logical bottom, and undermines policies on good lending practice.

I.

Bankruptcy Policy is Premised on Equality of Creditors

When Congress passed its first set of comprehensive bankruptcy statutes in 1898, a general claim against the estate was the basic unit. 11 U.S.C. § 93 (superseded 1978). To be distinguished from the general claim pool, a claim had to be either a claim secured by collateral or a claim granted a specific priority in payment. (*See* prior Bankruptcy Act § 57(e)). As the standard treatise of the day described the process:

> The general theory underlying the Bankruptcy Act is not difficult to grasp if a few general principles are borne in mind. First, the liquidation provisions of the Act aim at distribution of unencumbered assets (except exempt property) among his general, unsecured creditors, with certain of these creditors given a priority.

3 (Part 2) COLLIER ON BANKRUPTCY § 60.10 at 743, (14th ed. 1977). *Accord*, *Union Bank v. Wolas*, 502 U.S. 151, 161 (1991) ("The primary bankruptcy policy of equality of distribution among creditors of the debtor."). As one court explained, ". . . the purpose of the Bankruptcy Act is to bring about equality of division of assets amongst creditors. For the rule that to the diligent creditor belongs the reward, the act substitutes the rule that equality is equity." *Canright*

v. General Finance Corp., 35 F.Supp. 841, 844 (E.D. Ill. 1940). This core concept of equality of debt in distribution supplanted the only distinction at common law of unsecured claimants: that rule of first in time, first in right, with the first claimant to the recordation of its judgment receiving the only distinction. *E.g., Rankin & Schatzell v. Scott*, 25 U.S. 177, 179 (1827) (Marshall, C.J.) ("The principle is believed to be universal . . ."). *Accord, U.S. v. City of New Britain*, 347 U.S. 81, 85 (1954). *See* Collier on Bankruptcy ¶ 1.03[2][b], at 1-12 (15th ed. 2010) ("Unsecured claims often constitute most of debtor's debts. As the definition of claim makes clear, however, the Bankruptcy Code does not distinguish between claims that have been reduced to judgment and claims that may be unliquidated").

In its passage of the modern Bankruptcy Code in 1977, Congress did not disturb this fundamental model. The base structure remains in 11 U.S.C. § 726 through which the initial distribution of the estate is to the priority claims, the next distribution is "second, in payment of any allowed unsecured claim . . . .". After this, any distributions descend next to late filed unsecured claims, then to penalties, then to interest on claims, and finally to the debtor or equity. This base distribution model separates no sheep from goats as to which creditor should receive the general distribution of the estate. Nor is this baseline classification of distribution confined to liquidations under Chapter 7, since any unsecured creditor

can demand in a Chapter 11 that they receive "not less than the amount that such holder would receive or retain if the debtor were liquidated under Chapter 7 . . . ." 11 U.S.C. § 1129(a)(7)(A). This same provision reappears as the base distribution model for unsecured creditors in reorganization for farmers in Chapter 12 (§ 1225(a)(4)) and for individuals in Chapter 13 (§ 1325(a)(4)). Of course, parties can privately contract to subordinate one claim to one another (§ 510(a)) and a bankruptcy court, upon a determination in a formal adversarial proceeding, can equitably subordinate a particular claim relating to wrongful conduct (§ 510(c); BANKRUPTCY RULE 7001). But these are the unusual exceptions to *pro rata* distribution on unsecured claims. Congress itself legislated only one allowed subset of claims under a Chapter 11 plan, that being a small "cash out" class "administrative convenience" claims of a *de minimis* value (§ 1122(b) permits "administrative convenience class"). Otherwise, Congress simply directs that in creating a Chapter 11 plan class any class member must be "substantially similar." Secured claims, because of the individual characteristics of their collateral, have always been subject to separate classification. *Mokava Corp. v. Dolan,* 147 F.2d 340 (2nd Cir. 1940); *In re Sullivan,* 26 B.R. 677 (Bankr. W.D.N.Y. 1982). The statutes offer no suggestion that classes can be created of subsets of unsecured claims.

Notwithstanding this statutory structure and notwithstanding the law of the circuits, the bankruptcy judges below have now proposed a distinction by which some pigs are more or less equal than others: any unsecured claim that has a guarantee may be separately classified as a *per se* matter. This new *per se* classification creates a distinction unknown in the underlying state substantive law of claims.

II.

Relevant Bank Law Depends on the Underlying State Law Regime

A. The Bankruptcy Code Does Not *Create* Claims

The Bankruptcy Code is a federal collective remedy, but one built on state debtor-creditor law. "Federal law coexists peaceably with, and often expressly incorporates, state laws regulating the rights and obligations of debtors (or their assignees) and creditors." *In re Tippett*, 542 F.3d 684, 689 (9th Cir. 2008); *In re Applebaum*, 422 B.R. 684, 689 (9th Cir. BAP 2009).[2] "The 'basic federal rule' in bankruptcy is that *state law* governs the substance of claims, Congress having 'generally left the determination of property rights in the assets of a bankrupt's estate to state law.'" *Raleigh v. Ill. Dept. of Rev.*, 530 U.S. 15, 20 (2000) (emphasis added) quoting *Butner v. United States*, 440 U.S. 48, 54, 57 (1979). Indeed, "[c]reditors' entitlements in bankruptcy arise in the first instance from the

[2] A few federal nonbankruptcy statutes can give rise to private unsecured claims, but are rare and not relevant to this instant appeal

underlying substantive law creating the debtor's obligation, subject to any qualifying or contrary provisions of the Bankruptcy Code." *Travelers Cas. and Sur. Co. of Am. v. Pac. Gas and Elec. Co.*, 549 U.S. 443, 450 (2007) quoting *Raleigh v. Ill. Dep't of Revenue*, 530 U.S. 15, 20 (2000); *see also Butner*, 440 U.S. at 55; *Vanston Bondholders Protective Comm. v. Green*, 329 U.S. 156, 161-62 (1946). "That principle requires bankruptcy courts to consult state law in determining the validity of most claims." *Travelers*, 549 U.S. at 450. The United States Supreme Court further reiterated that "[courts] generally presume that claims enforceable under applicable state law will be allowed in bankruptcy unless they are expressly disallowed." *Travelers*, 549 U.S. at 452.

The Bankruptcy Code does not—and should not—alter a debtor's legal obligation to a creditor holding a claim under relevant state law (*e.g.*, Arizona) because the substantive state law specifically governs debts and obligations.

B. The Bankruptcy Code *Categorizes* Claims

Except where specifically addressed (*e.g.*, tax priorities, non-dischargeable fraud), the Bankruptcy Code does not address the underlying nature of claims and does not preempt the substantive creation of a claim under state law.

Under the statute, a "creditor" includes any entity "that has a *claim* against the debtor that arose at the time of or before the order for relief concerning the debtor." 11 U.S.C. § 101(10)(A) (emphasis added). "Claim" is defined 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 U.S.C. § 101(5) (emphasis added). As outlined in section 101(5), a "right to payment" means "nothing more nor less than an *enforceable obligation*." *Pennsylvania Dept. of Public Welfare v. Davenport*, 495 U.S. 552, 559 (1990) (emphasis added); *Johnson v. Home State Bank*, 501 U.S. 78, 83-84 (1991).

The Bankruptcy Code specifically categorizes and prioritizes those claims that have already been substantively created by underlying state law because Congress determined that such ranking advanced the *purposes* of the Bankruptcy Code. In contrast, the Bankruptcy Code is purposefully silent as to the underlying nature of claims and instead defers to applicable state law since unpacking substantive claims would not further the purpose of the Bankruptcy Code.

III.

Arizona law treats unsecured debt the same

Under Arizona law, debts that are guaranteed are treated the same as debts without a third-party source of recovery. For example, in the context of a general receivership action, the Arizona Supreme Court stated that, among the elementary

principles of handling insolvent corporations, is that all creditors of the same class be treated equally:

> [T]he fundamental principles governing the handling of insolvent corporations . . . may be stated as follows: (1) It is the duty of the receiver of an insolvent corporation to so handle the assets that the creditors and stockholders of the corporation may secure the largest possible dividends on their respective claims against the corporation; (2) in so doing, he must not only consider the rights of the claimants as between them and the corporation, but their respective rights as between themselves; (3) *in ordering a distribution of the assets of an insolvent corporation, all creditors of the same class must be treated on an equal basis*. These principles are so elementary that we think they need no citations to support them.

Sisk v. White, 50 Ariz. 103, 106, 69 P.2d 242, 243-44 (1937) (emphasis supplied). The application of payments also "is not affected by the fact that a surety or guarantor is liable for one or the other debts." *Standard Acc. Ins. Co. v. Copper Hills Motor Hotels, Inc.*, 102 Ariz. 26, 29, 424 P.2d 154, 157 (1967). And the general rule is that "where neither the debtor nor the creditor makes application of the payment, the law will apply it to the debt which is least secured, even though it may be to the disadvantage of the guarantor." *Valley Nat. Bank of Phoenix v. Shumway*, 63 Ariz. 490, 497, 163 P.2d 676, 679 (1945). A surety or guarantor therefor does not have any right to control or direct how payments made by a debtor shall be applied. *Id.*

Arizona law also supposes that a third-party source of recovery would not alter the number or amount of claims where sureties and guarantors have the right

of subrogation and/or indemnification, thereby standing in the shoes of a lender. Restatement (Third) of Suretyship & Guaranty § 29 (1996) ("Except as provided by statute, when a secondary obligor is subrogated to rights of the obligee, the secondary obligor has the same priority with respect to those rights as the obligee."); A.R.S. § 12-1643 (subrogation of surety to rights of judgment creditor); *W. Coach Corp. v. Rexrode*, 130 Ariz. 93, 97, 634 P.2d 20, 24 (Ct. App. 1981) (stating that a guarantor can exercise subrogation rights even before guarantor pays off the entire debt if creditor's rights are not impaired by the subrogation). The right of subrogation and/or indemnification is recognized in various other states within the Ninth Circuit. [3] Where a sole guarantor exercises

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[3] *See Trust of Strand v. Wel-Co Group*, 120 Wash. App. 828, 836, 86 P.3d 818, 822 (2004) ("Suretyship arises when one assumes an obligation to pay the debt of another. The note holder (here, Strand) is still entitled to only one performance."); Cal. Civ. Code § 2848 (West) ("A surety, upon satisfying the obligation of the principal, is entitled to enforce every remedy which the creditor then has against the principal to the extent of reimbursing what he has expended, and also to require all his co-sureties to contribute thereto, without regard to the order of time in which they became such."); *In re Steve's Furniture Warehouse, Inc.*, 46 B.R. 80, 82 (Bankr. S.D. Cal. 1985) ("Once a guarantor has paid the principal's obligation, the guarantor is subrogated to the creditor's rights."); *Valley Bank v. Larson*, 104 Idaho 772, 781, 663 P.2d 653, 662 (1983) ("A well-known principle of guaranty or suretyship is the right of subrogation in a guarantor to recover from his principal if the guarantor is required to satisfy the guarantied obligation. The guarantor is entitled to succeed to the creditor's position. "); *In re Hawaii Daiichi-Kanko, Inc.*, 71 B.R. 176, 178 (Bankr. D. Haw. 1987) (providing that, absent express contractual right of subrogation, "a guarantor is not entitled to be subrogated to the rights of the creditor until the creditor has been paid in full by the guarantor").

its right of subrogation after paying the lender, the amount and number of claims against the debtor remain unaltered. Arizona law therefore presumes that a third-party source of recovery would not change the debt structure of the principal obligor.

Arizona law also does not distinguish between creditors with third-party sources of recovery and those without when dealing with the liquidations other than a typical corporate receivership. For example, the liquidation of partnerships under Arizona law also calls for the distribution of assets "*first in the payment of creditors other than partners*, then come the claims of the partners other than those for repayment of capital contributions or profit, . . . and finally, any remaining balance of partnership property is distributable as profits." *Seguin v. Boyd*, 134 Ariz. 172, 175, 654 P.2d 808, 811 (Ct. App. 1982) (emphasis added); A.R.S. §§ 29-347(1), 29-1077(A). Similarly, when liquidating insurers, after distributing assets of the insurer to pay the expenses of administering the delinquency proceedings, claims of the insureds, (and other state and federal claims), any remaining assets are distributed to "*general creditors* that do not fall within any other priority under this section." A.R.S. § 20-629(A)(8) (emphasis supplied). Liquidation of Arizona banks also places "[c]laims of general creditors" into its own class. A.R.S. § 6-395.11. None of these statutes mentions

different treatment for general creditors should a third-party source exist for recovery.

IV.

Ignoring Substantive State Law Forces Bankruptcy Courts to Grapple with Contrived Distinction in Claims

While the courts below looked for a bright line of classification in the existence of a guarantee, the line turns murky, then illusory upon examination. Consider again the central principle of distribution equality, recently reiterated by the Supreme Court.

> In holding that claims for workers' compensation insurance premiums do not qualify for § 507(a)(5) priority, we are mindful that the Bankruptcy Code aims, in the main, to secure equal distribution among creditors. . . . We take into account, as well, the complementary principle that preferential treatment of a class of creditors is in order only when clearly authorized by Congress.

Howard Delivery Serv., Inc. v. Zurich Am. Ins. Co., 547 U.S. 651, 655 (2006). In contrast, consider the confusion fostered when the court looks outside the character of the claim against the estate, and speculates about non-estate sources of payment:

- Unsecured claim guaranteed by a solvent third party.
- Claim guaranteed by an *insolvent* third party.
- Judgment claim against multiple defendants, including the bankrupt, with other defendants holding rights of contribution.

- Claim backed by a mortgage credit insurer.
- Negligence claim that would be covered by a general liability insurer.
- Claim backed by a third party bonding agent or a standby letter of credit.
- Claim for fraud potentially possibly covered by a statutory victim fund or attorney general recovery.
- Claim for pollution damage that also qualifies for governmental cleanup.
- Claim also covered by ex-spouse's support requirements under a divorce decree.
- Claim against the debtor with a name beneficiary under a will for payment of the debt.
- Claim against the bankrupt estate, but purchased by a secondary holder party who retains recourse back to the seller.

Numerous other permutations can be offered, but the point remains the same. Once a court reaches beyond the state law creating the claims, no logical approach can be devised for legitimate distinctions. Is the guarantor solvent or not? Does a second source of payment have any distinction if that third party simply steps into the same claim by subrogation? Once cut loose from substantive state law, bankruptcy courts would have to contrive a federal jurisprudence of claims with no legal boundaries and no legislative direction. As Justice Brandeis long ago explained: "There is no federal general common law. Congress has no power to declare substantive rules of common law applicable in a state, whether they be

local in nature or "general", be they commercial law or torts. *Erie Railroad Co. v. Tomkins*, 304 U.S. 64 (1939). Arbitrariness as to indistinguishable state law claims would inevitably evolve into the undercutting of bankruptcy's first principle of equitable treatment. *See generally, Grupo Mexicano v. Alliance Bond Fund Inc.*, 527 U.S. 308, 332 (1999) ("rejecting expansion of remedies despite the Court's equity powers, citing Selden ("For law we have a measure and know what to trust to — Equity is according to the conscience of him, that is Chancellor…Tis all one, as if they should make the measure the Chancellor's foot.").

V.

Distinguishing Guaranteed Claims is Contrary to Good Lending Practices

A lender extends credit with the intent of obtaining repayment of the principal and contractual interest. Since lending institutions have received widening levels of direct and indirect insurance by the United States government over the past recessionary years, the practices in extending credit are the subject of increasing regulatory oversight and audit. Repeatedly the inclusion of a guarantee is cited as a relevant strengthening of a loan structure:

EX. 1. APPENDIX C TO PART 208 – INTERAGENCY GUIDELINES FOR REAL ESTATE LENDING POLICIES

* * *

> Each institution's policies must be comprehensive, and consistent with safe and sound lending practices, and must ensure that the institution operates within limits and according

to standards that are reviewed and approved at least annually by the board of directors.

* * *

UNDERWRITING STANDARDS

Prudently underwritten real estate loans should reflect all relevant credit factors, including:

- The capacity of the borrower, or income from the underlying property, to adequately service the debt.
- The value of the mortgaged property.
- The overall creditworthiness of the borrower.
- The level of equity invested in property.
- *Any secondary sources of repayment*.
- *Any* additional *collateral or credit enhancements (such as guarantees, mortgage insurance or takeout commitments*).

(emphasis supplied). (codified to 12 CFR, to part 365)

Ex. 2. OFFICE OF THE COMPTROLLER OF THE CURRENCY, 2012 SURVEY OF CREDIT UNDERWRITING PRACTICES (June 2012) (p. 16):

- Methods used to Change Commercial Underwriting Standards: Pricing, Covenants, Leverage, Collateral, Credit Line, Maturity, Amortization, *Guarantor*.

(emphasis supplied).

EX 3. COMPTROLLER OF THE CURRENCY: COMPTROLLER'S HANDBOOK (SECTION 206) EXAMINATION PROCEDURES:

- Assess credit risk by a borrower's collateral, on a departmental basis, by . . . analyzing any secondary support provided by *guarantors and endorsers*.
  * * *
- Determine that each file contains documentation <u>supporting</u> *guarantees* . . .

- Determine thereto any necessary insurance coverage is adequate and that the *bank is a loss payee*.

EX. 4. FEDERAL RESERVE BANK OF KANSAS CITY (JANUARY 20, 2011) UNDERWRITING STANDARDS FOR SMALL BUSINESS LOANS ORIGINATED UNDER THE SMALL BUSINESS LENDING FUND PROGRAM. (AT P.2).

Prudently underwritten small business loans should reflect all relevant credit factors, including:

- Capacity of the income from the business to adequately service the debt.
- Value and quality of the collateral.
- Overall creditworthiness of the borrower.
- Level of equity invested in the business.
- *Any secondary sources of repayment*.
- *Any additional collateral or credit enhancements (such as guarantees or key-person insurance*).

At p.2. (emphasis supplied). These are just a few federal sources underscoring the importance of guarantees (along with their similar secondary sources, such as cosigners and insurance coverages) in the formulation of good credit policy.

The ruling below impairs this approach to underwriting. Instead, a guarantee of an unsecured or undersecured loan may no longer simply be a form of credit enhancement or repayment assurance, but rather something that could lead to the segregation and discrimination of a lender's claim against its primary borrower should that borrower file Chapter 11. In a down market, the unsecured deficiency on a secured loan often represents the bulk of the bankrupt's entire unsecured debt pool, particularly in the plethora of single asset real estate cases. These cases often consist of one large undersecured loan and a sprinkling of small

unsecured claims. The lender on a project would question if a third-party guarantee could be twisted and used as a pretext to eliminate the lender's vote, which when counted by dollar percentage would typically control the unsecured class. 11 U.S.C. § 1126 (C) ("A class of claims accepted a plan if such a plan has been accepted by creditors . . . that hold at least two-thirds in amount and one half in number . . .) The federal guidelines, sampled above, are turned on their heads as guarantees become potential loan defects, not protections.

VI.

Conclusion

The attempt to distinguish unsecured claims by a third party guarantor abandoned the state law basis for claims and throws courts down a slope not just slippery, but a slope without any steps and without the prospect of any handholds.

Dated: February 6, 2013

Respectfully submitted

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CERTIFICATE OF COMPLIANCE WITH RULE 32(a)

Certificate of Compliance With Type-Volume Limitation, Typeface Requirements, and Type Style Requirements

1. This brief complies with the type-volume limitation of Fed. R. App. P. 32(a)(7)(B) because this brief contains <state the number of> words, excluding the parts of the brief exempted by Fed. R. App. P. 32(a)(7)(B)(iii).

2. This brief complies with the typeface requirements of Fed. R. App. P. 32(a)(5) and the type style requirements of Fed. R. App. P. 32(a)(6) because this brief has been prepared in a proportionally spaced typeface using Microsoft Word 2010 in 14 point font, Times New Roman.

Dated: February 6, 2013

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