



REPRINT | *Berger Singerman*

2009 Bankruptcy & Corporate Restructuring options for troubled enterprises



■ **Otero Mills: is the protection of a non-debtor's interests for the benefit of the estate still relevant after the 2007 real estate crash?**

BY ISAAC M. MARCUSHAMER

The real estate driven economic turmoil that enveloped the United States in the second half of 2007 caused a surge in the number of bankruptcy filings in the country. Many of these filings were driven by real estate investments. In the typical 'real estate' case the entity that files bankruptcy (the debtor) is the corporate entity that owns the real estate. Moreover, the debtor is generally the borrower on a loan that is secured by at least its real estate assets. Often, the principal of the debtor will personally guarantee the debt. This situation creates a potential conflict for the principal. On one hand, as the guarantor, the principal may be personally liable for the debtor's obligations and may seek to assuage the creditor by sacrificing the debtor's assets in return for personal freedom. On the other hand, the principal has a responsibility to the creditors of the estate as the debtor's representative to preserve value for all creditors. This conflict can be especially pronounced once the debtor files for bankruptcy and the secured creditor sues the principal on his guarantee.

One solution to this problem is to have the principal file bankruptcy as well, however, this is not always advisable as the principal's personal financial situation is generally markedly different from the debtor's. The other alternative, which will be explored by this article in more detail, is to seek an injunction from the bankruptcy court enjoining the creditor from pursuing the principal on his guarantee. This type of relief is often called an 'Otero Mills' injunction, named after one of the early cases granting this form of relief.

The analysis that follows will examine the original Otero Mills cases, followed by an examination of the differing standards that

have developed since Otero Mills was decided. Finally, the analysis will conclude with an examination of a recent bankruptcy court decision from the District of Oregon that attempted to use an Otero Mills injunction in reverse.

Otero Mills – the original case

In March of 1982 Otero Mills, Inc. filed for bankruptcy (*Otero Mills, Inc. v. Security Bank & Trust (In re Otero Mills, Inc.)*, 25 B.R. 1018 (D. N.M. 1982)). In April and September of 1979 Otero Mills executed two promissory notes in the combined amount of \$650,000. Both notes were guaranteed by Charles J. Dugan, the president and sole shareholder of Otero Mills. On 23 April 1982, Security Bank & Trust (SB&T), filed suit in state court against Dugan seeking to collect on the guarantees. Dugan's response to the SB&T suit was to have Otero Mills seek an injunction on his behalf from the bankruptcy court.

Otero Mills' theory was that the continued litigation against Dugan was causing an adverse effect on the bankruptcy estate by pressuring the debtor (Otero Mills) through Dugan. The bankruptcy court's first step was to analyse whether it had the jurisdiction to even consider enjoining SB&T from pursuing Dugan.

The bankruptcy court noted that 11 U.S.C. § 105(a) permits it to issue injunctions "under appropriate circumstances". The bankruptcy court then elaborated that the "power to enjoin extends to some cases of a creditor's action against a co-debtor or guarantor, but only in limited circumstances. To so enjoin a creditor's action against a third party, the court must find that failure to enjoin would affect the bankruptcy estate and would

adversely or detrimentally influence and pressure the debtor through that third party". Based on this reasoning, the bankruptcy court determined that it had jurisdiction to issue the injunction.

The second step in the bankruptcy court's analysis was to determine whether issuance of the injunction was appropriate. The bankruptcy court set forth a three part test: (i) irreparable harm to the bankruptcy estate if the injunction does not issue; (ii) strong likelihood of success on the merits; and (iii) no harm or minimal harm to other party.

With respect to the first prong, the bankruptcy court heard evidence that Dugan had pledged to sell assets and contribute the sale proceeds to pay Otero Mills' creditors. It was Otero Mills' position that this funding would provide more to its creditors if it was sold orderly rather than through the judicial process. The bankruptcy court also noted that SBT offered no evidence to refute that introduced by Otero Mills. Therefore, the bankruptcy court ruled that this prong was satisfied, and irreparable harm would come to the debtor if the injunction was not issued.

The bankruptcy court defined the 'success on the merits' prong as "the probability of a successful plan of reorganization in cases such as the one under consideration". The bankruptcy court further reasoned that because Otero Mills' Chapter 11 plan was not yet due at the time that the injunction was sought "any attempt at determining probability of success would be mere speculation". However, instead of being a death knell in the debtor's case, the bankruptcy court found that the debtor was entitled to present a Chapter 11 plan and that an "injunction is proper unless or until [the debtor] fails to file its plan within the required time or the plan is not approved". In essence, under Otero Mills the second prong of the test is automatically met, provided that the debtor still has the ability to present a plan or the plan has not yet been voted upon. Therefore, at least with respect to the second prong, an Otero Mills injunction has a stronger likelihood of success in the early stages of a case than it does as the case nears confirmation.

The final prong considered by the bankruptcy court was the harm to the enjoined party. SB&T admitted that its collateral was adequately protected, at least through a date certain, because of equity in the property. The bankruptcy court determined, albeit without any contrary evidence from SB&T, based on the existence of equity in the property SB&T would not suffer any harm from issuance of the injunction.

In essence, the bankruptcy court granted the injunction on three basic findings: (i) that the principal of the debtor would contribute money or assets to the estate; (ii) that no plan had yet been proposed; and (iii) that the secured creditor was adequately protected. As discussed below, these are significantly different from the traditional or non-bankruptcy injunction requirements.

Preliminary injunction standard vs. modified standard

In *In re Excel Innovations, Inc.*, the Ninth Circuit held that when a debtor seeks an injunction pursuant to section 105(a) of the

bankruptcy code to "stay a proceeding in which the debtor is not a party, the bankruptcy court must balance the debtor's likelihood of success in reorganization against the relative hardship of the parties, as well as consider the public interest if warranted" (*Solidus Networks, Inc., v. Excel Innovations, Inc., (In re Excel Innovations, Inc.)*, 502 F.3d 1086 (9th Cir. 2007)). The reason the debtor sought the injunction was because a shareholder and former CEO of the debtor was subject to an arbitration proceeding. The debtor made three arguments as to why an injunction should be granted: (i) the former CEO planned to seek indemnification from the debtor on the grounds that any liability he may have stemmed from his actions relating to his tenure as an officer and director of the debtor; (ii) any defence he would have in the arbitration proceeding would be focused on him and not the debtor; and (iii) he would be compelled to reveal the substance of critical privileged communications between himself and the debtor's attorneys. The bankruptcy court granted the stay, however, the Ninth Circuit reversed.

The Ninth Circuit determined that the "usual preliminary injunction standard applies to stays of proceedings against non-debtors under § 105(a)". This standard, according to the court, has the following four prongs: (i) a strong likelihood of success on the merits; (ii) the possibility of irreparable harm to the plaintiff; (iii) a balance of hardships in favour of the plaintiff; and (iv) advancement of the public interest, in certain cases. The court also noted that the majority of circuits have applied this standard to 105(a) injunctions. The Ninth Circuit reversed the lower courts on the basis that the bankruptcy court had failed to find that there was a reasonable likelihood of a successful reorganisation. Furthermore, the bankruptcy court failed to analyse the harm that would be suffered by the enjoined party. Finally, there was no showing of irreparable harm to the moving party. For these reasons, the Ninth Circuit reversed. It appears likely that if the debtor had been able to make the same evidentiary showings that were made in Otero Mills, that the Ninth Circuit would have upheld the injunction.

The Seventh Circuit uses a modified standard for injunctions issued by a bankruptcy court. In *In re L&S Industries, Inc.*, the Seventh Circuit noted the basic general requirements for an injunction are: (i) no adequate remedy at law; (ii) irreparable harm to the moving party; and (iii) a likelihood of success on the merits (*In re L&S Indus. Inc.*, 989 F.2d 929, 932 (7th Cir. 1993)). However, the court then held that a bankruptcy court does not need to address all of these standards. Instead, a bankruptcy court "can enjoin proceedings in other courts when it is satisfied that such proceedings would defeat or impair its jurisdiction over the case before it. In other words, the court does not need to demonstrate an inadequate remedy at law or irreparable harm". Therefore, the only requirements that need to be met in the Seventh Circuit are: (i) a satisfaction that bankruptcy court jurisdiction would be impaired by the proceeding; and (ii) a likelihood of success on the merits.

Under this two-part standard, all that a moving party would need

This article first appeared in Financier Worldwide's *Bankruptcy & Corporate Restructuring 2009 Ebook*. © 2009 Financier Worldwide Limited. Permission to use this reprint has been granted by the publisher. For further information on Financier Worldwide and its publications, please contact James Lowe on +44 (0)845 345 0456 or by email: james.lowe@financierworldwide.com

to establish would be that there is an effect on the bankruptcy estate by the continuation of the suit against a guarantor and that the debtor has not yet filed a plan of reorganisation. This is a substantially reduced burden from the traditional four-part test for the issuance of an injunction.

What *Otero Mills* and *Excel Innovations* demonstrate that is that the rote application of non-bankruptcy legal principles in a bankruptcy context, while conceptually simple, is practically difficult. The clear source of agreement between the differing positions is that there must be some appreciable effect on the bankruptcy proceedings and that the proceedings must be heading towards a possible restructuring.

Latest developments

This last section examines a case where an individual owned interests in hundreds of single asset real estate entities and attempted to his own personal bankruptcy to stay the foreclosure proceedings against his entities (*Harder v. Premierwest Bank (In re Harder)*, 2009 Bankr. LEXIS 854 (Bankr. D. Or. Feb 13, 2009)). This is, in essence, a reverse of the *Otero Mills* fact pattern.

The court applied the *Excel* standard for injunctions. With respect to the first prong of the test, the likelihood of success of a successful reorganisation, the court noted that it was the debtor's ability to reorganise that is the relevant inquiry. The court further opined that the debtor only had \$54,000 a month to contribute to the plan, compared to \$48m in claims against him. The court noted that there was little prospect of him reorganising,

and it refused to consider the reorganisation prospects of the corporations that he owned. The court found that there was no harm to his estate, as all actions against the debtor were already stayed and that there would not be any money due to him from operation of the real estate entities. Furthermore, it appears as though the court was unsympathetic to a debtor having to litigate issues relating to his own bankruptcy.

The most important takeaway from *Harder* is that the corporate relationships between the debtor and the non-debtor that is seeking the protection of the bankruptcy court are incredibly important. If the debtor is the party that is managing the assets, then that entity or person already has protection under the bankruptcy code and extending protection to the assets is not likely under an *Otero Mills* injunction theory.

Conclusion

In sum, unlike most other courts, bankruptcy courts have demonstrated a willingness under certain circumstances to issue injunctions in favour of third party non-debtors that protect the ability of a debtor to reorganise. This can be a powerful tool, because it allows both the company and its principal to stay any litigation against them during the bankruptcy proceedings and attempt to achieve a comprehensive reorganisation.

Isaac M. Marcushamer is a Bankruptcy/Restructuring attorney at Berger Singerman.



[Isaac M. Marcushamer](#)

Member

T: (305) 714-4376

E: imarcushamer@bergersingerman.com

www.bergersingerman.com

Isaac Marcushamer is a member of Berger Singerman's Business Reorganization Team. Mr. Marcushamer received a B.A., with honors, from University of Toronto in 2003. He received his J.D. from Hofstra University, cum laude, in 2006, where he received the Bankruptcy Law Award and was a member of the Hofstra Law Review.

Before joining Berger Singerman, Mr. Marcushamer served as a law clerk to the Honorable Raymond B. Ray, U.S. Bankruptcy Court, Southern District of Florida. As a law clerk, Mr. Marcushamer researched and drafted orders, opinions and bench memoranda on a wide range of Chapter 7, 11 and 13 issues; attended and helped prepare materials for bankruptcy legal education seminars; and prepared a bench memorandum for a district judge sitting by designation on the Eleventh Circuit Court of Appeals.

Mr. Marcushamer is admitted to practice in New York State. He is fluent in Spanish and Hebrew.