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5 UNITED STATES BANKRUPTCY COURT  
6 EASTER DISTRICT OF CALIFORNIA  
7 FRESNO DIVISION

8 In re ) Case No. 04-11065-B-11  
9 Waterman Industries, Inc., ) DC No. WLG-134  
10 Debtor. )

11 **MEMORANDUM DECISION REGARDING OBJECTION TO CLAIM**  
12 **AND INTERPRETATION OF CHAPTER 11 PLAN**

13 Gregory S. Powell, Esq., of the Walter Law Group, appeared on behalf of WII  
14 Liquidation, Inc., formerly known as the debtor Waterman Industries, Inc. (the “Debtor”).

15 Beth Maxwell Stratton, Esq., of Seng & Stratton, appeared on behalf of James E. Salven,  
chapter 7 trustee for Waterman Industries Sales, Inc. (the “Trustee”).

16 **This memorandum decision is not approved for publication and may not be cited**  
17 **except when relevant under the doctrine of law of the case or the rules of res**  
**judicata and claim preclusion**

18 The Debtor objects to a general unsecured claim (the “WISI Claim”) filed by  
19 Waterman Industries Sales, Inc. (“Waterman Sales”) which seeks reimbursement of  
20 money used to pay the Debtor’s secured creditor, Wells Fargo Bank, N.A. (“Wells  
21 Fargo”). The Debtor acknowledges that funds belonging to Waterman Sales were used to  
22 pay Wells Fargo, but contends that it has no obligation to pay the WISI Claim (the “Claim  
23 Objection”) under the terms of the Debtor’s confirmed first amended chapter 11 plan (the  
24 “Plan”). Liquidation of the WISI Claim will involve substantial discovery and additional  
25 litigation. The court has therefore bifurcated the “liability” portion of the Claim  
26 Objection for resolution before the parties litigate the remaining issues.

27 This Claim Objection requires an analysis of the Plan, together the pre and  
28 postpetition financial arrangements between the Debtor, Waterman Sales, and two

1 financial institutions, Wells Fargo and its successor-in-interest, Galena National  
2 Investments, LLC (“Galena”). The court therefore deems the Claim Objection, and  
3 Waterman Sales’ opposition thereto, to include a motion by both parties for interpretation  
4 of the Plan with regard to its classification and treatment of the WISI Claim.<sup>1</sup> For the  
5 reasons set forth below, the Claim Objection will be overruled. The WISI Claim shall be  
6 allowed and treated as a general unsecured claim under Class 3-A of the Plan.

7 The court has jurisdiction over this matter pursuant to 28 U.S.C. § 1334 and 11  
8 U.S.C. §§ 502<sup>2</sup> and 1141, and General Orders 182 and 330 of the U.S. District Court for  
9 the Eastern District of California. This is a core proceeding pursuant to 28 U.S.C. §  
10 157(b)(1)(B) and (O). This memorandum decision contains findings of fact and  
11 conclusions of law required by Federal Rule of Bankruptcy Procedure 7052, made  
12 applicable to this proceeding by Federal Rule of Civil Procedure 52.

13 **Background.**

14 The Debtor was engaged in the business of manufacturing water control gates,  
15 valves and related equipment used in the agricultural irrigation and waste water treatment  
16 industries. Waterman Sales was an affiliate of the Debtor.<sup>3</sup> Prior to this bankruptcy, its  
17 function was to market and sell on consignment products manufactured by the Debtor in

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18  
19 <sup>1</sup>Under Article 11 of the Plan, this court retains jurisdiction to determine (1) the  
20 allowance of claims, (2) disputes regarding the classification of claims, and (3) any  
21 dispute regarding interpretation of the Plan.

22 <sup>2</sup>Unless otherwise indicated, all chapter, section and rule references are to the  
23 Bankruptcy Code, 11 U.S.C. §§ 101-1330, and to the Federal Rules of Bankruptcy  
24 Procedure, Rules 1001-9036, as enacted and promulgated *prior* to the effective date of  
The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. 109-8,  
Apr. 20, 2005, 119 Stat. 23.

25 <sup>3</sup>The record is unclear as to whether the Debtor owns Waterman Sales or vice-  
26 versa. There is also evidence to suggest that as much as 49% of the Debtor may be owned  
27 by third parties. Resolution of the dispute is not important here. However, it does confirm  
28 that the Debtor and Waterman Sales were separate and distinct entities for purposes of the  
discussion that follows.

1 locations not covered by the Debtor's sales staff. The Debtor and Waterman Sales  
2 maintained separate books and records, they had separate creditors, and until sometime  
3 prior to the bankruptcy filings, they had their own employees.

4 The Debtor and Waterman Sales both filed bankruptcy petitions under chapter 11  
5 on February 10, 2004.<sup>4</sup> After that time, Waterman Sales had no employees. All  
6 postpetition business operations of Waterman Sales were conducted by employees of the  
7 Debtor for a "fee" of \$20,000 per month. The Debtor contends that it has a claim against  
8 Waterman Sales for payment of these "administrative services."<sup>5</sup>

9 The Debtor's principal secured creditor was Wells Fargo. At commencement of  
10 this case, the Debtor owed Wells Fargo more than \$10 million (the "Wells Fargo Debt")  
11 under a set of credit agreements dating back to December 2000. The Wells Fargo Debt  
12 was secured by a security interest in virtually all of the Debtor's assets, including its bank  
13 accounts and accounts receivable. Wells Fargo also held personal guarantees from the  
14 Debtor's principals.

15 In June 2003, Waterman Sales gave Wells Fargo a Continuing Guaranty of the  
16 Wells Fargo Debt (the "WISI Guaranty"). In addition, in December 2000 and January  
17 2003, Waterman Sales executed two security agreements granting Wells Fargo a security  
18 interest in, *inter alia*, its accounts receivable and equipment respectively (the "WISI  
19 Security Agreements").

20 In January 2004, Wells Fargo began enforcing its security interests by taking the  
21 cash (more than \$300,000) from the Debtor's and Waterman Sales' bank accounts and  
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23 <sup>4</sup>Waterman Sales' bankruptcy case was assigned # 04-11067.

24  
25 <sup>5</sup>This expense is reflected as a "Management & Admin. Fee (WII)" in some of the  
26 budgets attached to early cash collateral orders so it is not clear why these management  
27 fees were not paid in the ordinary course of business using Wells Fargo's cash collateral.  
28 However, this court has never specifically authorized Waterman Sales to enter into any  
"administrative" agreement with the Debtor or to pay the Debtor for "administrative  
services."

1 commencing a civil action for the appointment of a receiver. Those actions forced both  
2 the Debtor and Waterman Sales to temporarily suspend business operations and seek  
3 bankruptcy protection. At the commencement of this case, both debtors were controlled  
4 by the same principals and both debtors were represented by the same counsel. Shortly  
5 after the petitions were filed, the Debtor and Waterman Sales brought motions to have  
6 their cases jointly administered utilizing the same management personnel and the same  
7 professionals. Those motions were denied, in part because the two entities appeared to  
8 have different creditors and inter-corporate claims against each other. On March 12,  
9 2004, Waterman Sales retained separate counsel.

10 The Debtor filed its schedules on February 20, 2004, and amended the schedules in  
11 April 2004. The Debtor's amended schedules list an account receivable owed from  
12 Waterman Sales to the Debtor in the amount of \$161,022, purportedly for "inter-company  
13 debt." The schedules filed in the Waterman Sales' case list the Debtor as an unsecured  
14 creditor for approximately \$79,500. For reasons that have never been adequately  
15 explained, the Debtor's schedules do not list Waterman Sales as a creditor  
16 notwithstanding the fact that Waterman Sales had guaranteed the Wells Fargo Debt.

17 In June 2004, Wells Fargo filed a proof of claim in the Debtor's case in the amount  
18 of \$10,389,447.03 for "money lent." Wells Fargo also filed a proof of claim in the  
19 Waterman Sales' case for the same amount based on the WISI Guaranty. In January  
20 2005, Wells Fargo amended and reduced its claim against Waterman Sales to the amount  
21 of \$9,959,343.27 for "money lent" and "obligations owed under Guaranty" (the "Wells  
22 Fargo Claim").

23 The Waterman Sales' case was converted to chapter 7 on September 7, 2004. The  
24 Trustee was appointed on September 9, 2004. On December 3, 2004, the Trustee filed  
25 the WISI Claim on behalf of Waterman Sales for \$10,389,447, the same amount stated in  
26 the initial Wells Fargo Claim. The basis for the WISI Claim is stated as follows:

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1 Waterman Industries Sales, Inc., as guarantor of the debt owed by Waterman  
2 Industries, Inc. to Wells Fargo . . . is entitled to a claim against Waterman  
3 Industries Sales, Inc.

4 In June 2005, Galena acquired the Wells Fargo Debt, as well as all of the rights  
5 and obligations pertaining thereto, including the WISI Guaranty and WISI Security  
6 Agreements. Galena thereby became the successor in interest to all rights previously held  
7 by Wells Fargo (hereafter the “Galena Debt”). Galena filed a Notice of Transfer of Claim  
8 Other Than for Security in the Waterman Sales’ case to document the fact that the Wells  
9 Fargo Claim had been absolutely transferred and assigned to Galena (hereafter “Galena’s  
10 Claim”). Galena’s Claim has not been withdrawn or amended to reflect any reduction or  
11 adjustment based on payments received after commencement of the bankruptcy cases, or  
12 confirmation of the Debtor’s Plan.

13 **The Disclosure Statement, the Plan and the Subordination Payments.**

14 The court confirmed the Debtor’s Plan in December 2005. The Trustee was served  
15 with the Plan, but did not vote to reject it or object to its confirmation. Waterman Sales  
16 was not specifically mentioned in the Debtor’s first amended disclosure statement (the  
17 “Disclosure Statement”),<sup>6</sup> or the Plan, and the WISI Claim was not separately classified  
18 or provided for in the Plan. Similarly, the Disclosure Statement and Plan fail to make any  
19 distinction between the WISI Claim and the other general unsecured creditors. If the  
20 WISI Claim is allowed in any amount, it appears from the face of the Disclosure  
21 Statement and Plan that the WISI Claim will be treated as a general unsecured claim in  
22 Class 3-A of the Plan.<sup>7</sup>

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24 <sup>6</sup>The Disclosure Statement was filed on October 25, 2005 and approved by an  
25 order entered on October 27.

26 <sup>7</sup>The Plan provides for treatment of general unsecured claims in Article 3,  
27 paragraph 3.3 in pertinent part as follows:

28 Class 3-A is impaired. . . . Each holder of such a Claim shall receive Pro Rata

1 The WISI Guaranty contained a subordination provision (the “Subordination  
2 Clause”) which subordinated Waterman Sales’ right to receive any payments from the  
3 Debtor to Wells Fargo’s right to receive payments from the Debtor on account of the  
4 Wells Fargo Debt. The Subordination Clause also gave Wells Fargo a security interest in  
5 any obligation owed from the Debtor to Waterman Sales. The Subordination Clause  
6 provided in pertinent part:

7 SUBORDINATION. Any Indebtedness of [the Debtor] now or hereafter held by  
8 [Waterman Sales] is hereby subordinated to the Indebtedness of [the Debtor] to  
9 Bank. Such Indebtedness of [the Debtor to Waterman Sales] is assigned to Bank  
10 *as security* for this Guaranty and the Indebtedness and, if Bank requests, shall be  
11 collected and received by [Waterman Sales] as trustee for Bank and paid over to  
12 Bank on account of the Indebtedness of [the Debtor] to Bank but without reducing  
13 or affecting in any manner the liability of [Waterman Sales] under the other  
14 provisions of this Guaranty. (Emphasis added.)

15 Based on the Subordination Clause, the Plan created a term which is central to this  
16 Claim Objection known as “Subordination Payments” defined as follows:

17 Subordination Payments are Distributions under the Plan that are payable to  
18 *persons or entities* whose claims have been contractually subordinated to the claim  
19 held by Galena and which as a result thereof would be payable to Galena rather  
20 than to the original holder of such claims. (Emphasis added.)

21 The Plan contemplates that the assets of the Debtor would revest in the Debtor  
22 upon confirmation. Thereafter, some of the assets were acquired, via an Asset Purchase  
23 Agreement by a new entity, GNI Waterman, Inc. (“GNI Waterman”) which is wholly-  
24 owned by Galena. GNI Waterman continued the business operations of the Debtor. GNI  
25 Waterman made a \$1.25 million cash payment to the Debtor to help fund the Plan, and

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26 Distribution from any proceeds of Plan Assets available after Distributions  
27 required by this Plan have been made to holders of allowed Nonclassified Claims  
28 and Allowed [priority claims, real property taxes, and Convenience] Claims. Such  
Distributions shall be made from time to time in the discretion of the [Liquidating  
Agent] in an amount not to exceed the amount of such Allowed Claims and in a  
manner consistent with the provisions of this Plan. (All capitalized terms are  
defined in the Plan or in the Order Confirming Chapter 11 Plan and Fixing Bar  
Dates entered on December 13, 2005.)

1 assumed all of the Galena Debt. The remaining assets are being liquidated by Clifford  
2 Bressler, the “Liquidating Agent.” The Plan establishes a designated fund, the “Plan  
3 Account” from which payments will be made to unsecured creditors. The distribution to  
4 unsecured creditors after payment of administrative and priority claims is estimated in the  
5 Disclosure Statement to be between \$739,200 and \$2,839,000. Galena will not receive  
6 any payments from the Plan Account or from any assets not specifically designated for  
7 payment of its claim.

8 The Galena Debt is provided for in Class 2-A of the Plan. The Plan proclaims the  
9 Galena Debt to be “fully secured” and provides that Galena will receive the proceeds  
10 from liquidation of various specified assets. Galena agreed to release its lien against the  
11 remaining assets of the Debtor and the Debtor has no further obligation to make any  
12 payments to Galena. In the last sentence of the section dealing with Class 2-A, treatment  
13 of the Galena Debt, the Plan purports to “assign” the Subordination Payments back to the  
14 Debtor for distribution to the unsecured creditors. Specifically, the Plan provided for  
15 treatment of the Galena Debt as follows:

16 3.2.1 Class 2-A (Galena): Class 2-A is impaired. Galena’s Secured Claim shall be  
17 assumed by [GNI Waterman] and the *Debtor shall have no responsibility for*  
18 *payment of the Galena Secured Claim*; provided that Galena shall be entitled to  
19 also receive (a) fifty percent (50%) of the Excess Proceeds of Specified  
20 Receivables which shall be paid by the Debtor to Galena promptly upon the  
21 Debtor’s receipt thereof, and (b) if the Foundry has no [sic] been sold prior to the  
Effective Date, 40% of the net proceeds from sale of the Foundry, with such  
proceeds paid to Galena directly from escrow of any sale. *Any Subordination*  
*Payments to which Galena is entitled are hereby assigned to the Debtor and may*  
*be retained by the General Manager as Plan Assets for Distribution to Class 3-A.*  
(Emphasis added.)

22 **The Trustee’s Reimbursement Claim.**

23 In the months after commencement of this case, the Debtor and Waterman Sales  
24 entered into a series of cash collateral agreements with Wells Fargo which were approved  
25 by this court (the “Cash Collateral Orders”) and which authorized the Debtor to use the  
26 postpetition proceeds of accounts receivable to continue operating its business. Those  
27 Cash Collateral Orders also required Waterman Sales to make “adequate protection”  
28 payments to Wells Fargo, based on the WISI Guaranty, using postpetition proceeds of

1 Waterman Sales' accounts receivable.

2 During the time that Waterman Sales was in chapter 11, it shared with the Debtor a  
3 common post office box for the remittance of payments on their accounts receivable. The  
4 Trustee contends that the Debtor's employees took checks representing payment of  
5 Waterman Sales' accounts receivable and delivered those monies to Wells Fargo. There  
6 is a material dispute between the parties as to whether the Debtor failed to keep, or has  
7 failed to produce, a complete and accurate accounting of those transfers. However, the  
8 Debtor acknowledges in this Claim Objection that at least \$965,000 of Waterman Sales'  
9 money was collected and turned over to Wells Fargo between February and August  
10 2004.<sup>8</sup>

11 The WISI Claim seeks reimbursement for all monies used by the Debtor or paid to  
12 Wells Fargo on the Debtor's behalf. The Debtor contends in this Claim Objection that the  
13 Plan exonerates the Debtor from having to reimburse Waterman Sales for any money so  
14 used. The WISI Claim may also be subject to offset by the Debtor - the Debtor has filed a  
15 proof of claim in Waterman Sales' case for \$309,300 for "goods sold." The exact, or  
16 estimated, amount of the WISI Claim will require additional discovery and litigation. The  
17 court has bifurcated those issues for determination at a later time if necessary.

18 **The Claim Objection.**

19 The Debtor objects to the WISI Claim on several grounds. Initially, the Debtor  
20 contended that the WISI Claim was untimely because it was filed after the June 10, 2004,  
21 bar date which this court had previously approved for the filing of claims (the "Bar  
22 Date"). The Debtor also argued that the WISI Claim was not adequately documented. At  
23 the first hearing, the court stated its intention to overrule the "timeliness" objection and  
24 set the matter for further hearing after discovery on the "liquidation" issue. The Debtor  
25 then amended the Claim Objection to include the "subordination" issue addressed herein.

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27 <sup>8</sup>The Debtor also acknowledged in the Disclosure Statement that Wells Fargo  
28 received approximately \$900,000 from the bankruptcy estate of Waterman Sales.



1 The Debtor argues that it has no obligation to pay the WISI Claim because the Claim was  
2 subordinated to the Galena Debt. The subordination issue calls for an interpretation of  
3 the Plan itself. The Plan purports to assign the Subordination Payments back to the  
4 Debtor for use to pay unsecured creditors other than Waterman Sales. The Debtor also  
5 argues that any claim of Waterman Sales is contingent and must be disallowed under  
6 § 502(e)(1)(B).

7 **Issues Presented.**

- 8 1. Was the WISI Claim timely filed?
- 9 2. Did the Plan's assignment of the Subordination Payments to the Debtor  
10 exonerate the Debtor from its obligation to reimburse Waterman Sales for money  
11 paid to Wells Fargo on account of the WISI Guaranty?
- 12 3. Is the WISI Claim a contingent claim?

13 **Burden of Proof.**

14 A proof of claim executed and filed in accordance with the Federal Rules of  
15 Bankruptcy Procedure constitutes *prima facie* evidence of the validity and amount of the  
16 claim. Fed.R.Bankr.P. 3001(f). Upon objection, the proof of claim provides "some  
17 evidence as to its validity and amount" and carries over a "mere formal objection."  
18 *Lundell v. Anchor Const. Specialists, Inc.*, 223 F.3d 1035, 1039 (9th Cir. 2000). The  
19 objector must produce sufficient evidence "tending to defeat the claim by probative force  
20 equal to that of the allegations in the proofs of claim themselves." *Id.* (citing *Wright v.*  
21 *Holm (In re Holm)*), 931 F.2d 620, 623 (9th Cir.1991)(citations omitted). The claimant  
22 must "prove the validity of the claim by a preponderance of the evidence. The ultimate  
23 burden of persuasion remains at all times upon the claimant." *Lundell*, 223 F.3d at 1039.  
24 The Debtor, as the Plan's drafter and proponent, has the burden of proof in this dispute  
25 relating to interpretation of the Plan.

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28 / / /

1 **Analysis.**

2 **The WISI Claim was not Untimely.**

3       The Debtor first argued that the WISI Claim should be disallowed as “untimely”  
4 because it was filed after the Bar Date. At the initial hearing, the court overruled that  
5 objection for reasons stated on the record and supplemented below. The court found,  
6 *inter alia*, that the Bar Date could not apply to Waterman Sales and the Trustee. Both the  
7 Debtor and Waterman Sales were initially represented by the same law firm. Prior to  
8 conversion of Waterman Sales’ case to chapter 7, the business operations of the Debtor  
9 and Waterman Sales were conducted by the same people, the Debtor’s principals and  
10 employees. Waterman Sales had no employees and no ability to file its own proof of  
11 claim. The Debtor was diverting hundreds of thousands of dollars of Waterman Sales’  
12 money to reduce the Wells Fargo Debt, the same Debt that was personally guaranteed by  
13 the Debtor’s principals who should have protected Waterman Sales’ interests. Yet, the  
14 Debtor failed to schedule Waterman Sales as an unsecured creditor and failed to file a  
15 proof of claim on its behalf. The Debtor properly scheduled and filed its own claim  
16 against Waterman Sales based on purported “inter-company debt.” The Debtor also had a  
17 responsibility to protect Waterman Sales’ interests with regard to the same “inter-  
18 company debt,” but blatantly failed to do so.

19       On the Bar Date, Waterman Sales was still in chapter 11, totally under the  
20 management and control of the Debtor. That arrangement continued until the case was  
21 converted to chapter 7 in September 2004, about three months *after* the Bar Date. The  
22 Trustee could not have received notice of the Bar Date as a matter of law, and could not  
23 have filed a timely proof of claim on behalf of Waterman Sales because he had not been  
24 appointed yet. The Debtor’s criticism of the Trustee for failing to timely file the WISI  
25 Claim is so lacking in factual and legal support as to be virtually frivolous.

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1 **Assignment of the Subordination Payments Did Not Exonerate the Debtor from its**  
2 **Obligation to Reimburse Waterman Sales.**

3 This analysis begins by recognizing that Waterman Sales unquestionably has a  
4 claim against the Debtor based on the statutory right of reimbursement under California  
5 Civil Code § 2847 which states in pertinent part:

6 If a surety satisfies the principal obligation, or any part thereof, whether with or  
7 without legal proceedings, the principal is bound to reimburse what he has  
disbursed, including necessary costs and expenses . . . .

8 Accordingly, in the absence of a showing otherwise, Waterman Sales is entitled to  
9 reimbursement from the Debtor for the money that was taken from Waterman Sales to  
10 pay the Wells Fargo Debt. The Debtor does not really attempt to challenge this issue. The  
11 Debtor acknowledges that at least \$965,000 of Waterman Sales' money was indeed used  
12 to reduce the Wells Fargo Debt. The Debtor's argument challenges its obligation to pay  
13 the WISI Claim based on a convoluted analysis of the Plan.

14 The Debtor acknowledges in its Claim Objection that the WISI Claim is an  
15 "account" which was subject to Galena's security interest under the terms of the WISI  
16 Guaranty and Security Agreements. The Debtor correctly points out that the  
17 Subordination Clause operated to subordinate the WISI Claim to Galena's prior right to  
18 receive payments on its Debt. The Debtor cites § 510(a), for the proposition that the  
19 Subordination Clause is fully enforceable against Waterman Sales: "A subordination  
20 agreement is enforceable in a case under this title to the same extent that such agreement  
21 is enforceable under applicable nonbankruptcy law." However, the Subordination Clause  
22 inured to the benefit of Galena, not the Debtor, and the Galena Debt has been fully  
23 provided for in the Plan.

24 The Debtor then looks to the Plan which purports to assign the Subordination  
25 Payments to the Debtor. Based thereon, the Debtor leaps to the conclusion that it is no  
26 longer obligated to pay the WISI Claim. The Debtor contends that it holds the "right to  
27 payment" of the Subordination Payments and that any money paid on the WISI Claim  
28 would automatically revert directly back to the Debtor - a legal absurdity. The argument

1 here fails because the Debtor has misconstrued the nature and substance of the  
2 Subordination Payments.

3         At the time the Plan was confirmed, and the Subordination Payments “assigned” to  
4 the Debtor, Galena’s right to collect Waterman Sales’ accounts, ergo any right Galena  
5 may have had to collect the WISI Claim, was nothing more than a security interest. The  
6 WISI Guaranty and Security Agreements assigned Waterman Sales’ accounts to Wells  
7 Fargo *as security* for the Wells Fargo Debt. Neither Wells Fargo, nor Galena ever  
8 foreclosed on that security interest; they never sought an adjudication of title or  
9 ownership in Waterman Sales’ accounts. Waterman Sales’ accounts have at all times  
10 remained the property of Waterman Sales. Galena’s security interest in those accounts,  
11 and the purported assignment of that security interest, did not divest Waterman Sales of  
12 the accounts themselves. By creating and defining the term “Subordination Payments” in  
13 the Plan, the Debtor has attempted to fabricate, out of whole cloth, an absolute “right to  
14 payment” which never before existed independent of the underlying obligation embodied  
15 in the Wells Fargo Debt instruments.

16         The Debtor states repeatedly, without supporting evidence or authority, that Galena  
17 assigned the right to collect Waterman Sales’ accounts - specifically the right to collect  
18 the WISI Claim - back to the Debtor upon confirmation of the Plan. However, to  
19 accomplish this Galena would also have had to assign to the Debtor a portion of the  
20 underlying Galena Debt. Nothing in the Plan, the Disclosure Statement, or in any  
21 documents offered in support of the Claim Objection, suggests that any portion of the  
22 Galena Debt was assigned away to anybody.

23         The Disclosure Statement states that GNI Waterman would assume “all of the  
24 Debtor’s debt to Galena.” (Disclosure Statement at pg. 20, ¶ H(1)(a).) This disclosure is  
25 consistent with the fact that Galena still asserts a claim against Waterman Sales for the  
26 full amount originally owed under the WISI Guaranty. Galena’s Claim against Waterman  
27 Sales has not been withdrawn or amended to reflect any reduction for debt purportedly  
28 assigned to the Debtor. It would be absurd for this court to make a ruling which

1 effectively denies the Trustee the right to recover a debt owed to Waterman Sales, based  
2 on some contrived “assignment” of the Galena Debt, and which still leaves Waterman  
3 Sales’ estate exposed to the full amount of Galena’s Claim on the theory that Galena still  
4 holds the entire Galena Debt.<sup>9</sup>

5       The contradiction inherent in the Debtor’s argument is patently apparent in the  
6 Debtor’s amended Claim Objection wherein the Debtor makes the statements, “Galena  
7 assigned the right to receive these sums back to [Debtor] for distribution pursuant to the  
8 Plan” and that “payment on the WISI [Claim] . . . would only result in the funds being  
9 paid back to [Debtor] . . .” (Amended Objection to Proof Of Claim No. 322 filed on June  
10 13, 2006 at pg 6:16-23.) These statements squarely contradict the Debtor’s statement  
11 earlier in the same pleading that “[e]ven if there is an allowable [WISI Claim] . . . Galena  
12 would be entitled to the proceeds.” *Id.* at pg. 5:19-21.

13       It is well established under California law that there can be no assignment of a  
14 security interest independent of the assignment of the underlying debt. *Wolfe v. Leisure*  
15 *Time Sports, Inc. (In re Leisure Time Sports, Inc.)*, 194 B.R. 859, 861 (9th Cir. BAP  
16 1996)(citing *Union Supply Co. v. Morris*, 220 Cal. 331, 338-39, 30 P.2d 394, 397 (1934)).  
17 “A security interest cannot exist, much less be transferred, independent of the obligation  
18 which it secures.” *Id.* (citation omitted). A purported assignment of a security interest  
19 without an assignment of the debt which it secures is a “legal nullity.” *Id.*

20       This is not a mere technical legal requirement: To allow the assignee of a security  
21 interest to enforce the security agreement would expose the obligor to a double  
22 liability, since a holder in due course of the promissory note clearly is entitled to  
23 recover from the obligor. Furthermore, the definition of 'security interest' in  
24 Section 1-201(37), Uniform Commercial Code--an interest in personal property  
25 which secures payment of an obligation--indicates that a security interest cannot  
26 exist without a debt.

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25       <sup>9</sup> The court is not attempting to adjudicate here any issues with regard to Galena’s  
26 Claim vis-a-vie the Waterman Sales’ estate. If the Trustee contends that there is a basis  
27 for objecting to Galena’s Claim, based on confirmation of the Plan, full or partial  
28 satisfaction, or any other theory, that battle will have to be fought through a claim  
objection in the Waterman Sales’ case.

1 *In re Leisure Time Sports, Inc.*, 194 B.R. at 861 (citations omitted).

2       The court in *In re Leisure Time Sports, Inc.*, further held that, "[t]he only  
3 consequence of the ineffective assignment . . . was that no rights were created in the  
4 assignee." Consequently, Galena's attempt to assign its security interest in the WISI  
5 Claim, the purported Subordination Payments, had no force or effect.

6       Assuming, arguendo, that assignment of the Subordination Payments did  
7 effectuate a partial assignment of the Galena Debt back to the Debtor, the Debtor was still  
8 a co-obligor with Waterman Sales on the assigned Debt. Under California law, the  
9 assignment of a joint and several debt to one of the co-obligors extinguishes that portion  
10 of the debt altogether. *Great Western Bank v. Kong*, 90 Cal.App.4th 28, 32 (2001)  
11 (citations omitted). Either way, whether the assignment of Subordination Payments was a  
12 legal nullity, or whether it operated to extinguish a portion of the underlying Galena Debt,  
13 the court cannot reach the conclusion that the Debtor no longer has an obligation to  
14 reimburse Waterman Sales. Confirmation of the Plan did not exonerate the Debtor from  
15 its liability to pay the WISI Claim.

16 **The Disclosure Statement Failed to Comply With § 1125 and the Plan Failed to**  
17 **Comply With § 1123(a) With Regard to the WISI Claim.**

18       The WISI Claim was filed as a general unsecured claim. As such, it would be  
19 entitled to treatment in Class 3-A along with all of the other unsecured claims. But the  
20 Debtor contends that the WISI Claim must be treated differently. The Debtor essentially  
21 tried to eliminate the WISI Claim by adding the "assignment of Subordination Payments"  
22 provision to Class 2-A, which provides for treatment of the Galena Debt. If the Debtor  
23 intended to treat the WISI Claim outside of Class 3-A, then that should have been  
24 candidly disclosed in the Disclosure Statement.

25       Section 1125(b) prohibited the Debtor from soliciting acceptance or rejection of  
26 the Plan unless the creditors received a Disclosure Statement with "adequate  
27 information." The term "adequate information" is defined in § 1125(a) to mean  
28 "information of a kind, and in sufficient detail . . . that would enable a hypothetical

1 reasonable investor typical of holders of claims . . . of the relevant class to make an  
2 informed judgment about the plan.”

3 Here, the Disclosure Statement fails to separately classify the WISI Claim and  
4 contains virtually no information from which the Trustee could have made “an informed  
5 judgment about the plan” as it is now defined by the Debtor. Quite the opposite, to the  
6 extent that the Debtor argues for treatment of the WISI Claim outside of Class 3-A, the  
7 Plan and Disclosure Statement are grossly misleading.

8 For the same reasons, the Plan fails to comply with § 1123(a) which provides for  
9 the classification of claims. It states in pertinent part:

10 (a) Notwithstanding any otherwise applicable nonbankruptcy law, a plan shall—

11 (1) designate, subject to section 1122 of this title, classes of claims, other than  
12 [priority claims] . . . and classes of interests;

13 . . .

14 (3) specify the treatment of any class of claims or interests that is impaired  
under the plan;

15 (4) provide the same treatment for each claim or interest of a particular class,  
16 unless the holder of a particular claim or interest agrees to a less favorable  
treatment of such particular claim or interest.

17 Here, it is clear that the WISI Claim is impaired under the Plan because it is not  
18 going to be paid in full upon approval of the Claim. Section 1122(a) prohibits the Debtor  
19 from putting the WISI Claim in Class 3-A unless it is “substantially similar to the other  
20 claims or interests of such class.” However, the Debtor was required by § 1123(a) to  
21 separately classify the WISI Claim if it was not going to receive “the same treatment” as  
22 each other unsecured claim. Reading §§ 1122(a) and 1123(a) together, the WISI Claim  
23 must be treated as a Class 3-A claim; Class 3-A is the only class in the Plan which could  
24 provide for the WISI Claim. By deliberately failing to separately classify and provide for  
25 the WISI Claim, the Debtor is now estopped from arguing that the WISI Claim is not  
26 “substantially similar” to the other unsecured claims.

27 / / /

28 / / /

1 **The WISI Claim is Not a Contingent Claim.**

2 The Debtor argues that the WISI Claim should be disallowed because it is a  
3 “contingent” claim. Section 502(e)(1) provides in pertinent part:

4 [T]he court shall disallow any claim for reimbursement or contribution of an entity  
5 that is liable with the debtor on or has secured the claim of a creditor, to the extent  
6 that—

7 . . .

8 (B) such claim for reimbursement or contribution is contingent as of the time of  
9 allowance or disallowance of such claim for reimbursement or contribution. . . .

10 There are at least three reasons why this argument fails. First, the WISI Claim may  
11 still be unliquidated, but it is not “contingent” in the sense that some antecedent act or  
12 event must occur before Waterman Sales has a right to receive distributions on its Claim  
13 under Class 3-A of the Plan. Waterman Sales has already paid the money for which it  
14 seeks reimbursement. Section 502(e)(2) provides for the allowance of a reimbursement  
15 claim as follows:

16 (2) A claim for reimbursement or contribution of such an entity that becomes fixed  
17 after the commencement of the case shall be determined, and shall be allowed  
18 under subsection (a), (b), or (c) of this section, or disallowed under subsection (d)  
19 of this section, the same as if such claim had become fixed before the date of the  
20 filing of the petition.

21 Waterman Sales is entitled to a prepetition claim in the amount that it has already  
22 paid to Wells Fargo. A guarantor’s reimbursement claim is not contingent once it has  
23 paid on the guaranty. “The combined effect of section 502(e)(1)(B) and 502(e)(2) is that  
24 a surety or codebtor is generally permitted a claim for reimbursement or contribution *to*  
25 *the extent the surety or codebtor has paid the assured party at the time of allowance. . . .*”  
26 (Emphasis in original.) *In re Early & Daniel Industries, Inc.*, 104 B.R. 963, 969  
27 (Bkrtcy.S.D.Ind. 1989)(citing, 124 Cong Rec H11094 (daily ed. Sept. 28, 1978); S17410-  
28 11 (daily ed. Oct. 6, 1978); remarks of Rep. Edwards and Sen. DeConcini; *reprinted in*  
*Norton* at 288.

29 Second, the underlying purpose of § 502(e)(1)(B) is not applicable here. The  
30 purpose and effect of § 502(e)(1)(B) has been described as follows:



1 Section 502(e)(1)(B) was enacted "to prevent . . . competition between a creditor  
2 and [its] guarantor for limited proceeds of the estate." H.R. Rep. No. 595, 95th  
3 Cong., 1st Sess. 354 (1977). Thus, section 502(e)(1)(B) is applicable to a debt  
4 owed by the debtor to a creditor which has been guaranteed by a third party. If the  
5 primary obligee seeks payment from its guarantor, the guarantor may seek  
6 reimbursement or contribution from the debtor. Both the primary obligee and the  
7 guarantor have a claim against the debtor that arises from the same debt; the  
8 primary obligee has a right to payment from the debtor, and the guarantor has a  
9 contingent right to reimbursement or contribution from the debtor which may  
10 become noncontingent in the event that it fully satisfies the primary obligee's  
11 claim. By disallowing the guarantor's contingent claim for reimbursement or  
12 contribution, section 502(e)(1)(B) insures that the estate will not be liable to the  
13 primary obligor and the guarantor for the same debt. *See Potter v. CNA Insurance*  
14 *Companies (In re Mei Diversified, Inc.)*, 106 F.3d 829 (8th Cir. 1997); *Juniper*  
15 *Dev. Group v. Kahn (In re Hemingway Transp., Inc.)*, 993 F.2d 915 (1st Cir.  
16 1993).

17 4 *Collier on Bankruptcy*, (15th Ed. Revised 2003), ¶ 502.06[2][d], pg. 502-62, 63 (some  
18 citations omitted).

19 Here, there is no competition between Galena and Waterman Sales for the "limited  
20 proceeds" of the Debtor's estate. The Plan designates exactly what assets will be  
21 liquidated to pay Galena. GNI Waterman assumed the remainder of the Galena Debt.  
22 The unsecured claims will be paid from a separate fund, the Plan Account. Galena made  
23 a \$1.25 million payment to help fund the Plan Account. Galena has no "competing"  
24 rights against the Plan Account.

25 Third, any remaining contingency was removed upon confirmation of the Plan.  
26 The Plan establishes the Plan Account for the payment of unsecured claims. The unpaid  
27 Galena Debt has been either assumed by GNI Waterman, or provided for through the  
28 liquidation of designated assets. The Debtor has no other obligation to make payments to  
Galena which must be satisfied ahead of the WISI Claim.

The only arguable restriction on payment of the WISI Claim was the Subordination  
Clause. However, the Subordination Clause is now meaningless. The purpose of the  
Subordination Clause was essentially the same as the purpose ascribed above to  
§ 502(e)(1)(B); to protect Galena's right to get paid from the Debtor's assets before the  
Debtor could use those assets to reimburse or pay any debt to Waterman Sales. Galena's  
rights against the Debtor's assets are now fixed in the Plan. Galena released its lien  
against all other assets. Galena has no rights against the Plan Account and the remaining

1 assets that have been designated for payment of the unsecured claims. Galena no longer  
2 holds any rights against the Debtor, or its assets, for the Subordination Clause to protect.

3 The Debtor cites to paragraph 6 of the WISI Guaranty which purports to waive any  
4 right of subrogation until the Galena Debt is paid in full. The Debtor argues that the  
5 Galena Debt will never be “paid in full” under the Plan. The argument is misplaced. The  
6 Galena Debt has been assumed by GNI Waterman. Galena owns GNI Waterman. It is  
7 unknown whether the Galena Debt will ever be literally “paid in full” under the Plan, but  
8 it is fully provided for under the Plan. After liquidation of the assets designated for  
9 payment of Galena, the Debtor’s obligation to Galena will be fully satisfied. The Plan is  
10 binding on Galena. § 1141(a). The Plan’s treatment of the Galena Debt is the functional  
11 equivalent of “full payment” with regard to any waivers contained in the WISI Guaranty.

12 Further, the WISI Claim is enforceable based on Waterman Sales’ statutory right  
13 of *reimbursement*, not subrogation. Section 509(b) requires the trustee to elect between  
14 the subrogation and reimbursement remedies.<sup>10</sup> Although the Trustee initially asserted the  
15 WISI Claim based on the right of subrogation, he has apparently abandoned that theory

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17 <sup>10</sup>Section 509 provides in pertinent part:

18 (a) Except as provided in subsection (b) or (c) of this section, an entity that is  
19 liable with the debtor on, or that has secured, a claim of a creditor against the debtor, and  
20 that pays such claim, is subrogated to the rights of such creditor to the extent of such  
21 payment.

22 (b) Such entity is not subrogated to the rights of such creditor to the extent that—  
23 (1) a *claim of such entity for reimbursement* or contribution on account of such  
24 payment of such creditor’s claim is—

25 (A) allowed under section 502 of this title;

26 . . .

27 (c) The court shall subordinate to the claim of a creditor and for the benefit of such  
28 creditor an allowed claim, by way of subrogation under this section, or for reimbursement  
or contribution, of an entity that is liable with the debtor on, or that has secured, such  
creditor’s claim, until such creditor’s claim is paid in full, either through payments under  
this title or otherwise. (Emphasis added.)

1 and elected instead, by his response to this Claim Objection, to assert the Claim for  
2 reimbursement.

3 Based thereon, the court finds and concludes that confirmation of the Plan  
4 abrogated the Subordination Clause in the WISI Guaranty in so far as it might have any  
5 affect on the WISI claim. Upon confirmation of the Plan, any restriction or  
6 “contingency” to payment of the WISI Claim terminated and § 502(e)(1)(B) has no  
7 application.

8 **Final Comment - Equity and Fundamental Due Process.**

9 Having explained above the factual and legal reasons why the court cannot sustain  
10 the Debtor’s Claim Objection, the court feels compelled to address the due process and  
11 equitable issues that do not fit neatly within the prior discussion. Looming like a “dark  
12 cloud” over this contested matter are a number of questions which the Debtor has failed  
13 to address with any kind of credible explanation. Those questions include: Why did the  
14 Debtor fail to schedule Waterman Sales as a creditor even though Waterman Sales had  
15 guaranteed the Wells Fargo Debt? Why did the Debtor’s management fail to file a timely  
16 proof of claim for Waterman Sales even though the Debtor had transferred almost \$1  
17 million of Waterman Sales’ money to Wells Fargo? Why did the Debtor fail to identify  
18 and separately classify the \$10 million WISI Claim in the Disclosure Statement and Plan  
19 if the Debtor intended that the Claim would not be treated as it was filed, a general  
20 unsecured claim? Why did the Debtor instead fabricate the Subordination Payments as an  
21 artifice for subsequent disallowance of the WISI Claim? If the assignment of  
22 Subordination Payments was intended to apply specifically to the WISI Claim, why did  
23 the Plan vaguely describe the Subordination Payments as being applicable to unidentified  
24 “persons or entities?”<sup>11</sup> Did the Trustee have adequate notice of how the Plan was

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26  
27 <sup>11</sup>The record suggests that Waterman Sales is the only creditor affected by the  
28 assignment of Subordination Payments. There are no other claim objections in which the  
Debtor has asked to apply this provision to any other creditors.

1 supposed to treat the WISI Claim when that treatment was disguised as an “assignment of  
2 Subordination Payments” and buried deep within the paragraph of the Plan which  
3 provides for treatment of the Galena Debt? The Debtor argues that the Trustee failed to  
4 object to confirmation of the Plan, that the confirmed Plan is binding on the Trustee, and  
5 that the Trustee is barred by *res adjudicata* from questioning the Plan’s treatment of the  
6 WISI Claim. But the Plan does not properly classify and provide for separate treatment of  
7 the WISI Claim. How much effort was the Trustee supposed to spend analyzing every  
8 term of the Plan trying to figure out what secret scheme was hidden within the Plan that  
9 he might need to object to? On the face of the Plan and the Disclosure Statement, the  
10 WISI Claim would appear to be entitled to treatment like any other general unsecured  
11 claim in Class 3-A. Did the Disclosure Statement and Plan, as defined now by the  
12 Debtor, give the Trustee adequate notice of the intended result, and satisfy the  
13 fundamental notions of due process with regard to a different treatment of the WISI  
14 Claim?<sup>12</sup>

15 The Trustee argues kindly that the Debtor and Galena, “put a great deal of thought  
16 into how they might structure a Plan that would destroy [Waterman Sales’] right to obtain  
17 reimbursement from [the Debtor] for payment made on the [Wells Fargo Debt].” After  
18 careful consideration of the Plan, and the arguments made by the Debtor in the  
19 subsequent Claim Objection, the court is inclined to agree with the Trustee. The Debtor  
20 and Galena were co-proponents of the Plan. Why didn’t the Plan proponents disclose in  
21 plain, clear language what they were intending to do with the WISI Claim? The obscure  
22

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23 <sup>12</sup>The Supreme Court identified the due process requirements for notice in *Mullane*  
24 *v. Central Hanover Bank & Trust Co.*, 339 U.S. 306, 314, 70 S.Ct. 652, 657 (1950).

25 An elementary and fundamental requirement of due process in any proceeding  
26 which is to be accorded finality is notice reasonably calculated, under all the  
27 circumstances, to apprise interested parties of the pendency of the action and  
28 afford them an opportunity to present their objections. The notice must be of such  
nature as reasonably to convey the required information . . . . (citations omitted.)

device which they conceived in an effort to avoid the Debtor's legal liability to Waterman Sales is "disappointing" to say the very least. The "Subordination Payments" scheme borders on the realm of "dirty tricks." The bankruptcy court is a court of equity and the equities of this contested matter lie squarely with the Trustee. To the extent that the court has any discretion to interpret the Plan and rule on the Claim Objection, the Debtor has shown no reason why the court should rule in its favor on this issue.

### **Conclusion.**

Based on the foregoing, the court finds and concludes that the WISI Claim was not untimely filed. The WISI Claim is enforceable against the Debtor based on Waterman Sales' statutory right of reimbursement. Confirmation of the Plan did not exonerate the Debtor from its obligation to Waterman Sales because the assignment of Subordination Payments was a nullity. Confirmation of the Plan abrogated the Subordination Clause in the WISI Guaranty because the Debtor has no further duty to make payments to Galena. Finally, the WISI Claim is not a contingent claim. Accordingly, the Debtor's Claim Objection will be overruled with regard to the issue of the Debtor's liability to pay the WISI Claim as a general unsecured claim pursuant to Class 3-A of the Plan. The court will set a further hearing and discovery schedule, if necessary, to liquidate the amount of the WISI Claim.

Dated: March 30, 2007

/s/ W. Richard Lee  
W. Richard Lee, Judge  
United States Bankruptcy Court