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Partnership - Sharing of Profits - the United States Bankruptcy Court for the Northern District of Texas Holds an Insurer Liable for the Bankruptcy Debt of Its Obligor Based on Finding of De Facto Partnership When Premiums Entitled the Insurer to Share in the Obligor's Profits

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PARTNERSHIP—SHARING OF PROFITS—
THE UNITED STATES BANKRUPTCY
COURT FOR THE NORTHERN DISTRICT
OF TEXAS HOLDS AN INSURER LIABLE
FOR THE BANKRUPTCY DEBT OF ITS
OBLIGOR BASED ON FINDING OF DE
FACTO PARTNERSHIP WHEN PREMIUMS
ENTITLED THE INSURER TO SHARE IN
THE OBLIGOR'S PROFITS

Sarah Moore

IN *Lain v. ZC Specialty Insurance Co.*, the United States Bankruptcy Court for the Northern District of Texas applied Illinois law to hold that a *de facto* partnership existed between a debtor and an insurance company that issued a surety bond to guarantee the debtor's payment of a mortgage loan.¹ The court determined that, because the debtor paid the insurance company a fixed base premium on the surety bond in addition to variable "supplemental" premiums that fluctuated with the amount of remaining cash flow after payment of the debtor's operating expenses, loan, and note obligations, and because the insurance company was entitled to either seventy or ninety percent of the debtor's fair market value upon its eventual wind up, the parties' relationship went beyond that of debtor-creditor.² Holding that the parties had formed a *de facto* partnership based on its reasoning that the insurer was effectively receiving a share of the debtor's profits and equity, the court went on to determine that the insurance company was liable for all the debtor's bankruptcy debt.³ This holding does not comport with the Illinois Safe Harbor provision for debtor-creditor relationships,⁴ does not give effect to the parties' contractual expectations of limited liability, and may effectively preclude this innovative form of credit-enhanced structured financial transactions.

1. See generally, *Lain v. ZC Specialty Ins. Co.*, 309 B.R. 223 (N.D. Tex. 2004).

2. See *id.* at 266.

3. See *id.*

4. See 805 ILL. COMP. STAT. 205/7(4)(a), (d) (1978).

Senior Living Properties, L.L.C. ("SLP") was formed in 1998 for the acquisition of nursing homes in Illinois and Texas.⁵ SLP acquired the homes in a transaction designed with the aid of Complete Care Systems, L.P. ("CCS"), a nursing home management company that acted to obtain a mortgage loan from GMAC Commercial Mortgage Corporation ("GMAC") in order to finance the SLP transaction.⁶ GMAC agreed to loan SLP \$226 million for the purchase of the homes provided that ZC Specialty Insurance Company ("Zurich"), a Texas property and casualty insurance company, would agree to issue a surety bond to guarantee payment of \$145 million of the mortgage loan.⁷ Zurich agreed to provide the surety bond, GMAC loaned SLP the \$226 million to purchase the homes, and SLP granted a mortgage to secure the GMAC loan.⁸

The Zurich/SLP transaction essentially allowed SLP to "rent" the financial rating of Zurich, who drew on its portfolio to credit-enhance the SLP mortgage loan.⁹ In turn, Zurich required SLP to enter into a reimbursement agreement, which defined the premiums to be paid by SLP in consideration for the surety bond and the terms by which SLP agreed to reimburse Zurich in the event that Zurich made payments to GMAC under the surety bond.¹⁰ Under the terms of the reimbursement agreement, SLP was required to maintain a liquidity fund to service the GMAC mortgage loan and the Zurich surety premium, should a net cash flow shortage exist after payment of operating expenses.¹¹

The distribution of the liquidity fund was to be made pursuant to a "Waterfall" provision, which dictated that SLP would first apply its monthly gross receipts toward operating expenses, then toward principal and interest on the GMAC loan and any other indebtedness to GMAC, and finally toward the fixed premium reimbursement obligation to Zurich.¹² After payment of all operating expenses, loan, and note obligations, including the fixed surety bond premium, free cash flow would then be distributed to Zurich in the form of three variable surety premiums: a "Performance Surety Premium," defined as an amount equal to free cash flow up to a limit of \$4 million, "a Supplemental Performance Surety Premium," defined as "an amount equal to seventy percent of the remaining free cash flow," and, upon SLP's "eventual windup," a "Final Supplemental Performance Surety Premium," described as "the present value of any unpaid Base Surety Premium and Additional Surety Premium," and "seventy percent of SLP's net fair market value, unless CCS is no longer manager, in which case, means ninety percent."¹³

5. *Lain*, 309 B.R. at 235.

6. *Id.*

7. *See id.*

8. *Id.*

9. *Id.* at 236.

10. *Id.* at 237.

11. *Id.*

12. *Id.* at 238-39.

13. *Id.*

The Final Supplemental Performance Premium was to be due on “the earlier of the GMAC note maturity date, payment of GMAC note, or the date of the disposition of substantially all of SLP’s capital assets.”¹⁴ However, Zurich could negotiate to extend the GMAC maturity date at its sole discretion if it concluded that SLP could not pay the Final Supplemental Performance Surety Premium in an amount Zurich found satisfactory.¹⁵ Additionally, under the terms of the reimbursement agreement, SLP was required to maintain general liability insurance coverage with Zurich as a co-insured, to provide Zurich with financial statements, to allow Zurich to examine its books and records, and to provide Zurich with at least ten business day’s notice of members meetings and the opportunity to attend.¹⁶ Moreover, SLP could not terminate the CCS management agreement or choose a new manager absent Zurich’s prior written consent.¹⁷

On May 14, 2002, SLP filed for reorganization pursuant to Chapter 11 of the Bankruptcy Code.¹⁸ In a resulting adversary proceeding, Dan Lain, the court-appointed trustee of the SLP Trust, brought suit to declare Zurich liable for all of SLP’s debts as a *de facto* partner.¹⁹ Finding in favor of Lain, the court purported to rely on the “integrated” and “unambiguous terms” of the reimbursement agreement as its sole basis for determining that, under the Illinois Uniform Partnership Act, Lain had established by “very clear and convincing evidence” a *prima facie* showing that the parties intended to enter into a partnership.²⁰ However, because the court found that, in light of the circumstances surrounding the alleged formation of partnership, Zurich had rebutted Lain’s *prima facie* showing, the court went on to consider extrinsic evidence of the parties’ negotiations, document projections, internal analysis, and the pricing of the Zurich-SLP transaction.²¹ Specifically, the court noted the following: (1) the parties did not execute a partnership agreement; (2) the parties did not file a declaration or certificate of partnership; (3) there was no evidence that the parties did business under a partnership name; (4) the parties did not advertise as partnership; (5) the parties did not create telephone or other listings as a partnership; (6) the parties did not file partnership tax returns; (6) the reimbursement agreement does not refer to SLP and Zurich as partners; (7) the closing documents suggest that SLP did not have a partner; (8) the GMAC note states that SLP and Zurich had a debtor-creditor relationship; (9) the parties *did* have a debtor-creditor relationship; and (10) under the terms of the reimbursement agreement, the surety company is defined as holder of the note, not partner.²²

14. *Id.* at 238.

15. *Id.* at 237.

16. *Id.*

17. *Id.*

18. See Brief for Appellant at 16, *Lain* (No. 03-3262).

19. *Lain*, 309 B.R. at 228.

20. Brief for Appellant at 16, *Lain* (No. 03-3262).

21. *Lain*, 309 B.R. at 256-57.

22. *Id.*

Nevertheless, the court held that the extrinsic evidence offered by Zurich in rebuttal did not defeat Lain's case, reasoning that a contract to share in profits remains the essential test.²³ Further, despite expert testimony that substantial involvement in the operations of an obligor is common among credit-enhanced structured financial transactions, the court noted additional indicia that it considered evidence of the parties' intent to form a partnership,²⁴ including that Zurich contracted to assure that creditors were paid before excess cash was distributed to equity level interests, had ultimate control over hiring and termination of SLP management, and could dictate the priority of payments on expenses and debt obligations.²⁵

Although the bankruptcy court's holding may reach the equitable result with which it was concerned by allowing SLP's general unsecured creditors and personal injury claimants the potential for recovery on their claims,²⁶ the holding is nevertheless problematic for several reasons. First, the court summarily dismisses the Illinois Statutory Safe Harbor provision for debtor-creditor relationships.²⁷ Second, the court refuses to give effect to the limited liability relationship that the parties contracted for and reasonably expected under the terms of the reimbursement agreement.²⁸ Finally, the court's holding undermines the potential for nursing home companies to benefit from participation in financial structuring geared toward back-end payments as opposed to higher, unaffordable fixed premium payments.²⁹

Under the Illinois Statutory Safe Harbor provision of the Illinois Uniform Partnership Act ("Safe Harbor provision"), no inference of partnership may be drawn where profits are received "[a]s a debt by installments or otherwise," or "[a]s interest on a loan, though the amount of payment vary with the profits of a business."³⁰ Thus, the Safe Harbor provision clearly provides that, when profits are paid on a loan, profit-sharing "cannot be proof of partnership as a matter of law."³¹ The bankruptcy court is quick to dismiss this provision, holding, without further explanation, that "Zurich did not loan any money to SLP, SLP purchased an insurance surety bond from Zurich [and] Zurich contracted for the payment of the premium for that insurance."³²

However, the court overlooks the fact that Zurich did in essence loan its credit rating to SLP, without which GMAC would not have issued the

23. *Id.*

24. *Id.* at 257.

25. *See id.* at 257-61.

26. *See id.* at 269 (stating that, as a matter of public policy, "the parties to that agreement should be bound to pay those expenses.").

27. *See id.* at 255.

28. *See Omnitrus Merging Corp. v. Ill. Tool Works, Inc.*, 628 N.E.2d 1165, 1168 (Ill. App. Ct. 1993) (stating that "[t]he primary objective in contract construction is to give effect to the intention of the parties . . . to be ascertained from the language of the contract.").

29. *See Lain*, 309 B.R. at 269.

30. 805 ILL. COMP. STAT. 205/7(4)(a), (d) (1978).

31. *Fed. Sav. & Loan Ins. Corp. v. Griffin*, 935 F.2d 691, 699-700 (5th Cir. 1991).

32. *Lain*, 309 B.R. at 255.

mortgage loan. Further, the court provides no reasonable basis for distinguishing the applicability of the Safe Harbor provision in one instance, where a loan is issued and payments are received with interest, from the situation where a surety bond is issued and premiums are paid in consideration for the bond.³³ Moreover, it is well-settled that profits, when received in repayment of debt, do not evidence that there was a partnership.³⁴ Under the terms of the reimbursement agreement, SLP owed a debt to Zurich for which the Performance Premiums and Supplemental Performance Premiums were paid in consideration.³⁵ Thus, under the Safe Harbor provision of the Illinois Uniform Partnership Act, whether viewed as interest on a loan or payments on a debt, the Performance Premiums and Supplemental Performance Premiums paid by SLP to Zurich in consideration for the surety bond did not constitute *prima facie* evidence of a partnership.³⁶

Furthermore, the “unambiguous” terms of the reimbursement agreement clearly establish that SLP and Zurich intended to create a debtor-creditor relationship, which has been held to be the controlling consideration in the absence of a partnership agreement.³⁷ In fact, the reimbursement agreement contains a provision that binds SLP to comply with the terms of its operating agreement, which provides in “Article I, Organization, Section 1.6, No Partnership:” “[t]he members intend that the Company not be a partnership (including, but without limitation, a limited partnership) or joint venture, and that no Member be a partner or joint venturer of any other Member.”³⁸ Moreover, the court’s finding that the parties intended to create a partnership is particularly problematic in light of the fact that, “where the evidence contains writings of the parties that distinctly indicate a relationship other than a partnership, the assertion that a partnership exists must be based on very clear and convincing evidence,” and, as discussed above, profit-sharing is not sufficient evidence of a partnership.³⁹ Moreover, when a surety bond is at issue, an increasingly heightened burden of proof is placed on the party asserting partnership, namely that the agreement must be “strictly construed and may not be extended by implication or imposed beyond the express terms of the instrument.”⁴⁰ Rather than apply the plain language of the reimbursement agreement to give effect to the parties’ intent, as the bank-

33. See generally *id.*

34. See, e.g., *Wash. Comm. Group v. Henry*, 18 B.R. 437, 444 (D.D.C. 1982) (finding that a debtor and lender did not create partnership when the lender was entitled to receive forty percent of debtor’s profits in return for line of credit).

35. See *Lain*, 309 B.R. at 238.

36. See 805 ILL. COMP. STAT. 205/7(4) (1978).

37. See *Lain*, 309 B.R. at 256; *Seidmon v. Harris*, 526 N.E.2d 543, 546 (Ill. App. Ct. 1988) (finding that absent a partnership agreement, the controlling consideration under Illinois law and the Uniform Partnership Act is the intent of the parties to agree to form a partnership).

38. Brief for Appellant at 16, *Lain* (No. 03-3262).

39. *Seidmon*, 526 N.E.2d at 546.

40. *Chandler v. Maxwell Manor Nursing Home, Inc.*, 666 N.E.2d 740, 749 (Ill. App. Ct. 1996).

ruptcy court recognizes it should,⁴¹ the court's holding instead transforms the debtor-creditor relationship for which SLP and Zurich contracted into the unlimited liability of a general partnership.⁴²

While the bankruptcy court purports to give effect to the parties' intent as evidenced in the reimbursement agreement, it proceeds to consider the circumstances surrounding the alleged partnership between Zurich and SLP.⁴³ Such additional circumstances indicating a partnership include "the manner in which the parties have dealt with each other; the mode in which each has, with the knowledge of the other, dealt with persons in a partnership capacity; [and] whether [the parties] have filed with the county clerk a certificate setting forth the name of the partnership."⁴⁴ As the court notes, none of these conditions were present in the SLP-Zurich transaction. Instead, the court's finding that the reimbursement agreement created a partnership is based solely on its view that the Performance Premiums and Supplemental Performance Premiums support the inference of a partnership.⁴⁵ As noted above, under the application of the Safe Harbor provision, that partnership presumption does not apply.

Finally, the court's holding may effectively preclude nursing home companies from participating in this innovative form of credit-enhanced structured financial transaction. Because the Zurich-SLP transaction model allows for the payment of back-end premiums in place of higher, unaffordable fixed premium payments, nursing homes can more easily enter the marketplace. However, as the bankruptcy court itself notes as a matter of public policy, "providing nursing home facilities absent a private market would be a government function."⁴⁶ The court's holding may effectively deter the marketplace from providing this form of back-end premium driven credit-enhanced financing for nursing home operations that cannot afford the fixed premium alternative.⁴⁷ While the argument over the merits of a privatized versus a government-supported public health care system remains ongoing, any particular result is certainly not for the judiciary to compel through the misapplication of law.

The bankruptcy court's holding that SLP and Zurich formed a *de facto* partnership and that Zurich is thus liable for all of SLP's bankruptcy debt is, at best, an erroneous application of the Illinois Uniform Partnership Act and a failure to give effect to the plain language of the reimbursement agreement.⁴⁸ The court's reasoning that, under the terms of the parties' agreement, Zurich was effectively receiving a share of SLP profits and equity, and thus formed a *de facto* partnership with SLP, fails to con-

41. See *Lain*, 309 B.R. at 239.

42. See *id.* at 268-69.

43. See *id.* at 234 (citing *Seidmon*, 526 N.E.2d at 545-46 for the proposition that "[a]s between the parties, the existence of a partnership is a question of intent, based on all of the facts and circumstances.").

44. See *id.* (citing *Snyder v. Dunn*, 638 N.E.2d 744, 746 (Ill. App. Ct. 1994)).

45. *Id.* at 239-42.

46. See *id.* at 269.

47. See *id.*

48. See *id.* at 266.

sider the natural application of the Illinois Safe Harbor provision for debtor-creditor relationships.⁴⁹ Under this provision, the inference of a partnership based on profit-sharing does not apply.⁵⁰ Moreover, under the plain language of the reimbursement agreement, Zurich and SLP clearly established a debtor-creditor relationship, even going so far as to expressly state that no partnership relationship was to exist.⁵¹ The court's finding of *de facto* partnership runs directly contrary to the parties' expressed intent, held to be the controlling consideration of a finding of partnership in the absence of a partnership agreement.⁵² On appeal, the bankruptcy court's holding should be reversed in light of the Safe Harbor provision of the Illinois Uniform Partnership Act, thereby giving effect to the contractual expectations of limited liability for which SLP and Zurich actually bargained and reassuring the marketplace that it may continue to provide nursing homes with this innovative form of credit-enhanced structured financial transaction.

49. See 805 ILL. COMP. STAT. 205/7(4) (1978).

50. See *id.*

51. Brief for Appellant at 16, *Lain* (No. 03-3262).

52. See *Lain*, 309 B.R. at 239.

