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**UNITED STATES BANKRUPTCY COURT
IN AND FOR THE DISTRICT OF ARIZONA**

In Re)
)
RFI REALTY, INC.,)
)
 Debtor.)
)
_____)
)
REMEDICATION FINANCIAL, INC.,)
et al.)
)
 Plaintiffs,)
)
v.)
)
STEADFAST SANTA CLARITA)
_____)

Chapter 11 Proceedings

Case No. 04-10486-PHX-CGC

Adv. No. 07-520

**UNDER ADVISEMENT
DECISION RE:
MOTIONS FOR SUMMARY
JUDGMENT**

I. Introduction

This matter comes before the Court on the Complaint filed by RFI Realty, Inc., Remediation Financial, Inc., Santa Clarita, LLC (“SCLLC”) and Bermite Recovery, LLC’s (“Bermite”) (collectively “Debtors”) against various entities regarding the priority and payment of liens. Since the filing of the adversary proceeding, numerous cross-claims, counter-claims and motions for summary judgments have been filed¹ with corresponding responses and replies thereto. A hearing was held on April 29, 2008 and the matter is ripe for decision.

¹These include:
1. Whittaker’s Amended Opening Brief in Support of Counterclaim and Cross-Claim (Docket 53);
2. KPCO’s Opening Brief in Support of Its Cross-Claim (Docket 55);
3. Debtors’ Motion for Summary Judgment (Docket 56);
4. PBL’s Opening Memorandum Re: Priority Liens on Proceeds of the Sale of Debtors’ Property (Docket 58);
5. SSCH’s Motion for Summary Judgment (Docket 59);
6. DTSC’s Opening Brief (Docket 60); and
7. AISLIC’s Opening Brief in Support of Counterclaim and Cross-Claim (Docket 61).

1 **II. Background**

2 A. The Parties and the Issues

3 Whittaker Corporation (“Whittaker”) is the previous owner of the approximately 1000 acres
4 of real property in Santa Clarita, California now owned by SCLLC (“SCLLC Property”). Over the
5 years, Whittaker’s operation of a munitions factory caused environmental contamination. The
6 Debtors purchased the property from Whittaker with the intent of remediating the contamination
7 and reselling the property for development. Debtors filed this case before that goal was met. Under
8 applicable environmental laws, Whittaker remained financially responsible for cleaning up the
9 property even though it was no longer the owner.

10 The case presents two overarching issues: 1) the extent and nature of insurance coverage for
11 onsite environmental cleanup and offsite water supply contamination, and 2) the nature, extent,
12 amount and priority of claims against the SCLLC Property. The insurance issues are complex and
13 involve several different carriers. Whittaker is the Named Insured under a policy issued by
14 American Insurance Specialty Lines Insurance Company (“AISLIC”) that covers both clean up
15 costs and third party liability. Whittaker is also the Named Insured under a policy issued by ZC
16 Speciality Insurance Company (“ZC”) for ongoing cleanup expenses. SCLLC is the Named Insured
17 under Property Transfer Liability Insurance Policy Number PLC 3598792-00 issued by Steadfast
18 Insurance Company (“Steadfast”)² that was the subject of coverage litigation in which Steadfast
19 alleged that the policy had been cancelled due to failure to pay the premium. In addition, there are
20 various “historical policies” as to which claims were asserted.

21 Likewise, the claims issues are complex. A loan made by Kennedy Funding Inc.
22 (“Kennedy”) was acquired by Steadfast Santa Clarita Holdings, LLC (“SSCH”), an affiliate of
23 Steadfast, the amount of which was disputed. Knight Piesold & Co. (“KPCO”) asserts a mechanic’s
24 lien against the property. The State of California Department of Toxic Substance Control (“DTSC”)
25 recorded a lien for clean up supervisory cost and Porta Bella Lender, LLC (“PBL”), a private
26 lender, also asserts a secured claim against the property.

27 _____
28 ² ZC and Steadfast are affiliate companies under the Zurich insurance umbrella.

1 After months of negotiation, Debtors, the AISLIC parties³, Whittaker, and the Steadfast
2 parties entered into a Coverage And Claims Settlement Agreement (“CCSA”) in November 2005.⁴
3 The CCSA has several purposes. It resolves the amount and priority of several substantial claims
4 against the Debtors, thus eliminating the potential expense of continued litigation. Importantly, it
5 provides “seamless gapless” insurance coverage for environmental cleanup on site and sets out a
6 source of recovery for claims arising from off-site water contamination. In addition, KPCO, the
7 Debtors and the Steadfast parties had previously entered into an agreement concerning the amount
8 and priority of the KPCO claim (the “KPCO Agreement”) which had not been approved by the
9 Court prior to the motion to approve the CCSA. The KPCO Agreement was approved
10 simultaneously with the CCSA, its key elements were imported into the CCSA and it was
11 incorporated by reference into the CCSA.

12 The CCSA created two escrows, SF Escrow 1 and SF Escrow 2 (collectively “Steadfast
13 Escrows”). The Steadfast Escrows were funded by Steadfast from approximately \$64,000,000 in
14 the remaining limits of by depositing approximately \$32,000,000 into each escrow. SF Escrow 1
15 funds are designated to fund a settlement, satisfy a judgment, pay litigation fees and costs and/or pay
16 for clean up costs in a case brought by the Castaic Lake Water Agency for offsite water pollution.
17 SF Escrow 2 funds are designated to pay for clean up costs, remediation efforts and cost of oversight
18 by DTSC.

19 The DTSC is the California government agency responsible for the enforcement of California
20 laws relating to the cleanup of hazardous substances. In order to develop the property, SCLLC was
21 required to meet DTSC environmental standards. Accordingly, DTSC and SCLLC entered into an
22 “Enforceable Agreement” in February 2001 that required SCLLC to meet certain testing and cleanup
23 milestones and to pay for all of DTSC’s past and future environmental response costs. SCLLC
24 breached the agreement and did not perform the work as agreed. Under state and federal law,
25 Whittaker remained responsible for cleanup despite the sale to SCLLC.

26
27 ³There are numerous carriers affiliated with AISLIC.

28 ⁴ Importantly, neither PBL nor DTSC are parties to the CCSA or any other settlement agreement.

1 The CCSA was a key component in the parties' efforts to clean up and sell the property,
2 thereby generating sales proceeds for the payment of claims. After approval of the CCSA, the
3 Debtors commenced a sales process that led, after numerous continuances and the resolution of
4 various objections, to an order approving the sale of the property to SunCal Santa Clarita, LLC by
5 order dated August 15, 2006. Under the terms of the approved sale, closing may not occur for a
6 period of years but certain interim payments have been made.

7 A dispute has arisen regarding the extent and applicability of these settlement agreements
8 relating to the priority of liens. Because of this dispute, when DTSC made demand upon Whittaker
9 for payment of certain clean up oversight claims, AISLIC, as administrator of SF Escrow 2, refused
10 to pay. Because the dispute turned on the nature, extent and priority of liens, the Court required that
11 an adversary proceeding be filed to resolve the conflict. *Fed. R. Bank. P. 7001(2)*.

12 B. The Secured Claims

13 The SCLLC Property is encumbered by liens in favor of various entities. PBL is the holder
14 of a lien recorded on January 11, 1999 ("PBL Lien"). On March 1, 2000, PBL contractually
15 subordinated the its lien to Kennedy's February 2000 lien now held by SSCH (the "Allowed
16 Kennedy Secured Claim"). KPCO filed a mechanic's lien on April 16, 2001 with the Los Angeles
17 County Clerk and Recorder ("KPCO Lien"). The extent and priority of the KPCO Lien were
18 resolved, as between Debtors and the Steadfast parties, under the January 26, 2005 KPCO
19 Agreement. The DTSC recorded a lien against the SCLLC Property on February 24, 2003 for
20 unpaid regulatory and oversight expenses for \$1,004, 050.70 plus interest ("DTSC Lien").

21 C. The Settlements and the Approval Order

22 The priority of the PBL Lien was not explicitly treated under either the CCSA or the KPCO
23 Agreement. However, the agreements did rearrange certain priorities, specifically in elevating the
24 DTSC lien to a position senior to PBL. Accordingly, PBL objected to approval of the CCSA
25 claiming that the priority scheme in the CCSA improperly subordinated its claim without its consent.
26 PBL argued that, absent its consent, there was no legal basis to elevate the DTSC lien's priority.
27 Accordingly, PBL urged that the settlement should either be denied in full or the portions of the
28 CCSA that created the new priority scheme should be denied or deferred.

1 PBL objected separately to the KPCO Agreement, claiming that the Debtor did not properly
2 notice the hearing on the KPCO Agreement and that its lien was senior to KPCO because it was
3 recorded earlier.

4 A hearing was held on both the CCSA and the KPCO Agreement on December 20, 2005.
5 The Court overruled PBL's objection to the KPCO Agreement, holding that notice was proper and
6 that the seniority of the KPCO Lien over that of PBL had already been determined in the United
7 States Bankruptcy Court for the Central District of California. After discussion, the parties agreed
8 that the CCSA could be approved so long as the issue of the priority of DTSC's lien was reserved
9 for later determination. The resolution of the matters before the Court today turns on the
10 interpretation of the meaning of 1) the approval of the KPCO Agreement and 2) the reservation of
11 the DTSC lien priority dispute as part of the approval of the CCSA.

12 Today's issue was presaged during the hearing on December 20, 2005. At that time, Mr.
13 Salerno, counsel for Whittaker, set forth a process to pay DTSC until a decision was made regarding
14 the priority of liens.⁵ In essence, his position was that, if demand was made by DTSC on Whittaker

15 _____
16 ⁵ The exchange is worthy of lengthy quotation:

17 THE COURT: Well, why don't we – what I want to do is get a handle around what is remaining here now at
18 the beginning of the hearing, Mr. Salerno?

19 MR. SALERNO: Thank you, Your Honor, Thomas Salerno, Squire, Sanders & Dempsey on behalf of Whittaker
20 Corporation. Also present is Mr. Eric Cartier, general counsel. Your Honor, with respect to the deferral of the lien
21 priority issue for DTSC, Ms. Lacey mentioned that Porta Bella Lender objected because the way the settlement
22 agreement reads, DTSC is being paid from sales proceeds. They're being paid ahead in fact, ahead of even Steadfast by
23 agreement. And that's why it's in there. Porta Bella Lender says we have a lien. They're priming our lien and we
24 objected. And the parties have agreed to defer that issues to either the sales, because if the sale doesn't occur, it kind of
25 becomes an academic point, or even at plan confirmation or whatever. But, Your Honor, one thing that we want
26 to be—Whittaker needs to be very sure about is Whittaker has no objection to deferring that issue. One thing that we want
27 to be sure that every settling party is in agreement on is this. If the DTSC makes a demand on Whittaker to pay because
28 both Whittaker and the debtors under the assumption agreement have agreed to pay this claim, Whittaker needs the
ability and believes it has the ability under the settlement agreement to go to SF Escrow 2 and to get that money so that
it can pay DTSC. If we defer this issue, and a month from now or 30 days from now, we're at plan confirmation, but we
get a demand, if we can't make that demand against SF Escrow 2, what's going to wind up happening is we have to come
out of pocket, and that's not what we bargained for. There are certain penalty provisions under California law that you
want to pay that timely; you don't want to ignore that. So what we want to be sure is that all settling parties agree that
if we defer this issue and if DTSC makes a demand on Whittaker to pay it, Whittaker has the right to obtain that money
from SF Escrow 2. At that point, one of two things is going to happen, assuming a sale. There will be a sale, and the
Court will subsequently rule through some subsequent proceeding that DTSC could in fact have been paid from the sales
proceeds. If that happens, that money will simply go to replenish SF Escrow 2. If the Court rules that they couldn't be
paid for some reason from the sales proceeds, then SF Escrow 2 – that's what it was set up for, to pay them in the event
that they didn't get paid out of sale proceeds. The intention was--

THE COURT: Well, what's the – so then what's the point of deferring the issue?

MR. SALERNO: Well, Your Honor, I think there is a big point for this reason. The DTSC claim that – the

1 for payment of remediation oversight claims, AISLIC would pay the demand from SF Escrow 2,
2 pending resolution of the priority dispute. Thereafter, depending on the resolution of the priority
3 issue, SF Escrow 2 would either be reimbursed from the sales proceeds (if DTSC's claim were found
4 to be senior and therefore eligible for payment from sales proceeds ahead of other claims) or would

5 _____
6 escrows are set up, Your Honor, to do go forward remediation. If you paid the claim of DTSC now from SF Escrow 2,
7 for example, that's taking a million-four that is not – or whatever the dollar amount is – I mean I think it's a million-four
8 in principle, so to speak, but whatever that amount is, you're taking that from that escrow, so now that's not available
9 to pay necessarily go-forward clean-up costs. So there is an economic issue.

10 THE COURT: Well, Let's say that we go forward and we defer the issue. Demand is made. You go to SF
11 Escrow 2; you take out the money; you pay DTSC. The issue then gets resolved in favor of Porta Bella. In other words

12 MR. SALERNO: So DTSC cannot be paid from sales proceeds.

13 THE COURT: In other words, Porta Bella is found to be senior to DTSC.

14 MR. SALERNO: I understand.

15 THE COURT: Now, let's just assume that scenario. What then happens?

16 MR. SALERNO: Nothing.

17 THE COURT: Nothing. What's happened then is that SF Escrow 2 has been diminished by that amount.

18 MR. SALERNO: Correct.

19 THE COURT: But it's happened at the later time than today.

20 MR. SALERNO: Correct.

21 THE COURT: And so the parties who end up – so Porta Bella then is able to get paid that amount from the sale,
22 but the amount that's in SF Escrow 2 is permanently reduced by that amount.

23 MR. SALERNO: Correct. The way the settlement agreement is currently set up Your Honor, is that if, for
24 example, there were no sale – because that's a possibility, you know, for whatever reason there's no sale here – we still
25 have a settlement agreement that provides for the funding of escrows and money available for remediation. So it's not
26 a foreign concept, so to speak, with respect to SF Escrow 2. We just want to be sure that by deferring it, everyone
27 understands that we have the right to go to that so we're not injured by the deferral, economically injured by the deferral.
28 And if in fact, the Court overrules Porta Bella, it gets replenished.

THE COURT: Right

MR. SALERNO: If you grant their objections –

THE COURT: And if I – yeah.

MR. SALERNO: Exactly.

THE COURT: Does anybody have any problem with that proposal?

MS. LACEY: The debtors do not, Your Honor.

THE COURT: Or with that -- not proposal – with that construction of the parties' rights under the settlement
agreement.

MS. LACEY: The debtors do not, Your Honor. We believe that that's what the settlement agreement now
provides.

MR. SELMAN: Good Morning, Your Honor, Neil Selman for the Zurich parties. We agree with the request
for clarification.

THE COURT: For the Zurich parties, for Steadfast, et cetera.

MR. SELMAN: Yes, Your Honor.

* * *

THE COURT: Right. I just want to make sure – I want to find out if there's anybody who disagrees or wants
to raise an objection to the clarification that Mr. Salerno put on the record about – about the impact of the deferral of the
PBL – the PBL/DTSC lien priority issue, and there appears not to be anybody, and so I will take that as an appropriate
construction of the settlement agreement. So now let's move on to the CLWA parties and understand where we stand
with regard to your outstanding objections. Settlement H'rg Tr. 17:22-23:4, December 20,2005.

1 not be reimbursed at all (if found to be junior to other claims). After the colloquy between Mr.
2 Salerno and the Court, no other party raised an issue or an objection to the stated interpretation of
3 the CCSA and the deferral of the DTSC/PBL issue. The Court then approved the CCSA and the
4 KPCO Agreement and an order encompassing the Court's approval, including the reservation of the
5 priority dispute, was entered on December 22, 2005 ("Approval Order").⁶

6 The controversy centers around the interpretation of the CCSA, KPCO Agreement and the
7 Approval Order. Section III.A.2 of the CCSA states:

8 Debtors shall pay to SSCH the Allowed Kennedy Secured Claim in immediately
9 available funds and in full immediately upon Closing from the sale proceeds. Such
10 payment shall be made prior to the payment of any other liens, claims or expenses,
11 except for the following which shall also be paid from the sale proceeds:

- 12 a. those priming liens allowed by the Bankruptcy Court in the interim
13 financing orders previously entered (the Parties hereby consent to such payment);
- 14 b. any priming lien(s) or charges allowed by the Bankruptcy Court in orders
15 entered in the future (in Section IV C below, the Parties consent to certain future
16 priming lien(s));
- 17 c. any accrued and unpaid property tax liens on the Property (the Parties
18 hereby consent to such payment);
- 19 d. any amount owed (accrued as well as billed) to the DTSC for regulatory
20 oversight and supervision as of Closing (the Parties hereby consent to such
21 payment); and
- 22 e. the amount owed to Knight Piesold & Company ("KP&C") under the
23 settlement agreement between KP&C and Debtors, a copy of which is attached
24 hereto as Exhibit 6, provided it is approved by the Bankruptcy Court (the Parties
25 hereby consent to such approval and payment).

26 Thus, the CCSA priority scheme is the following:

- 27 • Approved unpaid priming liens (none at this time)
- 28 • Approved future unpaid priming liens (none at this time)
- Unpaid real estate taxes
- DTSC
- KPCO Agreement payment (a compromised amount)
- SSCH for the Kennedy lien (as modified in amount by the CCSA)

29 All parties acknowledge that PBL's lien is junior to SSCH; that was accomplished by
30 subordination agreement at the time of the Kennedy loan. The thorn in PBL's side is the proposed
31 elevation of DTSC above SSCH—and therefore above PBL.

32 The context of the CCSA makes it clear that the intent of that agreement was to elevate the

33 ⁶ There was no separate order of approval for the KPCO Agreement.

1 payment of the DTSC without cost to the otherwise senior liens. In other words, this is not a
2 situation where the parties have embraced the so-called doctrine of partial subordination under
3 which a amount equal to the elevated lien would be subtracted from the subordinating creditor's lien
4 (here SSCH) and that subtracted amount would step into the shoes of the previously junior lien (here
5 DTSC) Rather, the CCSA simply calls for elevation of the least junior lien (DTSC) at the expense
6 of the less junior lien (PBL). It is this "push down" aspect of the CCSA to which PBL objects and
7 as to which it preserved its rights.

8 The language that preserves those rights is in Section (I)(9) of the Approval Order which
9 states, "[PBL] has requested certain modifications and reservations of rights with respect to the
10 Settlement. Those modifications and reservations of rights are contained in this Court's order below
11 and have been agreed to by the Parties to the Settlement." Section (III)(9) of the Approval Order
12 states, "determination of the priority of payment of the DTSC claims will not be resolved by this
13 Court's Order approving the Settlement."

14 Finally, the KPCO Agreement lays out the following payment priority:

- 15 • Unpaid property tax related to SCLLC Land.
- 16 • DTSC Lien
- 17 • Presently allowed priming Liens on the SCLLC Land
- 18 • KPCO Lien in the amount of \$1.8 million
- 19 • SSCH Lien (by agreement to subordinate).⁷

20 Additionally, the stated premise of the KPCO Agreement was to assure payment of \$1,800,000 to
21 KPCO from the proceeds from the sale of SCLLC Property.

22 Based on these facts, the Court is left with three basic options: 1) determine that the priorities
23 set forth in the CCSA and KPCO Agreement were approved and set the priority of liens according
24 to the terms of the settlements; 2) decide that the priority in the CCSA was not approved, but the
25 priority in the KPCO Agreement was approved and therefore partially subordinate the KPCO Lien⁸

26 ⁷ The Court notes that there is an apparent inconsistency between the CCSA and the KPCO Agreement in treatment
27 of priming liens. Because there are no priming liens at this point, it is a distinction without a difference and this ruling
28 does not resolve the inconsistency.

⁸ This is Whittaker's position: i.e., that the reservation by PBL extended only to the CCSA and not to KPCO
Agreement, with the effect that the priority scheme of the latter has been fully and finally approved. As a result,

1 or 3) rule that the Approval Order did not establish the priorities of various liens and use California
2 law to establish the priorities of the liens.

3 D. Payment to DTSC

4 The Approval Order also sets forth a mechanism to pay DTSC for any demands made for
5 remediation. Under Section (III)(9) of the Approval Order the DTSC claims shall be paid from SF
6 Escrow 2 upon written demand by DTSC to Whittaker. DTSC made a written demand upon
7 Whittaker for regulatory oversight and supervision in July 2007 for the total amount of
8 \$3,011,751.18 (“DTSC Demand”). AISLIC filed the demand with the Court on August 16, 2007.
9 The parties have agreed to sequester \$3,011,751.18 in SF Escrow 2 pending the outcome of this
10 matter.⁹

11 During the course of the April 29, 2008 hearing the Court encouraged AISLIC and DTSC
12 to establish the undisputed amount demanded by DTSC. AISLIC has filed a notice that a payment
13 of \$2,270,463.55, representing 85% of the amount demanded by DTSC, is being processed by
14 AISLIC to DTSC, leaving a putative balance of \$741,287.60. (Dkt # 1244). In its reply
15 memorandum to its Motion to Retain Interest (Dkt# 1259), AISLIC further states that:”AISLIC,
16 DTSC, and Whittaker have recently reached a settlement agreement in principle concerning
17 Whittaker’s alleged liability for all of the invoices included in DTSC’s July 20, 2007 letter demand,
18 and additional amounts to be paid to DTSC from SF Escrow 2. The settling parties are in the process
19 of preparing a written settlement agreement which will be presented to this Court for approval.”
20 Based on these filings, the dispute has apparently been resolved.

21 **III. Discussion**

22 A. Motion for Summary Judgment Standard

23 A motion for summary judgment should be granted if movant has shown that there are no
24 genuine issues of material fact and the movant is entitled to judgment as a matter of law. Fed. R.

25 _____
26 Whittaker’s argument goes, KPCO agreed to partial subordination of its claim in favor of DTSC, thereby leaving only
27 about \$800,000 in the senior position and relegating about \$1 million to DTCS’s junior position, in no way affecting
PBL.

28 ⁹ Based on the sequestering of funds, Debtors’ motion for summary judgment is only for Count I of the Complaint.

1 Civ. P. 56(c), Fed. R. Bankr. P. 7056. Ruling on a motion for summary judgment necessarily
2 implicates that substantive evidentiary standard of proof which would apply at trial. *Anderson v.*
3 *Liberty Lobby, Inc.*, 477 U.S. 242, 106 S.Ct. 2505, 91 L.Ed.2d 202 (1986). A material fact is
4 genuine if the evidence is such that a reasonable jury could return a verdict in favor of the
5 non-moving party. *Id.* Procedurally, "the proponent of a summary judgment motion bears a heavy
6 burden to show that there are no disputed facts warranting disposition of the case on the law without
7 trial." *In re Aquaslide 'N' Dive Corp.*, 85 Bankr. 545, 547 (9th Cir. BAP 1987). Once that burden
8 has been met, "the opponent must affirmatively show that a material issue of fact remains in
9 dispute." *Frederick S. Wyle P.C. v. Texaco, Inc.*, 764 F.2d 604, 608 (9th Cir. 1985). In this matter,
10 summary judgment is particularly proper because there is no real dispute as to the facts and the
11 Court will apply law to the facts presented.

12 B. Settlements and Approval Order

13 The Court must determine the effect of the Approval Order on Section III.A.2 of the CCSA.
14 The role of the parties and the Court in the settlement process is key to determining the effect of the
15 Approval Order. Under Fed R. Bankr. P. 9019 the parties have the discretion to negotiate a
16 settlement, but the Court must approve the settlement. *In re Rake*, 363 B.R. 146 (Bankr.D.Idaho
17 2007). A review of the Approval Order, and the record at the hearing, demonstrates that the Court
18 did not approve Section III.A.2 of the CCSA and the record reflects universal agreement among the
19 parties on this point. Section (III)(9) of the Approval Order encompasses these reserved rights by
20 stating:

21 Any provisions in the Settlement relating to the bankruptcy estate's payment and/or
22 priority of DTSC's claims are reserved for consideration at a later date. Specifically,
23 determination of the priority of payment of the DTSC claims will not be resolved by
24 this Court's Order approving the Settlement.

25 Despite the above language, AISLIC argues that Debtors and SSCH are still bound by the
26 priority scheme set out in the CCSA because AISLIC would not have agreed to the settlement
27 without payment to DTSC being made from sales proceeds. AISLIC's position is that SSCH agreed
28 that its lien would be subordinated and it should be held to its agreement, notwithstanding the
reservation of the issue for later determination. Likewise, the DTSC interprets the provision as

1 reserving only the effect of the CCSA's subordination at a later date. Both of these arguments
2 ignore the language of Section(III)(9) which states, "determination of the priority of payment of the
3 DTSC claims will not be resolved by this Court's Order." The Court clearly reserved determination
4 of the priority of DTSC's claim for a later day.

5 Whittaker argues that the Court should find that the priority in the CCSA was not approved,
6 but the subordination in the KPCO Agreement was approved because the Approval Order only refers
7 to the defined term "Settlement" and not to the KPCO Agreement. Under Whittaker's theory,
8 KPCO subordinated its claim to the original \$1 million claim of DTSC resulting in the following
9 priorities:

- 10 1. DTSC Lien Claim- \$1,000,000
- 11 2. KPCO - \$800,000 of the KPCO Lien
- 12 3. Allowed Kennedy Secured Claim
4. PBL Lien
5. KPCO - Remainder of KPCO Lien

13 Whittaker is asking the Court to rule that KPCO agreed to relinquish its original \$2.6 million
14 claim and accept \$800,000 instead. This makes no economic sense and is contrary to the stated
15 purpose of the KPCO Agreement. KPCO Agreement Recitals Section J states:

16 The essence of this Agreement is that KPCO will relinquish approximately \$800,000
17 of its claim and will relinquish its claim to a lien on the Bermite Land, in exchange
18 for which KPCO will be assured of payment from the proceeds of the sale of the
SCLLC Land and/or the estate in the amount of \$1,800,000.

19 It was clearly the intent of KPCO to secure receipt of \$1.8 million dollars in reaching the
20 settlement. Although Section (III)(9) of the Approval Order only refers to the defined term
21 "Settlement" and not to the KPCO Agreement, the KPCO Agreement was not approved separately
22 by the Court, but instead was approved part and parcel of the CCSA. Importantly, under KPCO
23 Agreement Recitals(I) the KPCO Agreement was contingent on the approval of the CCSA by the
24 Court. In the end, the Approval Order states that "determination of the priority of payment of the
25 DTSC claims will not be resolved by this Court's Order approving the Settlement." This includes
26 the priorities in the KPCO Agreement.

27 It is critical to note that the CCSA (including the KPCO Agreement) **was approved** with
28 this one issue carved out. An alternative available to the parties was to ask that the agreement be

1 disapproved in total, returning them to the bargaining table because of the lack of consent of PBL
2 to the subordination of its claim. But that is not what happened. All parties at the hearing consented
3 to the approval of the CCSA, thereby accepting the uncertainty that the eventual judicial resolution
4 of the issue may leave them in a different position from that for which they originally bargained.
5 Everyone in the courtroom that day knew that they could either win or lose once the issue was teed
6 up but nevertheless accepted that risk.

7 AISLIC and DTSC argue that SSCH's (and KPCO's) agreement to allow DTSC to be paid
8 before them is sufficiently in the nature of a true subordination agreement to trigger the application
9 of "partial subordination" or "circularity of liens." But, as noted above, the record does not support
10 this conclusion. Both SSCH and KPCO agreed to substantial discounts in the amounts of their
11 claims, in effect giving up the possibility of a higher claim through litigation in exchange for the
12 certainty of a lower claim fixed by settlement. There is nothing in the CCSA or the KPCO
13 Agreement to suggest that they also accepted the risk that their claims would be further reduced
14 because of the reordering of DTSC's priority. Because this reordering of priorities was a matter of
15 agreement (as opposed to imposed by operation of law), it is necessary to construe the agreements
16 in a way that makes economic sense consistently with the economic interests of those affected.

17 This meaning of the Approval Order is buttressed by the statements made by Mr. Salerno
18 during the December 20, 2005 hearing on settlement approval. According to Mr. Salerno, the parties
19 agreed to defer determination of DTSC's priority to a later day in order to foster a settlement. At
20 the conclusion of the conversation, the Court asked if any party, "disagrees or wants to raise an
21 objection to the clarification that Mr. Salerno put on the record about – about the impact of the
22 deferral of the PBL – the PBL/DTSC lien priority issue, and there appears not to be anybody, and
23 so I will take that as an appropriate construction of the settlement agreement." Settlement H'rg Tr.
24 22:22-23:2. "A stipulation made in open court and recorded by the reporter 'constitutes not only
25 an agreement between the parties, but also between them and the court, which the latter is bound to
26 enforce.'" *In re Haynes*, 97 B.R. 1007, 1011 (9th Cir. BAP 1987) (quoting *Webster v. Webster*, 14
27 P.2d 522, 523 (Cal. 1932)). The Court concludes that neither the record at the hearing nor the
28 Approval Order authorized the payment priority listed in Section III.A.2 of the CCSA, but instead

1 carved that issue out, for all purposes, for later consideration.

2 Accepting the AISLIC and Whittaker arguments would directly reduce the heavily negotiated
3 claim amounts of SSCH and/or KPCO. While there is undoubtedly an economic impact on AISLIC
4 and Whittaker of requiring the payment of DTSC's claim to come from SF Escrow 2, and not from
5 sales proceeds, it is considerably less direct. In effect, they are saying that those two creditors
6 agreed to take the hit for the DTSC payment by agreeing that a portion of their liens equal to that
7 payment would be dropped to DTSC's very junior position. That simply makes no economic sense.
8 Construing the overall agreement, the Court concludes that the negotiated claim amounts were fixed
9 and not subject to further reduction, thereby requiring payment of the DTSC demand from SF
10 Escrow 2 without reimbursement from sales proceeds.

11 Because the Approval Order did not determine the priorities between PBL and DTSC and
12 there is no basis in the Code to change those priorities, "the court must refer to state law to
13 determine the relative priorities of competing liens." *In re Van de Kamp's Dutch Bakeries*, 908 F.2d
14 517, 519 (9th Cir. 1990). In California, "[o]ther things being equal, different liens upon the same
15 property have priority according to the time of their creation." Cal.Civ.Code §2897. Further,
16 priority is determined by the time of recordation. *Brachter v. Buckner*, 109 Cal.Rptr.2d 534, 539
17 (Cal.App.4.Dist. 2001). "The exception to this rule is when parties enter into a subordination
18 agreement whereby a party agrees to subordinate the priority of his or her lien to another." *Id.* It
19 is undisputed that the KPCO Lien is senior to the Allowed Kennedy Secured Claim by agreement
20 and is senior to the PBL Lien via the default judgment issued by the California Bankruptcy court.
21 Stip. Facts 2.29 and 2.28. PBL contractually subordinated the PBL Lien to the Allowed Kennedy
22 Secured Claim on March 1, 2000. Stip. Facts 2.6. The PBL Lien was recorded January 11, 1999.
23 Stip. Facts. 2.5. The DTSC Lien was recorded on February 24, 2003. Stip. Facts 2. There is no
24 provision under California that would otherwise grant priority to DTSC.

25 At bottom, what makes the most sense is that 1) the elevation of DTSC's priority was not
26 approved but the rest of the Settlement was; 2) as a result, all parties accepted the risk that the result
27 could be contrary to their economic interests; 3) the negotiated claim amounts were fixed by the
28 CCSA and KPCO Agreement, as approved, and are not subject to further reduction through

1 application of partial subordination or any similar legal theory; 4) PBL's lien is senior in priority
2 to DTSC's lien under applicable law and cannot be subordinated without its consent; 5) PBL has not
3 consented; 6) SF Escrow 2 was established for the purpose, among others, of making payments in
4 the nature of the DTSC demand; 7) therefore, the DTSC demand must be paid from SF Escrow 2
5 without reimbursement from sales proceeds.

6 Accordingly, the priority of liens among the parties is as follows:

- 7 • KPCO Lien
- 8 • Allowed Kennedy Secured Claim
- 9 • PBL Lien
- 10 • DTSC Lien

11 Under this priority scheme, reimbursement of the amounts paid from SF Escrow 2 from sales
12 proceeds is not appropriate.

13 **IV. Conclusion**

14 The Debtors', SSCH's and KPCO's motions are granted and/or positions sustained;
15 AISLIC's, Whittaker's and DTSC's motions are denied and/or positions overruled.

16 Counsel for Debtor is to upload an appropriate form of order.

17 So ordered.

18 DATED: June 25, 2008

19 
20 Charles G. Case II
21 UNITED STATES BANKRUPTCY JUDGE

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24 **COPY** of the foregoing mailed by the BNC and/or
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