AMERICAN BANKRUPTCY INSTITUTE

2019 Midwest Regional Bankruptcy Seminar

Case Law and Rules Update: Parts I and II

William J. Rochelle, III
American Bankruptcy Institute; New York

2019

Abundant Splits and Other Significant Bankruptcy Decisions

Midwest Regional Bankruptcy Seminar

Cincinnati, Ohio
August 20 & 21, 2019

Bill Rochelle • Editor-at-Large
American Bankruptcy Institute
bill@abi.org • 703. 894.5909

66 Canal Center Plaza, Suite 600 • Alexandria, VA 22014 • www.abi.org

Table of Contents

Supreme Court

Decided This Term

Supreme Court says that activities not required by state law in nonjudicial foreclosure may be covered by the FDCPA.

Nonjudicial Foreclosure Is *Not* Subject to the FDCPA, Supreme Court Rules

The Supreme Court ruled unanimously today that nonjudicial foreclosure is not subject to regulation by the federal Fair Debt Collection Practices Act, known as the FDCPA, 15 U.S.C. § 1692-1692p.

The opinion for the Court by Justice Stephen G. Breyer contained an important caveat: Nonjudicial foreclosure is exempt from the FDCPA only with regard to actions *required* by state law.

The Circuit Split

After a homeowner defaulted on his mortgage, the lender hired a law firm, which gave notice that it was retained to conduct nonjudicial foreclosure under Colorado law. The homeowner responded with a letter purporting to invoke rights under Section 1692(g) of the FDCPA, which obliges a debt collector to halt collection activities until it provides the debtor with a "verification of the debt."

However, the law firm proceeded to initiate nonjudicial foreclosure. The homeowner then filed suit alleging violation of the FDCPA. The district court dismissed the suit, finding that the law firm was not a "debt collector" within the purview of the FDCPA. The Tenth Circuit affirmed, holding that merely enforcing a security interest through nonjudicial foreclosure is not governed by the FDCPA.

The circuits were split. The Fourth, Fifth and Sixth Circuits held that the FDCPA applies to nonjudicial foreclosure, while the Ninth and Tenth Circuits concluded that it does not. The Supreme Court granted *certiorari* on June 28, 2018, to resolve the split and heard oral argument on January 7.

The Statutory Provisions

The FDCPA applies to "debt collectors," defined in the first sentence of 15 U.S.C. § 1692a(6) as someone who "regularly collects or attempts to collect, directly or indirectly, debts owed . . . or due another." The definition makes the statute applicable to a law firm pursuing *judicial* foreclosure when the lender is entitled to a deficiency judgment.

The case turned on the meaning of the third sentence in Section 1692a(6), which applies to enforcement of security interests. "For the purpose of section 1692f(6) [governing the conduct of someone repossessing property nonjudicially]," the third sentence of Section 1692a(6) says that the "term [debt collector] also includes any person who uses [the mail or interstate commerce] in any business the principal purpose of which is the enforcement of security interests."

The third sentence applies to nonjudicial foreclosure. However, Section 1692f(6) does not impose all of the FDCPA's regulations on those who only enforce security interests. Section 1692f(6) only prohibits certain activities, such as threatening to repossess when there is no intention of repossessing or there is no right to repossess. The law firm was not alleged to have violated the proscriptions in Section 1692f(6).

The Unanimous Opinion

Writing for the Court, Justice Breyer said that the FDCPA would apply to nonjudicial foreclosure if the statute contained only the primary definition in the first sentence of Section 1692a(6). If the third sentence did not contain the reference to someone whose principal business "is the enforcement of security interests," he said that a person engaged in nonjudicial foreclosure proceedings "would qualify as a debt collector for all purposes," because foreclosure "is a means of collecting a debt."

Justice Breyer said that the primary definition of "debt collector" in the first sentence in Section 1692a(6) does not apply only to someone who attempts to collect from a debtor. Even if nonjudicial foreclosure were not a direct attempt to collect a debt, he said, "it would be an *indirect* attempt to collect a debt." [Emphasis in original.]

The third sentence in Section 1692a(6) changed the result, however. The phrase "[f]or the purpose of section 1692f(6)," Justice Breyer said, "strongly suggests that one who does no more than enforce security interests does *not* fall within the scope of the general definition. Otherwise why add this sentence at all?" [Emphasis in original.]

Justice Breyer also surmised that Congress did not intend for the FDCPA to be generally applicable to nonjudicial foreclosure "to avoid conflicts with state nonjudicial foreclosure schemes."

For "those of us who use legislative history to help interpret statutes," he said that "the history of the FDCPA supports our reading." He alluded to how competing versions of the bill would or would not have made nonjudicial foreclosure subject to regulation. The third sentence, he said, "has all the earmarks of a compromise: The prohibitions contained in Section 1692f(6) will cover security-interest enforcers, while the other 'debt collector' provisions of the Act will not."

Caveats in the Opinion

Justice Breyer added two caveats to say that specific acts in connection with nonjudicial foreclosure could conceivably be subject to the FDCPA, although nonjudicial foreclosure generally is not.

The homeowner argued that the third sentence applies only to a "repo man," meaning someone who repossesses personal property and has no interaction with the debtor. Judge Breyer rejected this contention, saying, "if Congress meant to cover only the repo man, it could have said so."

In the same paragraph, Justice Breyer went on to say it is "at least plausible that 'threatening' to foreclose on a consumer's home without having legal entitlement to do so is the kind of 'nonjudicial action' without 'present right to possession' prohibited by that section." He went on to say parenthetically, "We need not, however, decide precisely what conduct runs afoul of Section 1692f(6)."

Of greater significance, Justice Breyer said near the end of his 14-page opinion, "This is not to suggest that pursuing nonjudicial foreclosure is a license to engage in abusive debt collection practices like repetitive nighttime phone calls . . . ."

Because the case before the Court involved "only steps required by state law, we need not consider what *other* conduct (related to, but not required for, enforcement of a security interest) might transform a security-interest enforcer into a debt collector subject to main coverage of the Act." [Emphasis in original.]

The Concurring Opinion

Justice Sotomayor concurred in the opinion. Calling it "a close case," she said that Justice Breyer made "a coherent whole of a thorny section of statutory text." She was persuaded to concur because the third sentence would be superfluous "if all security-interest enforcement is already covered" by the first sentence.

Justice Sotomayor made two points: (1) "[T]oday's opinion does not prevent Congress from clarifying today's opinion if we have gotten it wrong," and (2) enforcing a security interest does not confer blanket immunity from the FDCPA.

"I would see as a different case one in which the defendant went around frightening homeowners with the threat of foreclosure without showing any meaningful intention of ever actually following through." In such a case, she said, there would be a question of whether the person was actually in the business of enforcing a security interest or "was simply using that label as a stalking horse for something else."

The case is *Obduskey v. McCarthy & Holthus LLP*, 139 S. Ct. 1029, 203 L. Ed. 2d 390 (Sup. Ct.).

Supreme Court gets around to overruling* Lubrizol *almost 35 years later.

Licensee May Continue Using a Trademark after Rejection, Supreme Court Rules

Today, the Supreme Court handed down its decision in *Mission Product Holdings Inc. v. Tempnology LLC*, 17-1657 (Sup. Ct.), reversed the First Circuit and held that rejection of an executory trademark license does not bar the licensee from continuing to use the mark. As Justice Elena Kagan said, "A rejection breaches a contract but does not rescind it."

The opinion was almost unanimous, with Justice Neil M. Gorsuch dissenting; he believes the petition for *certiorari* should have been dismissed as improvidently granted. In his view, the Court could not grant effective relief.

Justice Sonia Sotomayor wrote a concurring opinion to say that nondebtor parties to rejected trademark licenses may have more rights following rejection than parties to other types of intellectual property licenses whose rights are limited by Section 363(n).

The Court granted *certiorari* in October to resolve a split of circuits.

The Circuit Split

It took decades, but the Supreme Court ruled on May 20 that the Fourth Circuit was wrong almost 35 years ago when it held that rejection of an executory license for intellectual property precludes the nonbankrupt licensee from continuing to use the license. *Lubrizol Enterprises Inc. v. Richmond Metal Finishers Inc.*, 756 F.2d 1043 (4th Cir. 1985).

Lubrizol was subjected to withering criticism, prompting Congress three years later to adopt Section 365(n) and the definition of "intellectual property" in Section 101(35A). Together, they allow a nondebtor to continue using patents, copyrights and trade secrets despite rejection of a license.

Congress did not mention trademarks, leading most lower courts to interpret the omission as meaning that rejection cuts off the right to use trademarks.

In 2012, the Seventh Circuit differed with *Lubrizol* when it handed down *Sunbeam Products Inc. v. Chicago American Manufacturing LLC*, 686 F.3d 372 (7th Cir. 2012), and held that rejection does not preclude the continued use of a mark. According to Circuit Judge Frank Easterbrook, "nothing about this process [of rejection] implies that any other rights of the other contracting party have

been vaporized." If a licensor's breach outside of bankruptcy would not bar continued use of the mark, the same would hold true in bankruptcy after rejection by the licensor, he said.

In Tempnology's chapter 11 case, the debtor had granted the licensee a nonexclusive, nontransferable, limited license to use the debtor's trademarks. Following *Lubrizol*, the bankruptcy court rejected the license and ruled that the licensee could not continue using the license. The Bankruptcy Appellate Panel reversed, following *Sunbeam*.

The First Circuit reversed the BAP in January 2018. *Mission Product Holdings Inc. v. Tempnology LLC (In re Tempnology LLC)*, 879 F.3d 389 (1st Cir. Jan. 12, 2018).

In a 2/1 opinion, the First Circuit majority in *Tempnology* sided with *Lubrizol* and criticized *Sunbeam* for "largely [resting] on the unstated premise that it is possible to free a debtor from any continuing performance obligations under a trademark license even while preserving the licensee's right to use the trademark." The majority favored "the categorical approach of leaving trademark licenses unprotected from court-approved rejection, unless and until Congress should decide otherwise." To read ABI's discussion of the First Circuit's opinion in *Tempnology*, click here.

As it had done in the First Circuit, the debtor argued in the Supreme Court that allowing the licensee to continue using the trademark would force the debtor to continue shouldering the onerous burden of policing the quality of the licensee's use of the mark. Absent quality control, the debtor contended, the licensor abandons the mark, and it reverts to the public domain. Rejection frees the debtor from the burden of policing the mark and is thus a necessary adjunct to the power of rejection, according to the debtor.

Justice Kagan's Opinion

Mootness

Joined by all justices except Justice Gorsuch, Justice Kagan began by holding that the appeal was not moot.

Initially, the bankruptcy judge had only granted a plain, vanilla motion to reject the trademark license. Following rejection, the debtor returned to court, where the bankruptcy judge issued a declaration saying that rejection terminated the licensee's use of the mark. Later still, the license terminated by its own terms.

To counter the notion of mootness, the licensee contended that it had a claim for damages resulting from its inability to use the mark. The debtor responded by saying that the bankruptcy court had authorized distribution of the last funds in the estate. The licensee countered by saying it might prevail on the bankruptcy court to compel other creditors to disgorge distributions.

Justice Kagan held that the appeal remained "a live controversy." "If there is any chance of money changing hands, [the licensee's] suit remains alive." Citing the Court's precedent, she said that "courts often adjudicate disputes whose 'practical impact' is unsure at best, as when 'a defendant is insolvent.'"

The Merits: Rejection Isn't Rescission

Justice Kagan said that the text of Section 365 and "fundamental principles of bankruptcy law" lead to a conclusion that rejection is not rescission. In particular, she relied on Section 365(g), which provides that rejection "constitutes a breach of such contract" immediately before the filing of the bankruptcy petition.

Or "more pithily for current purposes," Justice Kagan said that "rejection is a breach." In turn, breach "means in the Code what it means in contract law outside bankruptcy."

As an example, Justice Kagan supposed that a debtor had leased a copy machine to a law firm. Were the debtor to reject the lease, she said the debtor could stop servicing the machine, but the debtor "cannot take it back."

Applying the same notion to trademarks, Justice Kagan said that "breach does not revoke the license or stop the licensee from doing what it allows."

Justice Kagan also bought into the idea that the power to reject does not convey the same remedies as avoidance actions, which, she said, are "exceptional cases in which trustees . . . may indeed unwind pre-bankruptcy transfers."

No Negative Inference from Section 365(n)

The debtor argued that the omission of trademarks from Section 365(n) meant that Congress intended for rejection to cut off use of a mark.

"Still," Justice Kagan said, "Congress's repudiation of *Lubrizol* for patent contracts does not show any intent to *ratify* that decision's approach for almost all others. Which is to say that no negative inference arises. Congress did nothing in adding Section 365(n) to alter the natural reading of Section 365(g) — that rejection and breach have the same results." [Emphasis in original.]

Aiding Reorganization

The debtor argued that it would be better able to reorganize if the court relieved it of the burden of policing the use of the mark. To that, Justice Kagan said, "The Code of course aims to make

reorganization possible. But it does not permit anything and everything that might advance that goal."

Justice Kagan said that Section 365 therefore does not "relieve the debtor of the need . . . to invest the resources needed to maintain a trademark. . . . The resulting balance may indeed impede some reorganizations, of trademark licensors and others."

For the Court, Justice Kagan held that rejection "has the same effect as a breach outside of bankruptcy. Such an act cannot rescind rights that the contract previously granted. Here, that construction of Section 365 means that the debtor-licensor's rejection cannot revoke the trademark license."

Danielle Spinelli, a former Supreme Court law clerk, represented the licensee. Douglas Hallward-Driemeier, a former Assistant Solicitor General, argued for the debtor. Assistant Solicitor General Zachary D. Tripp argued on behalf of the government in favor of reversing *Lubrizol*.

Justice Sotomayor's Concurrence

Justice Sotomayor said she concurred "in full." She wrote "to highlight two potentially significant features of today's holding."

First, Justice Sotomayor said the opinion does not mean that "every trademark licensee has the unfettered right to continue using licensed marks post rejection." The opinion may not apply, she said, if provisions in the license or "state law" might "bear" on continued use of the mark.

Second, and of greater significance, Justice Sotomayor said that the "holding confirms that trademark licensees' postrejection rights and remedies are more expansive in some respects than those possessed by other types of intellectual property." For instance, she said that licensees of patents, copyrights and four other types of intellectual property (which are covered by Section 365(n)) "must make all [their] royalty payments."

The Dissent

Dissenting, Justice Gorsuch said nothing about the merits. He would have dismissed the *certiorari* petition for having been improvidently granted.

The case should have been considered moot, Justice Gorsuch said, because the licensee "hasn't come close to articulating a viable legal theory on which a claim for damages could succeed. And where our jurisdiction is so much in doubt, I would decline to proceed to the merits . . . . [T]here is no need to press the bounds of our constitutional authority . . . ."

The Irony, Import and Utility of the Decision

For appellate jurisprudence, the inability of Justice Gorsuch to prevail in his view about mootness seems to mean that the Court can reach the merits even when the existence of a live controversy is in doubt.

James M. Wilton of Ropes & Gray LLP in Boston, one of the counsel for the debtor, told ABI that "the decision will enhance the negotiating leverage of trademark licensees vis a vis secured lenders and other creditors and make it more difficult for debtor-licensors to rebrand their businesses and reorganize."

In the very hypothetical that Justice Kagan mentioned, the bankruptcy of a lessor of personal property will not enable the debtor to use rejection as a means for recovering the equipment for lease to someone else at a higher price.

Ironically, some non-debtor third parties would now be better off had Congress not come to their aid. Section 365(n) is not the only Code provision where a party to a rejected contract or lease would have greater rights after *Mission Product*.

Judge Kagan mentioned real property leases, contracts for the sale of real property and time-share interests in Sections 365(h) and (i). Having balanced the interests of debtor and creditors in those sections, Congress could have given third parties fewer rights and remedies than they might otherwise have been found to have following *Mission Product*. Nonetheless, the certainty provided by Sections 365(h) and (i) is perhaps a fair trade-off.

The opinion is *Mission Product Holdings Inc. v. Tempnology LLC*, 139 S. Ct. 1652, 203 L. Ed. 2d 876 (Sup. Ct.).

'No objectively reasonable basis' is the high court standard to find civil contempt for violating the discharge injunction.

Court Rejects Strict Liability for Discharge Violations

Today, the Supreme Court rejected a strict-liability standard for the imposition of contempt for violating the discharge injunction. Instead, the justices held unanimously that the bankruptcy court "may impose civil contempt sanctions when there is no objectively reasonable basis for concluding that the creditor's conduct might be lawful under the discharge order."

The opinion for the Court by Justice Stephen G. Breyer also rejected the Ninth Circuit's idea that a subjective, good faith belief about the inapplicability of the discharge injunction is a defense to contempt. It is unclear from the opinion whether the Court's standard for a discharge violation also applies to violations of the automatic stay under Section 362.

A Discharge Violation Was Unclear

The procedural history of the case in the lower courts was exceptionally complex. Suffice it to say that the debtor had transferred his interest in a closely held corporation. After the debtor received his chapter 7 discharge, two other shareholders sued him in state court for transferring his interest without honoring their contractual right of first refusal. They also sued the transferee of the stock.

After the debtor raised his discharge as a defense in state court, the parties agreed he would not be liable for a monetary judgment. The state court eventually ruled in favor of the creditors and unwound the transfer.

The creditors then sought attorneys' fees as the prevailing parties, invoking a fee-shifting provision in the shareholders' agreement. The state court ruled that the debtor "returned to the fray" and thereby made himself liable for post-discharge attorneys' fees.

Meanwhile, the debtor reopened his bankruptcy case, seeking to hold the creditors in contempt for violating the discharge injunction. The bankruptcy judge sided with the debtor and imposed sanctions. The Bankruptcy Appellate Panel reversed the finding of contempt, ruling that the creditors' good faith belief that their actions did not violate the injunction absolved them of contempt.

Meanwhile, the state appellate court and a federal district court in related litigation both ruled that the debtor's participation in the litigation did not constitute returning to the fray, thus taking

away the grounds for imposing attorneys' fees and lending credence to the notion that the creditors did technically violate the injunction.

In sum, judges disagreed over whether the discharge injunction applied to the litigation to recover attorneys' fees.

The debtor appealed the BAP's opinion to the Ninth Circuit, where Circuit Judge Carlos T. Bea upheld the BAP in April 2018 and found no contempt. However, he expanded the defense available to someone charged with contempt of a discharge injunction. The appeals court held that "the creditor's good faith belief that the discharge injunction does not apply to the creditor's claim precludes a finding of contempt, even if the creditor's belief is unreasonable."

The debtor filed a petition for *certiorari*, which the Supreme Court granted in January. Oral argument was held on April 24.

The Standard Borrowed from Equity

In his 11-page opinion, Justice Breyer said the outcome was informed by Section 524(a)(2), the statutory discharge injunction, and by Section 105(a), the bankruptcy version of the All Writs Act.

Those two sections, according to Justice Breyer, "bring with them the 'old soil' that has long governed how courts enforce injunctions." The "old soil," he said, includes "the traditional standards in equity practice for determining when a party may be held in civil contempt for violating an injunction."

Justice Breyer cited Supreme Court precedent from 1885 holding that civil contempt should not be found "where there is [a] *fair ground of doubt* as to the wrongfulness of the defendant's conduct." *California Artificial Stone Paving Co. v. Molitor*, 113 U.S. 609, 618 (1885) (emphasis added by Justice Breyer).

Justice Breyer then cited *Schmidt v. Lessard*, 414 U.S. 473, 476 (1974) (*per curiam*), for the notion that "principles of 'basic fairness requir[e] that those enjoined receive explicit notice' of 'what conduct is outlawed' before being held in civil contempt."

Although subjective intent is not "always irrelevant," Justice Breyer said, "This standard is generally an *objective* one." [Emphasis in original.] Again citing high court precedent, he said that "a party's good faith, even where it does not bar civil contempt, may help determine an appropriate sanction."

Given that the "typical discharge order entered by a bankruptcy court is not detailed," Justice Breyer held that civil contempt "therefore may be appropriate when the creditor violates a

discharge order based on an objectively unreasonable understanding of the discharge order or the statutes that govern its scope."

The Rejected Standards

Justice Breyer rejected the Ninth Circuit's "good faith belief" standard. Recognizing the realities of life for debtors, he said that the rule proposed by the circuit court "may too often lead creditors who stand on shaky legal ground to collect discharged debts, forcing debtors back into litigation (with its accompanying costs) to protect the discharge that it was the very purpose of the bankruptcy proceeding to provide."

On the other hand, he also rejected a strict-liability standard that would authorize a contempt finding "regardless of the creditors' subjective beliefs about the scope of the discharge order, and regardless of whether there was a reasonable basis for concluding that the creditor's conduct did not violate the order."

In support of strict liability, the debtor argued that a creditor can turn to the bankruptcy court for a so-called comfort order declaring that a proposed action would not violate the discharge injunction. To that, Justice Breyer said that a "risk averse" creditor would seek a comfort order "even when there is only a slight doubt" about a violation of discharge. Often, he said, there will "be at least some doubt as to the scope of" the discharge.

Frequent use of comfort orders, Justice Breyer said, would run contrary to Section 523(c)(1), where only three categories of debts require advance determinations of dischargeability.

Frequent resort to comfort orders, according to Justice Breyer, would "alter who decides whether a debt has been discharged, moving litigation out of state courts, which have concurrent jurisdiction over such questions, and into federal courts."

Because the Ninth Circuit had not employed the proper standard, the Justice Breyer vacated the judgment of the appeals court and remanded "the case for further proceedings consistent with this opinion."

What About the Automatic Stay?

Does the Supreme Court's standard for contempt of the discharge injunction also apply to violations of the automatic stay under Section 362(a)?

Justice Breyer said that the language in Section 362(k)(1) "differs from the more general language in Section 105(a)." Section 362(k)(1) allows an individual to recover actual damages, costs, attorneys' fees and even punitive damages (in "appropriate circumstances") for "any willful violation" of the automatic stay.

The debtor argued that lower courts have often imposed strict liability for violating the automatic stay. Coupled with the different purpose of the automatic stay, the absence of the word "willful" in the discharge context prompted Justice Breyer to reject the idea of importing lower courts' standards for violation of the automatic stay to contempt of the discharge injunction.

Parenthetically, Justice Breyer noted that the use of "willful" in Section 362(k)(1) is "a word the law typically does not associate with strict liability." However, he ducked the question, saying that "[w]e need not, and do not, decide whether the word 'willful' supports a standard akin to strict liability."

Although the Court made no holding about automatic stay violations, Justice Breyer's parenthetical observation can lay the foundation for contending there is also no strict liability for stay violations.

So, the question remains: Is the contempt standard different for automatic stay violations?

Craig Goldblatt of Wilmer Cutler Pickering Hale & Dorr LLP in Washington, D.C., observed that "the Code sets out a standard for the stay but not the discharge injunction. Bankruptcy lawyers think they serve a similar role and so read them to be parallel. But there is no textual basis for that."

"In the absence of text," Goldblatt said in a message to ABI, "the Court says you read the discharge injunction just like you would any injunction outside of bankruptcy. That is all that he needed to say to resolve this case. Because it is not a case about the automatic stay, it presented no basis to opine on how the automatic stay works."

Goldblatt therefore concluded, "*Taggart* has nothing at all to do with the automatic stay." He has argued three bankruptcy cases in the Supreme Court.

Assuming the Court said nothing about automatic stay violations with respect to individuals, what about violations of the stay protecting corporate debtors where there is no statutory standard like 362(k)(1)? Does the absence of a statutory standard for corporate debtors throw the issue back to common law regarding injunctions?

However, the standards may be different, because, as Justice Breyer observed, the automatic stay has a shorter duration and a different purpose in preventing disruptions in the administration of bankruptcy cases.

The high court's ruling on discharge violations may touch off decades of litigation over the standard for deciding whether someone violated the automatic stay.

The opinion is *Taggart v. Lorenzen*, 139 S. Ct. 1795, 204 L. Ed. 2d 129 (Sup. Ct. June 3, 2019).

Bankruptcy needs blanket judicial immunity from the Federal Arbitration Act after the Supreme Court's* Schein *decision.

Supreme Court Decision on Arbitration Has Ominous Implications for Bankruptcy

Justice Brett M. Kavanaugh wrote his first opinion for the Supreme Court in what *The New York Times* called a "minor arbitration case."

If Justice Kavanaugh's ruling in *Henry Schein Inc. v. Archer & White Sales Inc.* is applied rigorously in bankruptcy, it's a "really big deal," because bankruptcy judges will not be able to bar creditors from initiating arbitrations over "core" issues such as allowance of claims, objections to dischargeability of debts, and even adequate protection.

Indeed, *Schein* could be interpreted to mean that the bankruptcy court cannot bar a creditor from initiating arbitration against an individual or corporate debtor, even if the call for arbitration was frivolous.

'Wholly Groundless'

Schein was argued on October 29 and decided for the unanimous Court by Justice Kavanaugh on January 8. By contract, the parties agreed to arbitrate before the American Arbitration Association and according to AAA rules.

Later, the plaintiff filed suit under federal and state antitrust laws, seeking damages and an injunction. The contract called for arbitration "except for actions seeking injunctive relief . . . ." The rules of the AAA call for the arbitrator to decide issues of arbitrability.

Invoking the Federal Arbitration Act, 9 U.S.C. § 2, the defendant responded to the complaint by asking the district judge to refer the case to arbitration. Adopted in 1925, the FAA provides that a contract calling for arbitration "shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract."

Following Fifth Circuit authority, the district court refused to compel arbitration, finding that the demand for arbitration was "wholly groundless" because the plaintiff was seeking an injunction. The Fifth Circuit affirmed.

The Circuit Split

The circuits were split. The Fourth, Fifth, Sixth and Federal Circuits have held that a federal court could refuse to compel arbitration if the demand was "wholly groundless."

The Tenth and Eleventh Circuits ruled to the contrary, holding that the arbitrator alone is entitled to rule on the arbitrability of the dispute, if the contract so provides.

To resolve the split, the Court granted *certiorari* on June 25.

Justice Kavanaugh's Rationale

In substance, Justice Kavanaugh said the Court had already decided the question. In 2010, the high court ruled that the parties may agree by contract that an arbitrator, not the court, will resolve threshold arbitrability questions, not just the merits of the dispute. *Rent-A-Center West Inc. v. Jackson*, 561 U. S. 63, 68−70 (2010).

Justice Kavanaugh said that "some federal courts nonetheless will short-circuit the process" by deciding the arbitrability question if the demand for arbitration is "wholly groundless." Those courts, he said, adopted the "wholly groundless" exception to *Rent-A-Center* "to block frivolous attempts to transfer disputes from the court system to arbitration."

Reversing the Fifth Circuit, Justice Kavanaugh held that the "court possesses no power to decide the arbitrability issue" if "the parties' contract delegates the arbitrability question to an arbitrator."

Justice Kavanaugh reaffirmed the principle that a court can decide whether there was a valid arbitration agreement before referring a dispute to arbitration. "But," he said, "the court may not decide the arbitrability issue" if "a valid agreement exists, and if the agreement delegates the arbitrability issue to an arbitrator."

Justice Kavanaugh rejected the policy argument that the "wholly groundless" exception is "necessary to deter frivolous motions to compel arbitration." He said that arbitrators can quickly and efficiently dispose of frivolous cases, imposing costs and attorneys' fees on the movant "under certain circumstances."

Because the lower courts had not considered the issue, Justice Kavanaugh remanded the case for the Fifth Circuit to rule on whether the agreement "in fact delegated the arbitrability question to an arbitrator." He said the judge "'should not assume that the parties agreed to arbitrate arbitrability unless there is clear and unmistakable evidence that they did so,'" quoting *First Options of Chicago Inc. v. Kaplan*, 514 U.S. 938, 944 (1995).

Fewer and Fewer Exceptions to Arbitration

The implications of Justice Kavanaugh's opinion for bankruptcy cases are better understood in the context of the progression of recent Supreme Court authority.

In 1987, the Supreme Court ruled that a court could decline to enforce an arbitration agreement if there was an inherent conflict between arbitration and the statute's underlying purpose. *Shearson/American Express Inc. v. McMahon*, 482 U.S. 220, 227 (1987).

Building on *McMahon*, the Second, Fourth, Fifth and Ninth Circuits have held in bankruptcy cases that the court may decline to compel arbitration if the issue is "core" and arbitration would represent a "severe conflict" with the Bankruptcy Code.

Last year, the Second Circuit utilized that concept to override an arbitration agreement when a debtor mounted a class action contending that the creditor had violated the discharge injunction. *One Bank NA v. Anderson (In re Anderson)*, 884 F.3d 382 (2d Cir. March 7, 2018), *cert*. denied Oct. 1, 2018.

Anderson and the other circuit decisions overriding arbitration agreements in bankruptcy cases were all decided before *Epic Systems Corp. v. Lewis*, 138 S. Ct. 1612, 1624 (May 21, 2018), where the Supreme Court held last term that the language of a statute must be "clear and manifest" before a court can disregard an arbitration agreement. In *Epic*, the Supreme Court nixed a class action and required individual arbitration of a former employee's claim that the employer's failure to pay overtime violated the Fair Labor Standards Act.

Epic was a 5/4 decision, with the justices divided on ideological grounds.

Applying *Epic* and *Schein* to Bankruptcy Cases

Assume that a debtor and a creditor had a prebankruptcy agreement to arbitrate all disputes, including any arising in bankruptcy, such as the allowance of claims, counterclaims, preferences, and adequate protection. Further assume that the agreement called for the arbitrator to decide whether the dispute was arbitrable, even following bankruptcy.

If *Epic* and *Schein* were applied rigorously, the bankruptcy judge arguably would have no right to bar the creditor from initiating arbitration. If the dispute raised a core issue — such as the allowance of a claim, dischargeability or adequate protection — the bankruptcy judge might have no power to bar arbitration even if there was a "severe conflict" with bankruptcy law.

A chapter 11 debtor could find itself defending dozens of arbitrations, giving the bankruptcy judge little ability to confirm a plan or avoid liquidation. Or, an individual debtor might be fighting dischargeability in several arbitrations.

The prospect of arbitrating dischargeability is not fanciful. *See Williams v. Navient Solutions LLC (In re Williams)*, 564 B.R. 770 (Bankr. S.D. Fla. 2017) (debtor compelled to arbitrate student loan dischargeability); *but see Golden v. JP Morgan Chase Bank NA (In re Golden)*, 587 B.R. 414 (Bankr. E.D.N.Y. 2018), and *Roth v. Butler University (In re Roth)*, 18-50097, 2018 BL 427188 (Bankr. S.D. Ind. Nov. 16, 2018) (arbitration of dischargeability of student loan not permitted). For ABI's discussion, click here.

Supreme Court authority on arbitration seems headed to a pivotal case for the justices to decide whether bankruptcy represents a general exception to the enforceability of arbitration agreements.

In that regard, bankruptcy cases have an element not present in *Epic* and *Schein*. The underpinning of the Bankruptcy Code is centrality of administration. Bankruptcy law has always recognized that an individual cannot win a fresh start and a company cannot reorganize if issues related to bankruptcy must be litigated in several forums. Bankruptcy is designed so one judge decides all core disputes. Even if there is a *Stern* problem, the case goes to a district judge in the same courthouse.

Epic's requirement of a statute's "clear and manifest" exception to arbitration may be found in the centrality of administration of bankruptcy cases. And if that's not enough, the most conspicuous feature of bankruptcy is the automatic stay.

Surely, a creditor cannot continue or initiate arbitration without relief from the automatic stay. If the automatic stay is not a "clear and manifest" exception to arbitration, it's hard to imagine what is.

Justice's Kavanaugh's opinion reaffirms the power of courts to determine in the first instance whether an arbitration agreement is valid. An arbitration clause purportedly enforceable in bankruptcy could be viewed as an invalid agreement, just like an agreement is invalid if it waives the automatic stay or precludes the filing of bankruptcy.

But the question remains: Is a contract calling for arbitration of bankruptcy issues an invalid contract that the bankruptcy court can override, or does *Schein* require the bankruptcy court to refer the dispute to an arbitrator who will decide whether bankruptcy questions are arbitrable?

To read ABI's discussion of *Anderson*, click here, here and here.

The Supreme Court opinion is *Henry Schein Inc. v. Archer & White Sales Inc.*, 139 S. Ct. 524, 202 L. Ed. 2d 480 (Sup. Ct. Jan. 8, 2019).

'Certs' Granted and Denied This Term

The appeal to the Supreme Court may become moot if the Senate confirms the appointment of the existing members of the Puerto Rico Oversight Board.

Supreme Court to Say Whether Puerto Rico Oversight Board Was Constitutionally Appointed

With extraordinary alacrity, the Supreme Court granted *certiorari* on June 20 to decide whether the appointment of the members of the Financial Oversight and Management Board of Puerto Rico violated the Appointments Clause of the Constitution because they were not nominated by the President and confirmed by the Senate.

In the order granting *certiorari*, the justices accelerated the briefing schedule and directed that oral argument be held on October 15 or 16, the second week of arguments in the Court's new term.

It is unclear whether the high court will eventually hear or decide the case, because the President on June 18 sent nominations of the current Board to the Senate for confirmation. Should the Senate confirm the appointment of the current Board members, the appeal in the Supreme Court presumably will become moot in large part, if not entirely.

The Puerto Rico case is the second bankruptcy matter that the Supreme Court has decided to review in the next term. By ruling on *Ritzen Group Inc. v. Jackson Masonry LLC*, 18-938 (Sup. Ct.) (cert. granted May 20, 2019), the high court will shed more light on what is or is not a final order conveying a right of appeal in a bankruptcy case. For ABI's discussion of *Ritzen*, click here.

The Proceeding Below and the Motion for a Stay

After the Supreme Court ruled in June 2016 that Puerto Rico was ineligible for chapter 9 municipal bankruptcy, Congress quickly adopted the Puerto Rico Oversight, Management, and Economic Stability Act, or PROMESA (48 U.S.C. §§ 2161 *et. seq.*). PROMESA was designed so that the island commonwealth could restructure its unsupportable mountain of debt.

The members of the Financial Oversight and Management Board of Puerto Rico were not nominated by the President and confirmed by the Senate. Instead, PROMESA allowed the President to appoint one member of the Oversight Board. The President selected six more from a list of candidates provided by leaders of Congress. If any members appointed by the President were not on the congressional list, Senate confirmation would have been required. Since the six were all on the list, there was no Senate confirmation.

After an initial effort at negotiating a compromise with creditors out of court, the Oversight Board commenced debt-adjustment proceedings for the commonwealth and its instrumentalities beginning on May 3, 2017, in district court in Puerto Rico.

Aurelius Investment LLC and affiliates filed a motion in August 2017 seeking dismissal of Puerto Rico's debt-arrangement proceedings, arguing that the filing of the petition on behalf of the Commonwealth of Puerto Rico by the Board under Title III of PROMESA violated the Appointments Clause. Holders of Puerto Rico general obligation bonds joined Aurelius but were opposed by the Oversight Board, the official unsecured creditors' committee, and COFINA bondholders, among others.

District Judge Laura Taylor Swain of New York, sitting in the District of Puerto Rico by designation, handed down an opinion in July 2018 holding that PROMESA and the Board were properly constituted under the Territories Clause of the Constitution, Article IV, Section 3, Clause 2. *In re The Financial Oversight and Management Board for Puerto Rico*, 318 F. Supp. 3d 537 (D.P.R. July 13, 2018). To read ABI's discussion of the district court opinion, click here.

On appeal, the First Circuit reversed, holding that the appointment of the members of the Oversight Board violated the Appointments Clause of the Constitution because they were not nominated by the President and confirmed by the Senate. Relying on the *de facto* officer doctrine, the appeals court went on to rule that its opinion would "not eliminate any otherwise valid actions of the Board prior to the issuance of our mandate in this case." *Aurelius Investment LLC v. Commonwealth of Puerto Rico*, 915 F.3d 838 (1st Cir. Feb. 15, 2019). For ABI's report on the First Circuit opinion, click here.

Without prompting from the parties, the First Circuit held up the issuance of the mandate for 90 days, giving the Senate time to confirm the appointment of the Board members. The appeals court did not enter a stay.

The Oversight Board filed its petition for *certiorari* on April 23. Four other petitions followed, by the U.S. Solicitor General, Aurelius, the official creditors' committee, and a labor union in Puerto Rico.

The justices of the Supreme Court met in conference on Thursday, June 20, to consider the petition. Ordinarily, the Court issues orders granting or denying petitions on the following Monday. Instead, the Court issued its order on June 20 granting the petition, setting out a briefing schedule, and stating that oral argument will be held on October 15 or 16, the second week the justices will hear arguments in the coming term.

Meanwhile, the First Circuit had declined to issue a stay at the Board's request but instead further delayed issuance of the mandate until July 15. On June 18, the Oversight Board filed a motion again asking the First Circuit to delay issuance of the mandate until the Supreme Court

finally disposes of the appeal. The Board asked the appeals court to act by June 24, so time enough would remain to ask the Supreme Court for a stay pending appeal.

The Questions Presented

The justices granted *certiorari* to review two questions: (1) Did the Appointments Clause of the Constitution require Senate confirmation of the members of the Oversight Board; and (2) does the *de facto* officer doctrine allow the Board to continue acting validly prior to the issuance of the mandate?

The first briefs are due by July 25, with the last briefs due on October 8. The justices slapped page limits on all the briefs, with the longest allocated 20,000 words.

Senate confirmation of Board members would seemingly moot the appeal in the Supreme Court. However, the Board told the First Circuit "there is virtually no possibility that the Senate will confirm the Board members before the mandate issues on July15."

Even if the chief issues become moot following Senate Confirmation, questions remain regarding the validity of actions taken by the Board before and after the First Circuit's opinion. It is questionable whether the Supreme Court would reach out to decide those more amorphous questions if the issue in chief becomes moot. If questions remain, the Court might remand the case to the First Circuit.

The appeal is *Financial Oversight and Management Board for Puerto Rico v. Aurelius Investment LLC*, 18-1334 (Sup. Ct.).

For now, the high court ducks an important automatic stay question for chapter 13 debtors.

Supreme Court Agrees to Rule on What Is or Is Not a 'Final, Appealable' Order

In addition to ruling on the effect of rejecting a trademark license, the Supreme Court yesterday agreed to review one bankruptcy case and denied a petition for *certiorari* in another.

In *Ritzen Group Inc. v. Jackson Masonry LLC*, the Court granted *certiorari* to shed more light on what is or is not a final order conveying a right of appeal in a bankruptcy case. The justices declined to review *Davis v. Tyson Prepared Foods Inc.*, a case that could have said whether passively holding property of the estate violates the automatic stay under Section 362(a).

Yesterday, the high court ruled that rejecting an executory trademark license does not bar the licensee from continuing to use the license. To read ABI's report on *Mission Product Holdings Inc. v. Tempnology LLC*, 17-1657 (Sup. Ct. May 20, 2019), click here.

Ritzen and Final Orders

In *Bullard v. Blue Hills Bank,* 135 S. Ct. 1686 (2015), the Supreme Court ruled that an order denying confirmation of a chapter 13 plan is not a final order conferring a right to appeal. In *Ritzen*, the high court will have an opportunity to flesh out the definition of finality.

The creditor who lost in *Ritzen* contends that the Sixth Circuit deepened an existing circuit split by erroneously holding that an order denying a motion to modify the automatic stay is always a final order that must be appealed immediately.

In bankruptcy court, the creditor lost a motion to modify the automatic stay in Section 362 but did not appeal within 14 days. Instead, the creditor appealed from denial of the lift-stay motion months later when the bankruptcy judge sustained the debtor's objection to the creditor's claim.

In October, the Sixth Circuit upheld the district judge who had dismissed the stay appeal for being untimely. *Ritzen Group Inc. v. Jackson Masonry LLC (In re Jackson Masonry, LLC)*, 906 F.3d 494 (6th Cir. Oct. 16, 2018). To read ABI's analysis of the Sixth Circuit's opinion, click here.

The Sixth Circuit cited five other circuits and the *Collier* treatise for saying that courts "almost uniformly" hold that denial of a lift-stay motion is an appealable order. However, the Sixth Circuit went on to lay down a two-part rule to determine whether any type of order is final and therefore appealable.

Interpreting the governing statute, 28 U.S.C. § 158(a), the Sixth Circuit said that an order is final if it was entered in a "proceeding" and if the order terminated that proceeding. Because a lift-stay motion is a core "proceeding," denial of motion was final because it was procedurally complete and precluded the creditor from pursuing its claim against the debtor outside of bankruptcy court, citing *Bullard*.

In the petition for *certiorari,* the creditor contends there is a split of circuits, with eight circuits holding that orders denying lift-stay motions "are categorically appealable." On the other hand, the petitioner claims that the First and Third Circuits take a flexible approach by saying that denying a modification of the stay sometimes may not be final.

The petitioner believes that the Sixth Circuit misapplied *Bullard* and *Gillespie v. U.S. Steel Corp.*, 379 U.S. 148, 152 (1964). In *Gillespie*, the petitioner says, the Supreme Court said that finality is sometimes a "close question" and that it is "impossible to devise a formula to resolve all marginal cases."

The petitioner may be correct in interpreting Supreme Court precedent. The Sixth Circuit did establish a seemingly rigid, two-part test for all cases, arguably at odds with *Gillespie*. However, the Sixth Circuit may have correctly applied *Bullard* and *Gillespie* to the case before the appeals court. In *Bullard*, the high court ruled that an order denying confirmation of a chapter 13 plan was not a final, appealable order because denying confirmation did not terminate the proceeding, unlike denial of a lift-stay motion.

In deciding *Ritzen*, the Supreme Court might lay down a one-size-fits-all rule to discern between orders that are final and those that are not. A more difficult question arises with denials of lift-stay motions.

Suppose that the bankruptcy court denies a lift-say motion without prejudice, saying the creditor can apply again because the passage of time might inform a difficult result. In times past, some bankruptcy judges routinely denied stay motions without prejudice, ostensibly to preclude the creditor from appealing.

Ruling that denials of stay motions are never appealable can effectively preclude appellate review, because later events in the case can moot the stay appeal. To this writer, a hard-and-fast rule may appeal to those seeking an answer in the statute, but rigidity ignores the realities of bankruptcy practice.

For decades, courts have been taking a flexible approach to appealability in bankruptcy cases. *Bullard* cut back on the notion of flexibility, and *Ritzen* may allow the Court to impose a more inflexible standard.

With *certiorari* granted this spring, the case will be argued in the fall of 2019, unless the parties request extensions of time to file their briefs on the merits. A decision could be expected two or three months later.

The Automatic Stay Case

The high court refused to permit a final appeal in *Davis v. Tyson*, where the Tenth Circuit held that the automatic stay does not prevent a statutory worker's compensation lien from attaching automatically after bankruptcy to a recovery in a lawsuit. *Davis v. Tyson Prepared Foods Inc. (In re Garcia)*, 740 Fed. Appx. 163 (10th Cir. Oct. 17, 2018). To read ABI's analysis of *Davis*, click here.

The outcome in *Davis* was not surprising, because the Tenth Circuit had ruled in *WD Equipment v. Cowen (In re Cowen)*, 849 F.3d 943 (10th Cir. Feb. 27, 2017), that passively holding an asset of the estate in the face of a demand for turnover does not violate the automatic stay in Section 362(a)(3) as an act to "exercise control over property of the estate."

The circuits are split. According to the debtor who sought Supreme Court review in *Davis*, the Second, Seventh, Eighth, Ninth and Eleventh Circuits have held that passively holding estate property or passively obtaining an interest in estate property after filing violates the automatic stay. In those circuits, for example, a creditor who repossessed an auto before bankruptcy must automatically return the car after the debtor files a chapter 13 petition, on pain of contempt.

The Tenth and the District of Columbia Circuits have ruled to the contrary, holding that an affirmative action is required to underpin an automatic stay violation.

Although the Court will not rule on *Davis*, the same issue likely will come to the justices again, sooner rather than later. Last week, the identical question was argued in the Seventh Circuit in *City of Chicago v. Fulton*, 18-2527 (7th Cir.). Indeed, *Fulton* may turn out to be a better vehicle for the Supreme Court to resolve the circuit split.

Fulton deals with cars impounded by the City of Chicago for unpaid parking tickets. Chicago believes that the mere filing of a chapter 13 petition does not compel the automatic turnover of an impounded car. The debtors argue that holding onto a car violates the automatic stay.

At last week's oral argument, the appeals court panel seemed to believe that the outcome was already decided in that circuit by *Thompson v. General Motors Acceptance Corp.,* 566 F.3d 699 (7th Cir. 2009). There, the Seventh Circuit ruled that passively holding an asset is an act to "exercise control" that violates the automatic stay under Section 362(a)(3).

Whoever wins in *Fulton*, there is likely to be a petition for *certiorari*. If the Seventh Circuit hands down a decision this summer, the request for Supreme Court review could arrive before the year's end.

The cases are *Ritzen Group Inc. v. Jackson Masonry LLC*, 18-938 (Sup. Ct.) (*cert*. granted May 20, 2019), and *Davis v. Tyson Prepared Foods Inc.*, 18-941 (Sup. Ct.) (cert. denied May 20, 2019).

Circuits are split on whether a tax refund presumptively goes to the subsidiary that created the losses giving rise to the refund.

Supreme Court to Tackle a Bankruptcy Tax Refund Circuit Split

To resolve a split of circuits, the Supreme Court has granted *certiorari* to decide whether state or federal law governs the ownership of tax refunds when a subsidiary generated the losses but the government pays the refund to the bankrupt corporate parent.

The issue came to the fore in the wake of the banking crisis beginning some 10 years ago. A bank would fail and be taken over by the Federal Deposit Insurance Corporation, or FDIC. The bank's parent holding company often would end up in bankruptcy.

The parent and subsidiary typically would have a prebankruptcy tax allocation agreement, or TAA, calling for the parent holding company to file a consolidated tax return for the corporate group. Usually, the failed bank would have incurred the losses giving rise to a tax refund. However, the Internal Revenue Service would pay the refund to the parent corporation as the entity that filed the tax return.

When the tax refund arrives from the IRS, does the bankrupt parent keep the cash, or does it go to the FDIC as receiver for the failed bank? That's where the courts are split.

The Two Results

Courts resolved the question by employing two conflicting methodologies leading to different results.

The first group of courts employ state law to decide who keeps the refund. Sometimes, the TAA would create a valid trust or agency arrangement under state law. In those cases, the refund would not be property of the bankrupt estate of the parent holding company. Consequently, the refund would end up in the hands of the FDIC.

When the TAA did not create a trust or agency relationship, the first group of courts would conclude that the TAA resulted in a debtor/creditor relationship between the parent and the subsidiary. In those cases, the first group of courts would conclude that the FDIC had nothing more than an unsecured claim against the bankrupt parent. Creditors of the bankrupt parent, sometimes bondholders, would benefit because the parent might otherwise have precious few assets aside from the tax refund.

The second group of courts employ the so-called *Bob Richards* rule, derived from a Ninth Circuit opinion in 1973. *In re Bob Richards Chrysler-Plymouth Corp.*, 473 F.2d 262 (9th Cir. 1973). Those courts adopted a presumption — evidently a creation of federal common law — that the subsidiary with the losses is presumptively entitled to the refund absent a TAA that clearly gives the refund to the parent.

Under the same set of facts, the FDIC would come out on top in courts following the *Bob Richards* presumption.

The split worked out like this: The Fifth, Ninth and Tenth Circuits follow *Bob Richards*. Naturally, the FDIC does too.

The Second, Third, Sixth and Eleventh Circuits reject *Bob Richards* and employ state law to decide who owns the refund and whether the TAA creates an unsecured debtor/creditor relationship.

The Case on *Certiorari*

In the case to be heard in the Supreme Court, the parent holding company ended up in chapter 7 with a trustee. The bank subsidiary was taken over by the FDIC, as receiver. The bank subsidiary's losses resulted in a $4 million tax refund payable to the parent under a TAA.

The bankruptcy court in Colorado granted summary judgment in favor of the holding company's trustee. Finding that the TAA did not create a trust or agency under Colorado law, the bankruptcy court believed the parent and subsidiary had a debtor/creditor relationship under the TAA, meaning that the parent was the owner of the tax refund.

The district court reversed, believing that the Tenth Circuit had previously adopted *Bob Richards*. The Tenth Circuit affirmed, ruling that the case was governed by federal common law, not state law, unless the TAA unambiguously specified where the refund would go. Because the TAA did not unambiguously favor the holding company, the refund went to the FDIC as receiver.

Citing the split of circuits, the bankruptcy trustee filed a petition for *certiorari* in April. The justices of the Supreme Court considered the petition at two conferences and granted *certiorari* on June 27. The case will be argued in the term to begin in October. The date for argument has not been set as yet.

How Will the Justices Rule?

In recent years, the Supreme Court has often resolved bankruptcy cases based on textualism, limitations on the powers of federal courts or deference to state law.

In *Butner v. U.S.*, 440 U.S. 48 (1979), the Supreme Court ruled that state law determines the nature and extent of a debtor's property interests. If the justices adhere to *Butner*, they may invoke state law, reverse the Tenth Circuit, overrule *Bob Richards*, and reinstate the judgment of the Colorado bankruptcy court giving the refund to the parent holding company.

The bankruptcy trustee also argues that courts adopting *Bob Richards* disregarded the rules for creating federal common law. According to the trustee, the Supreme Court requires a "significant conflict between some federal policy or interest and the use of state law" before a court is entitled to create federal common law. *O'Melveny & Myers v. FDIC*, 512 U.S. 79, 87 (1994).

Of course, the bankruptcy trustee sees no significant conflict with federal policy and thus no reason to adopt the *Bob Richards* presumption.

It is not entirely clear to this writer that the Supreme Court will reach the *Bob Richards* issue. Arguing on behalf of the FDIC, the U.S. Solicitor General contends that the Tenth Circuit applied Colorado law in concluding that the refund belonged to the FDIC. If the justices are persuaded that the Tenth Circuit invoked state law and did not rely on the *Bob Richards* presumption, the Court might dismiss the *certiorari* petition as having been improvidently granted.

The Significance of the Outcome

Obviously, the outcome in the Supreme Court will be significant in the liquidation of banks by the FDIC. In chapter 11 reorganizations of large non-bank companies with multiple debtors, the ruling by the high court will affect valuations underpinning the treatment of creditor classes under chapter 11 plans.

The case in the Supreme Court is *Rodriguez v. Federal Deposit Insurance Corp.*, 18-1269. *cert.* granted June 27, 2019 (Sup. Ct.).

Arguably ignoring Sections 506(a) and 506(d),* Dewsnup *barred chapter 7 debtors from stripping down undersecured mortgages.

The Supreme Court Refuses to Revisit *Dewsnup*

The Supreme Court won't be overruling *Dewnsup* this year, and probably never. Yesterday, the justices denied the petition for *certiorari* in *Ritter v. Brady*, 18-747 (Sup. Ct.).

Dewsnup was the notorious 1992 decision where the Supreme Court held that a chapter 7 debtor may not employ Sections 506(a) and 506(d) to "strip down" an undersecured mortgage. *Dewsnup v. Timm*, 502 U.S. 410 (1992). Justice Antonin Scalia wrote a vigorous dissent, accusing the majority of ignoring the plain language of the statute in adopting a policy contrary to decisions that Congress made by enacting the Bankruptcy Code.

Twenty-three years later, the justices seemed primed to revisit *Dewsnup*. At oral argument in *Bank of America N.A. v. Caulkett*, 135 S. Ct. 1995 (2015), several justices apparently thought *Dewsnup* was wrongly decided. Indeed, the unanimous opinion in *Caulkett*, written by Justice Clarence Thomas, said that "straightforward reading of the statute" would allow a debtor to strip off an underwater mortgage.

The *Dewsnup* issue arose in *Ritter*, where the chapter 7 debtor sought to strip off a wholly underwater mortgage. All the way through the Ninth Circuit, the courts summarily denied the debtor's request, saying the issue had been decided definitively by the Supreme Court in *Caulkett*.

Scott L. Nelson of the Public Citizen Litigation Group of Washington, D.C., along with Bradley Girard and Brian Wolfman of the Georgetown Law Appellate Court Immersion Clinic, filed a *certiorari* petition in December. Several law professors and former judges, including Eugene Wedoff, Leif M. Clark and Bruce A. Markell, filed *amicus* briefs urging the Court to grant *certiorari*.

In a terse order, the Court denied the *certiorari* petition on February 19.

Craig Goldblatt, a partner at Wilmer Cutler Pickering Hale and Dorr LLP in Washington, D.C., explained why the court declined to re-examine *Dewsnup*. In a message to ABI, Goldblatt said, "The Court regularly notes that principles of *stare decisis* apply with special force in statutory cases, since Congress is presumed to acquiesce in the Court's prior rulings and is able to enact legislation if it believes the Court got it wrong. Indeed, there are only a handful of occasions in recent decades in which the Court overruled prior statutory decisions."

In the *certiorari* petition and in the *amicus* briefs, those who disagree with *Dewsnup* gave it their best shot. The papers persuasively explained where *Dewsnup* went off the rails, but the justices have shown their disinclination to revisit the issue, not now and perhaps never.

The petition for *certiorari* is in *Ritter v. Brady*, 18-747 (Sup. Ct.).

Possible for Next Term

Disagreeing with the Tenth and D.C. Circuits and siding with four other circuits, the Seventh Circuit rules that passively holding estate property violates the automatic stay.

Seventh Circuit Solidifies a Circuit Split on the Automatic Stay

Solidifying a split of circuits, the Seventh Circuit ruled that the City of Chicago must comply with the automatic stay by returning impounded cars immediately after being notified of a chapter 13 filing.

The decision lays the foundation for the Supreme Court to grant *certiorari* and decide whether violation of the automatic stay requires an affirmative action or whether inaction amounts to control over estate property and thus violates the stay.

The Second, Seventh, Eighth, Ninth and Eleventh Circuits hold that a secured creditor or owner must turn over repossessed property immediately or face a contempt citation. The Tenth and the District of Columbia Circuits have ruled that passively holding an asset of the estate in the face of a demand for turnover does not violate the automatic stay in Section 362(a)(3), which prohibits "any act . . . to exercise control over property of the estate."

The same issue was argued on May 23 in the Third Circuit, where the lower courts were siding with the minority. *See Denby-Peterson v. NU2U Auto World*, 18-3562 (3d Cir.). For ABI's report on *Denby*, click here.

The Impounded Cars in Chicago

Four cases went to the circuit together. The facts were functionally identical.

The chapter 13 debtors owed between $4,000 and $20,000 on unpaid parking fines. Before bankruptcy, the city had impounded their cars. Absent bankruptcy, the city will not release impounded cars unless the fines are paid. If the cars are not redeemed by their owners, most of them are scrapped.

In 2016, Chicago passed an ordinance giving the city a possessory lien on impounded cars.

After filing their chapter 13 petitions, the debtors demanded the return of their autos. The city refused to release the cars unless the fines and other charges were paid in full.

The debtors mounted contempt proceedings in which four different bankruptcy judges held that the city was violating the automatic stay by refusing to return the autos. After being held in contempt, the city returned the cars but appealed.

In all four cases, the owners confirmed chapter 13 plans treating the city as holding unsecured claims. The city did not object to confirmation or appeal.

In the four cases, the city never sought adequate protection for its alleged security interests under Section 363(e).

Thompson Controls

Circuit Judge Joel M. Flaum was not writing on a clean slate in his June 19 opinion, given the circuit's controlling precedent in *Thompson v. General Motors Acceptance Corp.*, 566 F.3d 699 (7th Cir. 2009). *Thompson*, he said, presented "a very similar factual situation."

Although *Thompson* came down only 10 years ago, Judge Flaum nonetheless wrote a comprehensive, 27-page opinion, perhaps sensing that the case will go to the Supreme Court on *certiorari*.

In *Thompson*, Judge Flaum said, "we held that a creditor must comply with the automatic stay and return a debtor's vehicle upon her filing of a bankruptcy petition. We decline the City's request to overrule *Thompson*." He also agreed with the bankruptcy courts "that none of the exceptions to the stay apply."

Quoting extensively from *Thompson*, Judge Flaum said that the Seventh Circuit had already "rejected" the city's contention that "passively holding the asset did not satisfy the Code's definition of exercising control." He noted that Congress amended Section 362 in 1984 by adding subsection (a)(3) and making the automatic stay "more inclusive by including conduct of 'creditors who seized an asset pre-petition,'" citing *U.S. v. Whiting Pools Inc.*, 264 U.S. 198, 203-204) (1983).

Again citing *Whiting Pools*, Judge Flaum said that Section 362(a)(3) "becomes effective immediately upon the filing of the petition and is not dependent on the debtor first bringing a turnover action." He added, the "creditor . . . has the burden of requesting protection of its interest in the asset under Section 363(e)."

Judge Flaum found support for his conclusion in Section 542(a). Again quoting *Thompson*, he said the section "'indicates that turnover of a seized asset is compulsory.'" *Thompson*, *supra*, at 704.

"Applying *Thompson*," Judge Flaum held "that the City violated the automatic stay . . . by retaining possession . . . after [the debtors] declared bankruptcy." The city, he said, "was not passively abiding by the bankruptcy rules but actively resisting Section 542(a) to exercise control over the debtors' vehicles."

Telling Chicago how to proceed in the future, Judge Flaum said the city must turn over the car and may seek adequate protection on an expedited basis. The burden of seeking adequate protection, he said, "is not a reason to permit the City to ignore the automatic stay and hold captive property of the estate, in contravention of the Bankruptcy Code."

In sum, Judge Flaum declined the city's invitation to overrule *Thompson*. He said, "Our reasoning in *Thompson* continues to reflect the majority position and we believe it is the appropriate reading of the bankruptcy statutes."

Exceptions to the Automatic Stay

Judge Flaum devoted the last third of his opinion to explaining why Chicago was not eligible for any of the exceptions to the automatic stay.

Section 362(b)(3), allowing acts to perfect or continue perfection of liens, does "not permit creditors to retain possession of debtors' property," Judge Flaum said. Rather, it allows creditors to file notices to continue or perfect a lien when bankruptcy has intervened. The city, he said, could perfect its possessory lien by a filing with the Secretary of State.

Judge Flaum cited Illinois decisions holding that giving up possession involuntarily does not destroy a possessory lien. The notion that turning over cars would abrogate the possessory lien was one of Chicago's primary arguments on appeal.

Judge Flaum held that Section 362(b)(4), excepting police or regulatory powers from the automatic stay, did not apply. On balance, he said, the municipal machinery to impound cars "is an exercise of revenue collection more so than police power."

Is *Certiorari* Next?

In the term that ends this month, the Supreme Court denied a petition for *certiorari* raising the same question. *See Davis v. Tyson Prepared Foods Inc.*, 18-941 (Sup. Ct.) (cert. denied May 20, 2019).

Davis, from the Tenth Circuit, was a challenge to the Tenth Circuit's holding in *WD Equipment v. Cowen (In re Cowen)*, 849 F.3d 943 (10th Cir. Feb. 27, 2017). In *Cowen*, the Tenth Circuit ruled that passively holding an asset of the estate in the face of a demand for turnover does not violate

the automatic stay in Section 362(a)(3) as an act to "exercise control over property of the estate." To read ABI's discussion of the denial of *certiorari*, click here.

In this writer's opinion, the Chicago parking ticket cases are a better vehicle for *certiorari* because they raise the issue more cleanly. *Davis* was a step or two removed from the question of whether overt action is required to violate the automatic stay.

Given the recent change in administration in Chicago, it is not certain that the city will pursue *certiorari*.

Eric Brunstad told ABI, "The issue is certainly not going away. I predict that eventually the Supreme Court will grant *certiorari* in a case involving the issue and resolve the conflict among the courts of appeals." Brunstad represented the debtor who unsuccessfully sought Supreme Court review in *Davis*.

The opinion is *In re Fulton*, 18-2527, 2019 BL 225881 (7th Cir. June 10, 2019).

Reorganization

Dismissal

Judge Vyskocil denounces an involuntary petition as an attempt by senior, fully secured noteholders to profit at the expense of subordinate noteholders.

New York Judge Dismisses an Involuntary Petition Against a CDO

Holders of nonrecourse notes issued by a "static pool investment vehicle" do not have claims against the issuer and therefore are not eligible to be involuntary petitioners under Section 303(b), according to Bankruptcy Judge Mary Kay Vyskocil of New York City.

Even if they were eligible petitioners, Judge Vyskocil said she would dismiss the involuntary chapter 11 petition for "cause" under Section 1112 because the senior noteholders were attempting to "increase their recovery at the expense of junior noteholders."

As described by Judge Vyskocil, the case involved a conventional "structured finance entity known as a collateralized debt obligation," or CDO. The debtor issued 11 classes of 30-year notes, in descending order or priority, scheduled to mature in 2036.

With funds from issuance of the notes, the debtor mostly purchased long-term securities issued by real estate investment trusts. The indenture trustee held a lien on the securities as collateral for the noteholders. Income from the REITs was intended to pay debt service on the notes.

In 2009, four years after issuance, the debtor defaulted on notes junior to the senior-most notes held by the petitioning noteholders. In 2016, six years later, the petitioning senior noteholders purchased the remainder of the senior notes they did not already own. Later, they filed an involuntary chapter 11 petition and submitted a proposed liquidating plan alongside a motion to terminate the debtor's exclusivity.

After Judge Vyskocil denied the petitioner's motion for summary judgment, she held a trial on the involuntary petition. The debtor and junior noteholders urged dismissal, contending that the senior noteholders, by virtue of holding nonrecourse debt, did not qualify as petitioning creditors because they held no claims against the debtor.

Under Rule 52, made applicable by Bankruptcy Rule 7052, Judge Vyskocil ruled that the petitioners had failed at trial to make out a *prima facie* case. Having held a trial, the judge said she was not required to take the evidence in the light most favorable to the petitioners, nor was she obliged to take inferences in the petitioners' favor.

Opposing dismissal, the petitioners advanced several theories to show they held claims against the debtor. Judge Vyskocil rejected them all.

Judge Vyskocil focused on Section 303(b)(1), which requires that the three involuntary petitioners must each hold "a claim against such person . . . ." She interpreted the section to mean that each petitioner must hold "a claim *against the target of the involuntary petition*." [Emphasis in original.]

The petitioners argued that they held recourse claims against the debtor. Judge Vyskocil rejected the contention, found no ambiguity in the indenture, and quoted numerous provisions in the indenture saying that the obligations were nonrecourse, that the notes were payable solely from the collateral, and that the debtor has no personal liability to the noteholders. Furthermore, the indenture says the noteholders cannot look to the debtor for a deficiency if the collateral is exhausted.

Under the terms of the indenture, Judge Vyskocil therefore held that senior noteholders were not qualified to be involuntary petitioners because they held only nonrecourse claims that were not claims against the debtor, only claims against the collateral.

Next, Judge Vyskocil rejected the petitioner's contention that Sections 1111(b)(1) and 102(2) eliminate the distinction between recourse and nonrecourse debt in specifying who may be an involuntary petitioner.

Judge Vyskocil ruled that the "clear and unambiguous" statutory language makes Section 1111(b) applicable only to the allowance and distribution of claims. Furthermore, she said, the purpose of the statute was to protect secured creditors when the debtor elects to retain the collateral, not "to give nonrecourse lenders . . . a right to commence an involuntary bankruptcy case against the borrower."

The petitioner's argument under Section 102(2) likewise failed. The section provides that the term "'claim against the debtor' includes claim against property of the debtor."

Judge Vyskocil noted that Section 303(b) does not employ the phrase "claim against the debtor." Rather, it says that a petitioner must have an unsecured claim "against such person." She therefore held that Section 102(2) does not authorize a nonrecourse creditor to be an involuntary petitioner.

Even if the senior noteholders qualified as involuntary petitioners, Judge Vyskocil held that she would nonetheless dismiss the petition *sua sponte* under Section 1112, citing the Second Circuit's decision this year in *Wilk Auslander LLP v. Murray*, 900 F.3d 53 (2d Cir. Aug. 14, 2018). To read ABI's discussion of *Wilk Auslander*, click here.

Making 15 findings of fact from the trial record, Judge Vyskocil found "cause" for dismissal under Section 1112 because "no bankruptcy purpose is served by this filing." She said the petitioners "will not suffer any prejudice if the case is dismissed."

Among other things, Judge Vyskocil said the petitioners "are seeking to liquidate the collateral solely for their benefit, and at the expense of other noteholders." The debtor, she said, is not operating a business and neither needs nor wants a discharge. No assets are being lost or dissipated; the petitioners are "fully secured," and the petitioning creditors are being paid.

The petitioners were making "no genuine attempt to reorganize . . . . Rather, this case is a last-ditch effort by a senior sophisticated noteholder to further its personal, tactical and pecuniary aims . . . *to the detriment of junior creditors*." [Emphasis in original.]

Citing an *amicus* brief by an industry group, Judge Vyskocil dismissed petition for "cause" under Section 1112 because validating the petitioners' tactics "would create significant uncertainty across the capital markets."

Observation

Before filing, the three petitioners had waived their security interests in the amount of $5,259 each, so they could claim to be unsecured creditors with the required $15,775 in unsecured claims. The waiver of their secured claims gave the petitioners a facially persuasive argument.

Judge Vyskocil said the petitioners took "intricate — choreographed — steps to manufacture eligibility to file an involuntary case." Although she specifically declined to find that they filed in bad faith, she evidently found "cause" to dismiss under Section 1112 even if they held the required $15,775 in unsecured claims.

Beyond Section 1112, the unsecured claims still might not qualify the petitioners for at least two reasons: (1) By waiving their security interests, the senior noteholders arguably held no claims at all against the debtor; and (2) even if they held unsecured claims, the claims may be subject to *bona fide* dispute, disqualifying them under Section 303(b)(1).

The opinion is *Taberna Preferred Funding IV Ltd. v. Opportunities II Ltd. (In re Taberna Preferred Funding IV Ltd.)*, 17-01087 (Bankr. S.D.N.Y. Nov. 8, 2018).

Fraudulent Transfers

Neither comity nor the presumption against extraterritorial application of U.S. statutes bars trustees from suing to recover subsequent transfers made abroad.

Second Circuit Allows Extraterritorial Application of Sections 548 and 550

In a broadly worded opinion in the *Madoff* liquidation, the Second Circuit held that Sections 548 and 550 can be applied extraterritorially to recover fraudulent transfers even if subsequent transfers occurred abroad.

The appeals court reversed District Judge Rakoff, who had ruled in July 2014 that Section 550 does not permit recovering from a subsequent foreign recipient of stolen funds, given comity and the presumption against extraterritorial application of U.S. statutes.

As Circuit Judge Richard C. Wesley was careful to say in his February 25 opinion, the ruling by the appeals court closed a "loophole," because the district court's decision would have enabled a fraudster to transfer property to a "foreign entity," thereby rendering the "property recovery-proof."

The opinion avoided a split of circuits with the Fourth Circuit and lower courts that have given extraterritorial effect to Section 548.

The opinion has practical significance for the victims of Bernie Madoff's Ponzi scheme, who have already received distributions representing about 67% of what they invested. The revival of the trustee's lawsuits means the victims have a realistic shot at recovering 100%. Reinstatement of the lawsuits may convince some defendants to settle, because they face the possibility of liability for 10 years of prejudgment interest on top of a judgment for the stolen money they received.

"The opinion has a broad application, and we think the court got it 100% right," Stephen P. Harbeck, the president and chief executive of the Securities Investor Protection Corp., told ABI.

The Fraudulent Transfers

Some of the largest investors in the Madoff Ponzi scheme were so-called offshore feeder funds, located in places like the Cayman Islands. Many of the feeder fund investors were foreigners, or at least nominally so.

Some of the feeder funds reinvested virtually everything with Madoff. The feeder fund investors seemingly made out very well until the fraud came crashing down. When it did, some of the feeder funds had taken more cash out of the Madoff firm than the cash they had invested.

The feeder funds were called "net winners" if they had taken out more cash than they invested. Under prior Second Circuit decisions in the *Madoff* case, net winners are recipients of fraudulent transfers with "actual intent," making them liable to disgorge fictitious profits received within two years of bankruptcy under Sections 548(a)(1)(A) and 550(a)(1).

Madoff's bankruptcy in 2008 put many of the feeder funds into liquidation abroad. The feeder funds' bankruptcies left the Madoff trustee unable to claw back fraudulent transfers made to the feeder funds themselves. Undeterred, the Madoff trustee sued feeder fund investors as subsequent transferees under Section 550(a)(2), because the feeder funds had paid out their fictitious Madoff profits to the feeder funds' investors. The payments were fictitious profits because they represented money stolen from other investors, not legitimate income from investments.

The Madoff firm is being liquidated under the Securities Investor Protection Act, which incorporates large swaths of the Bankruptcy Code, including the avoiding and recovery powers under Sections 548 and 550.

Judge Rakoff's Ruling

Before the bankruptcy judge could rule on the liability of the feeder funds' investors as subsequent recipients of fraudulent transfers, they banded together and persuaded Judge Rakoff to withdraw the reference.

The feeder fund investors contended that U.S. fraudulent transfer law does not apply to them abroad. Judge Rakoff heard argument in September 2012 and handed down his opinion in July 2014. *Securities Investor Protection Corp. v. Bernard L. Madoff Investment Securities LLC (In re Bernard L. Madoff Investment Securities LLC)*, 513 B.R. 222 (S.D.N.Y. 2014).

Reciting black letter law, Judge Rakoff said that U.S. statutes do not apply extraterritorially absent contrary intent by Congress. For him, the origination of the fraudulent transfers in the U.S. was insufficient to transform "these otherwise thoroughly foreign subsequent transfers" into a "domestic application" of bankruptcy law. He also found no "clearly expressed" congressional intent to allow application of the law abroad.

Even if Congress had intended to allow suits against foreigners, Judge Rakoff said he would still dismiss the suits on a second ground: international comity. He said that foreigners "had no reason to expect that U.S. law would apply to their relationships with the feeder funds."

After ruling, Judge Rakoff sent the lawsuits back to bankruptcy court. Implementing Judge Rakoff's mandate, the bankruptcy court on remand dismissed suits seeking $4 billion from feeder fund investors. Because Judge Rakoff had already ruled on the issues, the Second Circuit permitted the trustee to take a direct appeal in 88 consolidated appeals.

The Second Circuit Opinion

Reversing Judge Rakoff, the Second Circuit could have rested its decision on the unique provisions of SIPA giving special powers to trustees liquidating brokerage firms. Instead, Judge Wesley found the result entirely within the four corners of the Bankruptcy Code, meaning that the decision is equally applicable to ordinary bankruptcies, not merely brokerage liquidations under SIPA.

Judge Wesley agreed with Judge Rakoff about the presumption against extraterritoriality, saying that the lawsuits could go ahead "if either the statute indicates its extraterritorial reach or the case involves a domestic application of the statute." From there on, however, Judge Wesley knocked the props out from under Judge Rakoff's theories.

Extraterritoriality

Following Supreme Court authority, Judge Wesley said the court looks to the statute's "focus" to decide "whether a case involves a domestic application of that statute."

Where the district court focused on Section 550, Judge Wesley said the proper focus was Section 548, because Section 550 merely provides a remedy for a fraudulent transfer.

Judge Wesley said the harm to the estate resulted from the initial transfer, which was made in the U.S. He said that Section 550 is a "utility provision" helping to execute the policy in Section 548. Paraphrasing the Supreme Court, he said that Section 550 is merely the means by which the statute achieves its ends of "regulating and remedying the fraudulent transfer of property."

Judge Wesley thus held that a fraudulent transfer emanating from the U.S. "is a domestic activity for the purposes of Sections 548(a)(1)(A) and 550(a)." Consequently, "the presumption against extraterritoriality therefore does not prohibit the debtor's trustee from recovering, . . . regardless of where any initial or subsequent transferee is located." Mimicking the Supreme Court's terminology, he said the "relevant conduct in these actions is the debtor's fraudulent *transfer* of property, not the transferee's *receipt* of property." [Emphasis in original.]

Comity

Having decided that the presumption against extraterritoriality did not bar the lawsuits, Judge Wesley next dealt with international comity as grounds for dismissal. His opinion is a ringing

endorsement of a trustee's ability to chase defendants around the world when the fraudulent transfer initiated in the U.S.

Comity, Judge Wesley said, comes into play only when there is a "true conflict" between American law and that of a foreign jurisdiction. Assuming without deciding that there was such a conflict, he said that the U.S. nevertheless "has a compelling interest in allowing domestic estates to recover fraudulently transferred property."

There would be a better argument for comity were Madoff also in liquidation abroad. The absence of any parallel Madoff proceeding abroad "seriously diminishes the interest of any foreign state in our resolution of the Trustee's claims," Judge Wesley said. Even where the initial recipient of the fraudulent transfer is in liquidation abroad, he said, the foreign "interests are not compelling."

Even if the foreign liquidators were trying to recover the same funds from the same subsequent recipients, Judge Wesley said "those are not comity concerns," nor are they "compelling enough to limit the reach of a federal statute that would otherwise apply here."

Judge Wesley saw no reason to believe that "Congress would have decided that trustees looking to recover property in domestic proceedings are out of luck when trustees in foreign proceedings may be interested in recovering the same property." Indeed, he saw the "opposite": "Congress wanted the claims resolved in the U.S., rather than through piecemeal proceedings around the world."

Judge Wesley said the district court erroneously focused on the subsequent transfer. He held that "[p]roscriptive comity poses no bar to recovery when the trustee of a domestic debtor uses Section 550(a) to recover property from a foreign subsequent transferee on the theory that the debtor's initial transfer of that property from within the U.S. is avoidable under Section 548(a)(1)(A)."

Judge Wesley ended by debunking the district court's theory that the feeder fund investors had no reason to believe that U.S. law would apply to their relationship with the offshore feeder funds. "When these investors chose to buy into feeder funds that placed all or substantially all of their assets with Madoff Securities," he said, "they knew where their money was going."

An Important Footnote and an Omission

The conclusion on extraterritoriality was based on two factors: The Madoff firm was a domestic entity, and the fraud occurred when Madoff transferred funds from a U.S. bank account.

In a footnote, Judge Wesley expressed "no opinion on whether either factor standing alone would support a finding that a transfer was domestic." Thus, the Second Circuit left the door open

for the trustee of a domestic corporation to pursue a fraudulent transfer made from a bank account abroad.

Judge Rakoff found significance in *FDIC v. Hirsch (In re Colonial Realty)*, 980 F.2d 125 (2d Cir. 1992), where the Second Circuit said that fraudulently transferred property is not estate property until it has been recovered. The Second Circuit's *Madoff* opinion did not mention *Colonial Realty*, implying that the pursuit of estate property is not a necessary factor to overcome the presumption against extraterritoriality involving a fraudulent transfer emanating from the U.S.

The opinion is *In re Picard, Trustee for the Liquidation of Bernard L. Madoff Investment Securities LLC*, 917 F.3d 85 (2d Cir. Feb. 25, 2019).

Long Island's Judge Grossman follows the Third Circuit by finding limitations on the* Rooker-Feldman *doctrine.

Trustee Allowed to Sue for Fraudulent Transfer on an Unenforceable Contract

Even if a contract is unenforceable under state law, a bankruptcy trustee still has the ability to recover the value provided by the debtor as a constructive fraudulent transfer, according to Bankruptcy Judge Robert E. Grossman of Central Islip, N.Y.

The corporate debtor had a contract with a municipality to build sidewalks and curbs for the city. To be enforceable under state and municipal law, the original contract had been subjected to competitive bidding and was approved by the town board.

About two weeks after the original contract expired, the debtor agreed to build more sidewalks and curbs for a price of about $450,000. Once the new job was completed and the time for payment arrived, the city refused to pay, citing state law and the lack of approval of the new agreement by the town board. According to the city, the local laws are designed to prevent corruption and favoritism.

Before bankruptcy, the debtor sued in state court, seeking a money judgment for the $450,000 called for in the new agreement. Before the suit was resolved, the debtor filed a chapter 11 petition and removed the action to bankruptcy court. The bankruptcy court granted the city's motion for mandatory abstention, returning the suit to state court.

Back in state court, the judge granted the city's motion to dismiss because the agreement was unenforceable under local and state law. The state judge said that the public interest in preventing collusion precluded the debtor from enforcing the contract.

Meanwhile, the chapter 11 case had been converted to chapter 7, and a trustee was appointed. The trustee commenced an adversary proceeding in bankruptcy court against the town under Section 544, seeking the same $450,000 and alleging that the debtor's uncompensated work was a constructive fraudulent transfer under the New York Debtor & Creditor Law. (The transfers occurred more than two years before filing, preventing the trustee from suing under Section 548. Thus, the trustee used his status as a creditor under Section 544 to sue under state fraudulent transfer law.)

The city filed a motion to dismiss the adversary proceeding, contending that the state's interest in preventing corruption and collusion was superior to the right of a trustee to recover avoidable

transfers under Section 544. The city also contended that the *Rooker-Feldman* doctrine was the death knell of the suit in bankruptcy court.

On several grounds — including federal preemption and the inapplicability of *Rooker-Feldman* — Judge Grossman denied the motion to dismiss in an opinion on July 10.

Preemption

The city argued that Congress did not intend for trustees to violate state law by relying on the Bankruptcy Code. Judge Grossman countered by saying that the suit would not compel the city to violate state law. Rather, he said that the suit was designed to recover property for which the city gave no consideration.

Judge Grossman then ruled that the Bankruptcy and Supremacy Clauses in the U.S. Constitution meant that the Bankruptcy Code and Section 544 preempted state law under the rubric of "conflict preemption." He said that "the interests protected by these state laws must be subservient to [the avoidance powers in Section 544], which promote the objectives of protecting a debtor's creditors from harm as a result of transfers made by a debtor for less than fair consideration."

He went on to say that "the public's health and safety is not at risk if the Trustee is permitted to recover the value of the materials and labor provided to the town" under Section 544 and New York's fraudulent transfer law.

Rooker-Feldman

Next, the city argued that the trustee's suit should be dismissed for lack of jurisdiction under the *Rooker-Feldman* doctrine. Named for two Supreme Court decisions, *Rooker-Feldman* stands for the proposition that federal courts lack subject matter jurisdiction to review judgments by state courts. It means that a plaintiff cannot appeal a state court judgment in federal court.

Judge Grossman rejected the *Rooker-Feldman* argument, wrapping himself in the flag sewn last year by the Third Circuit in *In re Philadelphia Entertainment & Development Partners*, 879 F.3d 492 (3d Cir. 2018). To read ABI's report on *Philadelphia Entertainment*, click here.

For starters, Judge Grossman said that *Rooker-Feldman* might not even apply because courts "routinely" hold that the doctrine is not relevant when the Bankruptcy Code is modifying or avoiding a state court judgment under Sections 544 or 548.

Even if it were applicable, Judge Grossman explained why *Rooker-Feldman* did not kick in: The bankruptcy court would not be disturbing the findings by the state court. Citing *Philadelphia*

Entertainment, he said that the "trustee was not inviting review and rejection" of the ruling in state court.

Instead, the trustee is seeking "recovery for the materials and labor provided by the Debtor without the benefit of a contract."

Issue and Claim Preclusion

Next, Judge Grossman dismissed the city's contentions based on issue and claim preclusion, which he referred to as collateral estoppel and *res judicata*.

Judge Grossman "easily rejected" collateral estoppel because the Section 544 claim could not have been asserted in state court. Moreover, the state court did not consider the "identical issue" of dealing with fraudulent transfer law and the trustee's right to sue under Section 544.

Likewise, *res judicata* did not apply, because the lawsuit in state court was not between the same parties and did not entail the same causes of action. Even if the trustee were in privity with creditors whose claims he was asserting under Section 544, the suit in state court did not concern fraudulent transfer claims.

Substantive Law

The city contended that New York law on fraudulent transfer does not allow recovery for personal services.

Because the debtor was a corporation, Judge Grossman said the suit sought to recover for materials and labor provided by third parties, not personal services.

Judge Grossman denied the motion to dismiss. The gist of the opinion implies that the city will have few defenses when there is a trial on the merits of the fraudulent transfer claim. Because the trustee is not suing under contract, the trial may boil down to a dispute about damages.

Observation: A mediated settlement would be a good idea, unless the city is intent on taking federal preemption and *Rooker-Feldman* to the Second Circuit.

The opinion is *Pryor v. Town of Smithtown (In re Jadeco Construction Corp.)*, 18-08013, 2019 Bankr Lexis 2076 (Bankr. E.D.N.Y. July 10, 2019.)

Executory Contracts & Leases

Fifth Circuit leaves the door open to preventing automatic rejection if the existence of an executory contract is intentionally undisclosed.

Executory Contracts Are Automatically Rejected Even if Unscheduled, Fifth Circuit Holds

On a topic where there is scant appellate authority, the Fifth Circuit held that a trustee cannot assume and assign an executory contract after the deadline for assumption has passed, even if the contract had not been scheduled and was unknown to the trustee.

The case involved a corporate debtor who knew it owned a patent license but failed to list the license in its schedules. However, there was no effort to conceal the license, Circuit Judge Patrick E. Higginbotham said in his October 29 opinion.

After the case converted from chapter 11 to chapter 7, the trustee sold all of the estate's property. The sale occurred more than 60 days after conversion. Section 365(d)(1) provides in effect that an executory contract not assumed within 60 days of conversion "is deemed rejected."

The sale agreement transferred all of the debtor's property and listed the assets by category. Although the license fell within a category of transferred property, the license was not specifically listed because the trustee was unaware of the existence of the license. The sale-approval order provided that all executory contracts were assumed and assigned to the purchaser.

A year after the sale, a lawsuit ended up in bankruptcy court where the licensor of the patent license contended that the license was rejected and had not been sold to the purchaser. The bankruptcy judge agreed with the licensor and held that the license had been rejected automatically and could not have been sold. The district court agreed.

The Fifth Circuit affirmed, first holding that the license was an executory contract because material, reciprocal obligations remained outstanding on both sides. The erstwhile purchaser argued that there is an implicit exception to automatic rejection under Section 365(d)(1) when an executory contract is not scheduled and the trustee is unaware of the existence of the asset.

With one exception, there is no authority at the circuit level about exceptions to automatic rejection. In the lower courts, Judge Higginbotham said there is "sparse authority" and "no clear consensus." He said some lower courts hold that a contract is not deemed rejected if the debtor has intentionally concealed the existence of the asset. That was not the state of facts in the case on appeal, he said.

When there has been no intentional concealment, Judge Higginbotham said that "some courts" have held that failure to schedule a contract does not prevent its automatic rejection. However, he cited a district court for holding that failure to schedule a contract tolls the deadline for assumption.

Judge Higginbotham followed a 1985 Ninth Circuit opinion decided under the former Bankruptcy Act: *Cheadle v. Appleatchee Riders Association* (*In re Lovitt*), 757 F.2d 1035 (9th Cir. 1985).

In *Cheadle*, the Ninth Circuit said that a trustee has an affirmative duty to investigate for unscheduled assets. Therefore, the appeals court found a conclusive presumption that unscheduled contracts are rejected in 60 days.

Because the Bankruptcy Code likewise imposes a duty on a trustee to investigate the debtor's affairs, Judge Higginbotham decided that the reasoning of *Cheadle* "still applies." "More to the point," he said, Section 365(d)(1) "does not impose an actual or constructive notice requirement for when the sixty-day deadline applies." He declined to "read such a requirement into the statute."

"At a minimum," Judge Higginbotham therefore held that "the statutory presumption of rejection after sixty days is conclusive where there is no suggestion that the debtor intentionally concealed a contract from the estate's trustee."

The purchaser argued that setting aside the sale amounted to a collateral attack on the sale-approval order.

On rejection, Judge Higginbotham said, the license ceased to be property of the estate, and there was nothing in the purchase contract or sale-approval order to suggest that the trustee was selling anything other than estate property. Therefore, the decision by the bankruptcy court was not a collateral attack on the prior sale-approval order but was "merely an interpretation of the bankruptcy court's orders."

The opinion is *RPD Holdings LLC v. Tech Pharmacy Services (In re Provider Meds LLC)*, 17-11113 (5th Cir. Oct. 29, 2018).

Sales

Operations must continue for a debtor to invoke Section 1114 in a chapter 11 liquidation, Eleventh Circuit says.

Eleventh Circuit Allows Termination of Retiree Benefits in a Chapter 11 Liquidation

The Eleventh Circuit broadly interpreted the words "maintain" and "reorganization" in Section 1114 to ensure that companies of all types, including coal producers, can terminate retiree health benefits, even if the company sells its assets under Section 363 and converts from chapter 11 to chapter 7.

The appeals court added a caveat: To terminate or modify retiree benefits following a sale of assets in chapter 11, the business must continue to operate.

The decision means that a liquidation in chapter 11 allows the buyer to compel the rejection of union contracts and the termination of retiree health benefits. Prof. Richard Squire, the Alpin J. Cameron Chair in Law at Fordham University School of Law, told ABI that the "decision . . . is both logically sound and consistent with the purpose of chapter 11, which is to rehabilitate insolvent yet commercially viable businesses."

In his message to ABI, Prof. Squire said that the Eleventh Circuit "decided that the essence of the statutory term 'reorganization' is the continued operation of the business, regardless of whether its ownership changes through a sale (a liquidation) or a debt-for-equity exchange pursuant to a negotiated plan (a traditional reorganization)."

The Sale in Chapter 11

The appeal arose in the attempted reorganization of coal producer Walter Energy Inc. The company sold its major assets to the senior secured lenders in a so-called credit bid for $1.15 billion. The buyers also assumed $115 million in liabilities, funded wind-down trusts and supplied some cash.

Alongside the sale under Section 363, the debtor sought authority to terminate collective bargaining agreements under Section 1113 and health care benefits to retirees under Section 1114. The purchaser said it would only buy the assets, continue some of the business and preserve some jobs if it were not bound by union contracts and if the bankruptcy court cut off obligations related to retiree health benefits.

The union and retiree health insurance funds opposed, but Bankruptcy Judge Tamara O. Mitchell of Birmingham, Ala., approved the sale. She also rejected labor contracts and ruled under

Section 1114 that the buyer would not be liable for retiree health costs. As a result, the federal government became liable for retiree health costs under the 1992 federal Coal Act.

The district court upheld the sale and the termination of the buyer's statutory obligation to pay retiree health benefits under the Coal Act. The health insurance funds appealed to the Eleventh Circuit. While the appeal was pending, the company converted the case to chapter 7.

The Eleventh Circuit Opinion

The 74-page opinion on December 27 by Circuit Judge Jill Pryor contains a detailed history of the succession of federal legislation culminating in the 1992 Coal Act. She explained how the law converted a contractual obligation to provide retiree health benefits into a statutory obligation. The Coal Act also made successors and purchasers liable to pay retiree health benefits.

Judge Pryor said the case raised "very important and complex issues," requiring a "nuanced analysis" of Section 1114 and the Coal Act. Turning the issues on appeal, she began with a lengthy analysis of the federal Anti-Injunction Act, which deprives a court of jurisdiction to enjoin the collection of a tax.

The Anti-Injunction Act

The health care funds argued that health care costs were taxes on the coal companies that the bankruptcy court had no jurisdiction to cut off. Judge Pryor wrote a detailed analysis of Supreme Court cases where the high court seems to have developed flexible, results-oriented standards for deciding whether an exaction is or is not a tax for the purpose of the Anti-Injunction Act.

Suffice it to say, Judge Pryor concluded after long analysis that the obligation to pay retiree health benefits is not a tax, thus giving the bankruptcy court jurisdiction to invoke Section 1114.

The Meaning of the Word "Maintained"

In Section 1114(a), "retiree benefits" means payments to provide medical care under a program "maintained" by the debtor before bankruptcy. The health care funds argued that the obligation to pay for health care did not fall within the definition of "retiree benefits" because the obligation was imposed by statute, not "maintained" by the debtor.

Although she said it was a "close question," Judge Pryor again concluded, after lengthy analysis, that the debtor "maintained" the health care programs because predecessors had agreed to provide health insurance in prior collective bargaining agreements.

The Statutory Mandate

From several angles of attack, the health care funds contended that the adoption of the Coal Act, four years after the enactment of Section 1114, precluded the bankruptcy court from overriding the Coat Act's statutory mandate that successors continue providing retiree health benefits.

Judge Pryor found "nothing" in the Coal Act "indicating that Congress intended to bar bankruptcy courts from exercising authority under Section 1114 to modify or terminate a coal company's obligation under the Coal Act to pay premiums to the Funds." She buttressed her conclusion by the notion that "repeal or amendment by implication is 'not favored' . . . ."

Judge Pryor found "no clear and manifest indication that Congress intended the Coal Act, the later statute, to limit the scope of Section 1114." She also ruled that Section 1114 remains viable in the coal context because a court must construe both statutes to be effective, "rather than construing the Coal Act as implicitly amending and narrowing the definition of retiree benefits in Section 1114."

Necessary for Reorganization

Section 1114(g)(3) allows the bankruptcy court to modify or terminate retiree benefits after finding, among other things, that the relief is "necessary to permit the reorganization of the debtor."

The health care funds argued that the debtor could not employ Section 1114 because the asset sale was not a "reorganization."

Judge Pryor rejected the argument, holding that "reorganization" refers "to all types of debt adjustment under chapter 11, including a sale of assets on a going-concern basis."

Although an asset sale in chapter 11 under Section 363 is sometimes colloquially referred to as a liquidation, Judge Pryor said the "transaction is different in kind from a chapter 7 liquidation." In chapter 7, she said, the trustee typically shuts down the business and sells the assets piecemeal.

In chapter 11, on the other hand, she said that the assets are liquidated, "but not in the sense that its business is shut down," quoting Prof. Squire.

Under Section 1114(g)(3), Judge Pryor then turned to the question of whether termination of retiree benefits was "necessary to permit the reorganization of the debtor" when the company was selling its assets from the outset. She framed the question as whether "reorganization" in the subsection "refers only to classic reorganizations or more broadly to any proceeding under chapter 11."

Putting some limits on Section 1114, Judge Pryor said that in a "reorganization, at a minimum, the business concern must continue to operate." A chapter 11 liquidation, she said, "could qualify" where the debtor sells substantially all of its assets as a going concern, "because the debtor's business continues operating as a going concern, albeit under new ownership."

Judge Pryor said that other courts considering the same issue in chapter 11 liquidations have permitted the debtors to modify retiree health care benefits.

Judge Pryor said that the judges on the circuit panel made the decision "not as policy makers . . . . If changes in these laws are desirable from a policy standpoint, it is up to Congress to make them."

The opinion is *United Mine Workers of America Combined Benefit Fund v. Toffel (In re Walter Energy Inc.)*, 16-13483 (11th Cir. Dec. 27, 2018).

U.S. Trustee rebuffed in subjecting liquidators to retention as 'professionals' under Section 327.

Liquidators Conducting GOB Sales Are Not 'Professionals' Covered by Section 327

A liquidator conducting store-closing sales for a retailer is not a "professional" whose employment is governed by Section 327, according to Bankruptcy Judge Brendan Linehan Shannon of Delaware.

In the reorganization of Brookstone Holdings Corp., the debtor signed a contract one day before the chapter 11 filing for a liquidator to conduct going-out-of-business sales, or GOB sales, at the company's 102 mall-based stores. The debtor intends to reorganize around its 35 airport locations and its internet business.

Immediately after filing, the debtor filed a motion to authorize the GOB sales and assume the prepetition contract with the liquidator.

In his October 1 opinion, Judge Shannon said there had been a "well-developed practice in this and other courts" to authorize the retention of liquidators to conduct GOB sales by the assumption of prepetition contracts. Recently, however, he said the U.S. Trustee had begun objecting and contending that liquidators are "professionals" who must be retained under Section 327.

Disclosure of potential conflicts of interest was not the issue, however, because the liquidator in the Brookstone case had filed an extensive list of connections with the debtor and other parties. Applying Section 327 was significant because being a "professional" might later preclude the liquidator from providing other necessary functions for the debtor, such as purchasing assets or making loans.

Subjecting liquidators to the structures of Section 327, Judge Shannon said, "would have a significant and detrimental impact . . . in most retail chapter 11 cases by severely limiting the type of work and service [liquidators] could perform."

Section 327(a), entitled "Employment of professional persons," requires court approval to engage "attorneys, accountants, appraisers, auctioneers, or other professional persons."

Judge Shannon said the liquidator was not an "auctioneer" because the firm was selling inventory and fixtures in an ordinary retail setting at fixed prices, not at auction.

Next, the U.S. Trustee argued that the liquidator fell within the rubric of "other professional persons."

Judge Shannon was not writing on a clean slate. In Delaware, he had guidance from *In re First Merchants Acceptance Corp.*, 1997 WL 873551 (D. Del. Dec. 15, 1997), where the district court developed a six-factor test focusing on the amount of independence exercised by the service provider and the nexus between those services and the reorganization.

The first factor focuses on whether the liquidator sells assets "significant" to the reorganization. "At first blush," Judge Shannon said the asset sales were significant. On further analysis, he noted that the debtor retains control of all aspects of the GOB sales, including pricing strategy and duration of the sales. Consequently, the liquidator neither controls nor manages the GOB process, he said.

The liquidator is not involved in the formulation of a reorganization plan and is not exercising discretion in the administration of the estate, two factors that also weigh against the application of Section 327.

However, the scales did tip toward Section 327 because the GOB sales were not routine business operations. Instead, the sales related to the debtor's restructuring.

The sixth factor, the firm's special or knowledge or skill, is "entirely unhelpful," Judge Shannon said. "[L]iterally all business and service activities require 'specialized knowledge or skill,' . . . but so do all of the other entities providing services to the debtor, from IT support to waste management."

All factors considered, Judge Shannon concluded that the liquidator was not in the category of "other professionals" and was thus not subject to retention under Section 327.

In similar or analogous circumstances, a court might consider whether the alleged "professional" must have obtained specialized education and licensing, like accountants, lawyers, or appraisers. However, a mortician must be specially educated and licensed, but his or her engagement by a bankrupt funeral home would not seem to invoke Section 327.

The opinion is *In re Brookstone Holdings Corp.*, 592 B.R. 27 (Bankr. D. Del. Oct. 1, 2018).

Estate Property

As his parting shot, Judge Carey requires turnover of almost everything in the files of professionals for an independent audit committee.

The Debtor or Trustee Control the Privileges of an Independent Audit Committee

Writing what may be his last opinion, Bankruptcy Judge Kevin J. Carey of Delaware parsed a split of authority before concluding that a liquidating trustee may compel counsel for an independent audit committee to turn over almost all of its files.

Judge Carey is stepping down from the bench on August 31 after 19 years of service as a bankruptcy judge. He was a bankruptcy judge in Philadelphia for five years before transferring his flag to Delaware.

The Audit Committee's Investigation

Before bankruptcy, the debtor corporation formed an independent audit committee that hired a law firm and forensic accountants. The committee was tasked with investigating senior management's financial reporting. Later, the company filed a chapter 11 petition when the inability to produce audited financial statements caused a default on secured credit facilities.

Before bankruptcy, shareholders commenced a class action lawsuit alleging the issuance of false or misleading financial statements. The audit committee's professionals presented their conclusions to the debtor and the Securities and Exchange Commission several months into the chapter 11 case. The debtor paid the audit committee's professionals $6.3 million for their work.

The company confirmed a liquidating chapter 11 plan that conveyed all of the debtor's claims and rights of action to a liquidating trust. The liquidating trustee demanded that the audit committee's professionals turn over their files. The law firm declined to turn over documents that it claimed to be covered by the attorney/client and work-product privileges.

The Split of Authority

In his June 20 opinion, Judge Carey began the analysis with *C.F.T.C. v. Weintraub*, 471 U.S. 343, 105 S. Ct. 1986 (1985), where the Supreme Court held that a corporation's bankruptcy trustee has the power to waive the corporation's attorney/client privilege. He explained why the high court "determined that the trustee's control of the corporate debtor's attorney-client privilege would be consistent with the policies of the bankruptcy laws." Were it otherwise, a trustee could not carry out the duty of investigation if former management controlled the privilege.

However, the law firm contended that the audit committee was a separate, independent body with its own privileges to which the trustee did not succeed.

There is a split of authority among district judges in the Southern District of New York, Judge Carey said. The more recent case allowed a trustee to recover privileged documents from an audit committee, while an earlier case did not.

Judge Carey adopted the reasoning of the more recent Southern District case, saying that "it is appropriate to extend the Supreme Court's analysis in *Weintraub* and recognize that the trustee appointed as the representative of a corporate debtor controls the privileges belonging to the independent committee established by the corporate debtor."

The analysis was not over. Did the transfer of the privileges extend to the work-product privilege, not just the attorney/client privilege?

Judge Carey followed a third decision from the Southern District of New York holding that a firm may not invoke the work-product doctrine to withhold documents from a client or former client, given that the client paid for the creation of the materials.

But wait, there's more! Judge Carey cited the Delaware Chancery Court for pointing out a split of authority about a firm's duty to release files to a client or former client. The majority require production of the entire file, while the minority require the lawyer to produce only the end product.

Judge Carey decided to follow the Delaware Chancery Court's policy of requiring the production of everything, subject to limited exceptions for documents intended for internal law office review and use.

Judge Carey therefore directed the audit committee's counsel to turn over everything "except for those items that are firm documents intended for internal law office review and use." He only allowed the firm to withhold documents with "counsel's mental impressions." He required the firm to turn over draft legal and factual memoranda, even if they were only circulated within the firm. He also required counsel to turn over communications between the lawyers and individual audit committee members.

The opinion is *In re Old BPSUSH Inc.*, 16-12373, 2019 BL 231071, 2019 Bankr Lexis 1867 (Bankr. D. Del. June 20, 2019).

In a large 'prepack,' the debtor was required to spend $80,000 a month for its depository bank to obtain a bond required by Section 345(b).

New York Judge Refuses to Waive Collateralization for Debtors' Bank Accounts

A large company in chapter 11 must ensure that its depository banks comply with Section 345(b), even if it means the bank charges the debtor $80,000 a month for providing a bond to collateralize the deposits, according to Bankruptcy Judge James L. Garrity, Jr. of New York.

The debtors constituted a major mortgage originator and servicer that filed a prepackaged chapter 11 petition in February intended for confirmation in August. The debtors' operations utilized more than 1,000 bank accounts, including over 500 accounts at Citibank N.A. with aggregate daily balances of some $95 million.

Section 345(b) requires debtors to maintain their accounts at authorized depositories that are required to maintain collateral at the U.S. Treasury amounting to 115% of aggregate bankruptcy funds on deposit in excess of FDIC insurance limits. Or, the bank can obtain a surety bond.

Although Citibank is an authorized depository, the debtors discovered that the bank had not collateralized its accounts as required by Section 345(b). After negotiations, Citibank agreed to obtain a bond, at a monthly cost to the debtors of $80,000.

The debtors nonetheless filed a motion asking Judge Garrity to waive the requirement that the bank post security. In an opinion on June 24, Judge Garrity declined to grant the waiver and stuck the debtors with the $80,000 monthly cost.

Judge Garrity explained that Congress amended Section 345(b) in 1994 by allowing the court to waive the security requirement "for cause." He analyzed *In re Service Merchandise Co., Inc*., 240 B.R. 894 (Bankr. M.D. Tenn. 1999), where the court found cause for waiving the collateral requirement based on 10 factors.

Without adopting *Service Merchandise*, Judge Garrity evaluated the facts before him that weighed in favor of a waiver. Among other factors, moving the accounts to another bank would take nine months and cost $500,000. The U.S. Trustee conceded that the risk of loss was "minimal" because Citibank enjoyed a long-term deposit rating by Standard & Poor of A+.

On the other hand, Citibank was giving the debtors a "favorable" interest rate of 2.6% on its deposits. Judge Garrity estimated that the $80,000 monthly fee would be a "small fraction" of earnings on interest.

Evaluating the factors for and against granting a waiver, Judge Garrity concluded "on balance" that the debtors "failed to establish 'cause' to excuse them from collateralizing the Citibank Accounts, as required by Section 345(b) of the Bankruptcy Code." Providing a bond, he said, "clearly ensures the safety of the funds on deposit . . . and, under the facts of this case, the payment of a monthly fee to do so, does not 'handcuff' the Debtors."

The opinion is *In re Ditech Holding Corp.*, 19-10412, 2019 BL 235032, 2019 Bankr Lexis 1892 (Bankr. S.D.N.Y. June 24, 2019).

Like physics, bankruptcy searches for a unified theory to explain claims by and against the estate.

Different Rules Govern When Claims Accrue By or Against an Estate

Recently, courts have been holding that the accrual of claims by and against an estate are not governed by the same rules. An appeal on the way to the Sixth Circuit will perhaps give some clarity to the issue.

Frenville

To determine whether a claim accrued before bankruptcy and was therefore discharged, there is no longer a circuit split.

In *Avellino & Bienes v. M. Frenville Co. (In re M. Frenville Co.)*, 744 F.2d 332 (3d Cir. 1984), the Third Circuit had held that a claim was not discharged in bankruptcy if it had not arisen *under state law* before bankruptcy. Third Circuit sat *en banc* in 2010, overruled *Frenville* and sided with seven other circuits. *See Jeld-Wen Inc. v. Van Brunt (In re Grossman's Inc.)*, 607 F.3d 114 (3d Cir. 2010).

In *Grossman's*, the Third Circuit held that an asbestos claim is presumptively discharged if exposure occurred before bankruptcy, even though injury was not manifest until years later. The *en banc* court reasoned that *Frenville* was contrary to the broad definition given to the word "claim" in the Bankruptcy Code.

When the tables are turned, the rules recently are different in deciding whether a claim belongs to the estate or to the debtor. In those cases, the result has turned on whether the claim by the debtor accrued *under state law* before or after filing. In other words, the discredited *Frenville* concept still holds water in deciding whether a claim is property of the estate.

Legal Malpractice Claims

In April, we reported *Church Joint Venture LP v. Blasingame (In re Blasingame)*, 598 B.R. 864 (B.A.P. 6th Cir. April 5, 2019). There, the Bankruptcy Appellate Panel for the Sixth Circuit held that a legal malpractice claim leading to the loss of the debtors' discharges belonged to the debtors, not to the estate.

Because there was no pre-petition injury, the BAP held that "the malpractice cause of action arose post-petition and is not property of the bankruptcy estate." The case is on appeal to the Sixth

Circuit. *Church Joint Venture LP v. Blasingame (In re Blasingame)*, 19-5505 (6th Cir.). To read ABI's discussion of the BAP's *Blasingame* opinion, click here.

In June, Bankruptcy Judge Elizabeth D. Katz of Worcester, Mass., dealt with a case where the debtor's pre-bankruptcy attorney advised his client to make a transfer of valuable property before filing. The attorney advised the client that the transfer might be attacked as a fraudulent transfer.

That's exactly what happened. The chapter 7 trustee sued the transferees to set aside the pre-bankruptcy transfer. The trustee also sued the debtor's pre-bankruptcy counsel, contending that the advice was malpractice.

In her June 28 opinion, Judge Katz held that the legal malpractice claim belonged to the debtor, not to the trustee. She therefore dismissed the malpractice suit in bankruptcy court for lack of jurisdiction.

Judge Katz held that the "plain language" of Section 541(a) required dismissal, because the claim did not arise under state law until after bankruptcy when the debtor suffered injury. Knowledge of potential injury before bankruptcy was "not dispositive," she said.

The opinion by Judge Katz raises a question: Did *Segal v. Rochelle*, 382 U.S. 375 (1966), decided under the former Bankruptcy Act, survive adoption of the Bankruptcy Code? *Segal* held that a claim by the debtor belonged to the estate if it was "sufficiently rooted in the prebankruptcy past."

Judge Katz followed Thomas L. Perkins of Peoria, Ill., who held in May that *Segal* no longer determines whether an asset is estate property. The two judges are of the view that property of the estate is governed by state law, following *Butner v. U.S.,* 440 U.S. 48 (1979), which, by the way, was also decided under the former Bankruptcy Act.

Judge Perkins' opinion is *In re Brown*, 18-81242, 2019 BL 168813 (Bankr. C.D. Ill. May 9, 2019). *Brown* was not appealed. To read ABI's discussion of *Brown*, click here.

The Search for a Unified Theory

The concept of the accrual of property interests is evidently different when dealing with claims by the estate, as opposed to claims against the estate. The difference makes sense in terms of viewing the Bankruptcy Code as a statute primarily for debtor relief.

Grossman's ensures that more, not fewer, claims will be discharged. Decisions like those by Judges Katz and Perkins let debtors keep more intangible property. The decisions by those two judges make even more sense when the debtors have malpractice claims.

In the case of malpractice leading to the loss of discharge, debtors would suffer twice if malpractice claims belong to the trustee. The debtors will have lost their discharges and also find themselves without a suit against the lawyer who caused the damage in the first place.

So, the diverging rules make sense when the debtors are individuals. But what if the debtor is a corporation?

Assume that a chapter 7 corporate debtor has a claim that will not accrue under state law until after filing. If accrual is the only test, then the chapter 7 trustee will be unable to pursue the claim on behalf of creditors. Instead, the claim will remain property of the corporate debtor.

But the corporate debtor in chapter 7 does not receive a discharge.

So, what happens with a corporate chapter 7 debtor? Will shareholders pursue the claim and hope the trustee and creditors never find out? Will the target of the late-accruing claim escape liability? Can a creditor pursue the claim? Can the chapter 7 trustee somehow use strong-arm powers to lay claim to the lawsuit?

Perhaps *Segal* and *Frenville* reflect a policy that answers this hypothetical question. In the case of a corporate debtor, maybe the claim is sufficiently rooted in the prebankruptcy past so that the trustee could bring the claim on behalf of all creditors. Perhaps the rules are the same for claims by and against a corporate debtor in chapter 7. But does it make sense if the results are different for corporate chapter 7 debtors than for individual debtors?

If any of our readers have answers to these questions, please pass them along. We are flummoxed.

The opinion is *White v. Gaffney (In re Lloyd)*, 18-4027, 2019 Bankr Lexis 1982 (Bankr. D. Mass. June 28, 2019).

Jurisdiction & Power

Fifth Circuit rejects the 'recodification canon' to divest bankruptcy courts of jurisdiction over Social Security suits.

Circuits Split on Bankruptcy Jurisdiction for Social Security, Medicare Suits

Deepening an existing split of circuits, the Fifth Circuit held that the recodification canon does not divest the bankruptcy court of subject matter jurisdiction to hear Social Security claims.

In a revised opinion on July 25 by Circuit Judge Edith Brown Clement, the Fifth Circuit joined the Ninth Circuit. On the other side of the fence, the Third, Seventh, Eighth and Eleventh Circuits held there is no bankruptcy or diversity jurisdiction over Social Security claims.

The issue is important because the same jurisdictional question looms over Medicare and Medicaid claims. As a result of the Eleventh Circuit's opinion in *Florida Agency for Health Care Administration v. Bayou Shores SNF LLC (In re Bayou Shores SNF LLC)*, 828 F.3d 1297 (11th Cir. July 11, 2016), the bankruptcy court, for example, lacks jurisdiction to force the government to continue funding a hospital or nursing facility that files a chapter 11 petition. To read ABI's report on *Bayou Shores*, click here.

It remains to be seen whether judges following the Fifth Circuit will conclude that the bankruptcy court has jurisdiction to force the government into funding hospitals and nursing homes in chapter 11.

The Fifth Circuit Case

A debtor allegedly received an overpayment of Social Security benefits. According to the debtor, the Social Security Administration, or SSA, was improperly withholding a portion of his Social Security benefits to recover the overpayment.

Before bankruptcy, the debtor appealed to an administrative law judge from the agency's denial of a refund. The appeal was pending when the debtor filed a chapter 7 petition.

In bankruptcy court, the debtor sued the SSA to recover the benefits. The bankruptcy court granted the SSA's motion to dismiss and was upheld in district court on jurisdictional grounds.

The debtor appealed to the Fifth Circuit and won a reversal reinstating the suit in bankruptcy court. The debtor was represented in the circuit by Prof. John A. E. Pottow, the John Philip Dawson Collegiate Professor of Law at the University of Michigan Law School.

The Recodification

Section 405(h) of Title 42 provides that no one may sue the government "under section 1331 or 1346 of Title 28 to recover on any claim arising under" the Social Security, Medicare or Medicaid laws until there is an exhaustion of remedies in the agency. Because jurisdiction in the bankruptcy court was based on Section 1334 — not Sections 1331 or 1346 — the plain language of the statute would seem to allow the suit in bankruptcy court. But it's not so simple.

From 1939 to 1984, bankruptcy courts lacked jurisdiction over SSA claims because Section 405(h), as adopted in 1939, deprived federal courts of jurisdiction "under section 26 of the Judicial Code." At the time, Section 26 contained virtually all of the grants of jurisdiction to federal courts, including bankruptcy and diversity jurisdiction.

In 1948, Congress recodified Section 26, establishing jurisdictional grants in Section 1331 for federal questions, Section 1332 for diversity, Section 1346 for suits against the government, and Section 1334 for bankruptcy. However, Congress did not get around to correcting Section 405(h) until 1984. In the intervening years, Section 405(h) continued referring to "section 26 of the Judicial Code" and was interpreted to mean there was no bankruptcy or diversity jurisdiction over Social Security, Medicare and Medicaid disputes.

Congress eventually recodified Section 405(h) in a technical corrections bill in 1984, resulting in the statute as it now reads, depriving federal courts of jurisdiction over Social Security, Medicare and Medicaid disputes under Sections 1331 and 1346. Pointedly, the recodification did not list Section 1334, the grant of bankruptcy jurisdiction, or 1332, for diversity jurisdiction.

The legislative history said that the bill was intended only to correct "technical errors." The bill itself contained a provision saying that none of the amendments "shall be construed as changing or affecting any right, liability, status, or interpretation which existed (under the provisions of law involved) before" the amendments' effective date.

The Doctrine of Recodification Error

In the late nineteenth century, the Supreme Court pronounced the doctrine of recodification error, proclaiming that a recodification does not effect a substantive change without a clear expression of congressional intent.

The Third, Seventh, Eighth and Eleventh Circuits held that the omission of Sections 1332 and 1334 from Section 405(h) was a mistake in recodification and continued to hold that there was no bankruptcy or diversity jurisdiction.

A circuit split arose in 1991 when the Ninth Circuit handed down *In re Town & Country Home Nursing Services Inc.*, 963 F.2d 1146 (9th Cir. 1991), and held that Section 405(h) did not prohibit the exercise of bankruptcy jurisdiction.

The Fifth Circuit Heeds Justice Scalia

Writing for the Fifth Circuit, Judge Clement didn't buy the notion that there is "a hidden jurisdictional bar" resulting from a mistake in recodification. She said the doctrine only applies "in the absence of a clear indication from Congress that it intended to change the law's substance." She said that the clear indication of congressional intent is contained in the "actual words" of the statute.

Judge Clement cited *Reading Law: The Interpretation of Legal Texts*, a book by the late Justice Antonin Scalia. He said that the "new text is the law . . . even when the legislative history . . . expresses the intent to make no change."

Judge Clement interpreted Section 405(h) "to mean what it says. And it says nothing about Section 1334." Given the language of the statute, she said that the recodification canon cannot "trump the clear text."

The debtor did not win outright, however. A different sentence in Section 405(h) provides, "No findings of fact or decision of the Commissioner of Social Security shall be reviewed by any person, tribunal, or governmental agency except as" provided in Section 405(g). She went on to say that channeling into Section 405(g) "applies only where the would-be plaintiff is challenging a decision regarding his entitlement to benefits."

Judge Clement remanded for the bankruptcy court to determine whether there is jurisdiction. She said there would not be jurisdiction if the debtor's claims were "primarily about his entitlement to benefits." The bankruptcy court would have jurisdiction, she said, if the debtor was making a "claim for money because the [Social Security Administration] failed to comply with its own regulations in recouping the overpayment."

Prof. Pottow's Observations

Prof. Pottow told ABI, "This is an area of flux.

"Earlier decisions were more confident brushing away the text. We now live in a different world of statutory interpretative methodology, so the [Eleventh Circuit's *Bayou Shores* opinion] had to do much heavier lifting to combat the text, resorting gamely to something called the recodification canon.

"The Fifth Circuit has just taken the wind out of those sails, holding that properly applied, the recodification canon cannot bear such weight, and the text is the text." With regard to Medicare, he said "it's not obvious how their standard applies there."

The Modified Opinion

Judge Clement handed down her original opinion on May 10, prompting the government to file a motion for rehearing *en banc* on July 15. The rehearing motion led Judge Clement to issue her modified opinion on July 25. The new opinion did not alter the original version except with regard to the description of the issue for the bankruptcy court to decide on remand.

The government could file another petition for rehearing *en banc* or a petition for *certiorari* to the Supreme Court. ABI will report if the government takes another bite at the apple.

The revised opinion is *Benjamin v. U.S. (In re Benjamin)*, 18-20185, 2019 BL 275779 (5th Cir. May 10, 2019).

Judge Sontchi declines to rule that 28 U.S.C. § 157 is unconstitutional by denominating fraudulent transfer suits as 'core' proceedings.

Reading *Stern* Narrowly, Delaware Judge to Issue Final Order in Fraudulent Transfer Suit

Narrowly interpreting Supreme Court authority, Chief Bankruptcy Judge Christopher S. Sontchi of Delaware disagreed with the Ninth Circuit and several district courts by holding that the bankruptcy court has constitutional authority to enter a final judgment in a fraudulent transfer suit against a defendant who neither filed a claim nor consented to final adjudication in bankruptcy court.

Judge Sontchi concluded that the Supreme Court has not explicitly ruled that Sections 157(b)(1) and (b)(2)(H) are unconstitutional when applied to fraudulent transfer suits against defendants who have not filed proofs of claim. Absent high court authority, he declined to find the statute to be unconstitutional.

When thinking about Judge Sontchi's opinion, consider this question: Did he ignore an obvious implication of *Stern v. Marshall*, 564 U.S. 462 (2011)?

The Suit by the Creditors' Trust

The Paragon Offshore PLC chapter 11 plan created a trust to pursue claims on behalf of creditors. The trust filed suit after confirmation to recover allegedly fraudulent transfers that occurred before Paragon's chapter 11 filing.

The defendants filed a motion asking Judge Sontchi to declare that he could only enter proposed findings of fact and conclusions of law. Judge Sontchi denied the motion in a scholarly March 11 opinion that surveys the ups and downs (mostly downs) of bankruptcy courts' powers following *Northern Pipeline Construction Co. v. Marathon Pipe Line Co.*, 458 U.S. 50 (1982) (plurality opinion).

Judge Sontchi laid out the statutory framework, beginning with 28 U.S.C. § 157(b)(1), where Congress gave bankruptcy courts power to "hear and determine . . . all core proceedings." Section 157(b)(2)(H) lists fraudulent transfer suits among "core proceedings." Thus, the statute permits bankruptcy courts to enter final judgments in fraudulent transfer suits.

By contending that he could not issue a final judgment in a fraudulent transfer suit, Judge Sontchi said that the defendants were asking him to rule that parts of 28 U.S.C. § 157 are unconstitutional.

Granfinanciera and *Stern*

Judge Sontchi parsed the Supreme Court's bankruptcy decisions to identify what the justices held and how they limited their opinions. After *Marathon Pipe Line*, he examined *Granfinanciera S.A. v. Nordberg*, 492 U.S. 33 (1989), which, he said, was closely related but not binding, even though the facts were "closely analogous." Like the case at bar, *Granfinanciera* involved a fraudulent transfer suit against a defendant who had not filed a claim. The high court ruled that the defendant was entitled to a jury trial.

Judge Sontchi said that *Granfinanciera* at bottom was a Seventh Amendment case involving the right to a jury trial, not an Article III case regarding the constitutional limitations on the powers of bankruptcy judges. He said that *Granfinanciera* "alone" did not compel him to rule that Section 157(b)(2) violates Article III of the Constitution.

Judge Sontchi said that *Granfinanciera* "intentionally and explicitly refrained from extending its opinion to the constitutionality of the entry of final orders by bankruptcy courts pursuant to [Section 157] — the very issue before this Court today."

Next, Judge Sontchi turned to *Stern*. Like *Granfinanciera*, he said that *Stern* "does not bind lower courts on issues that were not directly before it."

While "its rhetoric may have been at points, sweeping," Judge Sontchi said that *Stern*'s "ultimate holding was not." Rather, he alluded to how the Chief Justice said that *Stern* should little affect the distribution of work between district and bankruptcy judges.

Stern, Judge Sontchi said, "included a crystal-clear statement that 'Congress, in one isolated respect, exceeded' its Article III power when passing the 1984 Amendments — and that 'isolated' issue is not the issue before this Court today."

Nodding to the Ninth Circuit and other courts that have ruled otherwise, Judge Sontchi said, "Perhaps *Stern* provides compelling evidences of how the Supreme Court *would* rule on this issue if it were to address it directly, but it does not decide it." [Emphasis in original.]

Since neither *Stern* nor *Granfinanciera* were controlling, Judge Sontchi said that the defendants "are not asking this Court to apply controlling precedent to the matter at hand. Instead, Movants are asking this court to *extend* the holdings of those cases, in order to find that 28 U.S.C. § 157(a) is unconstitutional to the extent it directs bankruptcy judges to enter final orders in

fraudulent transfer claims against parties who have not filed claims against the bankruptcy estate. The Court decline to make that leap." [Emphasis in original.]

Judge Sontchi made two other notable rulings. First, he held that a claim for unjust enrichment is noncore even when the claim is based on the same facts as a fraudulent transfer claim that is core. He also held that the defendants had not waived their objections to the final adjudicatory power of the bankruptcy court by participating in the formulation of the plan.

Observations

Stern found a constitutional infirmity insofar as Section 157 lodged final adjudicatory authority in the bankruptcy court over a counterclaim based on a tortious interference claim under state law. *Stern* did not deal with a fraudulent transfer counterclaim.

So, the question is: Given the 5/4 ruling in *Stern* that Section 157(b)(2)(C) was unconstitutionally applied to the facts of the case before the Supreme court, does it follow ineluctably that Section 157(b)(2)(H) is also unconstitutional when the defendant has not filed a claim or consented to final adjudication in bankruptcy court?

In this writer's view, *Stern* does imply that Section 157(b)(2)(H) is also unconstitutional on the facts of a case like that before Judge Sontchi. However, keep in mind that *Stern* was a 5/4 decision. Also recall that none of the opinions in *Marathon Pipe Line* commanded a majority of the justices.

It is therefore not a foregone conclusion that the Supreme Court will assuredly rule that Section 157(b)(2)(H) is unconstitutional when and if the question is squarely presented. It is possible that the high court will draw a line and say that the Court has gone far enough in eroding the powers of bankruptcy judges. However, don't hold your breath.

The opinion is *Paragon Litigation Trust v. Noble Corp. PLC (In re Paragon Offshore PLC)*, 598 B.R. 761 (Bankr. D. Del. March 11, 2019).

Following* dicta *in* Bellingham*, Judge Collins finds no power to enter a final order in a fraudulent transfer suit against a defendant who did not consent.

Final Orders Allowed in Preference Suits Against Defendants Who Didn't File Claims

Constrained by the logic of *In re Bellingham Ins. Agency Inc.*, 702 F.3d 553, 565 (9th Cir. 2012), although not by its holding, Bankruptcy Judge Daniel P. Collins of Phoenix went as far as he could toward holding that bankruptcy courts have constitutional authority to issue final orders in preference and fraudulent transfer suits.

The March 15 opinion by Judge Collins is strikingly similar to a decision four days earlier by Chief Bankruptcy Judge Christopher S. Sontchi of Delaware in *Paragon Litigation Trust v. Noble Corp. PLC (In re Paragon Offshore PLC)*, 17-51882, 2019 BL 81418, 2019 WL 1112298 (Bankr. D. Del. March 11, 2019).

Judge Sontchi held in *Paragon* that a bankruptcy court has constitutional authority to enter a final judgment in a fraudulent transfer suit against a defendant who neither filed a claim nor consented to final adjudication in the bankruptcy court. To read ABI's discussion of *Paragon*, click here.

The Fiduciary Duty Claims

The case before Judge Collins involved an adversary proceeding against multiple defendants asserting claims for breach of fiduciary duty, preference, and intentionally fraudulent transfer. Some of the defendants had filed proofs of claim, but others had not.

In what it described as a "narrow" holding, the Supreme Court ruled in *Stern v. Marshall*, 564 U.S. 462 (2011), that the bankruptcy court lacks constitutional authority to issue a final judgment on a state law counterclaim for tortious interference that would not be resolved in ruling on the creditor's proof of claim. In view of *Stern*, the plaintiff in the case before Judge Collins conceded that the bankruptcy court could not enter a final judgment on the fiduciary duty claims.

The Preference Claims

The defendants argued that the bankruptcy court could not enter final orders on preference claims against those who had not filed proofs of claim.

Judge Collins disagreed. He said that preference claims only exist as a matter of bankruptcy law and are "not independent of federal bankruptcy law." He cited *Paragon* approvingly for the proposition that fraudulent transfer defendants are subject to the bankruptcy court's final adjudicatory power, even if the defendant has not filed a proof of claim.

The "narrow scope of *Stern*," together with the nature of preference claims as a "creature of the Bankruptcy Code," led Judge Collins "to determine that preferential transfer avoidance claims are the type of 'core proceedings' over which this Court has the authority to enter final orders, regardless of whether a given Defendant has filed a proof of claim in this case."

Fraudulent Transfer Claims

On his final authority regarding fraudulent transfer claims, Judge Collins was constrained by *Bellingham*, whereas Judge Sontchi was not. *Bellingham* is generally understood to mean that the bankruptcy court has no final adjudicatory power over a fraudulent transfer defendant who did not file a claim or otherwise submit to the bankruptcy court's power.

However, Judge Collins parsed *Bellingham* further. He said the case was "entirely resolved" by the determination that the defendant has "implicitly consented to the bankruptcy court's authority by failing to challenge the court's authority until the bankruptcy court's decision was appealed." *Bellingham* was *dicta*, he said, for the idea that defendants who had not filed proofs of claim are not subject to the bankruptcy court's final adjudicatory power.

Finding *Bellingham's* logic nonetheless "compelling," Judge Collins held that a bankruptcy court cannot enter a final order against a fraudulent transfer defendant absent consent or the filing of a claim.

Judge Collins devoted the remainder of his opinion to describing what is or is not consent.

Consent

One defendant had made a setoff argument to counter a fraudulent transfer claim. By raising setoff, Judge Collins said that the defendant had waived objections to the court's power by invoking the claims-allowance process, even though he had found there was no valid setoff.

None of the defendants had demanded a jury trial. Consent did not result, Judge Collins said, because "failing to request a jury trial . . . is not indicative of Defendants' consent to entry of final orders by a non-Article III Court."

The plaintiff argued that some of the defendants consented to the bankruptcy court's power by having participated in administrative aspects of the bankruptcy case before they were sued. Judge Collins found no waiver.

While not having filed a claim, participating in "the administrative portion" of the case "does not waive the participant's right to adjudication by an Article III court in a subsequent adversary proceeding brought against them."

The opinion is *Morris Anderson & Associates Ltd. v. Redeye II LLC (In re Swift Air LLC)*, 14-00534, 2019 BL 94442, 2019 Bankr Lexis 852 (Bankr. D. Ariz. March 15, 2019).

Judges Pappas and Teel permit avoidance actions for small amounts to be prosecuted in the debtors' bankruptcy courts.

Courts Divided on Venue for Small-Dollar Avoidance Actions

When a trustee pursues an avoidance action for less than $12,850, is the debtor's bankruptcy court the proper venue?

The courts are divided, but Bankruptcy Judges Jim D. Pappas of Pocatello, Idaho, and S. Martin Teel, Jr., of Washington, D.C., concluded that venue is proper in the debtor's court, even if their conclusions were based on a drafting error that Congress may have committed in adopting 28 U.S.C. § 1409(b).

The facts in both cases were typical of a small-dollar avoidance actions. The trustees were seeking to recover about $11,000 and $12,000, respectively. In Idaho, the trustee was pursuing a constructively fraudulent transfer under Section 548 and Idaho law. In Washington, D.C., the trustee was after a preference under Section 547.

Claiming that venues in the debtors' courts were improper under Section 1409(b), both defendants filed motions to dismiss under Rule 12(b)(3).

Saying that the courts do not agree, Judges Pappas and Teel relied on the plain meaning of Section 1409(b) in concluding that venue was proper in the debtors' courts.

Section 1409 governs venue in bankruptcy cases. Subsection (a) says that "a proceeding arising under title 11 or arising in or related to a case under title 11 may be commenced in the district court in which such case is pending."

Subsection (b) provides that a trustee "may commence a proceeding arising in or related to such a case to recover a money judgment of or property worth less than $1,300 or a consumer debt of less than $19,250, or a debt (excluding a consumer debt) against a noninsider of less than $12,850, only in the district court for the district in which the defendant resides."

The two subsections use notably different language. Subsection (a) applies to proceedings arising under, arising in, or related to a title 11 case. Subsection (b) only refers to proceedings "arising in or related to" a title 11 case. Is the distinction significant, or is the absence of "arising under" in subsection (b) a distinction without a difference?

Because the suits sought less than $12,850, the defendants contended that they could only be sued where they resided, not in the debtors' home courts.

Like Judge Teel, Judge Pappas pointed out that subsection (b) "makes no mention of cases 'arising under' title 11." For both judges, the distinction was important, given the parties' concessions that the avoidance actions — based on Sections 547, 548, 544(b) and 550 — were proceedings arising under title 11.

If subsection (a) alone was applicable, venue in the debtor's bankruptcy court was proper because the proceedings arose under title 11. However, the defendants made several arguments contending that subsection (b) applied, but both judges knocked them all down.

Judge Pappas said that the "plain language interpretation" of subsection (b) "has led many courts to conclude that it applies only to claims 'arising in' and 'related to' under title 11, but not to those 'arising under' title 11." Other courts, including the Bankruptcy Appellate Panel for the Ninth Circuit, held otherwise, he said, believing "that Congress unintentionally omitted 'arising under' from subsection (b)."

Citing *Lamie v. U.S.*, 540 U.S. 526 (2004), both judges said that the Supreme Court nixed the idea that a court may disregard the plain language of a statute by presuming that Congress made a mistake. Even if the BAP opinion were binding, Judge Pappas said it was not good law because it preceded *Lamie*.

Finding no absurd result, Judge Pappas held that the monetary limitations of subsection (b) did not apply because the avoidance action arose under title 11. Because subsection (a) applied, Judge Pappas concluded that venue was proper in the debtor's court.

Likewise, Judge Teel agreed with decisions concluding "that Section 1409(b) does not apply to a proceeding 'arising under title 11.'"

Cases to the contrary, according to Judge Teel, were "unpersuasive." Similarly, Judge Pappas declined to follow a pair of bankruptcy court decisions that had invoked the $12,850 threshold for avoidance actions, saying they gave "terse treatment" to the question.

Judge Teel pointed out several "odd results" that would occur if "arising under" cases were included in subsection (b). A trustee could avoid a transaction in the debtor's home court under subsection (a) but then be forced to obtain a money judgment for the value of the property in the defendant's hometown under subsection (b).

Judge Teel came up with another odd result: Subsection (b) only applies to trustees. Thus, a debtor could always sue in the debtor's home court, but a trustee seeking the same relief on the same claim could not.

Another question: If subsection (b) did apply, which part governed? Was the suit (1) "a case to recover a money judgment of or property worth less than $1,300," where venue would be proper in the debtor's bankruptcy court, or was it (2) a case to recover "a debt . . . of less than $12,850," in which event venue would be improper, Judge Pappas asked?

Employing a "practical reading" of the statute, Judge Pappas said that the "real effect" of the suit was "to recover money judgments or property" for more than $1,300, making the $12,850 threshold inapplicable and meaning that venue was proper.

Judges Pappas and Teel denied the motions to dismiss for improper venue.

The opinions are *Klein v. ODS Technologies LP (In re J & J Chemical Inc.)*, 596 B.R. 704 (Bankr. D. Id. Jan. 11, 2019); and *Webster v. Republic National Distributing Co. LLC (In re Tadich Grill of Washington DC LLC)*, 598 B.R. 65 (Bankr. D. D.C. March 12, 2019).

Ninth Circuit says that Section 158(d)(1) isn't an appeals court's jurisdiction over a 'Stern' matter.

'*Stern*' Disputes Invoke a Circuit Court's General Jurisdiction Under 28 U.S.C. § 1291

In a nonprecedential opinion, the Ninth Circuit identified one of the finer points of an appeals court's jurisdiction over a noncore dispute falling under the ambit of *Stern v. Marshall*, 564 U.S. 462 (2011).

The Ninth Circuit said it was "visiting an old friend," because the case involved the deceased Anna Nicole Smith, her similarly deceased husband, J. Howard Marshall II, and E. Pierce Marshall, J. Howard's son. You guessed it! They are the litigants whose disputes resulted in the *Stern* decision defining constitutional limits on a bankruptcy court's power to enter final orders.

Long after the Supreme Court ruled in *Stern*, Anna Nicole's estate appealed the denial of a motion in district court for relief from a judgment under Rule 60(b)(5)-(6) of the Federal Rules of Civil Procedure. The district court ruled that it did not have jurisdiction for several reasons. The Ninth Circuit reversed.

For bankruptcy nerds, one aspect of the Ninth Circuit's January 31 opinion is significant.

The genesis of the dispute, as the Supreme Court said in its landmark *Stern* decision, was a noncore matter where the bankruptcy court could only issue proposed findings under 28 U.S.C. § 157(c)(1).

The Rule 60(b) motion was therefore made in a noncore dispute, but the district court said it was exercising bankruptcy appellate jurisdiction.

The Ninth Circuit disagreed, saying the district court was not exercising bankruptcy appellate jurisdiction under 28 U.S.C. § 158(a)(1). Rather, the appeals court said the district court "entered judgment pursuant to its original jurisdiction in bankruptcy matters. *See* 28 U.S.C. § 1334(b)."

Consequently, the Ninth Circuit ruled that it had jurisdiction "under 28 U.S.C. § 1291, our general grant of jurisdiction to hear appeals from 'final decisions of the district courts of the United States.'"

Appellate jurisdiction therefore did not rest in the circuit court under 28 U.S.C. § 158(d)(1), the Ninth Circuit said, "because that provision only authorizes appeals from district court orders entered under 28 U.S.C. § 158(a)."

The opinion is *Marshall v. Stern (In re Marshall)*, 754 Fed. Appx. 566 (9th Cir. Jan. 31, 2019).

A divided panel of the Sixth Circuit holds that Section 106 does not waive sovereign immunity for Indian tribes.

Creating a Split, Sixth Circuit Holds: No Waiver of Immunity for Indian Tribes

In a 2/1 decision, the Sixth Circuit created a split of circuits by holding that Sections 106 and 101(27) do not waive sovereign immunity with respect to Indian tribes.

The majority on the appeals court also held that the tribe's filing of a bankruptcy petition for one of its businesses did not waive sovereign immunity when creditors later filed a fraudulent transfer suit against the tribe.

The opinion appears to mean that a tribe can loot a business it owns, put the business in bankruptcy, then escape liability for its pre-bankruptcy conduct, unless the tribe has waived immunity under the tribe's internal governing rules.

The Facts

A tribe was part owner of a casino in Michigan that filed a chapter 11 petition and confirmed a plan, creating a creditors' trust. In bankruptcy court, the trust sued the tribe for $180 million, contending that the tribe had been the recipient of a pre-bankruptcy fraudulent transfer.

In a prior appeal, the district court ruled that Congress had not waived a tribe's sovereign immunity in Section 106. However, the district court remanded the case for the bankruptcy court to determine whether the tribe's conduct waived sovereign immunity.

The bankruptcy court found no waiver by conduct. District Judge Paul D. Borman upheld dismissal of the suit in January 2018, ruling that the tribe had not waived sovereign immunity. The trustee appealed to the Sixth Circuit. To read ABI's report on the district court opinion, click here.

The Circuit's Opinion

Writing for himself and Circuit Judge Richard A. Griffin, Circuit Judge Eric L. Clay recited black letter law for the notion that Congress must "unequivocally" express intent to waive sovereign immunity. Do Sections 106 and 101(27) "express such an intent," he asked?

Section 106(a) abrogates sovereign immunity "as to a governmental unit" with respect to enumerated sections of the Bankruptcy Code, including Sections 544 and 550, under which the trustee was suing the tribe.

In turn, Section 101(27) defines "government unit" to "mean" (not "include"), among other things, the U.S., states, municipalities, foreign states or "other foreign or domestic government."

Waiver by Statute

Judge Clay said that only two circuits have dealt with tribal sovereign immunity under the Bankruptcy Code. The Ninth Circuit found a waiver in *Krystal Energy Co. v. Navajo Nation*, 357 F.3d 1055 (9th Cir. 2004), holding that Congress did express an unequivocal intent to waive immunity.

On the other hand, Judge Clay cited *Meyers v. Oneida Tribe of Indians of Wisconsin*, 836 F.3d 818 (7th Cir. 2016), where the Seventh Circuit found no waiver under a different statute. In *dicta*, the Seventh Circuit said its reasoning would apply to Section 106.

Judge Clay was persuaded by *Meyers*, not by the Ninth Circuit. Although a tribe is both "domestic" and a "government," "that is not the real question," he said.

For Judge Clay, the "real question" is "whether Congress . . . unequivocally expressed an intent to abrogate tribal sovereign immunity."

Judge Clay said there was not one instance where the Supreme Court had found a waiver of tribal immunity when the statute did not expressly mention "Indian tribes somewhere in the statute." He found only one instance at the circuit level, and that was the Ninth Circuit in *Krystal*.

Judge Clay did not hold that Congress can only waive immunity by specific reference to tribes. Rather, he held that Sections 106 and 101(27) "lack the requisite clarity of intent to abrogate tribal sovereign immunity.

Waiver by Conduct

Next, Judge Clay dealt with the question of whether the tribe had waived immunity by conduct.

The tribe's casino had waived immunity by contract. However, the tribe's board had not authorized the waiver of immunity. Consequently, the waiver was not binding on the tribe.

Still, could the tribe waive immunity by litigation conduct? Although the Supreme Court has held that litigation conduct can be a waiver for non-tribal governments, Judge Clay said that only a few courts had found a litigation waiver by tribes.

Judge Clay cited two circuit courts holding that intervention in a lawsuit constitutes waiver and three that found a waiver by filing a lawsuit. He therefore held that "Indian tribes can waive

their tribal sovereign immunity through sufficiently clear litigation conduct, including by filing a lawsuit."

However, he went on to hold on the next page that "litigation conduct by alter egos or agents of Indian tribes cannot be attributed to the tribes for the purpose of waiving tribal sovereign immunity."

Therefore, the majority upheld dismissal, ruling that "the filing of a bankruptcy petition does not waive tribal sovereign immunity as to separate, adversarial fraudulent transfer claims."

The Dissent

Sitting by designation from the Northern District of Ohio, District Judge Jack Zouhary dissented.

In Section 101(27), Judge Zouhary said that Congress "chose to speak broadly" by abrogating immunity "of any government, of any type, anywhere in the world." For him, the statute was a "clear" waiver. Next, he said that a tribe is a "domestic government."

Judge Zouhary concluded that the Bankruptcy Code waived sovereign immunity as to tribes because immunity is abrogated "as to all governments[, and] Indian tribes are governments."

Judge Zouhary disputed the idea that there is an extant circuit split. The Seventh Circuit, he said, dealt with a different statute where the waiver as to tribes was "ambiguous." The statute before the Seventh Circuit made "no mention of sovereign immunity, [while] the [Bankruptcy] Code targets it directly," he said.

Judge Zouhary criticized the idea that a statutory waiver must mention Indian tribes. He pointed to Justice Antonin Scalia, who provided the fifth vote in an immunity case and said that a congressional waiver is not required to make explicit reference to any particular terms.

Courts could also look to the "larger statutory scheme," Judge Zouhary said. To enforce an equitable distribution, he said that Sections 106 and 101(27) have a broad abrogation of sovereign immunity, where "all governments must play by the rules."

The opinion is *Buchwald Capital Advisors LLC v. Sault Ste. Marie Tribe of Chippewa Indians (In re Greektown Holdings LLC)*, 917 F.3d 451 (6th Cir. Feb. 26, 2019).

Appeals court insinuates that denial of a lift-stay motion without prejudice is not appealable.

Sixth Circuit Pronounces a Two-Prong Test to Determine 'Finality'

Appointed to the appeals court last year, Circuit Judge Amul Thapar attempted what no court or commentator has so far accomplished successfully: He formulated a test for deciding when an order is "final" and therefore appealable in the bankruptcy context.

It is unclear, however, whether Judge Thapar's test can predictably and fairly discriminate between appealable and non-appealable orders in all circumstances.

The appeal to the Sixth Circuit involved a motion to lift the automatic stay, which was denied in bankruptcy court. The creditor who lost the motion did not appeal within 14 days.

Instead, the creditor filed an appeal from the denial of the lift-stay motion months later when the bankruptcy judge sustained the debtor's objection to the creditor's claim. In his October 16 opinion, Judge Thapar upheld the district judge who had dismissed the appeal for being untimely.

In his 15-page opinion, Judge Thapar cited five circuits and the *Collier* treatise for saying that courts "almost uniformly" hold that denial of a lift-stay motion is an appealable order. Rather than cite those authorities and be done with it, he searched for a principled standard to discern "finality."

Judge Thapar cited *Bullard v. Blue Hills Bank*, 135 S. Ct. 1686, 1692 (2015), for the proposition that orders are appealable in bankruptcy "if they dispose of discrete disputes within the larger case." He went on to say that "courts have taken the loose finality in bankruptcy as license for judicial invention. The result: a series of vague tests that are impossible to apply consistently."

According to Judge Thapar, some courts do not articulate a general test at all. They "simply treat the finality of the specific order before them as a case-by-case question and do not look to or articulate principles that can be applied to other types of orders."

For guidance in formulating a test, Judge Thapar took counsel from the statute governing appealability, 28 U.S.C. § 158(a), which grants appellate jurisdiction to district courts from "final judgments, orders, and decrees . . . of bankruptcy judges entered in cases and proceedings" under the Bankruptcy Code. "These extra words [cases and proceedings] have meaning," he said. For 100 years, "courts have viewed 'proceeding' as the relevant 'judicial unit' for bankruptcy finality," Judge Thapar said.

For Judge Thapar, the statute provides "a clear test for courts to apply: a bankruptcy court's order may be immediately appealed if it is (1) 'entered in [a] . . . proceeding' and (2) final — terminating that proceeding."

Applying the two-part test to the case at hand, Judge Thapar first analyzed whether the lift-stay motion was a "proceeding." He said that a "proceeding" under Section 158(a) is "a discrete dispute within the overall bankruptcy case." He concluded that a lift-stay motion "fits this description," because "there is a discrete claim for relief, a series of procedural steps, and a concluding decision."

Judge Thapar buttressed his conclusion by referencing 28 U.S.C. § 157(b)(2)(G), where lift-stay motions are listed among "core proceedings."

Turning to the second part of the test and the question of "finality," Judge Thapar quoted *Bullard's* statement that a final order "alters the status quo and fixes the rights and obligations of the parties." *Bullard*, 135 S. Ct. at 1692. He quoted a commentator on the idea that "a bankruptcy order is final 'if it is both procedurally complete and determinative of substantive rights.'"

Applying the definition to conclude that the order was appealable when entered, Judge Thapar ruled that denial of a lift-stay motion was "final" because it was procedurally complete and precluded the creditor from pursuing its claim against the debtor outside of bankruptcy court.

Judge Thapar then claimed that denial of a lift-stay motion *without* prejudice is an exception that "helps prove the rule." Insinuating that denial of a motion without prejudice is non-final, he said that courts "may deny stay-relief motions without prejudice if it appears that changing circumstances could change the stay calculus."

Having dangled the prospect that denial *without* prejudice is non-final, Judge Thapar said that "we need not determine now whether a stay-relief denial without prejudice is 'final,'" because denial with prejudice in the case at hand was the "final word on the matter."

Observation: This writer questions whether "finality" is susceptible to hard-and-fast rules applicable in all circumstances, much like the concept of an executory contract, on which scholars disagree.

Denial of a lift-stay motion without prejudice is a situation where application of Judge Thapar's test is problematic, because denial without prejudice raises additional considerations beyond the two prongs of his test.

In decades past, some bankruptcy judges often, if not routinely, denied lift-stay motions without prejudice, leading appellate courts to rule that the orders were not appealable because they

were not final. For the duration of the bankruptcy case, the creditor would not have recourse to appellate review, thus giving the debtor leverage in negotiations with the creditor.

Over time, some courts came to the view that denial without prejudice did not destroy finality, because dismissing an appeal would be manifestly unfair to the creditor when there was no realistic possibility of appellate review.

Perhaps decisions on finality are circumstances where judges should apply their experience and judgment rather than search for a blanket answer in the skeletal words of a statute. Perhaps case-by-case analysis of finality is not such a bad idea after all. Perhaps the underlying facts of a case will affect finality and defy categorizing specific types of orders as always either final or non-final.

The opinion is *Ritzen Group Inc. v. Jackson Masonry LLC (In re Jackson Masonry LLC)*, 18-5157 (6th Cir. Oct. 16, 2018), *cert.* granted May 20, 2019, in *Ritzen Group Inc. v. Jackson Masonry LLC*, 18-938 (Sup. Ct.).

***The Third Circuit's new opinion on 'finality' will be cast in doubt depending on how the Supreme Court rules in* Ritzen.**

Third Circuit Expands the Flexible Notion of 'Finality' on Bankruptcy Appeals

The Third Circuit further expanded the notion of a final order to include seemingly interlocutory rulings that will become essentially unreviewable because subsequent events will render them moot.

For example, the opinion will mean that an order denying a stay pending appeal from approval of a settlement will be appealable because consummation of the settlement will ordinarily make the appeal moot. In that regard, the Third Circuit and the Second Circuit disagree on appealability.

The Appeal from Denial of a Stay Pending Appeal

The appeal involved a law firm that had litigated successfully before bankruptcy under the Sarbanes Oxley Act of 2002, 15 U.S.C. § 7243.1. The firm was entitled to a fee award for creating a common fund by clawing back compensation paid to company executives whose misconduct required the restatement of financial statements.

Later, the bankruptcy court set aside $5 million to cover the fee award that the court might ultimately grant. Having sought a $15 million set-aside, the firm appealed. The appeal remains pending in district court.

Next, the firm sought a stay of distributions from the common fund created when the target of the clawback agreed in settlement to pay about $150 million. The bankruptcy court denied the law firm's motion for a stay of the distributions.

Appealing the denial of a stay, the law firm asked the district court for a stay of distributions until the district court decided the prior appeal from the refusal to set aside $15 million.

The law firm appealed to the Third Circuit when the district court denied the stay.

In a June 25 opinion, Circuit Judge Joseph A. Greenaway, Jr. ruled that the district court's denial of a stay pending appeal was a final, appealable order under 28 U.S.C. § 158(d)(1), which gives appellate jurisdiction to the circuits over appeals from final orders entered by district courts on appeal from bankruptcy courts.

The *Revel* Decision in 2015

Judge Greenaway followed *dicta* in an analogous Third Circuit opinion from 2015. *In re Revel AC, Inc.*, 802 F.3d 558 (3d Cir. 2015). To read ABI's discussion of *Revel*, click here.

Revel involved an appeal from denial of a stay of an order authorizing a sale of property. Writing for the Third Circuit in *Revel*, Circuit Judge Thomas L. Ambro conceded that the denial of a stay was "not technically a final judgment." He went on to say that the appeal was final in a "practical sense" because a statute, Section 363(m), would have rendered the appeal moot and prevented the court from later reaching the merits if there were no stay.

In the case on appeal, there was no statute to render the appeal moot. Consequently, Judge Greenaway said that *Revel* was not on point. However, he said that "this appeal . . . does fit within *Revel*'s *dicta*, to which we give teeth today."

The imminent distribution of the $150 million, Judge Greenaway said, would "effectively" moot the law firm's appeal from the bankruptcy court's order refusing to set aside $15 million. Once the money was out the door, there would be no way to take the distributions back from creditors if the law firm were awarded more than $5 million.

In bankruptcy, where the Third Circuit takes a "relaxed, pragmatic, and functional view of finality," Judge Greenaway said that treating the stay denial as a final order is a "mere logical application of *Revel*."

Having found appellate jurisdiction, Judge Greenaway next ruled on the merits. The denial of a stay was proper because the law firm had not shown that a $5 million set-aside was inadequate. On the merits, he used the sliding-scale approach adopted by *Revel* to judge whether a stay pending appeal would be appropriate.

Judge Ambro was on the panel alongside Judge Greenaway.

Observations

Revel and the new Third Circuit opinion are arguably in conflict with the Supreme Court's decision in *Bullard v. Blue Hills Bank*, 135 S. Ct. 1686, 191 L. Ed. 2d 621 (2015), holding that denial of confirmation of a chapter 13 plan is not a final, appealable order.

The Third Circuit is also in apparent conflict with an unreported opinion from the Second Circuit in 2014. There, the Second Circuit dismissed an application for a stay pending appeal, saying the creditors "have not shown that the district court's order denying a stay should be treated as a denial of injunctive relief." *BOKF NA v. Momentive Performance Materials Inc.* (*In re MPM Silicones LLC*), 14-3531 (2d Cir. Oct. 31, 2014).

Finality in the bankruptcy context will come before the Supreme Court in the new term to begin in October 2019. *See Ritzen Group Inc. v. Jackson Masonry LLC*, 18-938 (Sup. Ct.) (*cert*. granted May 20, 2019).

The creditor who took *Ritzen* to the Supreme Court contends that the Sixth Circuit deepened an existing circuit split by erroneously holding that an order denying a motion to modify the automatic stay is always a final order that must be appealed immediately. However it comes down, the Supreme Court is likely to tell us whether finality is formulaic and immutable in bankruptcy or whether there is a more relaxed, pragmatic approach to finality in bankruptcy cases.

The propriety of the new opinion from the Philadelphia-based appeals court will be in doubt if the Supreme Court goes against the Third Circuit's flexible approach to finality.

The opinion is *S.S. Body Armor I. Inc.*, 18-2558, 2019 BL 234018 (3d Cir. June 25, 2019).

Third Circuit makes a fine distinction regarding bankruptcy courts as 'courts of the U.S.'

A Lack of '*Stern*' Jurisdiction Bars a Transfer Under 28 U.S.C. § 1631

Even if a bankruptcy court is considered a "court of the United States," the bankruptcy court does not have power to transfer a suit to another district under 28 U.S.C. § 1631 if the bankruptcy court lacks constitutional jurisdiction in the first place, the Third Circuit held.

The Governing Statutes

Section 1631 was adopted to ensure that a suit will not be barred by the statute of limitations if the suit was originally filed in a district lacking jurisdiction. When "a civil action is filed in a court as defined in [28 U.S.C. §] 610, . . . and that court finds that there is a want of jurisdiction," the section provides that "the court shall, if it is in the interest of justice, transfer such action" to a court where the suit could have been brought, "and the action . . . shall proceed as if it had been filed [in the transferee court] . . . on the date" when it was filed in the original court.

In turn, Section 610 defines "courts" to include "the courts of appeals and district courts of the United States," and other courts not relevant to the case on appeal.

The Suit in Bankruptcy Court

A company confirmed a chapter 11 plan that created a liquidating trust. After confirmation, the liquidating trustee sued the company's former officers and directors for breach of fiduciary duties.

The bankruptcy court held that the suit was not "core." Even if the suit were "related to" the reorganization, the bankruptcy court also held that it had no jurisdiction because the suit did not have the required "close nexus" to the chapter 11 plan that must be present for the bankruptcy court to have jurisdiction following confirmation in the Third Circuit.

To avoid dismissal, the liquidating trustee moved the bankruptcy court to transfer the suit under Section 1631 to a district court that would have jurisdiction.

The bankruptcy court denied the transfer motion, reasoning that the bankruptcy court was not a "court" within the meaning of Sections 610 and 1631. The district court affirmed on the same grounds.

To avoid dismissal, the bankruptcy court permitted the liquidating trustee to file a motion to withdraw the reference, so the district court could exercise its indisputable power to transfer the suit under Section 1631.

Unfortunately, the district court denied the motion to withdraw the reference, concluding there was no power to withdraw the reference of a proceeding that was never properly referred because there was no jurisdiction in the bankruptcy court in the first place.

The Third Circuit Opinion

The liquidating trustee appealed to the circuit court from the orders of the bankruptcy court refusing to transfer the suit under Section 1631. The liquidating trustee argued that the Third Circuit had held that a bankruptcy court is a "court of the U.S." in the context of the imposition of sanctions under 28 U.S.C. § 1927. The same principle should apply to a bankruptcy court's power under Section 1631, the trustee argued.

In her Nov. 28 opinion, Circuit Judge Marjorie O. Rendell upheld the result in the lower courts, although on a different theory.

Judge Rendell noted that the courts are split on whether a bankruptcy court is a "court of the U.S." eligible to issue sanctions under Section 1927.

Some courts, according to Judge Rendell, hold that bankruptcy courts do not qualify because they are not among the courts listed in 28 U.S.C. § 451. However, the Third Circuit took the opposite view in *In re Schaefer Salt Recovery*, 542 F.3d 90 (3d Cir. 2008), by holding that bankruptcy courts may impose Section 1927 sanctions because they are "units" of the district court, even if they are not "courts of the U.S."

Nonetheless, Judge Rendell said there was a "key distinction" between the case on appeal and a Section 1927 case like *Schaefer Salt*, where the bankruptcy court clearly had jurisdiction. In the case at hand, the bankruptcy court lacked jurisdiction, she said.

Exercising jurisdiction by transferring the suit under Section 1631, according to Judge Rendell, "would have been *ultra vires*, regardless of whether the bankruptcy courts fall under Section 610's definition of courts." She went on to say that "a bankruptcy court that lacks jurisdiction over a proceeding cannot transfer that proceeding under Section 1631," regardless of whether "Congress intended bankruptcy courts to fall under Section 610's definition of courts by virtue of their status as units of the district courts."

Judge Rendell made another distinction. She analyzed Section 1631 "as intending to permit a transfer to remedy a lack of statutory jurisdiction," such as federal question jurisdiction or diversity jurisdiction. The case on appeal did not involve statutory jurisdiction but instead represented a lack

of constitutional jurisdiction. "Transfer under Section 1631 simply cannot cure this lack of constitutional jurisdiction," she said.

Judge Rendell ended her opinion by saying that the opinion "does not call into question" the power of a bankruptcy court to transfer suits or cases under other statutes or rules, such as Bankruptcy Rules 7087 and 1014.

The opinion is *Troisio v. Erickson (In re IMMC Corp.)*, 18-1177 (3d Cir. Nov. 28, 2018).

Bullard *and* Ritzen *combine to constrict the right of appeal in the Sixth Circuit.*

Denial of Motion to Dismiss Chapter 13 Is Not Appealable, BAP Says

Combining the Supreme Court's *Bullard* decision with an opinion handed down by the Sixth Circuit on October 16, the Sixth Circuit Bankruptcy Appellate Panel held that denial of a motion to dismiss a chapter 13 case after confirmation is not final and is therefore not appealable as of right.

The appellants were not sympathetic litigants. They had their shot at defeating the debtors' plan and failed. They did not appeal confirmation of the plan. Instead, they filed a motion to dismiss the chapter 13 case about two weeks after confirmation.

The creditors had purchased a home from the debtor and soon found the house infested with mold. Ultimately, the creditors won a judgment against the debtor for about $125,000, prompting the debtor to file a chapter 13 petition.

The creditors settled most of their disputes about the plan's treatment of their claim, and the bankruptcy judge ruled on the remainder. The creditors did not appeal the confirmation order. Instead, they filed a motion to dismiss soon after confirmation. When the bankruptcy judge denied the motion to dismiss, they appealed *pro se*.

Citing *Ritzen Group Inc. v. Jackson Masonry LLC (In re Jackson Masonry, LLC)*, Nos. 18-5157/5161, 2018 WL 4997779 (6th Cir. Oct. 16, 2018), Judge Dales described how the Sixth Circuit "recently prescribed a two-step approach for determining whether an order of a bankruptcy court is immediately appealable under 28 U.S.C. § 158(a)(1)." To read ABI's discussion on *Ritzen*, click here.

To decide whether an order is appealable, *Ritzen* requires identifying the "judicial unit" and then analyzing whether it is "final."

In his October 30 opinion, Judge Dales said that the creditors' contested matter to dismiss had "all the hallmarks" of a distinct "judicial unit." "Nevertheless," he said, "the relief they requested — dismissal of [the debtor's] entire bankruptcy case — reveals that the case itself (rather than the contested matter) is the relevant 'proceeding' at issue."

With regard to finality, an appealable order must end the litigation on the merits and leave nothing aside from executing the judgment, Judge Dales said. Denying a motion to dismiss, he

observed, "hardly leaves 'nothing to be done'" because the case remains pending with many decisions yet to be made.

Confirming that denial of the dismissal motion was not final, Judge Dales drew from *Bullard v. Blue Hills Bank*, 135 S. Ct. 1686 (2015), where the Supreme Court taught that finally resolving a contested matter does not necessarily make an order appealable. To confer a right of appeal, the order must alter the *status quo* and fix the parties' rights and obligations. *Id*. at 1688.

Judge Dales found guidance in *dicta* from *Bullard* where the Supreme Court said that only plan confirmation or dismissal alters the *status quo*. *Id*. He said *Bullard* therefore "suggests" that denial of a post-confirmation dismissal motion "would not be final because the denial does not alter the *status quo*."

Judge Dales said that the confirmation order "was the final order from which [the creditors] should have appealed." He likened denial of a motion to dismiss the case to a denial of a motion for summary judgment. He therefore held that denial of dismissal "effected no change in the parties' rights or the *status quo* and is a non-final order from which [the creditors] have no right to appeal."

In another case, Judge Dales left the door open a crack by saying "it is certainly conceivable that different factual circumstances surrounding a motion to dismiss might lead to a different decision about the finality of an order denying the motion."

Judge Dales also declined to grant leave to appeal an interlocutory order because there was nothing "novel or controversial" in the bankruptcy court's ruling.

Observation

Barring an appeal from denial of a motion to dismiss is not always beneficial for a debtor. Consider this:

Suppose the debtor makes plan payments for five years. Immediately after discharge, the creditor appeals the bankruptcy court's denial of dismissal five years earlier. If the appellate court then were to reverse and dismiss, the debtor would have nothing to show (no discharge) after paying creditors for five years.

That's a situation where a debtor might have preferred an immediate appeal.

In a similar case where the creditor immediately appeals denial of a dismissal motion after confirmation, a BAP or district court would do the debtor a favor by granting the motion to dismiss and also ruling on the merits.

The opinion is *In re Lane*, 18-8005 (B.A.P. 6th Cir. Oct. 30, 2018).

Chief District Judge in New York rules that 'core' jurisdiction includes non-consensual, third-party releases in confirmation orders.

New York and Delaware Agree: Releases Are Constitutionally Ok in Confirmation Orders

Within the space of three weeks, district judges in Delaware and New York have held that bankruptcy courts possess core jurisdiction and constitutional power to enter chapter 11 confirmation orders, including so-called non-debtor, third-party releases of non-bankruptcy claims.

On September 21, Chief District Judge Leonard P. Stark of Delaware handed down *Opt-Out Lenders v. Millennium Lab Holdings II LLC (In re Millennium Lab Holdings II LLC)*, 17-1461, 2018 BL 343110 (D. Del. Sept. 21, 2018). He held that bankruptcy courts have constitutional authority to issue non-consensual, third-party releases of non-bankruptcy claims along with confirmation of a chapter 11 plan. To read ABI's discussion of *Millennium Lab*, click here.

Chief District Judge Colleen McMahon of Manhattan reached the same legal conclusion in an October 10 opinion. Her case involved a minority shareholder appealing a confirmation order and contending that a shareholders' agreement preluded the chapter 11 filing without his consent.

Bankruptcy Judge Robert D. Drain of White Plains, N.Y., ruled earlier in the reorganization that the majority shareholders had not violated a shareholders' agreement by filing an involuntary petition against the corporate debtor. In the course of his decision denying the minority shareholder's motion to dismiss or abstain, Judge Drain concluded that the dispute over breach of the shareholders' agreement was core. The minority shareholder did not appeal.

Later, the majority shareholders filed a chapter 11 plan that Judge Drain confirmed. The plan gave control to the majority shareholders. Confirmation included a non-consensual, third-party release prohibiting the minority owner from initiating an arbitration in London aimed at showing that the bankruptcy was commenced in violation of the shareholders' agreement.

Contending that the bankruptcy court lacked jurisdiction and constitutional power to enjoin later litigation of non-bankruptcy claims, the minority owner appealed to District Judge McMahon, to no avail.

Judge McMahon said there "is no consensus among the courts" about the jurisdictional basis for third-party releases. She said that a minority, including the Third Circuit, hold that extinguishing third-party claims is an exercise of non-core jurisdiction.

On the other hand, Judge McMahon said that a majority — including the District of Columbia Circuit and Judge Stark in *Millennium Lab* — hold that bankruptcy courts exercise core jurisdiction in confirming plans with third-party releases.

Judge McMahon said that approving a non-consensual, third-party release "does not address the merits of the claims being released." She reasoned that an "incidental effect on claims beyond the scope of the immediate bankruptcy proceeding does not render the bankruptcy court's jurisdiction non-core."

The releases, Judge McMahon said, were not an "adjudication of the merits of third-party claims." Rather, she said, the "involuntary third-party releases merely extinguish those claims as part of a core bankruptcy process" of confirming a plan within the strictures of Sections 1123 and 1129.

Judge McMahon rejected the notion that third-party injunctions would give bankruptcy courts a "blank check" to exercise "infinite jurisdiction." Finding limits to the constitutional power, she said it "surely would be improper" to confirm a plan with third-party releases that were "unrelated (or even tangentially related) to the debtor or the bankruptcy case." She said that the release "must be sufficiently related to the issues before the bankruptcy court in order for core jurisdiction to cover an order extinguishing that claim."

Inclusion of the injunction was a core function, Judge McMahon said, to prevent the minority owner from mounting a "collateral attack" through arbitration in London.

Alternatively, *res judicata* prevented the minority shareholder from attacking the releases in the plan because the bankruptcy judge had ruled (in an order that the minority owner did not appeal) that disputes regarding the shareholders' agreement were core and therefore within the final adjudicatory power of the bankruptcy court.

Even if the releases were non-core, Judge McMahon went on to rule that the minority shareholder had impliedly consented to final adjudication in bankruptcy court by participating in proceedings below without raising the constitutional issue. She said that consent by implication is necessary to prevent "gamesmanship."

The opinion is *Lynch v. Lapidem Ltd. (In re Kirwan Offices SARL)*, 17-4339 (S.D.N.Y. Oct. 10, 2018).

Delaware district judge rules that the bankruptcy court has final adjudicatory power to include third-party releases in confirmation orders.

District Court Finds Constitutional Power to Grant Releases in Confirmation Orders

Unless the Third Circuit or the Supreme Court decides otherwise, bankruptcy courts in Delaware have constitutional authority to issue non-consensual, third-party releases of non-bankruptcy claims along with confirmation of a chapter 11 plan.

In an opinion on September 21, Chief District Judge Leonard P. Stark of Delaware abandoned the insinuation he made 18 months ago, adopted the analysis of Bankruptcy Judge Laurie Selber Silverstein from one year ago and held that the principles of *Stern v. Marshall*, 131 S. Ct. 2594 (2011), do not apply because confirming a reorganization plan with releases is not tantamount to a final judgment on the merits of non-bankruptcy claims.

Alternatively, Judge Stark held that the appeal from the Millennium Lab Holdings II LLC confirmation order was equitably moot because the plan had been consummated and releases could not be revoked without upsetting the plan as a whole. Judge Stark also reached the merits and held that the releases were proper because Judge Silverstein correctly applied Third Circuit criteria.

The Facts

Millennium Lab Holdings II LLC, the chapter 11 debtor, had obtained a $1.825 billion senior secured credit facility and used $1.3 billion of the proceeds before bankruptcy to pay a special dividend to shareholders.

Indebted to Medicare and Medicaid for $250 million that it could not pay, Millennium filed a chapter 11 petition along with a prepackaged plan calling for the shareholders to contribute $325 million in return for releases of any claims that could be made by the lenders. The plan did not allow the lenders to opt out of the releases.

Before confirmation, a lender holding more than $100 million of the senior secured debt filed suit in district court in Delaware against the shareholders and company executives who would receive releases under the plan. The suit alleged fraud and RICO violations arising from misrepresentations inducing the lenders to enter into the credit agreement.

Over objection, Judge Silverstein confirmed the plan in late 2015 and approved the third-party releases. The dissenting lender appealed.

Millennium filed a motion to dismiss the appeal on the ground of equitable mootness, because the plan had been consummated in the absence of a stay pending appeal.

District Judge Stark's Remand

On appeal in district court, the objecting lender contended that the bankruptcy court lacked constitutional power to enter a final order granting third-party releases. Judge Stark's decision in March 2017 could have been read to imply, without holding, that granting the releases was beyond the bankruptcy court's constitutional power to enter a final order because the releases were "tantamount to resolution of those claims on the merits against" the lender.

Rather than rule on the constitutional issue, Judge Stark remanded the case for Judge Silverstein to decide whether she had final adjudicatory authority, either as a matter of constitutional law or as a consequence of the lender's waiver. To read ABI's discussion of Judge Stark's opinion, click here.

Judge Silverstein's Opinion Following Remand

On October 3, 2017, Judge Silverstein handed down an impassioned, 69-page opinion concluding that the limitations on the constitutional power of a bankruptcy court under *Stern* are inapplicable to granting third-party releases because a confirmation order exclusively implicates questions of federal bankruptcy law and raises no issues under state or common law.

Judge Silverstein also analyzed the record and concluded that the objecting lender never raised the constitutional question during or even after confirmation. Citing the prohibition of sandbagging in *Wellness International Network, Ltd. v. Sharif*, 135 S. Ct. 1932 (2015), Judge Silverstein said that the lender could not lie in the weeds and raise constitutional infirmities for the first time on appeal. On the ground of waiver alone, Judge Silverstein found that she was entitled to enter a final order. To read ABI's discussion of Judge Silverstein's opinion, click here.

The objecting lender appealed again to Judge Stark.

The Bankruptcy Court's Confirmation Power Is Unimpaired

Judge Stark's 42-page opinion on September 21 contains a meticulous analysis of Judge Silverstein's decision and a detailed recitation of the parties' arguments. He upheld Judge Silverstein's conclusion that the bankruptcy court had constitutional power to approve third-party releases in a confirmation order. He also granted the motion to dismiss other issues in the appeal on the ground of equitable mootness.

Alternatively, Judge Stark reviewed the merits and ruled that the releases were proper under Third Circuit authority.

As he had done before, Judge Stark said it was proper to consider the constitutional issue before entertaining the motion to dismiss for equitable mootness.

On the constitutional issue, Judge Stark said that *Stern* was inapposite. In the case before the Supreme Court, the bankruptcy judge had conducted a bench trial and ruled on the merits of a counterclaim under state law. Persuaded by Judge Silverstein's opinion on remand, Judge Stark said that she "determined only that the bankruptcy-specific standards for approving nonconsensual releases in a plan were satisfied."

Judge Stark adopted Judge Silverstein's narrow reading of *Stern*. He said the Supreme Court did not address any context other than counterclaims, nor did it "'announce a broad holding addressing every facet of the bankruptcy process,'" quoting Judge Silverstein. To determine the applicability of *Stern*, he said that the "operative proceeding" was plan confirmation, where the bankruptcy court has final adjudicatory power. He explained that approving the releases did not entail an analysis of the merits of the lender's non-bankruptcy claims.

Because he decided the merits of the constitutional issue, Judge Stark did not decide, one way or another, whether the lender had waived the *Stern* question.

Turning to equitable mootness, Judge Stark said that the Third Circuit requires analysis of whether the plan has been substantially consummated and whether granting relief on appeal would "fatally unscramble the plan" or significantly harm third parties.

Substantial consummation was not an issue. However, the lender contended that the appellate court could grant relief without unscrambling the plan. The lender wanted Judge Stark to strike the releases only with respect to its claims and otherwise leave the plan intact.

Rejecting the argument, Judge Stark said that striking the release only as to the lender "would severely undermine the Plan and necessarily harm third parties." He said that the releases "cannot equitably be excised as they were the very centerpiece of the plan." They were, he said, "the inducement for the Equity Holders' $325 million contribution, and without this contribution, there could not have been a reorganization."

He said it would be inequitable were he to allow the lender to sue while also permitting the lender to retain the plan distribution made possible with the contribution from the released parties.

Judge Stark concluded that the plan was equitably moot because it was "unclear" to him "what other practicable relief" he could give the objecting lender.

Finally, Judge Stark examined the merits of the releases, as though he had ruled that the appeal was not equitably moot and the bankruptcy court lacked power to issue a final order with releases.

Because the debtor had indemnified the released parties, Judge Stark said the bankruptcy court had subject matter jurisdiction to issue the releases because there was a conceivable effect on the estate. In view of the bankruptcy court's "extensive findings upon the substantial and uncontroverted record," he said that releases were permissible under Third Circuit precedent.

The opinion is *Opt-Out Lenders v. Millennium Lab Holdings II LLC (In re Millennium Lab Holdings II LLC)*, 17-1461 (D. Del. Sept. 21, 2018).

Plans & Confirmation

The Third Circuit wrote an important decision on distributing collateral under an intercreditor agreement, but it wasn't precedential.

Intercreditor Agreement Didn't Apply to Plan Distributions, Third Circuit Holds

In a typical chapter 11 reorganization, distributions to secured creditors are not distributions of collateral, at least when there is no sale, according to the Third Circuit. Furthermore, undersecured creditors are not entitled to post-petition interest when calculating the distributions among creditors secured by the same collateral, the appeals court held.

Although rulings are critical for corporate reorganizations in Delaware, the June 19 decision by Circuit Judge Stephanos Bibas was nonprecedential. The opinion puts Delaware firmly in line with New York.

The Energy Future Noteholders

Two groups of Energy Future noteholders had liens on the same collateral. The notes were issued four years apart, and the more recently issued notes carried a higher rate of interest. The two noteholder groups were undersecured.

The issuer, Energy Future, filed a chapter 11 petition and confirmed a reorganization plan that distributed cash, stock and the right to tax benefits to the noteholders. In deciding how to split up the plan distribution, the holders of the more recently issued notes contended that the intercreditor agreement called for calculating how much would be owed to the two noteholder groups at the time of distribution.

If hypothetical post-petition interest accruals were included in the calculation, the holders of the more recently issued notes would receive a larger distribution by $90 million.

The two noteholder groups duked it out before Bankruptcy Judge Christopher S. Sontchi of Delaware, who ruled on a motion to dismiss in favor of the holders of the older notes and held that the holders of the newer notes were not entitled to the additional $90 million. To read ABI's reports on Judge Sontchi's opinions, click here and here.

The district court upheld Judge Sontchi, prompting the holders of the recently-issued notes to appeal to the Third Circuit.

The Intercreditor Agreement Didn't Apply

The intercreditor agreement between the noteholder groups contained a waterfall provision that would arguably give the additional $90 million to the holders of the newer notes because it allegedly required the inclusion of hypothetical post-petition interest in the calculation.

Judge Bibas explained that the waterfall "does not govern every asset the creditors receive." Quoting the waterfall provision, he said it applies to "'Collateral or any proceeds thereof received in connection with the sale or other disposition of . . . Collateral upon the exercise of remedies . . . by the Collateral Agent.'"

The noteholders were fighting over two types of distributions: The consideration handed out by the plan and adequate protection payments made throughout the course of the reorganization. Neither fell under the waterfall, Judge Bibas said.

"The waterfall provision would apply to the adequate protection payments and plan distributions if they were collateral. But they are not," Judge Bibas ruled.

Conceding that the noteholders held liens on essentially all of the debtor's assets, Judge Bibas nonetheless said that "not every payment from the subsidiary's assets is a payment of collateral." A payment of collateral reduces the debt, but neither the plan distribution nor the adequate protections payments reduced debt.

The adequate protection payments were for the use of collateral, but did not reduce the debt, Judge Bibas said. Judge Sontchi therefore correctly held, according to Judge Bibas, that the adequate protection payments were not payments of collateral.

With regard to the plan distributions, they were not made from assets on which the noteholders held liens. Instead, they derived from assets created by the plan over which the noteholders did not hold liens. Judge Bibas said, "plan distributions are not distributions of collateral," citing Section 552(a), which generally cuts off the attachment of prepetition liens to property acquired after filing.

Even if the distributions were collateral, the waterfall still would not apply for a second reason, Judge Bibas explained.

For the waterfall to kick in, the intercreditor agreement imposed two requirements: (1) The proceeds must arise from the sale or disposition of collateral; and (2) The sale or disposition of collateral must result from a remedy implemented by the collateral agent.

The adequate protection payments and plan distributions were neither, Judge Bibas held.

Referring to the adequate protection payments, Judge Bibas said, "Proceeds cannot be from a sale when there is no sale."

Although plan distributions might come from a sale or distribution, Judge Bibas said they did not stem from the collateral agent's remedy. Even if the plan distributions were equivalent to a disposition of collateral, the distribution "was not part of a remedy implemented by the collateral agent."

Even if the collateral agent's participation in the chapter 11 process was seen as exercising a remedy, Judge Bibas said that "the restructuring was not part of a remedy implemented by the collateral agent." The noteholders, not the collateral agent, voted for the plan, and the bankruptcy court confirmed it. "This corporate restructuring . . . is a far cry from a collateral agent's typical remedy: selling the collateral at a foreclosure sale."

Judge Bibas therefore held that "the plan distributions are not proceeds under the waterfall provision" because "the restructuring was not a remedy implemented *by the collateral agent*." [Emphasis in original.]

Holding that the waterfall did not apply, Judge Bibas upheld the lower courts and ruled that the plan distributions must be made according to the debts owing to the noteholder groups on the filing date.

Observations

In this writer's opinion, the result could have gone either way, depending on the prejudices of the presiding judge. However, the intercreditor agreement was negotiated between well represented, sophisticated parties. When an agreement like this is vague, the better result is one providing equal treatment. Giving $90 million in preferential treatment doesn't seem right when parties could have written with clarity but didn't. In other words, uncertainty demands equal treatment.

An intercreditor agreement could be drafted to achieve the opposite result, but we believe it must be very, very specific to evade the breadth of the ruling by Judge Bibas. Of course, the decision by Judge Bibas is not binding on later Third Circuit panels, because the opinion was nonprecedential.

Beyond the interpretation of a typical intercreditor agreement, the opinion is important for a second reason: The outcome will not lead to forum shopping because the result is the same in Delaware as it is in New York. Bankruptcy Judge Robert Drain of White Plains, N.Y. held that distribution under a plan are not distributions of collateral. *BOKF NA v. JPMorgan Chase Bank NA (In re MPM Silicones LLC)*, 518 B.R. 740 (Bankr. S.D.N.Y. 2014).

The opinion is *Delaware Trust Co. v. Morgan Stanley Capital Group Inc. (In re Energy Future Holdings Corp.)*, 18-1957. 2019 BL 226740 (3d Cir. June 19, 2019).

Newly appointed circuit judge uses ancient English law to illuminate the Bankruptcy Code.

Disallowing Part of a Claim Doesn't Make the Claim Impaired, Fifth Circuit Says

Siding with the Third Circuit, the Fifth Circuit held that a chapter 11 plan by itself, not state law, determines whether a claim is unimpaired. In other words, a claim is not impaired if some element of the claim, disallowed under the Bankruptcy Code, would be enforceable under state law.

Consequently, a creditor whose claim is otherwise paid in full has no right to vote on a chapter 11 plan just because part of the claim has been disallowed, perhaps because it represents unmatured interest.

The January 17 opinion by Circuit Judge Andrew S. Oldham primarily dealt with claims for a so-called makewhole premium, which chiefly arises under bond indentures when debt is repaid before maturity. The makewhole is designed to compensate bondholders for being forced to reinvest at a lower interest rate if rates have fallen.

Significantly, Judge Oldham did not delve into the split between the Second and Third Circuits regarding the allowance of makewholes. *See Delaware Trust Co. v. Energy Future Intermediate Holding Co. LLC (In re Energy Future Holdings Corp.)*, 842 F.3d 247 (3d Cir. 2016), and *BOKF NA v. Momentive Performance Materials Inc. (In re MPM Silicones LLC)*, 874 F.3d 787 (2d Cir. 2017).

Splitting with the Third Circuit, the Second Circuit held in 2017 that makewholes are not allowable in chapter 11. A year earlier, the Third Circuit held that bondholders have a valid makewhole claim in chapter 11. To read ABI's discussion of those decisions, click here and here.

In the appeal before the Fifth Circuit, neither the Second nor the Third Circuit's opinion would be definitive, because both prior cases dealt with insolvent debtors. On the other hand, Judge Oldham was dealing with solvent debtors.

Judge Oldham focused on the so-called solvent-debtor exception to a long-standing rule disallowing post-petition interest. If the exception survived adoption of the Bankruptcy Code, the makewhole might be allowable against a solvent chapter 11 debtor, he said.

Although he did not rule on the survival of the solvent-debtor exception, Judge Oldman hinted that makewholes are not allowable, regardless of whether the debtor is solvent or insolvent.

The Facts

The debtors were oil and gas producers that filed chapter 11 petitions in 2016 after the price of petroleum collapsed, rendering the companies insolvent. Later, however, the price of oil rose, making the debtors solvent once again.

The debtors proposed a chapter 11 plan where none of the creditors were impaired, thus theoretically barring them from voting on the plan.

Creditors included holders of unsecured bonds, whose indenture contained a makewhole premium. The plan did not propose to pay the makewhole.

The debtors also proposed to pay revolving credit lenders in full. However, the plan offered post-petition interest at the federal judgment rate, not the higher default rate called for in the loan agreement.

Because the plan did not pay the makewhole or the higher default interest rate, the creditors objected to the plan. To permit confirmation, the debtors set aside almost $400 million to compensate the bondholders and the revolving credit lenders if their claims for the makewhole and the default rate must be paid to render their claims unimpaired.

The Decision in Bankruptcy Court

The parties conceded that the makewhole and the default interest rate were both enforceable under state law.

After confirmation, Bankruptcy Judge Marvin Isgur of Houston ruled that the creditors must receive everything under state law to render their claims unimpaired.

The debtors appealed. Judge Isgur certified the questions for direct appeal to the Fifth Circuit. The Court of Appeals accepted the direct appeal.

Oral argument on November 5 was a clash of appellate titans, with Paul D. Clement for the debtors and Dennis F. Dunne for the creditors. We can't say yet who came out on top, because the case was remanded for Judge Isgur to anoint the winners, subject to whatever Judge Oldham might say on the next appeal.

The outcome of the next appeal may tell us for sure whether the Fifth Circuit sides with the Second Circuit or the Third Circuit on the allowance of makewhole premiums in chapter 11.

Judge Oldham's Opinion

In substance, Judge Oldman held that a claim is not impaired just because some portion of the claim is disallowed under the Bankruptcy Code.

For that proposition, he agreed with *In re PPI Enterprises (U.S.) Inc.*, 324 F.3d 197 (3d Cir. 2003), where the cap in Section 502(b)(6) of the Bankruptcy Code reduced the allowed claim of a landlord to an amount lower than it would have been outside of bankruptcy under state law. The Third Circuit held that the landlord's claim was not impaired, because the amount of the claim outside of bankruptcy "is not the relevant barometer for impairment." *Id*. at 204.

Judge Oldham said that the *Collier* treatise and every reported decision all agree that impairment arises from what the plan does, not from disallowance of a portion of a claim under the Bankruptcy Code.

Judge Oldham said his conclusion was based on the plain language of the statute, Section 1124(a), which says that a claim is not impaired "if the plan . . . leaves unaltered the [claimant's] legal, equitable, and contractual rights." The focus, he said, is on whether "'the plan' itself alters a claimant's 'legal, equitable [or] contractual rights.'"

Allowance of the Makewhole?

Ruling that the bondholders' claim was not impaired did not end the inquiry. The question remained as to whether the bondholders were entitled to the makewhole to ensure they were unimpaired. The bankruptcy court had not reached that issue, having ruled that the bondholders were impaired and thus entitled to the makewhole for that reason alone.

Judge Oldham embarked on a lengthy exegesis of English bankruptcy law and how it was or was not adopted by the Bankruptcy Act of 1898 and modified by the Bankruptcy Code in 1978 together with its later amendments. In particular, he noted how English law from hundreds of years ago disallowed post-petition interest.

English law, however, had developed exceptions to the rule disallowing post-petition interest. One exception allowed post-petition interest against a solvent debtor. Judge Oldman therefore analyzed whether the solvent-debtor exception survived adoption of the Bankruptcy Code.

Judge Oldham said that something similar to the solvent-debtor exception appears in Section 726(a)(5), where creditors are entitled to interest if claims have been paid in full. Section 1129(a)(7) incorporates Section 726(a)(5) when applying the best interest test.

However, Judge Oldman pointed out that Section 1129(a)(7) applies to an "impaired class of claims." He said that the "plain text does not apply to *unimpaired* claims." [Emphasis in original.]

Therefore, Section 1129(a)(7) did not entitle bondholders to the makewhole.

Other Reasons to Allow the Makewhole

Judge Oldham said that the makewhole might still be allowable if "the solvent-debtor exception survives Congress's enactment of Section 502(b)(2)." That section disallows claims for "unmatured interest."

Judge Oldham did not leave a blank slate for Judge Isgur. Instead, he spilled a ream of *dicta* addressing the solvent-debtor exception.

Judge Oldham said the debtors had a "compelling argument" that a makewhole is the "economic equivalent" of disallowed, unmatured interest. Further, he said the claim for the makewhole arose on the filing of the bankruptcy petition, possibly thereby making it an unenforceable *ipso facto* clause.

On the other hand, Judge Oldham said that the bondholders' "most persuasive response is that none of these arguments applies to a *solvent* debtor." [Emphasis in original.] The solvent-debtor exception, he said, might "operate as a carve-out from Section 502(b)(2)'s general bar on unmatured interest."

Did the solvent-debtor exception survive with regard to the makewhole? Judge Oldham said, "We doubt it," but he remanded the case for Judge Isgur to decide.

On remand, the survival — or not — of the solvent-debtor exception is not the end of the inquiry. Should Judge Isgur decide that the exception is not viable under the Bankruptcy Code, he still must confront *Energy Future*, where the Third Circuit held that a makewhole is allowable in chapter 11 even if the debtor is insolvent. Of course, the Second Circuit disagreed in *MPM Silicones*.

The Revolver's Default Interest Rate

But what about allowance of default interest on the revolving credit lenders' claim? Judge Oldham said the answer "is even murkier."

Both sides agreed that the revolver creditors were entitled to some post-petition interest. But how much? Should it be the lower federal judgment rate from 28 U.S.C. § 1961(a) or the higher contractual default rate?

Judge Oldham said that some courts have treated a bankruptcy claim as equivalent to a money judgment, thus invoking Section 1961(a). "Uniformity" would be a benefit of following Section

1961(a), he said. On the other hand, notions of equity might counsel for the allowance of the higher default rate.

Rather than rule, Judge Oldham again remanded the issue because Judge Isgur had not considered the rate of interest on the revolver debt.

Observations

This writer cannot recall an opinion of recent vintage using ancient English law to illuminate a complex question of modern U.S. bankruptcy law. Judge Oldham's opinion was also reliant on the Bankruptcy Code's legislative history.

The late Supreme Court Justice Antonin Scalia railed against reliance on legislative history and opposed the notion of enlightening U.S. law by the rules followed in other countries. For Justice Scalia, the statute was the beginning and the end of the discussion.

Judge Oldham, an ostensibly conservative jurist appointed by President Donald Trump, appears unbound by Justice Scalia's prescripts with regard to statutory interpretation. Notably also, legislative history has been creeping back into Supreme Court opinions following Justice Scalia's death, with "plain meaning" less often the basis for a high court ruling.

The opinion is *Ultra Petroleum Corp. v. Ad Hoc Committee of Unsecured Creditors (In re Ultra Petroleum Corp.)*, 913 F.3d 533 (5th Cir. Jan. 17, 2019).

Bankruptcy Judge Wiles explains the jurisdictional, statutory and constitutional reasons why nonconsensual releases are improper in the Second Circuit except in exceptional circumstances.

New York Judge Gives Reasons for Nixing Nonconsensual, Third-Party Releases

Bankruptcy Judge Michael E. Wiles of Manhattan refused to approve broadly worded, nonconsensual, third-party releases in the chapter 11 plan for Aegean Marine Petroleum Network Inc.

Judge Wiles said that "third-party releases are not a merit badge that somebody gets in return for making a positive contribution to a restructuring. They are not a participation trophy, and they are not a gold star for doing a good job."

Instead, Judge Wiles said, third-party releases are appropriate "only when they are actually important and necessary to the accomplishment of the transaction before the court." They "are not supposed to be imposed involuntarily just to make people feel better."

Explaining the limited circumstances when non-consensual, third-party releases are proper in the Second Circuit, Judge Wiles drew together statutory, constitutional and caselaw authorities in his published bench opinion on March 8.

Approved Releases in the Aegean Plan

In plain English, Judge Wiles laid out the release and exculpation provisions in the Aegean plan.

There being no objections, Judge Wiles explained why he was approving consensual releases and broad releases of the debtor's own claims. Releasing the debtor's claims, he said, would result in barring derivative claims. He also approved exculpation provisions, which he restricted in scope.

As written, Judge Wiles said the broadly worded exculpation would bar enforcement of contracts approved by the court. He said that an "appropriate exculpation" would protect "people from claims based on their negotiation, execution and implementation of transactions that I approved."

However, the Securities and Exchange Commission and the U.S. Trustee objected to broadly worded, third-party, *non*consensual releases.

The Circuit Split

Judge Wiles explained how the Fifth, Ninth, and Tenth Circuits have held that bankruptcy courts lack power to grant nonconsensual, third-party releases of the type he was being asked to approve.

On the other hand, he said, the Second, Fourth, Sixth and Eleventh Circuits permit nonconsensual, third-party releases in "rare" or "unusual" cases. In the Second Circuit, he said, releases of this type are proper only when "a particular release is essential and integral to the reorganization itself," citing *In re Metromedia Fiber Network, Inc.*, 416 F.3d 136, 141-43 (2d Cir. 2005).

The Proposed Nonconsensual Releases

Judge Wiles explained that he was also being asked to approve releases "even if the releasing parties did not agree to provide such releases. These proposed releases do not involve claims against the Debtors [nor] are they limited to claims that are derivative in nature . . . . They are also not limited to transactions that occurred during the bankruptcy case."

Instead, Judge Wiles said, the involuntary releases would immunize "certain parties" from claims by creditors, stockholders or parties in interest that relate "in any way" to the debtors, "with no exceptions for claims alleging fraud or willful misconduct."

The parties intended to receive nonconsensual releases fell into two categories: (1) The prepetition lender who was also the DIP lender and will be the acquiring party under the plan; and (2) three individuals on the debtor's audit committee.

Jurisdictional Limitations on Releases

Judge Wiles disagreed with the idea that the contested releases were "no big deal." Rather, he said, they were "an extraordinary thing [that is different] from what courts ordinarily do."

The claims to be released belonged to third parties in circumstances where the bankruptcy court lacks *in rem* jurisdiction, Judge Wiles said.

Even though the claims might fall under "related to" jurisdiction, Judge Wiles said he was being "asked to exercise power over a potential claim for which no actual proceeding exists." Even if there were a proceeding, he said the court needed personal jurisdiction over the parties to be bound by the releases.

To obtain personal jurisdiction, there must be formal service of process. Although the Supreme Court has recognized several exceptions, Judge Wiles said none applied.

Limitations on the Court's Power

Even if there were subject matter and personal jurisdiction, Judge Wiles said, "that would not mean that I would have the power to impose an involuntary release." For example, he said, the Supreme Court has "held that a court has no power to dictate settlement terms or to force parties to release their claims."

Rather, Judge Wiles said, a claim belonging to a third party "may only be resolved through litigation on the merits, or on terms to which the third party agrees," again citing the Supreme Court.

In addition, there are constitutional limitations, because the court cannot "take a third party's property without any hearing on the merits and without any of the discovery or other rights that a litigant usually would have."

Typically, Judge Wiles said, the releases are granted in return for contributions to the reorganization, "rather than the benefits to be provided directly to the persons whose claims are being released."

Finally, Judge Wiles said that the third-party releases are also improper because they would be broader than the released parties could obtain in their own bankruptcies, citing securities law claims as an example.

Second Circuit Restrictions

Judge Wiles said that involuntary releases are "often" justified by "the contention that anybody who makes a contribution to the case has earned a third-party release." If this were enough, he said, "releases would never be limited to the 'rare' and 'unusual' circumstances that the [Second Circuit] required in *Metromedia*."

The teaching of *Metromedia*, Judge Wiles said, "is that releases should be given only when they are an important part of a reorganization." In the case at bar, he said he was "at a loss to understand what claim is left as to which [the lender-buyer] needs protection," given the scope of the consensual leases he was approving.

To approve a third-party release, Judge Wiles said he should consider "not only" the contribution by the released parties, "but also the particular claims that are to be released, whether the releasing parties are otherwise getting recoveries on the released claims, and the fairness of the releases from the point of view of the people upon whom the releases are to be imposed."

Judge Wiles could not approve the nonconsensual releases because he was given none of the factual predicate, outlined above, that he interpreted the Second Circuit to require.

Indemnification of Directors

Having declined to approve nonconsensual releases in favor of the lender-buyer, Judge Wiles also disapproved releases designed to protect members of the audit committee.

The possibility that directors on the audit committee might assert indemnification claims against the reorganized debtor was given as a reason for the nonconsensual releases. In that respect, Judge Wiles said that some courts justify releases "to protect the debtor from indemnification claims."

"I fail to see how the possibility of an indemnification claim is a proper justification to take away the rights that claimants may have to pursue claims that they own directly against the officers and directors," Judge Wiles said.

N.B.: If anyone suspects that Judge Wiles slipped his opinion through because the debtor was not well represented, think again. The debtor, the creditors' committee, and the lender-buyer were represented by some of the country's most renowned bankruptcy counsel.

The opinion is *In re Aegean Marine Petroleum Network Inc.*, 599 B.R. 717 (Bankr. S.D.N.Y. April 8, 2019).

Stays & Injunctions

Caution: Do not use heavy machinery.
Reading this story may induce drowsiness.

Third Circuit Explores the Limits of Channeling Injunctions Protecting Insurers

The Third Circuit delved into the netherworld of so-called channeling injunctions protecting both companies that used asbestos and insurers that provided coverage.

The August 14 opinion by Circuit Judge Thomas L. Ambro explores the outer limits of channeling injunctions by defining when creditors cannot sue insurance companies and must collect their claims only from an asbestos trust created as part of a chapter 11 plan.

The appeal involved W.R. Grace & Co., whose bankruptcy soon will have kept platoons of lawyers fully employed for two decades. Grace confirmed a reorganization plan in 2011, 10 years after filing a chapter 11 petition.

The confirmed plan created a trust to pay asbestos claims and contained a channeling injunction protecting both the debtor and its insurers.

What is a channeling injunction? Judge Ambro described it as "an injunction that channels [asbestos] liability to a trust set up to compensate persons injured by the debtor's asbestos." He said it "can also protect the interests of non-debtors, such as insurers."

Giving rise to the appeal, asbestos claimants had sued insurance companies that had provided Grace with workers' compensation and employers' liability coverage, based on the insurers' right but not obligation to inspect the company's facilities.

After the plaintiffs sued in Montana state court, the insurance companies sought a declaratory judgment in bankruptcy court in Delaware. The bankruptcy court granted the insurers' motion for summary judgment and ruled that the channeling injunction enjoined the plaintiffs from suing the insurance companies.

Divining what he called "a befuddling maze of defined terms," Judge Ambro upheld the bankruptcy court's conclusion that the insurance companies' policies were covered by the channeling injunction. However, that wasn't the end of the story, because a channeling injunction can go only so far as Section 524(g) allows in protecting non-debtor third parties.

With respect to Section 524(g), Judge Ambro remanded the case to the bankruptcy court, where the result may be the same after another few years of litigation.

The remainder of this story is tedious and boring. We recommend turning to something more engaging unless you're involved in asbestos bankruptcies.

For a channeling injunction to protect a third party, the claims must arise "'by reason of' one of four statutory relationships between the third party and the debtor," Judge Ambro said, citing Section 524(g)(4)(A)(ii). Judge Ambro examined two of the four.

First, Judge Ambro examined whether the Montana claimants were seeking to hold the insurance companies "directly or indirectly liable for the conduct of, claims against, or demands on" Grace, as required by Section 524(g)(4)(A)(ii). Citing the Third Circuit's decision in *In re Combustion Engineering Inc.*, 391 F.3d 190, 234-235 (3d Cir. 2004), as amended (Feb. 23, 2005), he said that the statute limits the permissible scope of the injunction to claims based on derivative liability, meaning that the insurance companies' liability must "arise by reason of" the provision of insurance to Grace.

Judge Ambro remanded the case to the bankruptcy court, saying that the "proper inquiry is to review the law applicable to the claim being raised against the third party (and when necessary to interpret state law) to determine whether the third-party's liability is wholly separate from the debtor's liability or instead depends on it."

Judge Ambro said the circuit court could not rule on the question because it was not fully briefed.

Next, Judge Ambro analyzed the so-called statutory relationship requirement, also in Section 524(g)(4)(A)(ii). In that regard, he again remanded the case for the bankruptcy judge to review "the applicable law to determine the relationship's legal relevance to the third-party's alleged liability."

Similar to the derivative liability requirement, Judge Ambro said the bankruptcy court should "examine the elements necessary to make [a claim under Montana law] and determine whether [the] provision of insurance to Grace is relevant legally to these elements."

Again, he said the record was not sufficiently developed to make the determination on appeal.

The opinion is *Continental Casualty Co. v. Carr (In re W.R. Grace & Co.)*, 17-1208 (3d Cir. Aug. 14, 2018).

Fifth Circuit permits bar orders in receiverships while blocking nonconsensual, third-party releases in chapter 11 plans.

Fifth Circuit Bars Creditors' Own Claims Against Settling Defendants

In a 2/1 opinion arising from the R. Allen Stanford Ponzi scheme, the Fifth Circuit held that third parties who paid a receiver more than $130 million to settle claims are entitled to an order barring creditors from suing on the creditors' own claims.

This week's opinion stands in contrast to the Fifth Circuit's long-held ruling that bankruptcy courts lack power to grant nonconsensual, third-party releases in chapter 11 plans. *See, e.g.*, *Bank of N.Y. Trust Co. v. Official Unsecured Creditors' Comm. (In re Pacific Lumber Co.),* 584 F.3d 229, 251 (5th Cir. 2009).

Is it therefore fair to say that bar orders are proper in settlements in the Fifth Circuit but not in chapter 11 plans? And if that is a correct statement of the law in the Fifth Circuit, why is it true?

The dissenter in the Fifth Circuit would have held that the receivership court lacked subject matter jurisdiction to bar creditors from suing.

The Stanford Ponzi Scheme and the Settlement

The Securities and Exchange Commission put Stanford International Bank into a federal receivership in Dallas after discovering that the enterprise was a Ponzi scheme where hundreds of defrauded investors lost some $5 billion. The receiver brought lawsuits generating recoveries for distribution to all creditors *pro rata*. Stanford himself is serving a 110-year prison sentence.

The receiver sued two insurance brokers who provided policies that were advertised as providing investors with complete protection against loss. As it turned out, the policies were almost as illusory as the Stanford business.

After years of litigation and discovery, the two brokers agreed to settle and pay the receiver more than $130 million. At the time, the brokers were also defendants in lawsuits in state court brought by Stanford creditors. The brokers therefore insisted that the receivership court enter a bar order precluding creditors from pursuing their own claims.

The district court approved the settlement and the bar order. Objecting creditors appealed. For himself and Circuit Judge James E. Graves, Jr., Circuit Judge Patrick E. Higginbotham upheld the settlement and the bar order in a July 22 opinion.

Jurisdiction and Power

The objecting creditors principally argued that the district court lacked subject matter jurisdiction to bar claims that were not before the court.

The 30-page opinion by Judge Higginbotham is largely an explanation of the practical necessity for a bar order. As he said several times, the objecting creditors otherwise would "jump the queue" and potentially recover in full from their lawsuits, while other defrauded investors would only recover a fraction of their losses through the receiver.

Initially, it seemed as though Judge Higginbotham would approve the bar order by invoking federal securities laws, because he said the "district court's power to determine appropriate relief for a receivership is broad." He could not go far in that direction, because another panel of the Fifth Circuit had held on June 17 in a different *Stanford* appeal that receivers do not have greater powers than bankruptcy trustees to settle claims and enter bar orders based on the receivership court's *in rem* jurisdiction. *Becker v. Certain Underwriters at Lloyd's of London (In re Stanford International Bank Ltd.)*, 17-10663, 2019 WL 2496901 (5th Cir. June 17, 2019). To read ABI's discussion of *Becker*, click here.

Judge Higginbotham reasoned that the district court was not exercising jurisdiction over the objecting creditors or their claims. Rather, the district court was protecting the receivership and its assets. Without a bar order, there may not have been a settlement and $130 million for distribution to creditors, he said.

For authority, Judge Higginbotham relied on a nonprecedential Fifth Circuit opinion from 2013, *SEC v. Kaleta*, 530 F. App'x 360 (5th Cir. 2013). He described *Kaleta* as meaning that the "powers to fashion relief in a receivership context included the power to enjoin other proceedings by non-parties." He said that *Kaleta* was "based on principles so commonplace that [the opinion] was not published."

Judge Higginbotham said his decision was consistent with *Becker*. He described the opinion in June as approving a bar order where the enjoined creditors were receiving distributions as a result of the settlement.

Judge Higginbotham upheld the bar order in light of the "broad jurisdiction of the district court to protect the receivership *res*." The court's jurisdiction, he said, allows the court to bar "proceedings where they would undermine the receivership's operation."

The Dissent

Circuit Judge Don R. Willett dissented, although he said he appreciated the "settlement's practical value." In his view, the district court "lacked jurisdiction to grant the bar orders."

Judge Willett believed that the receiver only had standing to assert the receiver's claims and could not release the creditors' claims. He saw *Becker* as supporting his conclusion.

He interpreted *Becker* to mean that the court could not settle creditors' claims without their consent "and without the procedural protections of a class action." In his estimation, the right of the objectors "to participate in the receivership claims process does not change this."

Finally, he said that the district court "lacked *in rem* jurisdiction over these claims, as *in rem* jurisdiction extends only to receivership property. And receivership property consists of Stanford's assets, not its victim's claims."

A former justice of the Texas Supreme Court, Judge Willett was appointed to the circuit bench by President Trump. He was confirmed in the Senate on a party-line vote.

Observations

When it comes to the power to issue releases to nondebtors, the law is all over the map. Unlike the Fifth, Ninth and Tenth Circuits, the Second, Fourth, Sixth and Eleventh Circuits permit plans to have nonconsensual, third-party releases in "rare" or "unusual" cases. Even within more permissive jurisdictions, there is resistance to the notion of nondebtor releases. *See, e.g., In re Aegean Marine Petroleum Network Inc.*, 599 B.R. 717 (Bankr. S.D.N.Y. April 8, 2019). For ABI's discussion of *Aegean Marine*, click here.

Beyond the practical justification, what is the underlying legal rationale to support a finding of jurisdiction and power?

Granted, there are factual differences between a nondebtor release in a chapter 11 plan and one issued in the wake of a settlement. Are bar orders and releases justified when the third party is paying so much money that it hurts?

Perhaps there is a distinction between potential claims as opposed to existing claims. In a chapter 11 plan, the plan proponents want to ensure that creditors do not sue after confirmation by contending that someone sold them short. In the Fifth Circuit case, by contrast, there were existing claims that might double the defendants' exposure, not merely the hypothetical possibility of a claim in the future brought by a disgruntled creditor following plan confirmation.

One of these days, the issue of nondebtor releases may reach the Supreme Court. Will there be different rules for chapter 11 plans and for settlements? And if so, why?

The opinion is *Zacarias v. Stanford International Bank Ltd.*, 17-11073, 2019 BL 269784 (5th Cir. July 22, 2019).

Circuit split is widening on whether inaction can be a violation of the automatic stay.

Tenth Circuit Opinion Can Be the Springboard for a '*Cert* on the Automatic Stay

Predictably, the Tenth Circuit reaffirmed a deepening circuit split yesterday by holding that the automatic stay does not prevent a statutory worker's compensation lien from attaching automatically after bankruptcy to a recovery in a lawsuit. Yesterday's ruling sets up an opportunity for the Supreme Court to resolve the split and decide whether the automatic stay is really automatic.

Yesterday's decision in *Davis v. Tyson Prepared Foods Inc. (In re Garcia)*, 17-3247 (10th Cir. Oct. 17, 2018), was a foregone conclusion given *WD Equipment v. Cowen (In re Cowen)*, 849 F.3d 943 (10th Cir. Feb. 27, 2017), where the Tenth Circuit held last year that passively holding an asset of the estate in the face of a demand for turnover does not violate the automatic stay in Section 362(a)(3) as an act to "exercise control over property of the estate."

As the Tenth Circuit said yesterday, *Cowen* means that an "'act' for the purposes of [Section] 362(a)(3) is limited to affirmative conduct." The appeals court said that the automatic stay did not apply in *Garcia* because the "subrogation lien arose solely by operation of law."

In the lower court in *Garcia*, Bankruptcy Judge Robert E. Nugent of Wichita, Kan., reluctantly held, contrary to two prior decisions of his own, that the automatic stay did not prevent a statutory worker's compensation lien from attaching automatically after bankruptcy to a recovery in a lawsuit. Judge Nugent certified the case for direct appeal, and the circuit accepted the invitation.

The circuit court's decision in *Garcia* allows the lien to attach automatically despite the policy in Section 552(a), which precludes a "security interest" from attaching to property acquired after filing, with exceptions.

According to the transcript of oral argument in *Garcia* on September 26, the three-judge panel did not seem receptive to the idea of rehearing *en banc*, which would allow the Tenth Circuit to revisit *Cowen*. If the trustee in *Garcia* is bent on further appellate review, he may opt for filing a petition for *certiorari* and bypass an attempt at rehearing *en banc*.

The Tenth Circuit is in accord with the District of Columbia Circuit in holding that inaction does not violate the automatic stay. The Second, Seventh, Eighth, Ninth and Eleventh Circuits hold to the contrary, having ruled that a lender or owner must turn over repossessed property immediately or face a contempt citation.

At present, there is a race to decide whether a decision by the Tenth Circuit or Seventh Circuit will arrive first in the Supreme Court. In Chicago, some but not all bankruptcy judges have held that the city must automatically turn over automobiles that were impounded before bankruptcy on account of unpaid parking fines. The Seventh Circuit accepted a direct, consolidated appeal. The last brief is due in the Seventh Circuit on December 31. Consequently, the trustee in *Garcia* may end up filing the first *certiorari* petition.

To read some of ABI's coverage of *Cowen*, *Garcia*, and the Chicago cases, click here, here, here, here, and here.

The new Tenth Circuit opinion is *Davis v. Tyson Prepared Foods Inc. (In re Garcia)*, 17-3247 (10th Cir. Oct. 17, 2018).

Compensation

Seventh Circuit reverses and imposes the U.S. Trustee fee on 'revolver sweeps,' but Judge Huennekens rules that the fee increase violates two clauses in the Constitution.

Increased U.S. Trustee Fees Stick to 'Revolvers' but Not to Pending Cases

The struggle to roll back the U.S. Trustee fee is succeeding only with respect to companies whose chapter 11 cases were pending as of October 27, 2017, when the increase came into effect. Conversely, larger companies were dealt a setback when the Seventh Circuit reversed the bankruptcy court by ruling that the daily sweep on a revolving credit is a "disbursement" that must be included in calculating the U.S. Trustee fee.

Background

To ensure that taxpayers do not finance the U.S. Trustee Program, Congress revised the U.S. Trustee fees as part of the Bankruptcy Judgeship Act of 2017. Codified at 27 U.S.C. § 1930(a)(6)(B), the fee increases whenever the balance in the U.S. Trustee System Fund falls below $200 million at the end of any fiscal year through 2022.

Since the fund balance was below the threshold, the fee increased as of Oct. 27, 2017, when the amendment became effective. With the increase, "the quarterly fee payable for a quarter in which disbursements equal or exceed $1,000,000 shall be the lesser of 1 percent of such disbursements or $250,000."

In other words, if the debtor disburses $1 million a quarter, the quarterly fee is $10,000, or $40,000 a year. Under the prior fee schedule, the quarterly fee would have been $4,785 if disbursements were $999,999 in the quarter, or $6,500 if the quarterly disbursements were $1 million but less than $2 million.

If quarterly disbursements are $25 million or more, the fee is now $250,000 a quarter. At $25 million under the old schedule, the fee would have been $20,000 a quarter. For a company with $25 million in quarterly disbursements, the fee rose 1,250%

The word "disbursements" is not defined in the statute.

The increase is hitting middle-market companies, because the fee for large companies in chapter 11 is capped at $250,000 a quarter. The increase is tough on companies with low margins but high sales volumes.

'Revolvers' Are Taxed

Most larger companies in chapter 11 are financed with revolving credits provided by secured lenders. So-called revolvers allow the bank to reduce the debt every day by sweeping the debtor's income. The lender makes new advances if the company is in compliance with the loan agreement. Lenders prefer revolvers because they afford more control than term loans.

A company in Wisconsin persuaded the bankruptcy judge that the daily sweep by the revolver bank was not a "disbursement" because it did not effectively reduce the debt. Omitting the revolver sweep from the calculation of "disbursements" dramatically reduced the debtor's fee for the U.S. Trustee system. *See In re Cranberry Growers Cooperative*, 592 B.R. 325 (Bankr. W.D. Wis. 2018). To read ABI's discussion of *Cranberry Growers*, click here.

The bankruptcy judge authorized a direct appeal. The Seventh Circuit reversed on July 17 in a 29-page opinion by Circuit Judge Kenneth F. Ripple.

Since "disbursement" is not defined in the Bankruptcy Code, Judge Ripple looked to the word's "ordinary meaning." The term means money paid out or expenditures, and courts have given the term an "expansive meaning," he said.

Judge Ripple reversed the bankruptcy court, ruling that payments by the debtor's customers that reduced the revolver were "disbursements for the purposes of Section 1930(a)(6) and should have been included in the calculation of [the debtor's] quarterly fees."

On appeal in the circuit, the debtor for the first time latched on to decisions elsewhere holding that the quarterly fees were unconstitutional because they were not uniform throughout the U.S. Judge Ripple declined to reach the constitutional questions because they had not been raised in the bankruptcy court.

Question: Can bank lawyers draft revolvers so that daily sweeps won't look like disbursements, but still give the bank as much protection as traditional revolvers?

The 'Uniformity' Issue

Alabama and North Carolina never have been part of the U.S. Trustee program. Instead, the six federal districts in those states continue using bankruptcy administrators. Originally, debtors in those states did not pay fees to the U.S. Trustee system. The exemption was found to violate the Uniformity Clause of the U.S. Constitution, which provides that taxes "shall be uniform throughout the United States." *See St. Angelo v. Victoria Farms, Inc*., 38 F.3d 1525 (9th Cir. 1994), *amended*, 46 F.3d 969 (9th Cir. 1995).

Consequently, Congress amended the statute to allow imposition of the U.S. Trustee fee in non-trustee districts. However, the lack of uniformity reemerged.

When Congress increased the U.S. Trustee fee, the statute authorized the Judicial Conference of the U.S. to impose the larger fee in Alabama and North Carolina. The Judicial Conference did increase the fee, but not for pending cases.

In an opinion on July 15 dealing with a chapter 11 case that was pending when the larger fee came into effect, Bankruptcy Judge Kevin R. Huennekens of Richmond, Va., held that the increased fee violates the Uniformity Clause, if the fee is seen as a tax, and violates the Bankruptcy Clause, if the fee is considered a user fee. In a case pending when the fee rose, he ruled that the debtor was only liable to pay the lower rate under the prior version of the statute.

In substance, Judge Huennekens adopted rulings by Bankruptcy Judge Ronald B. King of San Antonio in *In re Buffets LLC*, 597 B.R. 588 (Bankr. W.D. Tex. 2019). To read ABI's discussion of *Buffets*, click here.

Last month, the district court in *Buffets* authorized a direct appeal to the Fifth Circuit.

The opinion from the Seventh Circuit is *In re Cranberry Growers Cooperative*, 18-3289, 2019 BL 263547 (7th Cir. July 17, 2019); the Virginia opinion is *In re Circuit City Stores Inc.*, 08-35653, 2019 BL 264824, 2019 Bankr Lexis 2121 (Bankr. E.D. Va. July 15, 2019).

The appeals court barred the secured lenders from renegotiating a carveout when a chapter 11 reorganization failed.

Sixth Circuit Enforces a 'Carveout' for Professionals after Conversion to Chapter 7

The Sixth Circuit nixed a plethora of arguments advanced by secured lenders aiming to nullify a cash collateral carveout to which the lender had agreed on several occasions before conversion to chapter 7.

In his December 28 opinion, Circuit Judge Gilbert S. Merritt, Jr. explained that the appeal was an effort by the lenders "to renegotiate the terms of the cash collateral order because payment of the $2.5 million in professional fees substantially impacts what they will recover under their already-diminished-in-value prepetition liens."

In a final cash collateral order in the chapter 11 case, the lenders agreed to a carveout allowing the use of some of their cash collateral to pay fees earned by counsel for the debtor and the official creditors' committee. When it became clear that confirming a plan was impossible, the lenders filed a conversion motion but agreed to the selling of assets in chapter 11. They also confirmed that cash collateral budgets would be modified to ensure payment to professionals working on the sales.

After conversion to chapter 7, counsel for the debtor and the committee filed fee applications seeking payment from the $2.5 million carveout. Over the lenders' objection, Chief Bankruptcy Judge Tracey N. Wise of Ashland, Ky., allowed the fees and directed payment from the lenders' cash collateral. The lenders appealed to the district court and lost.

Ruling on the lenders' second appeal to the Sixth Circuit, Judge Merritt upheld the lower courts, describing the cash collateral order as containing a typically comprehensive cash collateral carveout for professionals to remain binding in chapter 7 by its terms.

On appeal, the lenders argued that conversion to chapter 7 meant that the carveout could only be paid from post-petition, adequate-protection collateral, not from prepetition collateral. Judge Merritt said that the "plain language" of the cash collateral order allowed payment of counsel fees from prepetition collateral. Were it otherwise, he said, requiring payment only from post-petition, adequate-protection collateral "would render the carveout meaningless in the case of a chapter 7 conversion . . . ."

Ruling that the cash collateral order itself allowed payment of the fees, Judge Merritt said the lenders "may not now unilaterally renegotiate the terms of the cash collateral order to avoid paying

the professionals." Citing case law, he said that "courts routinely enforce carveout provisions in chapter 7 cases."

Next, Judge Merritt addressed the lenders' arguments based on Section 363(b) and (c). He interpreted the lenders as contending that the authority to use cash collateral terminated automatically when the debtor ceased operating. According to the lenders, they were entitled to "new" adequate protection before the professionals could be paid.

The lenders premised their argument on the idea that the funds carved out from the collateral became estate property on conversion, to be distributed in the order of priorities, with secured lenders coming ahead of professionals.

Judge Merritt said the "theory goes beyond anything appearing expressly or by implication in the Code." The Code, he said, only governs distributions of estate property.

In substance, Judge Merritt said the cash collateral order was an agreement by the lenders to pay professionals from their own property, not from estate property. "Nothing in the Code," he said, "prohibits the lenders from agreeing to use their collateral to pay the professionals."

The opinion is *East Coast Miner LLC v. Nixon Peabody LLP (In re Licking River Mining LLC)*, 17-6310 (6th Cir. Dec. 28, 2018).

***Jevic** doesn't mandate forcing professionals to disgorge interim allowances to achieve a* **pro rata** *distribution to administrative claimants in an administrative insolvency.*

Disgorgement by Professionals Is Not Required in an Administrative Insolvency

A bankruptcy judge is not required as a matter of law to order disgorgement of fees to effect a *pro rata* distribution among chapter 11 administrative claimants when the estate is administratively insolvent, according to District Judge Tanya Walton Pratt of Indianapolis.

The appeal entailed a typical case of administrative insolvency, which results when the unencumbered assets of the estate are insufficient to pay administrative claims in full.

A trustee had been appointed in a chapter 11 case. Counsel who represented the debtor before appointment of the trustee had been granted and paid two interim allowances of compensation totaling about $135,000.

The debtor's counsel filed a third interim fee application seeking another $110,000. The chapter 11 trustee objected to the third application. Approving settlement of the objection, Bankruptcy Judge Basil H. Lorch, III granted the application, but his order provided that neither the trustee nor the estate would pay any of the fee allowance.

There was about $4 million in unpaid administrative claims, but the trustee was holding only $1 million to apply toward those claims. The unpaid claims included an administrative claim of $2.6 million owing to the Internal Revenue Service for unpaid trust fund taxes.

Later, the trustee proposed a so-called structured dismissal of the chapter 11 case, where the bankruptcy court would authorize distribution of the estate's remaining funds, followed by a dismissal of the chapter 11 case without incurring the expense of a conversion to chapter 7.

In connection with dismissal, the trustee and the IRS asked Judge Lorch to order the debtor's counsel to disgorge $60,000, which would evidently allow the court to close the case with a *pro rata* payment of administrative claims. Judge Lorch denied the motion, and the IRS appealed.

Judge Pratt affirmed in a 12-page opinion on September 26.

The IRS argued that the Supreme Court's decision in *Czyzewski v. Jevic Holding Corp.*, 137 S. Ct. 973 (2017), required the bankruptcy judge to order disgorgement to the extent necessary to

result in a *pro rata* distribution among all of the chapter 11 administrative claimants, including the IRS. In *Jevic*, the Supreme Court held that a structured dismissal could not include a distribution that "deviate[s] from the basic priority rules" in Section 726(a). For ABI's discussion of *Jevic*, click here.

Judge Pratt said that *Jevic* "does not mandate disgorgement of [the debtor's counsel's] fees to achieve ultimate *pro rata* distribution among administrative claimants in this chapter 11 structured dismissal case." Similarly, she said that *Jevic* did not "concern whether a bankruptcy court can decline to order disgorgement where it has made, or makes, a final award of attorneys' fees."

Having concluded that *Jevic* did not require disgorgement, Judge Pratt asked whether the bankruptcy judge had authority to decline to order disgorgement. On that issue, she said, the case law is "relatively sparse."

In terms of statutory imperatives, Judge Pratt said that Section 330 contains "no requirement or any mention . . . that disgorgement must (or even should) be made to achieve a *pro rata* distribution among administrative claimants in a chapter 11 . . . structured dismissal . . . ."

According to Judge Pratt, the bankruptcy judge said he would not order disgorgement, even if he had power to do so, because the law firm had provided value to the estate by making the "single most important recovery" of assets.

Like the bankruptcy judge, Judge Pratt said that the value of the services was relevant to the question of disgorgement. Indeed, the bankruptcy judge had said that he would have considered a fee enhancement if the estate had sufficient assets.

Judge Pratt found "no basis" to overturn the bankruptcy judge's "weighing of the equities and his finding that [the law firm] had 'more than earned' a total fee of" $135,000.

The opinion is *U.S. v. Seiller Waterman LLC*, 17-00182 (S.D. Ind. Sept. 26, 2018).

Preferences & Claims

The circuits agree, but the lower courts disagree, on the allowance of post-petition attorneys' fees based on contract.

Another Circuit Allows an *Un*secured Claim for Contractual Attorneys' Fees

The circuit courts are consistently allowing unsecured claims for post-petition attorneys' fees when the creditor is entitled by contract to recover the costs of collection.

In an opinion on February 8, the Fourth Circuit joined the Second, Seventh and Ninth Circuits. Before the Supreme Court's pivotal decision in *Travelers Casualty & Surety Co. of America v. Pacific Gas & Electric Co.*, 549 U.S. 443 (2007), the First and Eleventh Circuits had reached the same conclusion.

Although the circuit courts agree, some lower courts have the opposite opinion.

The case at bar involved a secured creditor with collateral worth about $1.7 million. The loan agreement allowed the lender to recover the costs of collection, including attorneys' fees. The chapter 11 plan gave the creditor an allowed, secured claim for $1.7 million, an amount covering principal, interest, and some of the lender's post-petition attorneys' fees.

The plan permitted the lender to file an unsecured claim for additional post-petition attorneys' fees. Upheld in district court, the bankruptcy court disallowed the lender's unsecured claim for post-petition attorneys' fees.

The lender appealed and won a reversal in an opinion written by Fourth Circuit Judge Pamela Harris.

The lender relied largely on *Travelers*, where the Supreme Court overturned a rule developed in lower courts disallowing attorneys' fees for litigating issues peculiar to bankruptcy law. In a statement being followed in other contexts, the high court said that "claims enforceable under applicable state law will be allowed in bankruptcy unless they are expressly disallowed." *Id*. at 452.

Judge Harris said that bankruptcy and district courts "long have wrestled with this question, disagreeing as to whether creditors may assert unsecured claims for post-petition fees based on pre-petition contracts." She said that *Travelers* requires a determination of whether the Bankruptcy Code "expressly disallows" the claim.

Turning to the statute, Section 502(b) requires the court to "determine the amount of such claim . . . as of the date of the filing of the petition." The subsection goes on to list nine specific categories of otherwise valid claims that are disallowed, such as unmatured interest.

Judge Harris framed the question as whether the lender had a claim for post-petition counsel fees as of the filing date. Permitted under the loan agreement, the claim, she said, was "contingent on a future, post-petition event." She went on to say that the term "claim" is defined broadly in Section 101(5)(A) to include a "right to payment" that is "contingent."

Because the claim was valid under state law and did not fall into any of the nine categories of disallowed claims, Judge Harris concluded that the claim was allowable because she "found nothing in Section 502(b) that expressly disallows unsecured claims for post-petition attorneys' fees."

Judge Harris saw additional support in Section 502(c), which calls on the court to estimate claims that are contingent.

The debtor based an alternative argument on Section 506(b), allowing a secured claim for attorneys' fees only to the extent there is value in the collateral. The debtor interpreted the section to mean that undersecured claims for attorneys' fees are not allowed.

Judge Harris rejected the argument, saying that "Section 506(b) never mentions, let alone expressly disallows, unsecured claims for post-petition attorneys' fees." She found a second problem with the argument: "Section 506(b) has nothing to do with the allowance or disallowance of claims." (N.B.: The subsection does say that a claim for attorneys' fees "shall be allowed" under specified circumstances. However, the subsection may only be referring to the creditor's secured claim, not an unsecured claim.)

Judge Harris also declined to disallow the claim for "policy considerations." In that regard, the debtor had argued that allowance of unsecured claims for post-petition attorneys' fees would dilute the recovery by other unsecured creditors.

Judge Harris said the Bankruptcy Code itself already answered the question of whether the claim is allowable. She said the court "must defer to Congress' chosen policy" because the debtor's fairness argument "has no basis in the text of the relevant Code provisions."

The same issue is on appeal to the Third Circuit in *Tribune Media Co. v. Wilmington Trust Co. (In re Tribune Media Co.)*, 18-3793 (3d Cir.). In *Tribune*, the district court reversed the bankruptcy court by allowing an unsecured claim for post-petition counsel fees. To read ABI's discussion of the district court opinion, click here.

The opinion is *Summitbridge National Investments III LLC v. Faison*, 915 F.3d 288 (4th Cir. Feb. 8, 2019).

Appeals court holds that a specific request from the debtor isn't required to justify allowance of an 'admin' claim.

Fifth Circuit Clarifies 'Admin' Status for a Drilling Contractor's Post-Rejection Claims

In a significant opinion for the oil and gas industry, the Fifth Circuit clarified the circumstances when an offshore drilling contractor is entitled to an administrative expense claim after the rejection of a drilling contract. More generally, the appeals courts says that a specific request from the debtor in possession for services is not required for the allowance of an administrative claim.

After remand to make additional findings of fact, the drilling contractor may end up with a larger administrative claim than the bankruptcy court originally allowed.

The Drilling Contract

The debtor was the owner of an offshore drilling and production platform. Before bankruptcy, the debtor hired the drilling contractor to install a drilling rig and associated equipment on the platform and provide workers to drill a new well from the platform.

Before bankruptcy, a worker was killed in an accident on the platform. Federal regulators then shut down the drilling project. Two weeks later, creditors filed an involuntary petition against the owner of the platform.

In chapter 11, the debtor in possession paid the creditor to abandon the well. When abandonment was completed, the debtor filed a motion to reject the contract with the creditor.

The bankruptcy court granted the rejection motion, effective as of the day when abandonment had been completed.

Four months after rejection of the contract, regulators approved a demobilization plan for the drilling contractor to remove the drilling rig and its other equipment from the platform. Six months after rejection, the drilling contractor had removed its equipment from the platform.

The drilling contractor filed an administrative claim for about $7 million, covering the period from the effective date of rejection until it had removed its equipment from the platform.

The bankruptcy judge allowed an administrative claim for some $900,000, holding that the contractor was entitled to a priority claim only for services specifically requested by the debtor

after the effective date of rejection. The district court affirmed in July 2018. To read ABI's report on the district court affirmance, click here.

The drilling contractor appealed and won a remand in a July 26 opinion by Circuit Judge Stephen A. Higginson. Having clerked on the Supreme Court and served as an assistant United States Attorney, Judge Higginson was unanimously confirmed by the Senate in 2011.

The Law on 'Admin' Claims

Judge Higginson synthesized Fifth Circuit law on the allowance of administrative claims under Section 503(b)(1)(A). To qualify as "actual, necessary costs and expenses of preserving the estate," he said the claim must have arisen post-petition and as a result of actions taken by the debtor in possession that benefitted the estate.

More to the point, Judge Higginson said that the claim must have arisen from a transaction with the debtor in possession, as opposed to the pre-bankruptcy debtor. The creditor, he said, "must show some inducement by the debtor in possession." However, he said there need be no "explicit request by the debtor in possession for specific services."

In line with sister circuits, Judge Higginson said that an administrative claim can be based on a direct request by the debtor or by "the knowing and voluntary post-petition acceptance [by the debtor] of desired goods or services." In addition, the claimed expenses must benefit the estate.

Significantly, Judge Higginson said that a debtor in possession cannot rent equipment and then disclaim liability as an expense of administration "by asserting that it did not end up needing the equipment."

Judge Higginson said that the bankruptcy court drew a "sharp distinction" between being available to provide services and actually providing services. Nonetheless, he said, "conducting business as usual often requires that certain goods or services be available, even if ultimately not used."

Pre- and Post-Demobilization Claims

Applying the facts to the law, Judge Higginson broke down the claim into two segments: (1) Predemobilization, meaning the four months after rejection up until the contractor was authorized by regulators to begin removing its equipment from the platform, and (2) demobilization, or the two months it took to remove the equipment from the platform after the receipt of regulatory approval.

With regard to the predemobilization, Judge Higginson said that the denial of most of the claim for administrative status "appears to have been influenced by [the bankruptcy court's] stated view

that [the drilling contractor's] mere availability on the platform did not warrant administrative priority." To the contrary, he said, waiting for regulatory approval "can benefit the debtor in possession," because the debtor asked the contractor to prepare a demobilization plan and wanted the contractor to await regulatory approval before removing its equipment.

Applying the concepts to the facts, Judge Higginson said that the contractor would have a priority claim "for the actual and necessary cost of its presence on the platform for the period of time required to satisfy [the debtor's] logistical and regulatory requirements." On the other hand, he said the contract would not qualify for a priority claim "for the costs of its presence on the platform for any time attributable to its own unnecessary delay."

Judge Higginson remanded the case for the bankruptcy court to determine: (1) whether the debtor induced the contractor to remain on the platform; (2) the length of time the contractor was on the platform "because of [the debtor's] post-petition needs," and (3) "the actual and necessary costs of staying on the platform during this time period." He said that "actual and necessary" includes the costs of "remaining on the platform" and "the full and ordinary costs of providing a service, including overhead costs and other indirect expenses." In a footnote, he said the contractor is not entitled to a double recovery.

On the demobilization costs, the contractor did not fare so well, because Judge Higginson upheld the bankruptcy court by denying administrative status for everything. He said that demobilization "was simply the consequence of [the debtor's] rejection of the contract and did not benefit the estate."

The opinion is *Nabors Offshore Corp. v. Whistler Energy II LLC (In re Whistler Energy II LLC)*, 18-30940, 2019 BL 277164 (5th Cir. July 26, 2019).

Delaware district judge reads Supreme Court's* Travelers *opinion as requiring the allowance of post-petition contractual claims for attorneys' fees.

Delaware Judge Allows *Un*secured Claim for Contractual Attorneys' Fees

If attorneys' fees are disallowed on undersecured claims, it follows, does it not, that contractual claims for post-petition attorneys' fees are also disallowed on *un*secured claims?

Answer: No, it does not follow.

Reversing the bankruptcy court, District Judge Richard G. Andrews of Delaware interpreted *Travelers Casualty & Surety Co. of America v. Pacific Gas & Electric Co.*, 549 U.S. 443 (2007), to mean that an unsecured claim for post-petition attorneys' fees must be allowed if the contract makes the debtor liable.

Almost ancient history by now, the dispute arose in the reorganization of Tribune Media Co., which began with a chapter 11 filing in late 2008 and concluded on confirmation in 2012.

The indenture for unsecured, subordinated bonds called for Tribune to reimburse the indenture trustee for expenses and attorneys' fees incurred in collecting the debt. The claim by the indenture trustee included a claim for about $30 million in post-petition attorneys' fees. Were it allowed, the claim for attorneys' fees would receive a partial distribution under Tribune's plan.

The debtor objected to the claim. Bankruptcy Judge Kevin J. Carey disallowed the unsecured claims for attorneys' fees in an opinion on Nov. 19, 2015. To read Judge Carey's decision, click here.

Judge Carey adopted the conclusion of what he said were "some [lower] courts" in the Third Circuit that have held that post-petition attorneys' fees are not recoverable as part of an unsecured claim. Employing the *expressio unis* maxim, he noted that Section 506(b) expressly allows attorneys' fees for oversecured creditors, while no provision in the Bankruptcy Code allows fees for unsecured creditors. He also cited Section 502(b), which fixes the amount of claims as of the petition date.

Saying that the courts have "long been divided," Judge Carey rejected the indenture trustee's reliance on *Travelers*. He said the justices had overruled the so-called *Fobian* rule from the Third Circuit, which disallowed attorneys' fees for litigating issues peculiar to bankruptcy law. He

quoted the *Travelers* opinion where it said the high court was offering no opinion on whether the claim could have been disallowed on other grounds.

Reversing in a three-page opinion on November 26, Judge Andrews said that three circuit courts after *Travelers* "have allowed unsecured claims for contractual attorneys' fees that accrued post-filing of the bankruptcy petition." He added that two circuits had reached the same conclusion before *Travelers*.

Judge Andrews conceded that at least six decisions in 2016 and 2017 agreed with Judge Carey and disallowed contractual claims for post-petition attorneys' fees. However, Judge Andrews appeared to follow the statement in *Travelers* that "claims enforceable under applicable state law will be allowed in bankruptcy law unless they are expressly disallowed." *Id*. at 452.

Not able to contribute "anything new . . . to this debate," Judge Andrews said, "I cannot conclude that Section 506(b) 'expressly' disallowed the claims at issue here. Thus, I agree with the position adopted by every court of appeals faced with this question; Section 506(b) does not limit the allowability of unsecured claims for contractual post-petition attorneys' fees under Section 502."

The opinion is *Wilmington Trust Co. v. Tribune Media Co. (In re Tribune Media Co.)*, 15-01116, 2018 BL 432965, 2018 US Dist Lexis 199137 (D. Del. Nov. 26, 2018).

A failure to distinguish between res judicata and collateral estoppel turned out to be costly.

'Deemed Allowed' Claims Can Be Binding in Subsequent Litigation, Circuit Says

The validity and amount of a "deemed allowed" claim under Section 502(a) can be binding in a subsequent litigation between the same parties or their privies, according to the Sixth Circuit. Before applying issue preclusion or claim preclusion, however, courts should consider whether the claim was actually or necessarily litigated.

The case involved a trucking company that terminated a union contract and withdrew from a union pension fund. The pension fund sued to recover about $1.1 million, representing the trucking company's withdrawal liability.

The trucking company filed a chapter 7 petition, and the pension fund filed a claim for exactly same amount it sought in the pre-petition lawsuit, which had been stayed by bankruptcy. No one objected to the claim, so it was deemed allowed under Section 502(a).

Section 502(a) says that a proof of claim filed under Section 501 "is deemed allowed, unless a party in interest . . . objects." Eventually, the pension fund received a $52,000 distribution from the trustee on its deemed allowed claim of $1.1 million.

Around the time of the bankruptcy filing, the family that owned the bankrupt trucking company set up a new corporation and began the same business with many of the same customers. The pension fund mounted a suit in federal court against the new company, asserting it was an *alter ego* under the National Labor Relations Act, making it liable for the bankrupt's withdrawal liability.

The district court granted the pension fund's motion for summary judgment, holding that the new company was the bankrupt's *alter ego*. With regard to damages, the district court added interest and fees allowed under the NLRA, raising the judgment to some $3.2 million.

The "new" company appealed, contending that *res judicata* precluded the district court from awarding more than $1.1 million.

In his March 21 opinion, Circuit Judge Eric L. Clay upheld the district court's finding that the new company was the *alter ego* of the bankrupt company under the NLRA. He then addressed the question of whether the amount of the deemed allowed claim was binding in the new lawsuit under the doctrine of *res judicata*, or claim preclusion.

In the Sixth Circuit, claim preclusion requires proof of four elements: (1) A final decision on the merits by a court of competent jurisdiction; (2) a subsequent litigation between the same parties or their privies; (3) an issue in the later litigation that was actually litigated or should have been litigated; and (4) an identity of the cases of action.

On the first element, Judge Clay said that the Second, Fifth and Ninth Circuits had held between 1993 and 2007 that an uncontested proof of claim is a final judgment on the merits for the purposes of claim preclusion.

Judge Clay agreed with the sister circuits, quoting the Ninth Circuit's comment that it would be "most peculiar" if an uncontested proof of claim "had less dignity" than a claim that someone had contested. *Siegel v. Fed. Home Loan Mortgage Corp.*, 143 F.3d 525, 530 (9th Cir. 1998).

Judge Clay therefore held that "an uncontested proof of claim that was allowed under 11 U.S.C. § 502(a) is a final judgment on the merits for the purposes of *res judicata*, with or without a separate court order specifically allowing the claim."

In one paragraph, Judge Clay said that the new lawsuit involved the same parties or their privies.

On the issue of whether interest and fees under the NLRA could be litigated in bankruptcy court, Judge Clay said yes and held that interest and fees "should have been litigated."

The new company's *res judicata* argument came up short on the fourth and last element: an identity of the causes of action.

The pension fund's proof of claim rested on the bankrupt's failure to pay withdrawal liability. The claim in the new lawsuit dealt with the new company's *alter ego* liability. Thus, Judge Clay said, claim preclusion "does not bar litigation of the amount of [the new company's] liability" because the claim did not arise from the same "operative facts."

In a footnote, Judge Clay insinuated that the new company might have won were its argument based on issue preclusion (collateral estoppel) rather than *res judicata*. He refused to consider collateral estoppel because the new trucking company had not raised the argument until the reply brief.

So, if the new company had argued issue preclusion, the deemed allowed claim would have had preclusive effect regarding the amount of the claim. In other words, the lawyer's failure to distinguish between *res judicata* and collateral estoppel was a $2 million mistake.

Observations

The deemed allowance of a claim involves more issues than meets the eye. In a chapter 11 case, a deemed allowed claim logically should be binding in any later litigation involving the debtor or those in privity, such as officers and directors. In those situations, the company and its officers and directors were in control with regard to claim allowance. Even so, a small percentage distribution may not have justified the expense of a claim objection.

But take the case of a corporate debtor in chapter 7. The small size of the estate may not justify objecting to claims. Furthermore, is a trustee in privity with the debtor corporation and its officers and directors for the purpose of claim and issue preclusion? Indeed, the trustee may be the principal adversary of officers and directors. At least with regard to issue preclusion, a deemed allowed claim might not have been actually and necessarily litigated.

The opinion is *Trustees of Operating Engineers Local 324 Pension Fund v. Bourdow Contracting Inc.*, 18-1491, 2019 BL 229381, 2019 Us App Lexis 18653 (6th Cir. March 21, 2019).

Expiration of a lien is tolled anytime the automatic stay precludes enforcement of a judgment.

Section 108(c) Tolls the Expiration of a Lien, Ninth Circuit Holds over a Dissent

Drawing on two of its own precedents, a divided panel of the Ninth Circuit held that the tolling provisions in Section 108(c) prevent a lien on personal property from expiring during the pendency of a bankruptcy case under a unique California law.

Section 108(c) extended the duration of the lien, even though the creditor evidently could have extended the lien by filing a notice under Section 546(b)(2).

A creditor held an unsatisfied money judgment. Under California law, the creditor obtained an Order for Appearance and Examination, or ORAP, requiring the judgment debtor to appear for an examination. By serving the order on the debtor, the California statute gave the creditor a one-year lien on the debtor's personal property.

The lien was a secret lien in the sense that another creditor would only be aware of the lien by searching for lawsuits against the debtor and reading the individual dockets.

Before the one-year lien expired, the debtor filed a chapter 7 petition. The creditor filed a timely proof of claim.

The creditor did not take any action to extend the ORAP lien within the one-year period. About two years after the lien would have expired under state law, the creditor initiated an adversary proceeding in bankruptcy court seeking a declaration that her lien had priority over the trustee's hypothetical judicial lien.

On summary judgment, the bankruptcy court ruled that the ORAP lien had expired and was not tolled by Section 108(c). On appeal, the Bankruptcy Appellate Panel reversed, holding that the expiration of the lien was tolled by Section 108(c). The trustee appealed to the Ninth Circuit.

In a 2/1 decision on October 22, the Ninth Circuit upheld the BAP in a majority opinion written by Circuit Judge Jay S. Bybee.

To Judge Bybee's way of thinking, the outcome was governed by two Ninth Circuit precedents. In *Spirtos v. Moreno (In re Spirtos)*, 221 F.3d 1079 (9th Cir. 2000), the appeals court held that Section 108(c) tolls the period for renewing a judgment. *Spirtos* in part relied on *Miner Corp. v.*

Hunters Run LP (In re Hunters Run LP), 875 F.2d 1425 (9th Cir. 1989), where the Ninth Circuit held that Section 108(c) tolled the period for enforcing a mechanics' lien.

Judge Bybee nonetheless analyzed the statute's two pertinent provisions, Sections 362(a) and 108(c). In separate subsections of Section 362(a), the automatic stay enjoins the "commencement or continuation" of legal proceedings and the "enforcement . . . of a judgment."

In contrast, Section 108(c) does not differentiate between the continuation of legal proceedings and the enforcement of judgments. Instead, Section 108(c) only extends the time under nonbankruptcy law "for commencing or continuing a civil action in a court other than a bankruptcy court . . . ."

Judge Bybee therefore analyzed whether an ORAP lien "constitutes 'commencing or continuing a civil action.'" He also explored whether the omission of a reference to enforcement of judgments in Section 108(c) means that the ORAP lien expired, because an ORAP lien is one of California's means for enforcing a judgment.

Citing the *Collier* treatise, Judge Bybee said that Section 362(a) contains overlapping provisions to ensure that the automatic stay is expansive. Therefore, he said, the references in Section 362(a) to the commencement of legal proceedings and enforcement of judgments are not mutually exclusive.

Guided — if not compelled — by *Spirtos* and *Hunters Run*, Judge Bybee held that the expiration of the ORAP lien was tolled by Section 108(c) because enforcing a judgment falls within the rubric of "commencing or continuing a legal action."

Judge Bybee found support in *Morton v. National Bank of N.Y.C. (In re Morton)*, 866 F.2d 561 (2d Cir. 1989), where the Second Circuit held that the expiation of a 10-year judgment lien was tolled by Section 108(c).

Judge Bybee ended his opinion by expressly holding "that the period in which a creditor may enforce a judgment by executing on a lien constitutes the continuation of the original action that resulted in the judgment."

Arguably, Section 108(c) should not have applied because the creditor likely could have served a notice under Section 546(b)(2) to extend the perfection of the lien. However, Judge Bybee said that the Ninth Circuit had already ruled in *Spirtos* that Section 108(c) applies whenever the automatic stay bars enforcement of a judgment.

Circuit Judge Kim McLane Wardlaw dissented. Focusing on the plain language of the statute, she found significance in the omission of "enforcement" from Section 108(c). She said that enforcing a lien "is simply a different animal" from "commencing or continuing a civil action."

Judge Wardlaw said that Section 108(c) "expressly does not address" enforcement of a judgment. She saw the omission of enforcement in Section 108(c) to be "particularly persuasive" because the automatic stay applies "not only to 'commence and continuation' but also 'enforcement . . . of a judgment . . . .'"

The opinion is *Daff v. Good (In re Swintek)*, 16-60003 (9th Cir. Oct. 22, 2018).

Eleventh Circuit abandons the notion that new value must remain unpaid to offset a preference.

Circuit Split Narrows on the New Value Defense to a Preference

Narrowing a split among the circuits, the Eleventh Circuit no longer requires that new value remain unpaid on filing to qualify as a defense to a preference.

As it now stands, the Fourth, Fifth, Eighth, Ninth and Eleventh Circuits do not limit the new value defense to subsequent advances of credit that remain unpaid on the filing date. According to the August 14 opinion by Eleventh Circuit Judge Julie E. Carnes, "the Seventh Circuit held, without much discussion, that Section 547(c)(4) does require new value to remain unpaid."

Similarly, she said that the Third Circuit "also stated in a conclusory fashion [in *dicta*] that Section 547(c)(4) requires new value to remain unpaid."

In reality, the Eleventh Circuit was not reversing a prior holding. Judge Julie Carnes, not to be confused with Chief Judge Ed Carnes, said that her court's prior statement in *Charisma Investment Company N.V. v. Airport Systems Inc. (In re Jet Florida System Inc.)*, 841 F.2d 1082 (11th Cir. 1988), was *dicta* and therefore was not binding.

Commenting on Judge Carnes' opinion, Charles Tatelbaum of Miami told ABI, "It's about time."

The Facts in the Eleventh Circuit

The appeal to the Eleventh Circuit involved a typical preference, albeit for big bucks. The supplier to a chain of grocery stores was paid more than $550,000 in the 90-day preference period before bankruptcy. Also during the preference period, the supplier provided new value by delivering goods worth some $435,000.

The supplier conceded that the payments satisfied all of the elements of a preference under Section 547(b).

However, the supplier raised the so-called ordinary course defense under Section 547(c)(2) and the new value defense under Section 547(c)(4). The bankruptcy court rejected the ordinary course defense.

Relying on *Jet Florida*, the bankruptcy court did not allow the supplier to offset new value that the debtor had paid before filing. As a result, the bankruptcy court held the supplier liable for a net of about $440,000 in preferences. Had the defense been allowed, it is possible that the supplier may have had no preference liability at all.

The bankruptcy court certified a direct appeal, which the Eleventh Circuit accepted. The supplier only raised the new value defense on appeal.

Jet Florida's *Dicta*

In *Jet Florida*, the creditor had raised the new value defense under Section 547(c)(4), which allows a creditor to offset "new value" given after a preferential transfer that was "(A) not secured by an otherwise unavoidable security interest; and (B) on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor."

The bankruptcy court in *Jet Florida* concluded that the creditor had not given new value as a matter of fact. Agreeing that the creditor had not given new value, the circuit court in *Jet Florida* upheld the finding of a preference.

In the course of the decision, however, the Eleventh Circuit said that the new value defense has "generally been read to require . . . that the new value must remain unpaid." *Id.* at 1083.

Because the statement about remaining unpaid was not necessary to the decision in *Jet Florida*, Judge Carnes said it was *dicta* and was therefore not binding on the court.

Plain Language Saves the Supplier

Analyzing the issue anew, Judge Carnes said that the "plain language" of Section 546(c)(4) "does not require new value to remain unpaid." She also said that "policy considerations strongly disfavor the trustee's position" that new value must remain unpaid to provide an offset to a preference.

Judge Carnes found nothing in the language of Section 546(c)(4) allowing an offset "only for new value that remains unpaid." Instead, she said, the "plain language" in subsections (A) and (B) allow the defense "so long as the transfer that pays for the new value is itself avoidable."

Judge Carnes buttressed her conclusion by analyzing the history of preferences. Under the predecessor to the current preference statute, Section 60c of Bankruptcy Act of 1898 said there was an offset for "such new credit remaining unpaid." The "remaining unpaid" language, she said, was omitted from the Bankruptcy Code, to be replaced by "something substantively different" in the confusing double negatives now found in subsections (A) and (B).

Judge Carnes cited the Commission on the Bankruptcy Laws of the U.S. for recommending before adoption of the Code that the "remaining unpaid" provision be eliminated.

Even if Congress had not intended to make a change from prior law, Judge Carnes said she would reach the same conclusion from "the unambiguous statutory language."

Policy Considerations Point in the Same Direction

Requiring new value to remain unpaid "would hinder the policy objective of encouraging vendors to continue extending credit to financially troubled debtors," Judge Carnes said. Otherwise, a supplier who senses financial trouble would have a "strong disincentive" to continue delivering goods, for fear that preference liability would increase.

Judge Carnes described a hypothetical where a supplier received $5,000 in payments and made $5,000 in advances during the preference period. If "remaining unpaid" were a requirement, the supplier would be liable for the entire $5,000. If it did not matter, the supplier's maximum liability would be $1,000, she said.

Giving suppliers incentives to cut off customers in financial trouble would hasten bankruptcy, while harming both the debtor and other creditors, Judge Carnes said.

The trustee made a virtually unintelligible argument based on the word "otherwise" in subsection (B). Judge Carnes said that no court had accepted the argument and some have rejected it.

Judge Carnes remanded the case to recalculate the amount of the preference, if any, for which the supplier would be liable.

The opinion is *Kaye v. Blue Bell Creameries Inc. (In re BFW Liquidation LLC)*, 17-13588 (11th Cir. Aug. 14, 2018).

Mediation can result in a binding settlement even without a written agreement.

A Casually Written Email by Counsel Can Be an Agreement in the Second Circuit

An exchange of emails with a mediator can constitute a binding settlement, even if the parties never sign a written agreement, the Second Circuit said in a nonprecedential opinion.

The opinion drives home an important practice point: A casually written email can be a binding contract. Unless you intend for an email to be binding, always say that agreement depends on negotiating and signing a definitive settlement agreement.

As plan administrator, Lehman Brothers Holdings Inc. was in mediation with one of some 250 defendants in a so-called clawback suit where Lehman was attempting to recover payments made after bankruptcy. The amount of the payment the defendant would make was the only issue in mediation. The mediation took place while the defendants' motion was *sub judice* seeking dismissal of the adversary proceeding.

The mediator sent Lehman and the defendant an email confirming that they had accepted his proposal and agreed on the amount of a payment in settlement of Lehman's claim against that defendant. Lehman then sent the defendant the draft of a written settlement agreement. According to the defendant, the agreement contained additional terms that had never been discussed, much less agreed upon in mediation, such as the timing and manner of payment, the identity of the parties to the settlement, the scope of releases, and other terms.

Subsequently, the defendant requested changes in the agreement to which Lehman agreed. According to the bench opinion by Bankruptcy Judge Shelley C. Chapman in March 2017, the defendant's counsel sent Lehman an email saying its client would sign the written agreement as revised.

According to Judge Chapman, she issued her opinion granting the motion to dismiss the adversary proceeding against the defendant and others hours after the defendant's counsel said the client would sign the agreement. A few days later, the defendant said it would not sign the settlement agreement.

Lehman filed a motion to enforce the settlement agreement, which Judge Chapman granted.

In her bench opinion, Judge Chapman said the refusal to sign the settlement was a "change of heart" because she had granted the motion to dismiss, not for lack of intent not to be bound absent

a signed, written agreement. Applying the factors required by *Winston v. Mediafare Entertainment Corp.*, 777 F.2d 78 (2d Cir. 1985), Judge Chapman ruled that the settlement agreement was enforceable, although unsigned.

District Judge Denise Cote upheld Judge Chapman, and so did the Second Circuit in a *per curiam* opinion on July 18.

The circuit court analyzed the four *Winston* factors one by one. Two were in favor of finding a settlement, and two were not. The appeals court said it was a "close case."

On telling the mediator there was agreement on the settlement amount, the appeals court said the defendant "did not expressly reserve the right not to be bound in the absence of a writing." The first *Winston* factor therefore weighed in favor of finding an intent to be bound, the circuit said.

There was no partial performance, so the second *Winston* factor weighed against finding an agreement.

The third factor weighed in favor of an agreement, the circuit said, because the defendant's failure to identify disagreement on any material issues was "strong evidence" of agreement. The appeals court "comfortably" concluded that signing the agreement was the only remaining step, because the defendant "reneged" on the agreement only after the bankruptcy judge ruled that she would dismiss the adversary proceeding.

The fourth factor concerns the regularity with which writings are required. That factor was in favor of the defendant because Lehman conceded that no settlements had been in effect during the entire Lehman bankruptcy without a written agreement.

The circuit court said that the "balance tips in favor of finding an intention to be bound," given the absence of an express reservation of rights and the lack of material terms remaining to be negotiated.

It is unclear whether the appeals court would have found a binding agreement had the defendant not later said it would sign the settlement. However, the appeals court focused on the original email exchange when the mediator notified the parties that they had agreed on the settlement amount. The opinion therefore might be understood to stand for the proposition that there was a binding agreement at the earlier point in time, because the amount was the only issue in mediation.

Nonetheless, the opinion is nonprecedential, so its precedential value is limited.

The opinion is *Shinhan Bank v. Lehman Brothers Holdings Inc. (In re Lehman Brothers Holdings Inc.)*, 17-2700 (2d Cir. July 17, 2018).

Consumer Bankruptcy

Fair Debt Collection Practices Act

***Thomas Ambro on the Third Circuit answers a question the Supreme Court left open in* Henson v. Santander.**

FDCPA Applies to Debt Collectors Even if They Own the Debt

The Third Circuit jumped through a loophole the Supreme Court left open intentionally in *Henson v. Santander Consumer USA Inc.*, 137 S. Ct. 1718 (2017), by holding a debt purchaser is subject to the federal Fair Debt Collection Practices Act, or FDCPA, if its principal business is the collection of debts.

In *Henson*, the maiden opinion by newly-appointed Justice Neil M. Gorsuch, the headline holding was: Someone who purchases a defaulted debt is not a "debt collector" and is therefore not subject to the FDCPA, 15 U.S.C. § 1692, *et seq*.

A bank in *Henson* had purchased a debt already in default that had been originated by another lender. The opinion was often (but incorrectly) interpreted to mean that the FDCPA can never apply to a debt collector who has purchased a defaulted debt for its own account. However, Justice Gorsuch was careful to highlight two questions the Court did not decide:

(1) The debtor argued that the bank came within the FDCPA because it regularly collected debts for another. Justice Gorsuch said that question was not raised in the petition for *certiorari*, and the Court did not agree to review it; and
(2) Justice Gorsuch said the Supreme Court had not agreed to address another aspect of the definition of a debt collector in Section 1692a(6), which includes someone "in any business the principal purpose of which is the collection of any debts."

In his August 7 opinion for the Third Circuit based on the "plain text" of the statute, Circuit Judge Thomas L. Ambro latched onto the second unresolved question by holding that the FDCPA applies to "an entity whose principal purpose of business is the collection of any debts . . . regardless of whether the entity owns the debts it collects."

The Facts in the Third Circuit

The facts on the appeal before Judge Ambro were similar to those in *Henson*, except that the plaintiff in *Henson* had not argued below that the bank's principal business was debt collection.

In the Third Circuit, the plaintiffs owned a home subject to a mortgage owing to a bank taken over by the Federal Deposit Insurance Corp. Initially, they continued making monthly payments

after the takeover, but the FDIC neither cashed nor returned the checks. Eventually, the plaintiffs stopped sending monthly checks.

The FDIC declared the loan in default and sold it to a purchaser who demanded payment in full in an amount more than the plaintiffs owed. Having made several communications that might violate the FDCPA, the purchaser initiated foreclosure proceedings.

The homeowners filed suit in district court, alleging violations of the FDCPA. In several pleadings, the defendant-purchaser admitted that its sole business was acquiring and collecting debts.

Following a bench trial but before the district court rendered its decision, the Supreme Court handed down *Henson*. After additional briefing, the district court ruled that the purchaser was a debt collector and was liable for having violated the FDCPA.

The purchaser appealed, contending in the Third Circuit that it was not a debt collector subject to the FDCPA because it owned the debt.

Judge Ambro's Analysis

The FDCPA applies to a "debt collector" but not to a "creditor." A "debt collector" is defined as someone who uses the mails or interstate commerce "in any business the principal purpose of which is the collection of any debts" or someone "who regularly collects" debts owed to "another." 15 U.S.C. § 1692a(6).

A "creditor" under the FDCPA is someone who extends credit or is someone "to whom a debt is owed." The term "creditor" excludes "any person to the extent that he receives an assignment or transfer of a debt in default solely for the purpose of facilitating collection of such debt for another." 15 U.S.C. § 1692a(4) and (6).

Before *Henson*, the law in the Third Circuit followed the so-called default test in *Pollice v. National Tax Funding L.P.*, 225 F.3d 379, 403 (3d Cir. 2000), where the purchaser of a debt is a debt collector subject to the FDCPA if the debt was purchased after default.

Under *Pollice*, the purchaser in Third Circuit appeal would have been a "debt collector," but Judge Ambro said that *Henson* "recently repealed the 'default' test we followed."

Judge Ambro said that only one circuit court since *Henson* has ruled on the FDCPA in a precedential opinion. In that case, the District of Columbia Circuit held that the defendant was not a debt collector because there was no evidence that the bank's principal business was the collection of debt or that it was collecting the debt for someone else.

Addressing "the task before us today," Judge Ambro said that no circuit has issued a precedential opinion "on *Henson*'s applicability to the 'principal purpose' definition of 'debt collector.'" Picking what *Henson* held and what it did not hold, he said that *Henson* "affects" but "did not decide" who "fits the 'principal purpose' definition of 'debt collector.'"

Judge Ambro said that the phrase "any debt" as used in the statute does "not distinguish to whom the debt is owed." In contrast, he said, "debts owed or due . . . another" only applies to the "regularly collects" definition.

Contending that it could not be a debt collector because it also met the definition of creditor, the purchaser in substance argued that the definitions are mutually exclusive. Judge Ambro rejected the argument because, "following *Henson*, an entity that satisfies both is within the [FDCPA's] reach."

Whether the defendant owns the debt, Judge Ambro said, "does not resolve whether that entity is a debt collector." Because the purchaser conceded that its principal business was collecting debts, Judge Ambro held that the debt buyer was subject to the penalties in the FDCPA because it was a "debt collector under the 'principal purpose' definition."

To read ABI's discussion of Henson, click here.

The opinion is *Tepper v. Amos Financial LLC*, 898 F.3d 364 (3d Cir. Aug. 7, 2018).

Ethics

Bankruptcy courts must cooperate before debtors' counsel are assured of being reimbursed for advancing costs and expenses before filing.

Fifth Circuit Facilitates 'No Money Down' Chapter 13s

The Fifth Circuit opened the door a crack for so-called no-money-down chapter 13s, where debtors' counsel are not required to "eat" the filing fee, the credit counseling fee and the cost of a credit report.

The May 13 opinion by Circuit Judge Jennifer Walker Elrod gives an expansive interpretation to expenses that courts have the discretion to reimburse in fee applications by debtors' counsel. In that regard, the opinion should be applicable in chapter 11, not only chapter 13.

The opinion seems to chip away at *Lamie v. U.S. Trustee*, 540 U.S. 526 (2004), where the Supreme Court held that a chapter 7 debtor's counsel's fees cannot be paid from estate property, and any prepetition obligation for unpaid attorneys' fees is dischargeable.

The Business Model

By seeming to require the payment of retainers and filing fees before bankruptcy, strict enforcement of cases like *Lamie* had the effect of making bankruptcy unavailable for those most in need of bankruptcy — namely, individuals who are so broke they can't afford the cost of filing.

Last month, we reported a decision by Bankruptcy Judge Kevin R. Anderson of Salt Lake City, who laid down guidelines and disclosure requirements enabling lawyers to use so-called bifurcated fee arrangements, where chapter 7 debtors can pay all costs and fees in installments *after* filing. *In re Hazlett*, 16-30360, 2019 BL 130458 (Bankr. D. Utah April 10, 2019). To read ABI's report on *Hazlett*, click here.

The appeal in the Fifth Circuit dealt with so-called no-money-down chapter 13s, where debtor's counsel pays the filing fee, the fee for credit counseling and the cost of a credit report. Counsel would intend to recoup the fees through an allowance of compensation and reimbursement of expenses. We will refer to the fees and costs collectively as the "expenses."

Debtors, of course, do not pay prepetition retainers to lawyers whose business plan is no money down. In the test case on appeal, the debtor's counsel intended to take advantage of a local rule in the Western District of Louisiana permitting a so-called no-look fee. So long as the requested fee does not exceed the amount specified in the local rule, the debtor's counsel fees will be allowed

and paid under the plan without filing a detailed fee application, assuming there is no objection. The Fifth Circuit had previously permitted no-look fees.

The local rule in the district had changed. Previously, the local rule explicitly required the expenses to be included in the no-look fee. However, the local rule was modified in early 2017. The amended rule did not mention expenses, raising the question of whether debtors' counsel could recover expenses in addition to no-look fees.

And that's what debtor's counsel did, by filing a chapter 13 plan where the expenses would be reimbursed to the lawyer from the debtors' post-petition income. The chapter 13 trustee objected to the plan.

The bankruptcy court ruled that the expenses were not separately reimbursable under the local rule and were not administrative expenses reimbursable under Section 503(b)(1). Causing consternation in the debtor's bar, the bankruptcy court also held that the expenses could never be reimbursable as part of compensation in a fee application under Section 330(a).

Debtor's counsel appealed and lost in district court. *McBride v. Riley (In re Riley)*, 17-1302, 2018 BL 129776 (W.D. La. April 12, 2018). To read ABI's reports on the bankruptcy and district court opinions, click here and here.

On the second appeal, Judge Elrod affirmed in part and reversed in part, employing *de novo* review.

The Circuit's Analysis

Judge Elrod began by upholding the bankruptcy court's interpretation of the new local rule: Under the no-look rule, counsel was not entitled to reimbursement of expenses "separately from (and in addition to) the applicable no-look fee amount."

Likewise, Judge Elrod had little difficulty upholding the bankruptcy court's ruling that the expenses were not necessary costs of preserving the estate under Section 503(b). Had they fallen under Section 503(b), they would have been reimbursed in full as expenses of administration.

Judge Elrod said the expenses did not come under Section 503(b) because they were either the debtor's personal expenses or did not preserve the estate. She therefore upheld the lower courts by ruling that the expenses were not reimbursable as costs of administration under Section 503(b).

Of perhaps greatest significance to debtors' counsel, Judge Elrod concluded the opinion by holding that the fees "could" be allowed as part of attorneys' compensation under Section 330(a)(4)(B).

In an individual's chapter 12 or 13 case, the subsection provides that "the court *may allow* reasonable compensation to the debtor's attorney for representing the interests of the debtor in connection with the bankruptcy case based on a consideration of the benefit and necessity of such services to the debtor and the other factors set forth in this section." [Emphasis added.]

As "a matter of statutory interpretation," Judge Elrod rejected the lower courts' conclusions that the expenses never could be reimbursed. She said that Section 330(a)(4)(B) "vests the bankruptcy courts with discretion to determine what constitutes 'reasonable compensation.'"

Given the discretionary language in Section 330(a)(4)(B), Judge Elrod rejected the notion that the bankruptcy court must always reimburse counsel for advancing expenses. However, she held that the subsection "permits bankruptcy courts to reimburse debtor's counsel for the [expenses] as reasonable compensation."

Of significance beyond chapter 13, Judge Elrod held that "the plain meaning of 'compensation' is broad enough that it would generally be understood to include reimbursement." Still, she said, there is a separate question: Does the subsection permit reimbursement of the filing fee, the credit counseling fees, and the cost of a credit report?

To answer the question, Judge Elrod noted the "textual distinction" between Section 503(b)(1) and Section 330(a)(4)(B).

Section 503(b)(1) is limited to the expenses of preserving the estate, while Section 330(a)(4)(B) encompasses compensation for representing the debtor's interests. "[B]y any ordinary understanding of the words," the expenses are "interests" of the debtor, Judge Elrod said.

Therefore, Judge Elrod held that Section 330(a)(4)(B) "grants bankruptcy courts the discretion to authorize compensation to a Chapter 13 debtor's counsel even when the underlying activity fulfills a personal obligation of the debtor — such as advancing the cost of a filing fee — so long as that obligation is an interest of the debtor connected with the bankruptcy case."

Judge Elrod added, however, that the statute does not compel reimbursement. "That call remains within the discretion of each bankruptcy court."

The appeals court upheld the lower courts' rulings that counsel was not entitled to reimbursement of the expenses under the local rule, but the circuit vacated the rulings that the bankruptcy court could never award compensation including reimbursement of expenses.

The Takeaway

The Fifth Circuit is saying that courts can reimburse counsel for advancing prepetition costs. But will bankruptcy courts refuse reimbursement on the theory that passing debtors' expenses to the estate will diminish creditors' recoveries?

Maybe there should be no hard-and-fast rule. If a debtor is flush with cash, perhaps the debtor should pay the prepetition costs and not pass the expenses along to creditors. If the debtor is flat broke, and paying costs means defaulting on a mortgage or car payment, perhaps reimbursement is proper, if not almost compulsory.

Counsel nonetheless need a bright-line rule. This is another mess that Congress needs to clean up so those most in need can file bankruptcy.

The opinion is *McBride v. Riley (In re Riley)*, 923 F.3d 433 (5th Cir. May 13, 2019).

Judge Olson refers a lawyer for civil and criminal investigations after uncovering dozens of unauthorized filings.

For Petitions the Clients Had Not Seen or Signed, Lawyer Recommended for Disbarment

A solo bankruptcy practitioner in Florida was suspended from practice for two years and referred to the state and federal grievance committees with a recommendation that she be disbarred, for filing schedules and statements in dozens of cases where the debtors had neither seen, signed nor verified the papers under oath.

In his 37-page opinion on June 25, Bankruptcy Judge John K. Olson of Fort Lauderdale, Fla. called the lawyer "grossly incompetent" to practice in the bankruptcy court or anywhere else. Given that her actions had "serious criminal implications," Judge Olson declined to invoke the "empty head but pure heart" defense.

After reading Judge Olson's opinion, Prof. Nancy Rapoport told ABI, "In addition to being educated about a phrase I've misused all of my life ("Pandora's Jar," not "Pandora's Box") and loving the way Judge Olson writes, I think the main take-away is that those of us responsible for keeping the system of justice honest (in other words, *all* lawyers) must be vigilant in terms of reporting abuse, once we discover it, and I'm especially grateful to the lawyer who took the case *pro bono*."

Prof. Rapoport is the Garman Turner Gordon Professor of Law at the Univ. of Nevada at Las Vegas William S. Boyd School of Law, where she is an expert on legal ethics and fee allowances in bankruptcy cases.

The Slow Motion Train Wreck

The scandal unfolded by happenstance. A chapter 7 trustee filed a complaint to revoke a debtor's discharge because the trustee obtained information suggesting that the schedules and statement of affairs were not accurate. The revocation action, according to Judge Olson, opened "Pandora's Jar," later making him "aware of a multitude of extremely serious violations."

The lawyer who filed the petition and schedules — and soon found herself in hot water — was granted authority to withdraw as the debtor's counsel.

In discussions with the debtor who was then represented by *pro bono* counsel, the chapter 7 trustee learned that the debtor had neither seen nor signed the filed version of the debtor's

schedules and statement of affairs. So, the trustee filed a motion for sanctions against the debtor's former counsel.

At the conclusion of the ensuing hearing, Judge Olson entered an order directing the lawyer to produce all of her files for every bankruptcy the lawyer had filed in the previous two years. To his "shock and dismay," he said the lawyer did not produce a "single document." Instead, counsel for the lawyer filed a response saying that the documents filed with the court "in many instances" may have had "slight variations" from versions that the debtors had signed.

Counsel for the lawyer said his client had "made significant changes to her practice in order to avoid this problem in the future."

Judge Olson was not satisfied. He said the response was "in fact a last-ditch effort to keep the lid on Pandora's Jar, a farcical attempt to avoid accountability." So, he ordered the lawyer again to produce every document from her files for the 123 cases she had filed in the prior two years. He also directed her to show cause why she should not be suspended from practice.

By the required date, the lawyer produced a banker's box of documents which, it turned out, did not include 17 cases filed during the relevant time period. Judge Olson surmised that the records in those 17 cases may have reflected "especially poorly upon her, above and beyond the horrors produced in the banker's box."

What he found in the produced documents sent Judge Olson into earth orbit.

The lawyer had not produced all documents in 70% of the cases. On average, the lawyer filed the petitions 53 days after the debtors had signed drafts of the petitions and schedules. The filed petitions and schedules were not the ones the debtors had signed.

Judge Olson examined 10 cases in depth. In one, the schedules signed by the debtor omitted more than $1 million in debt appearing in the filed schedules. In another, the signed schedules omitted some $160,000 in income appearing in the filed schedules.

Like "the oncologist conducting exploratory surgery who finds metastatic cancer," Judge Olson said he "peaked and shrieked." From the documents and the attorney's testimony in court, he found, as a fact, that the debtors "have never seen, sworn to, or verified the accuracy of the documents" that the attorney filed.

On top of identifying violations of Bankruptcy Rule 9011(b), Judge Olson found that that the "method of production manifests a bad faith attempt to avoid detection of [the attorney's] shockingly inadequate and possible criminal standard operating procedure."

The Sanctions

"Accordingly and extremely regrettably," Judge Olson said he had "no other choice but to suspend [the lawyer] for a considerable period of time and to recommend that other entities act to disbar [her] from the practice of law entirely." He was convinced that "[n]o amount of continuing legal education could possibly fill the gaps of incompetence demonstrated here."

Judge Olson therefore suspended the lawyer from practice in the bankruptcy court for the Southern District of Florida for two years. He referred her to the state and federal grievance committees with a recommendation of disbarment. Finally, he referred the matter to the U.S. Trustee and the U.S. Attorney for such investigations as they "see fit."

Observation: Having lost her livelihood, the lawyer will presumably appeal. Will an appellate court grant a stay pending appeal? Will a softhearted appellate court give the lawyer a second chance and lift the suspension? How many hours of CLE would be enough? Should reinstatement depend on the lawyer's serving as an intern in a law office that abides by the rules?

A Possible Remedy: How should the courts respond if it appears that the Florida lawyer is not alone in filing petitions that debtors have not verified and signed? The Bankruptcy Rules could be amended or judges could adopt local rules requiring counsel to file optically scanned petitions and schedules showing the debtors' "wet" signatures with the debtors' "wet" initials on every page.

The opinion is *In re Pina*, 18-15928. 2019 BL 237273 (Bankr. S.D. Fla. June 25, 2019).

Discharge/Dischargeability

Fifth Circuit now says that student loans must 'impose intolerable difficulties' to be dischargeable.

Fifth Circuit Makes Student Loans Even More Difficult to Discharge

In the Fifth Circuit, student loans are arguably more difficult to discharge than elsewhere. The New Orleans-based appeals raised the already-high bar by holding that student loans may not be discharged unless "repayment would impose intolerable difficulties on the debtor."

To meet the *Brunner/Gerhardt* test in the Fifth Circuit, a debtor evidently must be both disabled and unemployable.

The Disabled Debtor

The debtor was a woman who contracted diabetic neuropathy after taking down $7,000 in student loans. The affliction is a degenerative condition that causes pain in the legs and feet. The debtor could not hold down jobs requiring her to stand and was unable to land a sedentary job.

The debtor filed a complaint to discharge the student loans, alleging she had shown "undue hardship" as required by Section 523(a)(8).

Bankruptcy Judge Harlan D. Hale of Dallas opened his opinion by saying that some debtors seeking to discharge student loans in his court "appeared to satisfy the plain language of the statute, which merely requires that the debt, if excepted from discharge, would impose an 'undue hardship' on the debtor and the debtor's dependents."

In his 15 years on the bench, Judge Hale said he had never discharged a single student loan over an objection by the lender, because "none have satisfied the demanding standard adopted as controlling law in this Circuit." He was referring to *In re Gerhardt*, 348 F.3d 89 (5th Cir. 2003), authored by Circuit Judge Edith H. Jones.

Although Judge Hale said he had "sympathy" for the debtor's "situation," he was constrained to rule that *Gerhardt* barred discharging the debt. He said the debtor conceded that she was "unable to show she is completely incapable of any employment now or in the future."

Although the district judge was similarly sympathetic to the debtor's plight, he upheld the judgment for the reasons given by Judge Hale. On appeal to the Fifth Circuit, the debtor and *amici* implored the appeals court to revisit *Brunner* and *Gerhardt*.

The Fifth Circuit rebuffed the debtor's appeal in an 11-page opinion on July 30, written by Judge Jones, who had been *Gerhardt's* author.

The *Brunner/Gerhardt* Standards

Judge Jones explained that eight circuits, in addition to the Fifth Circuit, have adopted the so-called *Brunner* test laid down by the Second Circuit in 1987, years before the adoption of Section 523(a)(8) as it now reads. *Brunner v. New York State Higher Education Service Corp.*, 831 F.2d 395 (2d Cir. 1987).

To discharge student loans under *Brunner,* the debtor must prove that (1) she cannot maintain a "minimal standard of living" if forced to repay the loan, (2) additional circumstances show that the state of affairs is likely to persist for a significant portion of the repayment period, and (3) the debtor has made a good faith effort to repay the loans.

As the bankruptcy court had concluded, Judge Jones said that the debtor failed the second part of the test regarding the persistence of her inability to work.

Applying the gloss on *Brunner* added by *Gerhardt*, Judge Jones said that the second part of the test is "exceptionally demanding." She said it requires the debtor to "show that circumstances out of her control have resulted in a 'total incapacity' to repay the debt now and in the future." *Gerhardt*, 348 F.3d at 92.

Judge Jones rejected the debtor's contention that *Brunner/Gerhardt* is inconsistent with the plain meaning of "undue hardship." She also rebuffed the debtor's argument that the Fifth Circuit should adopt the Eighth Circuit's more lenient "totality of the circumstances" test. *Long v. Educ. Credit Mgmt. Corp. (In re Long)*, 322 F.3d 549, 554 (8th Cir. 2003).

Judge Jones said the debtor failed the second part of the *Brunner* test because she admitted that she was "capable of employment in sedentary work environments." The circuit judge also said there was no evidence that the debtor's "present circumstances, difficult though they are, are likely to persist throughout a significant portion of the loans' repayment period."

The debtor's critiques of *Brunner/Gerhardt* were "unconvincing," Judge Jones said, in view of the history of the repeated legislative tightenings of the student loan dischargeability statute. She said that "the series of amendments clearly evinces an intent to limit bankruptcy's use as a means of offloading student loan debt except in the most compelling circumstances."

Judge Jones consulted the dictionary definitions of "undue" and "hardship" to conclude that Congress means for student loans to be dischargeable only when the debt "would impose intolerable difficulties for the debtor." She went on to say that Section 523(a)(8) "proscribe[s] student loan discharges in all but the most severe circumstances."

Upholding the nondischargeability of the student loans, Judge Jones said that adopting the Eighth Circuit's "totality of the circumstances" test would risk "creating intolerable inconsistency of results."

The ABI Commission Recommendation

Reacting to the Fifth Circuit's refusal to revisit *Brunner/Gerhardt*, Rudy J. Cerone told ABI, "It will take either an *en banc* reversal or a statutory revision by Congress to effect a change." Cerone, from McGlinchey Stafford PLLC in New Orleans, was a member of ABI's Commission on Consumer Bankruptcy.

The ABI commission's Final Report said that *Brunner*, "[i]f reasonably applied, . . . can allow appropriate bankruptcy relief during a period when discharge of student loans is not otherwise available." The commission went on to recommend that Congress "return to the pre-1998 rule that allowed student loans to be discharged after seven years from the time they first became payable. Before seven years, student loans would be dischargeable only upon a finding of undue hardship."

The commission also recommended that "only student loans made, insured, or guaranteed by a governmental unit receive any protection from discharge."

To read the commission's report, click here.

The opinion is *Thomas v. Department of Education (In re Thomas)*, 18-11091, 2019 BL 282170, 2019 USApp Lexis 22584 (5th Cir. July 30, 2019).

Conflicting standards among the circuits warrant a grant of certiorari to define 'undue hardship' required for discharging a student loan.

Recent Decisions Deepen and Entrench Circuit Split on Discharging Student Loans

There are two and perhaps three tests among the circuit courts for deciding when the repayment of a student loan amounts to an "undue hardship," enabling the court to discharge the debt under Section 523(a)(8).

Discharging a student loan is conceivable under the Eighth Circuit's somewhat lenient "totality of the circumstances" test. In the majority of circuits employing the so-called *Brunner* test, discharging a student loan is exceedingly difficult. Although professing to follow *Brunner*, the Fifth Circuit's new test means that student loans are essentially impossible to discharge.

Decisions in late July by the Fifth Circuit and the First Circuit Bankruptcy Appellate Panel underscore the need for the Supreme Court to grant *certiorari* and resolve the circuit split.

The Three Tests

The *Brunner* test emanated from the Second Circuit in 1987, 18 years before Congress adopted the current iteration of Section 523(a)(8). *Brunner v. New York State Higher Education Service Corp.*, 831 F.2d 395 (2d Cir. 1987).

To discharge a student loan under *Brunner*, the debtor must prove that (1) she cannot maintain a "minimal standard of living" if forced to repay the loan, (2) additional circumstances show that the state of affairs is likely to persist for a significant portion of the repayment period, and (3) the debtor has made a good faith effort to repay the loans. *Brunner* is followed in the Second, Third, Fourth, Fifth, Sixth, Seventh, Ninth and Eleventh Circuits.

Standing alone, the Eighth Circuit developed the so-called totality of the circumstances test, where the court must consider (1) the debtor's future financial condition, (2) the debtor's and dependents' reasonable and necessary living expenses, and (3) "other relevant facts and circumstances surrounding each particular bankruptcy case." *Long v. Educ. Credit Mgmt. Corp. (In re Long)*, 322 F.3d 549, 554 (8th Cir. 2003). Rejecting *Brunner*, the Eighth Circuit said it preferred a "less restrictive approach." *Id*.

Although professing to follow *Brunner*, the Fifth Circuit seemed to tighten its already higher standard by ruling on July 30 that a debtor may not discharge a student loan unless "repayment

would impose intolerable difficulties on the debtor." *Thomas v. Department of Education (In re Thomas)*, 18-11091, 2019 BL 282170, 2019 US App Lexis 22584 (5th Cir. July 30, 2019). To read ABI's discussion of *Thomas*, click here.

If nothing more, the Supreme Court should grant *certiorari* to decide whether the Fifth Circuit's requirement of showing "intolerable difficulties" is tougher than the "undue hardship" standard in the statute.

The Facts in the First Circuit BAP

The First Circuit has not definitively decided whether to follow *Brunner* or the "totality of the circumstances" test. However, most of the bankruptcy judges in the First Circuit and the circuit's BAP employ *Long* from the Eighth Circuit. Although invoking *Long*, a bankruptcy court in Massachusetts refused to discharge student loans owned by a debtor who was virtually destitute in terms of current income.

The debtor was in her mid-60s and lived alone in a home she purchased in 1998. She provided some support for her adopted child who was in his early 20s and attending college.

The debtor earned an undergraduate degree in 1997 and enrolled later in law school, emerging with a JD degree in 2009. In the process, she amassed $110,000 in student loans. Although she passed the bar and sought a law job for two years, she received no offers of employment and only had one interview after filing 100 job applications.

Suffering from a long list of medical ailments, she worked only sporadically as a solo practitioner and for a not-for-profit legal clinic where she earned minimal income. In three years before attempting to discharge the student loans, her annual income was no greater than $14,800.

More recently, her monthly income was less than $1,500 and her monthly expenses resulted in a deficit of $76 a month.

But here's the kicker: The debtor estimated that she had an equity of $125,000 in her home. The home was encumbered by a $59,000 mortgage.

The debtor claimed an exemption in the home. No one objected. The maximum homestead exemption in Massachusetts is $500,000, meaning that her exemption was one-quarter of what the state allows.

Although finding that the debtor lived "a spartan lifestyle not susceptible to further expense reduction," the bankruptcy court refused to discharge the student loans. According to the BAP, the bankruptcy judge said that the equity in the home by itself was "dispositive" and "negates any claim that payment of the loan imposes an undue hardship."

While the bankruptcy court did not require the debtor to sell the home, the bankruptcy judge said that the "substantial equity . . . can be used to pay these student loans in full."

The Remand by the BAP

The debtor appealed and won a remand in a July 26 opinion for the BAP written by Bankruptcy Judge Diane Finkle.

Judge Finkle emphasized two factor: Section 522(c) and *Law v. Siegel*, 571 U.S. 415 (2014). Section 522(c) says that exempt property "is not liable during or after the case for any debt of the debtor that arose . . . before the commencement of the case." *Law v. Segal* teaches that the court may not employ equitable considerations to override a debtor's statutory homestead exemption.

Judge Finkle therefore held that the debtor's "home equity is protected from liability for her student loans." She went on to say that Section 522(c)(3) does not permit invading an exempt asset to repay a student loan unless the loan was obtained through fraud.

Turning to *Long*, Judge Finkle said that the existence of exempt assets is not one of the factors in the "totality" test. By relying solely on the home equity, she said that the bankruptcy court "sidestepped the necessary evaluation of whether in the foreseeable future [the debtor] could increase her income and pay" part of all of the loans.

Judge Finkle ruled that the bankruptcy court committed error by overlooking the policy articulated in *Law v. Segal* and by "not fully evaluating other relevant factors" such as the debtor's future earning capacity and the impact of her health "on her future financial prospects."

Judge Finkle remanded the case for the bankruptcy judge to make the findings outlined in her opinion for the BAP. Unless facts come to light not evident from the BAP decision, the debtor would seem to be eligible in the First Circuit to discharge her student loans on remand.

However, the same debtor would not seem eligible to discharge the loans in the Fifth Circuit under the new *Thomas* standard.

The Need for High Court Review

Except in the Eighth Circuit, discharging student loans is exceptionally difficult. In the Fifth Circuit after *Thomas*, it appears that a debtor must be both disabled and unemployable to discharge student loans.

At a minimum, the Supreme Court should decide whether *Brunner* or the Eighth Circuit's "totality" test is proper. More fundamentally, the high court should decide whether all of the circuits have adopted standards that are higher than the statutory standard of "undue hardship." In

other words, the Supreme Court needs to specify the degree of hardship a debtor is required to endure before discharging student loans.

The First Circuit BAP opinion is *Schatz v. Access Group Inc. (In re Schatz)*, 18-016, 2019 BL 284018, 2019 WL3432801 (B.A.P. 1st Cir. July 26, 2019).

On an issue dividing the courts, the Seventh Circuit rules that an obligation to repay a domestic support obligation is a dischargeable debt, not a nondischargeable DSO.

Overpaying a DSO Doesn't Result in a Nondischargeable Debt, Seventh Circuit Holds

The Seventh Circuit narrowly interpreted "domestic support obligation" in direct appeals from rulings by two bankruptcy judges in Chicago. Some might say the appeals court ignored the plain meaning of Section 101(14A), defining a domestic support obligation, or DSO.

Others would say the Seventh Circuit employed good judgment to achieve a result that Congress likely intended and did not abandon common sense by relying only on the terse language of a statute.

The Cases in Bankruptcy Court

The cases before Bankruptcy Judges Deborah Thorne and A. Benjamin Goldgar were similar but not identical. In one, the chapter 13 debtor had received an $8,000 overpayment of child care tuition by the state. In the other, the chapter 7 debtor had received an overpayment of $3,400 for food stamps for herself and her two children.

In both cases, the state filed claims and contended that the overpayments were nondischargeable DSOs. Section 101(14A) defines a DSO as a debt "owed to or recoverable by . . . a spouse, former spouse . . . or a governmental unit" that is "in the nature of alimony, maintenance, or support (including assistance provided by a governmental unit) . . . ."

The state contended that the overpayments fit neatly within the definition because the benefits given by the state were designed to help the women support their children. If the obligations to repay the overpayments were DSOs themselves, the debts would be nondischargeable under Section 523(a)(5).

Judges Thorne and Goldgar concluded that the debts arising from the overpayments were not DSOs and were therefore dischargeable. When the state appealed, both bankruptcy judges certified direct appeals to the circuit. The circuit accepted the direct appeals, since courts around the country disagree on the outcome. To read ABI's report on Judge Thorne's decision, click here.

In her June 27 opinion for the appeals court, Chief Circuit Judge Diane P. Wood upheld the bankruptcy courts, saying that the result sought by the state "would expand the definition of domestic support obligation far beyond what is intended by the bankruptcy code."

Judge Wood favorably cited a 2010 decision by another Illinois bankruptcy judge involving a man who won a judgment for the repayment of child support because it turned out that he was not the father. The bankruptcy court held that the repayment obligation was not a DSO because erroneously charging the man for support obligations did not transform the refund obligation into a DSO.

Judge Wood said that the debtors did not owe "money for support obligations." Rather, she said they owed a debt because "they received money they were not statutorily entitled to."

Since the payment obligations by the debtors were "not in the nature of alimony, maintenance or support, we agree with the bankruptcy court decision that this is merely an overpayment of benefits and not a domestic support obligation," she said.

The opinion is *In re Dennis*, 18-2899, 2019 BL 239286 (7th Cir. June 27, 2019).

BAP joins the majority of courts by saying that defaulting on direct mortgage payments precludes a chapter 13 debtor from receiving a discharge.

Direct Mortgage Payments Are 'Under the Plan,' Ninth Circuit BAP Says

Circuitously, the Ninth Circuit Bankruptcy Appellate Panel joined what it called the "overwhelming majority of courts" by concluding that direct payments on a mortgage by a chapter 13 debtor are "payments under the plan."

Assuming the BAP's ruling is followed by lower courts, debtors in the Ninth Circuit who miss direct payments on their mortgages will not be entitled to discharges under Section 1328(a).

But that's not how the case arose.

Direct Mortgage Payments Under the Debtors' Plan

The debtors confirmed a 60-month chapter 13 plan calling for them to make monthly mortgage payments directly to the lender, not through the chapter 13 trustee. To deal with $65,000 in arrears, the plan had alternative provisions.

The plan provided that the arrears would be "cured" if the lender agreed to a mortgage modification. If the lender did not agree, the debtors were to modify the plan to pay the arrears. The plan paid nothing on unsecured claims.

After the last plan payment, the lender filed a motion for modification of the stay, alleging that the debtors failed to make more than $120,000 in mortgage payments. In the 67th month after they began making plan payments, the debtors responded with a motion to modify the plan by surrendering the property.

The bankruptcy court approved the plan modification. The chapter 13 trustee appealed and won in a May 6 opinion for the BAP by Bankruptcy Judge Julia W. Brand.

The Question on Appeal

Section 1329(a) allows modification of a plan "[a]t any time after confirmation of the plan but before the completion of payments under such plan." Because they had not made direct mortgage payments, the debtors contended that they had not completed plan payments and were thus entitled to modify the plan.

The BAP was thus charged with deciding whether the debtors had completed payments "under such plan." The analogous question arises under Section 1328(a), where the debtor must receive a discharge "after completion . . . of all payments under the plan."

Courts around the country are divided on whether a debtor who misses direct mortgage payments is nonetheless entitled to a discharge because the direct payments were not "under the plan."

Judge Brand said that the "overwhelming majority of courts" have concluded that direct mortgage payments are under the plan and must be made for the debtor to receive a discharge. However, she cited and analyzed two cases holding to the contrary: *In re Gibson*, 582 B.R. 15 (Bankr. C.D. Ill. 2018), and *In re Rivera*, 13-20842, 2019 WL 1430273 (Bankr. D. Ariz. Mar. 28, 2019).

In both cases, Judge Brand said, the debtors' sympathetic circumstances helped explain the outcomes. In *Gibson*, the debtor innocently misunderstood the plan's requirements. In *Rivera*, the debtor did not default on the mortgage until the 41st month of the plan. To read ABI's discussions of *Gibson* and *Rivera*, click here and here.

Although Judge Brand said that *Gibson* and *Rivera* were "thoughtful and well-intended," she "respectfully disagreed" and found "some flaws" in interpreting the statute.

First, Judge Brand did not understand how the debtor could obtain a discharge after missing mortgage payments when defaulting on the mortgage was grounds for dismissal.

Second, Judge Brand said that the computation of disposable income assumes the debtor will make mortgage payments. By skipping the mortgage, she said that the debtor would benefit from "living without mortgage payments at the expense of creditors." Had the debtors surrendered the home, the distribution to unsecured creditors would have increased.

Modification Shouldn't Have Been Allowed

Judge Brand laid the foundation for ruling that the debtors were not entitled to discharges. However, her legal analysis also led to the conclusion that the debtors had not completed payments under the plan. Ironically, the debtors were theoretically entitled to propose a plan amendment.

The bankruptcy court nevertheless erred in allowing the amendment.

Judge Brand identified three Code provisions prohibiting a plan running longer than five years, thus barring a payment in the 67th month.

The debtors argued that surrendering the home was not a payment and thus did not run afoul of the Code. Judge Brand disagreed. She held that "surrender is a form of payment for purposes of Section 1329(c)."

Finally, Judge Brand hinted that the proposed modification was not in good faith, thus rendering the amendment unconfirmable under Section 1325(a)(3). She said the debtors' good faith was "in question" because they paid nothing to unsecured creditors while retaining over $100,000.

The BAP therefore reversed the bankruptcy court for abuse of discretion because the court had no authority to allow an amendment after the 60th month.

N.B.: Since Arizona is in the Ninth Circuit, *Rivera* likely would have been reversed on appeal. However, there was no appeal, so the *Rivera* debtors received their discharges. The *Gibson* debtors likewise received their discharges because there was no appeal.

The opinion is *Derham-Burk v. Mrdutt (In re Mrdutt)*, 17-1256, 2019 BL 188185, 2019 Bankr Lexis 1587 (B.A.P. 9th Cir. May 6, 2019).

Illinois judges disagree on whether direct payments to a mortgagee are "under the plan" and must be made in full to obtain a chapter 13 discharge.

Judges Split on Denial of Chapter 13 Discharge for Missing Direct Mortgage Payments

Bankruptcy judges in Illinois disagree on whether a chapter 13 debtor who fails to make all direct payments on a home mortgage is eligible for a discharge.

Adopting the minority approach, Bankruptcy Judge Thomas L. Perkins of Peoria, Ill., ruled in March that failure to make direct payments on a nondischargeable mortgage is not grounds for denying a chapter 13 discharge. To read ABI's discussion of Judge Perkins' opinion, *In re Gibson*, 582 B.R. 15 (Bankr. C.D. Ill. March 5, 2018), click here.

Chief Bankruptcy Judge Laura K. Grandy of East St. Louis, Ill., confronted a similar case where the confirmed chapter 13 plan called for the debtors to make direct payments to the home mortgage lender going forward. Payments through the trustee cured arrears.

At the end of the plan, the trustee filed a notice saying that the arrears had been cured and that the debtors had made all payments required to be made to the trustee. The debtors filed a motion for entry of discharge, stating they had made all payments required by the plan.

Fifteen days before the deadline for objecting to discharge, the mortgage lender filed a response to the trustee's notice stating that the mortgage was in arrears by almost $71,000. The lender did not object to the entry of discharge, perhaps because the mortgage debt would not be discharged in any event under Sections 1322(b)(5) and 1328(a)(1).

Neither the chapter 13 trustee nor any creditor objected, so Judge Grandy entered the debtor's discharge under Section 1328(a).

One month after the entry of discharge, the chapter 13 trustee filed a complaint to revoke discharge under Section 1328(e), alleging that the debtors had obtained their discharges by fraud. The debtors' counsel argued that the motion for a discharge was accurate because direct payments allegedly were not "under the plan."

Judge Grandy said in her August 28 opinion that she "respectfully" disagrees with Judge Perkins because she believes that direct payments to a mortgagee are "payments under the plan," as required by Section 1328(a). Direct payments are "under the plan," she said, because they "must be addressed in that plan."

However, Judge Grandy did not revoke the debtors' discharges. Because the lender's response told the chapter 13 trustee in advance of discharge that the debtors had not made all payments, she allowed the discharge to stand under Section 1328(e) because the trustee knew about the alleged fraud before discharge.

Given the trustee's tardy objection to discharge, Judge Grandy said it was unnecessary to decide "whether or not the debtors' statement that they completed all plan payments was fraudulent."

She ended her opinion with an admonition, saying it was "entirely possible that such statements may rise to the level of fraud." Therefore, she said, debtors "are advised to carefully consider the accuracy and truthfulness of statements made in their motions for discharge."

The opinion is *Simon v. Finley (In re Finley)*, 18-4011 (Bankr. S.D. Ill. Aug. 28, 2018).

Finding 'undue hardship' held not to require discharging all student loan debt.

District Court Upholds Discharge of a Portion of Student Loan Debt

A district judge in Kansas upheld a decision handed down last year by Bankruptcy Judge Robert E. Nugent of Wichita, Kan., who ruled that a bankruptcy court has authority to discharge interest on a student loan while leaving the principal intact.

In his May 2 opinion, District Judge John W. Broomes also held that a discharge under Section 523 (a)(8) is not an "all or nothing" proposition. If the court decides that payment of part of a student loan results in undue hardship, the judge is not required to discharge the entire loan.

The debtor was a 59-year-old single woman with no dependents. Her gross annual income had ranged between $40,000 and $43,000, with little chance of substantial increase. Judge Nugent found that her standard of living was "spartan."

The debtor presented an attractive case for discharging student loans. She had borrowed about $16,000 between 1989 and 1991 to attend college for two years. She had paid about $14,000 toward the loans, almost all in a succession of three chapter 13 cases. Because her payments did not cover interest, the outstanding balance had grown to more than $67,000.

Having completed payments in her most third and most recent chapter 13 plan, the debtor sought to discharge the student loans under Section 523(a)(8).

Under three payment plans offered by the government, the only one she could afford was the smallest at $203 a month. If she made all the payments over the succeeding 25 years, Judge Nugent calculated that she would have ended up at age 84 owing more than $152,000, because $203 a month would be $301 a month short of paying current interest. If the remainder were forgiven at the end of the repayment program, she faced the possibility of incurring a nondischargeable tax liability for forgiveness of indebtedness income.

On the other hand, Judge Nugent calculated that she could pay off the $16,000 principal balance in about 10 years if she were to pay $203 a month.

Judge Nugent therefore ruled that everything in excess of the $16,000 principal balance would be discharged.

Both sides appealed. The lender argued that the debtor failed the so-called *Brunner* test and was not entitled to discharge anything. The debtor contended that the bankruptcy court should have

discharged the entire debt, arguing that the statute does not permit a partial discharge if the court finds an undue hardship.

The issues were well presented on appeal. The National Association of Bankruptcy Attorneys, the National Consumer Bankruptcy Rights Center, and the National Consumer Law Center submitted an *amicus* brief authored by Jill A. Michaux, William R. Fossey, and Tara Twomey. District Judge Broomes overruled the lender's opposition to the filing of the *amicus* brief.

Judge Broomes affirmed Judge Nugent right down the line. He began by explaining how the Tenth Circuit had adopted *Brunner* and its three-prong test. *Brunner v. New York State Higher Education Services Corp.*, 831 F.2d 395, 396 (2d Cir. 1987). Nonetheless, he said the Tenth Circuit had "cautioned" that the test "must not be applied such that debtors who truly cannot afford to pay their loans may have their loans discharged," quoting *Education Credit Management Corp. v. Polleys*, 356 F.3d 1302, 1309 (10th Cir. 2004).

On the first test — whether the debtor can maintain a minimal standard of living while repaying the debt — Judge Broomes cited Judge Nugent's finding that the debtor could only afford about $200 a month.

Because the debtor could pay something, the lender contended that the debtor failed the first test, making the entire loan nondischargeable. Judge Broomes disagreed. He cited the Tenth Circuit for holding that a debtor is not required to participate in one of the repayment programs to qualify for discharge. That, he said, is considered to be part of the good faith test.

Judge Broomes said that the lender had failed to make a "colorable argument that [the debtor] could ever truly repay her loan." He ruled that the debtor had therefore satisfied the first test, because participating in one of the repayment programs "would thwart the fresh start policy."

The second test asks whether the debtor's circumstances are likely to persist. Judge Broomes upheld Judge Nugent's finding that her financial condition was "likely to persist."

The third test deals with the debtor's good faith. On that topic, Judge Broomes upheld Judge Nugent's finding that the debtor had made a good faith effort to repay her loans.

Finally, Judge Broomes turned to the debtor's cross appeal, where she contended the court must discharge the entire loan once the debtor proves that paying the entire debt is impossible. The debtor cited *Skaggs v. Great Lakes Higher Education Corp. (In re Skaggs)*, 196 B.R. 865, 866-67 (Bankr. W.D. Okla. 1996), for the notion that discharging student loans is an all-or-nothing proposition under Section 523(a)(8).

According to Judge Broomes, the Tenth Circuit rejected the all-or-nothing approach in *dicta*, as do the "majority of courts." Requiring courts to discharge student loans entirely, he said, would run counter to the bankruptcy court's equitable authority to enforce bankruptcy laws.

Judge Broomes therefore ruled that the bankruptcy court has "equitable powers . . . to grant a partial discharge of student loan debt upon a finding of undue hardship."

Question: Where is the power in the statute allowing the bankruptcy court to impose a payment program on a lender long after the plan expires?

Answer: The bankruptcy court could tell the lender, "Agree to accept $203 a month without interest, or I will discharge the entire debt."

Observation: Creative uses of equitable powers, such as this, strike this writer as similar to the development of asbestos channeling injunctions before the adoption of Section 524(g).

The opinion is *Educational Credit Management Corp. v. Metz*, 18-1281, 2019 BL 158864, 2019 WL 1953119 (D. Kan. May 2, 2019).

Congress may have intended to preclude 'stay and pay,' but it didn't succeed.

BAPCPA Limits Remedies Against Debtors Who Don't Reaffirm or Surrender

In the BAPCPA amendments in 2005, Congress may have intended to bar debtors from allowing mortgages to "ride through" bankruptcy, but the statute won't help a lender in all circumstances, according to Bankruptcy Judge Mark X. Mullin of Fort Worth, Texas.

In his March 8 opinion, Judge Mullin said there was no statutory authority enabling the court to compel a debtor to turn over mortgaged property to the lender or to withhold entry of discharge until the debtor fulfills his or her stated intention of surrendering the property.

The Facts

Debtors in chapter 7, the husband and wife owned a mobile home that is personal property in Texas. The lender held a purchase money security interest in the mobile home. There were no defaults either before or after bankruptcy. The note did not contain a so-called *ipso facto* clause that would have made bankruptcy a default.

Originally, the debtors filed a statement of intention in which they elected to retain the mobile home and enter into a reaffirmation agreement with the lender. After the first meeting of creditors and after conferring with attorneys, Judge Mullin said, the couple decided not enter into a reaffirmation agreement.

Instead, the debtors amended their statement of intention by electing to "surrender" the mobile home.

When the debtors continued to pay the debt and had not vacated the mobile home, the lender filed motions asking Judge Mullins to (1) delay the entry of the debtors' discharges until they had surrendered the property and the lender had "secured" the property, and (2) allow the lender to "secure" the mobile home. The lender argued that simply modifying the automatic stay did not benefit nor provide adequate protection to the lender.

The Desired Remedy Isn't in the Statute

On issues raised by the lender, Judge Mullin said that courts around the country disagree.

Judge Mullin explained why the debtors' actions already had resulted in modifications of the automatic stay, on several grounds. Because the debtors had not timely performed their intention to surrender, the automatic stay terminated under Section 362(h)(1)(B). The automatic stay also terminated under Section 521(a)(6) because the debtors had not entered into reaffirmation agreements before the prescribed deadline. And, of course, the stay would terminate on discharge under Section 362(c). Discharge would absolve the debtors of personal liability were they to default later.

Because there was no default entitling the lender to foreclosure, the lender argued that the debtors were attempting to have the security interest "ride through" bankruptcy, allegedly in violation of Section 521(a)(2). That Section prescribes deadlines for debtors to state their intentions and perform their intentions regarding surrender of property. Indeed, Section 521(a)(6) provides that the debtor "shall . . . not retain possession of personal property" absent a reaffirmation agreement or redemption.

The lender argued that the word "surrender" in Section 521(a)(2) was sufficient to justify the requested relief. Noting that "surrender" is not defined in the Code, Judge Mullin cited the First Circuit for saying that "surrender" is not synonymous with "deliver." It means, he said, that the debtors will take "no action to resist any effort by the creditor to gain its collateral."

Therefore, Judge Mullin said, "the Debtors are not required to affirmatively deliver the Mobile Home to [the lender]." Aside from modifying the stay to permit foreclosure if there were a default, Judge Mullin said the "Bankruptcy Code does not provide any other remedy . . . resulting from the Debtors' failure to comply with Section 521(a)(2)."

Likewise, Section 521(a)(6) did not give the lender a remedy. That section says that "a debtor shall . . . not retain possession of personal property . . . unless the debtor . . . either" signs a reaffirmation agreement or redeems the property.

For violation of Section 521(a)(6), Judge Mullin said the remedy is in the hanging paragraph following Section 521(a)(7). In addition to modifying the automatic stay, the hanging paragraph allows the trustee to require "the debtor to deliver any collateral in the debtor's possession to the trustee."

The trustee is entitled to seek delivery of the property, Judge Mullin said, but the Code does not give a similar remedy to creditors.

Also in the 2005 amendments, Section 521(d) gave creditors an additional remedy: If a debtor has violated Section 521(a)(6), *ipso facto* clauses become enforceable. Unfortunately, the lender had no *ipso facto* clause, so even Section 521(d) provided no effective remedy.

With regard to delaying discharge, Judge Mullin said that Section 727(a) contains 12 grounds for delaying discharge, but none applied to the case. Absent grounds for delay, Rule 4004(c) requires the court to enter discharge "forthwith." The statute and rules therefore did not permit delaying discharge as a remedy for violating Section 521(a)(2).

In sum, the Code does not contain a remedy of the sort the lender requested. The court, Judge Mullin said, does not have the prerogative to provide a remedy not authorized by Congress.

In November 2017, Bankruptcy Judge Phillip J. Shefferly of Detroit reached a similar result in a similar case. *See In re McCray*, 578 B.R. 403 (Bankr. E.D. Mich. Nov. 30, 2017). Judge Mullin cited *McCray* among the authorities supporting his conclusions. For ABI's discussion of *McCray*, click here.

The opinion is *In re Seiffert*, 8-43114, 2019 BL 96637, 2019 Bankr Lexis 869 (Bankr. N.D. Tex. March 8, 2019).

Fraudulent Transfers/Children's Tuition

There is no prohibited double recovery from multiple defendants, the appeals courts says, until the trustee has recovered cash equaling the value of the fraudulently transferred property.

Second Circuit Defines a Prohibited Double Recovery on Fraudulent Transfers

Affirming Bankruptcy Judge Alan S. Trust, the Second Circuit explained when a trustee is prohibited from making a double recovery following an avoided transfer. Basically, a trustee can recover from multiple transferees until the cash taken in by the trustee equals the value of the avoided transfer.

Creditors filed an involuntary petition against the debtor, who owned a home with her husband as tenants by the entireties. The home was worth $260,000 above the first mortgage.

The debtor hired a lawyer to represent her in bankruptcy. Six months after the order for relief, the debtor was indicted for defrauding her creditors. The debtor then retained the same lawyer and two others to represent her in the criminal proceedings.

To fund her legal defense, the debtor and her husband borrowed $250,000 from a friend, secured by a second mortgage on their home. The original lawyer drafted the note and mortgage loan documents. The friend transferred $250,000 cash to the debtor's original lawyer, who in turn gave slightly more than half to the other two criminal lawyers.

The chapter 7 trustee sued the friend for avoidance of the second mortgage as an unauthorized post-petition transfer under Section 549. The friend settled by allowing the second mortgage to be avoided and preserved for the benefit of the estate.

The trustee then sought to sell the home under Section 363(h). Bankruptcy Judge Trust, of Central Islip, N.Y., refused to permit a sale of the property, concluding that the interest of the husband and the couple's child in the home outweighed the economic benefit to the estate.

Meanwhile, the trustee had also sued the first lawyer for the $119,000 that he had retained from the $250,000. The lawyer argued that a money judgment against him would be a double recovery barred by Section 550(d), because the trustee had already avoided the second mortgage.

Bankruptcy Judge Trust overruled the objection and entered judgment against the lawyer for about $59,500. Judge Trust reasoned that $125,000 from the loan was the amount the trustee was

authorized to recover, given the wife's half interest in the home. The $59,500 represented half of the $119,000 that the lawyer had retained for himself.

After the lawyer appealed, the district court upheld Judge Trust, resulting in a second appeal to the Second Circuit. Circuit Judge Gerard E. Lynch affirmed in an opinion on July 25.

Judge Lynch began by citing circuit authority for the proposition that a bankruptcy court has "broad discretion" in applying post-petition avoidance powers under Section 549 and in ordering the return of transferred property or its value pursuant to Section 550(a).

On appeal in the circuit, the lawyer did not challenge the idea that granting the mortgage was avoidable under Section 549(a), which permits a trustee to recover a transfer that "occurs after the commencement of the case" and that was "not authorized under [the Bankruptcy Code] or by the court."

Instead, the lawyer focused on the fact that the trustee had already avoided and preserved the second mortgage "for the benefit of the estate" under Section 550(a). The lawyer argued that a money judgment against him contravened Section 550(d), which says that a "trustee is entitled to only a single satisfaction under subsection (a) of this section."

Judge Lynch explained that Section 550(d) "commonly applies" when a trustee seeks to recover transferred property from more than one transferee, possibly allowing the trustee to recover more than the value of the transferred property.

The case on appeal was different, Judge Lynch said, because the "Trustee had not realized any part, let alone all, of the value of the debtor's equity interest" in the home. The preserved second mortgage, he said, "carries only a right to foreclose." He noted that the bankruptcy judge had already prohibited the trustee from selling the home.

Furthermore, Judge Lynch said, the settlement with the friend, which preserved the second mortgage for the estate, "did not provide for any payment to the Estate." He went on to say that the estate "realized none of the equity value of the Second Mortgage for the benefit of creditors and, notably, did not obtain title to real property."

The "Trustee's only route to realize any recovery for the Estate . . . was by seeking the proceeds" of the loan received by the lawyer, Judge Lynch said. Under the "plain language" of the statute, he therefore held that the trustee's "recovery of a portion of the [loan] does not violate the single satisfaction rule of Section 550(d)."

Having upheld Judge Trust's judgment against the lawyer, Judge Lynch ended the opinion by saying what happens next. If the trustee eventually manages to recover from the preserved second mortgage, Judge Lynch said the trustee is entitled to retain the debtor's equity in the home less the

$59,500 that he recovered from the lawyer. Judge Lynch said nothing about the right to contribution, if any, among the recipients of fraudulent transfer.

The opinion is *Jones v. Brand Law Firm PA (In re Belmonte)*, 18-2098, 2019 BL 274629, 2019 Us App Lexis 22173 (2d Cir. July 25, 2019).

Fifth Circuit rules that the Texas UFTA doesn't have a 'futility defense' when a transferee is on inquiry notice regarding receipt of a fraudulent transfer.

Texas Law Has Fraudulent Transfer Liability When the Bankruptcy Code Doesn't

The Fifth Circuit found fraudulent transfer liability under Texas law even though the same facts would give the transferee a complete defense under Section 548(c) of the Bankruptcy Code.

According to the January 9 opinion by Chief Circuit Judge Carl E. Stewart, the so-called futility exception to the good faith defense is not available under Texas law, although a defendant in an identical case under the Bankruptcy Code would have a valid defense under Section 548.

The appeal arose from the $7 billion Ponzi scheme orchestrated by R. Allen Stanford, now serving a 110-year prison sentence. The Securities and Exchange Commission initiated a receivership and tasked the receiver with bringing lawsuits to aid defrauded investors.

Under the Texas Uniform Fraudulent Transfer Act, or TUFTA, the receiver sued an investor who took out $79 in principal shortly before the fraud was exposed. The district court ruled that the investor was the recipient of a transfer made with actual intent to hinder, delay or defraud. The only issue was the investor's good faith defense under TUFTA.

The defendant escapes liability under TUFTA by proving it received the property "in good faith and for reasonably equivalent value." Good faith alone was at issue because repayment of the investor's principal established reasonably equivalent value.

The district court committed two questions for the jury to decide. First, the jury decided that the defendant was on inquiry notice regarding the question of good faith. The charge to the jury said that inquiry notice was "knowledge of facts . . . that would have excited the suspicions of a reasonable person and led that person to investigate."

However, the jury also decided that an investigation would have been futile. In the jury charge, a futile investigation was defined as "a diligent inquiry that would not have revealed to a reasonable person that Stanford was running a Ponzi scheme."

Although the defendant was on inquiry notice and thus ordinarily could not raise the good faith defense, the district court ruled that the defendant was nonetheless entitled to the defense by having proven that an investigation would have been futile.

The receiver appealed, contending that the trial court improperly engrafted a futility exception onto the good faith defense under TUFTA. Siding with the receiver, the Fifth Circuit reversed.

Judge Stewart in substance said that the district court erred by "analyzing bankruptcy good faith rather than TUFTA good faith."

Judge Stewart explained that Section 548(c) of the Bankruptcy Code "mirrors TUFTA's good faith defense." Section 548(c) provides that a transferee who "takes for value and in good faith" may retain the transfer to the extent it gave value to the transferor in return for the transfer. He went on to explain that courts interpreting the Section 548(c) "good faith defense permit transferees to 'rebut' a finding of inquiry notice by demonstrating that they conducted a 'diligent investigation' into their suspicions."

If the defendant did not conduct an investigation, Judge Stewart added that "some courts" still permit the defendant "to rebut inquiry notice" by proving that "the fraudulent scheme's complexity would have rendered any investigations futile."

Judge Stewart said that the Texas Supreme Court has not ruled on whether "good faith" under TUFTA "requires a diligent investigation or a corresponding futility exception." He therefore made an "*Erie*" guess on how the state's high court would rule were it confronted with the question.

Following a decision by an intermediate appellate court in Texas, Judge Stewart said that "no court has considered extending TUFTA good faith to a transferee on inquiry notice who later shows an investigation would have been futile." Indeed, he said that the trial court in the case on appeal was "the first to supplement [the Texas intermediate appellate court's] good faith analysis with interpretations of Bankruptcy Code good faith."

Judge Stewart said that the Fifth Circuit has previously "declined to rely on Section 548(c) to interpret TUFTA good faith." Those decisions, he said, are "reinforced by the fact that neither Section 548(c)'s text nor its legislative history defines good faith."

To the contrary, Judge Stewart said that the Fifth Circuit "has agreed with others that a transferee on inquiry notice 'must satisfy a "diligent investigation" requirement' to succeed on a Section 548(c) good faith defense." He said that courts "also disagree as to whether Section 548(c) permits a futility exception."

"This lack of conformity," Judge Stewart said, counsels against relying on Section 548(c) interpretations to construe TUFTA good faith.

In sum, Judge Stewart held, "Regardless of the intricate nature of a fraud or scheme, failing to inquire when on inquiry notice does not indicate good faith." He therefore declined "to hold that

the Supreme Court of Texas would" apply a futility exception to the good faith requirement when no other court had done so.

For some of ABI's discussions of divergent law in cases involving inquiry notice, click here and here.

The opinion is *Janvey v. GMAG LLC*, 17-11526 (5th Cir. Jan. 9, 2019).

Third Circuit lauds Bankruptcy Judge Agresti for 'prescient thinking.'

Third Circuit Pronounces a Damages Formula for Fraudulent Entireties Transfers

Bankruptcy Judge Thomas P. Agresti of Erie, Pa., was given the supreme compliment by the Third Circuit: The appeals court saluted his "prescient thinking" in devising a formula for calculating damages in a complex fraudulent transfer suit.

A man had been a partner in a law firm that went out of business. He was saddled with millions of dollars of liability for his guarantee of his "old" firm's lease. While working at a "new" firm, he was hit with a multimillion-dollar judgment in favor of the landlord.

To avoid having income from his "new" firm garnished, he directed the firm to deposit his income directly into an entireties account in his name and his wife's. Because the wife was not liable on the judgment, the landlord could not attach the joint bank account.

The man was forced into bankruptcy by the judgment. The trustee sued the debtor and his wife to recover fraudulent transfers under the Pennsylvania Uniform Fraudulent Transfer Act.

Eventually, the bankruptcy judge entered judgment against the debtor and his wife, calculating damages of about $275,000 under a formula suggested by the Third Circuit. The district court affirmed. Both the couple and the trustee appealed.

In an opinion on February 20, Circuit Judge Thomas L. Ambro upheld the judgment. In the process, he lauded Judge Agresti for recommending a formula for calculating damages resulting from fraudulent transfers into entireties accounts.

Liability

Judge Ambro had no difficulty finding fraudulent transfer liability. "When the wages of an insolvent spouse are deposited into a couple's entireties account, both spouses are fraudulent transferees," he said.

The direct deposit of the debtor's wages into the joint account was a "transfer" of an "asset" because: (1) Wages were the debtor's asset; (2) the wages were no longer his asset after deposit into the entireties account; and (3) the change in status was a "transfer."

The Third Circuit, Judge Ambro said, presumes that transfers into an entireties account are not made for reasonably equivalent value. Because the debtor was insolvent, the transfers of the debtor's income were therefore fraudulent transfers.

Next, Judge Ambro said that the wife was liable as a transferee. He cited the Third Circuit and numerous courts that have held a spouse liable for a fraudulent transfer into entireties property.

Judge Ambro went on to hold that the debtor was liable as both the transferor and a transferee.

Damages

The tricky question was damages, because some of the funds in the account came from the wife or sources that were not fraudulent transfers. Moreover, courts have held there is no liability when money is spent for reasonable and necessary household expenses. In that regard, the trustee must "prove by a preponderance of the evidence that [the debtor's] wage deposits were not spent on necessities," Judge Ambro said.

At that juncture, Judge Ambro said that the trustee faces "what appears to be an impossible task in a commingled account." Because money is fungible, he said it may be impossible to determine what deposit was used for a particular expenditure.

For his "prescient thinking," Judge Ambro praised Judge Agresti for advocating a damages formula that the Third Circuit went on to adopt in the February 20 opinion.

For "future courts facing commingled funds," Judge Ambro laid down what he called the "*pro rata*" formula for damage calculation. He said it "accounts for the fungibility of wage and nonwage funds that are commingled."

It goes like this: First calculate the deposits that were fraudulent transfers and those that were not. In the case at bar, the debtor's wages represented fraudulent transfers equaling about 60% of the deposits into the joint account.

Payments from the account totaled about $2.1 million, of which about $1 million were for non-necessities.

Applying the percentage of fraudulent deposits to the expenses for non-necessities, Judge Ambro said that the judgment should have been about $600,000.

Applying a prior formula that the Third Circuit seemingly had endorsed, the bankruptcy judge found the couple liable for only $275,000.

In substance, Judge Ambro said that the damages formula from the prior Third Circuit opinion was not holding and thus was not binding on a subsequent panel. In that respect too, he praised Judge Agresti for "sounding the alarm" about shortcomings in the prior damages formula.

The debtor got off lucky, however. Judge Ambro upheld that $275,000 judgment because the trustee had waived the issue regarding the formula.

N.B.: Circuit Judge Patty Shwartz did not join in the discussion of the *pro rata* formula, believing it was unnecessary given the trustee's waiver of the issue. She also believes that the amount of liability should be left to the discretion of the trial court.

The opinion is *Shearer v. Titus (In re Titus)*, 916 F.3d 293 (3d Cir. Feb. 20, 2019).

District judge in Brooklyn overturns the bankruptcy court and again exposes colleges and universities to the receipt of fraudulent transfers when insolvent parents pay their children's tuition.

Tuition Payments by Insolvent Parents (Likely) Constitute Fraudulent Transfers

Bankruptcy trustees in some parts of the country are filing fraudulent transfer suits to recover tuition payments that insolvent parents made on behalf of their children over age 18.

In March, Chief Bankruptcy Judge Carla E. Craig of Brooklyn, N.Y., notched a victory for colleges and universities by holding that concepts borrowed from structured finance will insulate educational institutions from fraudulent transfer liability. To read ABI's report on Judge Craig's decision, click here.

The trustee appealed, and District Judge Allyne R. Ross of Brooklyn reversed and remanded in an opinion on November 27.

Although upholding Judge Craig's legal construct, Judge Ross made a critical factual distinction that may end up making the universities automatically liable, even though they had no inkling that the parent was insolvent or making fraudulent transfers.

Because a child's higher education supposedly confers no value on the parent, some courts find fraudulent transfers to the schools while others do not, as Judge Craig said in her March 28 opinion. In assigning liability or not, it is this writer's view that some courts are making dubious law on who is a "mere conduit" and in deciding whether the school is the initial or subsequent transferee.

Instead, the courts and Congress should starkly confront this fundamental question: Does an insolvent parent make a fraudulent transfer by paying typical, reasonable expenses of a child over the age of 18?

Although schools are normally the defendants, not the children, nothing prevents trustees from suing the kids. Would society countenance holding children liable for receipt of fraudulent transfers when the parents have done nothing more than provide an education? If contemporary society believes that parents have a duty to educate children over the age of 18, should fraudulent transfer law adopt the same presumption?

As soon as possible, schools can and should tweak their student accounts to obviate the chance of being liable under Judge Ross's opinion. But that leads to another question: Should astute structured finance change the result when the underlying economic reality remains the same?

This writer also recommends that state legislatures adopt family laws to protect innocent educational institutions whose only sin is providing an education.

The Facts

In the lawsuit before Judge Craig, an insolvent parent had paid tuition for his children both before and after he filed a chapter 11 petition. After conversion to chapter 7, the trustee filed fraudulent transfer suits to recover the tuition payments.

Holding that the universities were not the initial transferees and were therefore entitled to the good faith defense as subsequent transferees under Section 550(b), Judge Craig granted summary judgment to the universities dismissing the adversary proceedings.

Judge Craig based her decision on the structure of student accounts created by the universities to pay tuition.

The accounts were in the name of the students. Payments by parents went into the accounts and were applied toward tuition when the students registered for classes. Even though they may have supplied the funds, parents had no right to access the accounts without the students' permission. If the students were to withdraw, refunds went to the students, not to the parents.

Judge Craig ruled that the students, not the universities, were the initial transferees because undisputed facts showed that the parent-debtor did not have dominion or control over the students' accounts when the parent made transfers into the accounts. After the initial transfers, she said, the debtor could not access the accounts without the students' authorization. Rather, she said, the students had dominion and control over their accounts.

Since the universities were subsequent transferees, Judge Craig ruled that the schools were entitled to dismissal because they had the good faith defense in Section 550(b). The trustee did not question the universities' good faith.

The Opinion by Judge Ross

In her 21-page opinion on appeal, Judge Ross said that Judge Craig's "analysis of this thorny issue was sound." Still, she reversed and remanded because Judge Craig had not "grappled with a key factual question" of whether the parent funded the student account before or after the child had registered for classes.

The trustee conceded that the schools took the payments in good faith. The only question, Judge Ross said, was whether the universities were the initial or subsequent transferees.

In the Second Circuit, Judge Ross said that an initial transferee is someone who can exercise dominion and control to put the funds to "his own purposes" and is not a "mere conduit."

Before a student registers for classes, Judge Ross said that any refunds must be made to the students. Before registration, she said the schools did not have "dominion over the tuition payments" because the students could withdraw from the university "and take the money with them," thus preventing the schools from being the initial transferees who would be liable automatically.

On the other hand, Judge Ross held that the schools would be the initial transferees, and thus deprived of the good faith defense, if the parent funded the student account "after [the tuition] was already due."

Judge Ross reversed and remanded the case for the bankruptcy court to determine whether the parent funded the accounts before or after tuition payments were due. She said that Judge Craig "did not discuss the timing of the payments in detail." Instead, she said that Judge Craig appeared to assume that the debtor funded the students' accounts before they registered for classes.

Although the schools may be liable after remand, Judge Ross did make rulings in favor of the universities, although not on issues that would absolve them of liability. She rejected the trustee's contention that the children were "mere conduits," evidently if the accounts had been funded before tuition was due for payment. Were the children "mere conduits," the schools would have been liable had they received the funds before or after the students registered.

Judge Ross went on to say that the outcome did not depend on the existence of the student accounts. Even if the funds were held by the schools in a commingled account, Judge Ross indicated that the result would be the same as long as the student had the contractual right to direct the disposition of refunds before tuition was due for payment.

Because Judge Craig must perform more than ministerial functions on remand, Judge Ross's decision is probably not a final order bestowing a right of appeal to the Second Circuit.

While the litigation grinds forward, the New York legislature should consider legislation to protect colleges, universities and perhaps, also, private secondary and elementary schools.

The opinion is *Pergament v. Brooklyn Law School*, 18-2204 (E.D.N.Y. Nov. 27, 2018).

New York judge allows insolvent parents to pay for a minor child's expensive education.

Tuition Payments for Adult Children Squarely Held to Be Constructively Fraudulent

On an issue dividing the lower courts, Bankruptcy Judge Martin Glenn of New York squarely held that educational expenses paid for a child over the age of majority are constructively fraudulent transfers, assuming the debtor-parent was insolvent.

Conversely, Judge Glenn found no fraudulent transfer in his December 4 opinion when parents paid educational expenses for a minor child, because parents receive reasonably equivalent value by satisfying their obligations to educate their children.

Judge Glenn said the case presented "culturally and socially charged issues." Citing a "developing body of case law," he listed decisions holding that tuition payments for adult children are or are not constructively fraudulent transfers.

Judge Glenn said he was "constrained" by the Bankruptcy Code and New York's fraudulent transfer law to determine whether the bankrupt parents received "reasonably equivalent value" or "fair consideration" for educational expenses they paid.

Stipulated facts presented the issues starkly. Within six years before their joint bankruptcies, the parents paid tuition and related expenses for their two children. Some payments came before the children were 21, and others were after. The trustee sued the children, the college they attended and student loan lenders.

In New York, majority occurs at age 21, not 18. State law requires parents to pay for their minor children's housing, food, education, and health care, Judge Glenn said.

The parents contended they received sufficient value because educating their children helped to ensure that the kids would be financially independent. Indeed, Judge Glenn cited studies showing that an education decreases the odds that a child will live with his or her parents.

Nonetheless, Judge Glenn said that "the economic 'benefit' identified by the [parent-debtors] does not constitute 'value' under [New York law] or the Bankruptcy Code." He therefore held that expenses paid for the children after majority were constructively fraudulent, assuming the trustee could later prove that the parents were insolvent at the time of the transfers.

The trustee contended that expenses paid before majority were also constructively fraudulent because the children attended an expensive private college.

Judge Glenn framed the question as whether "the parents receive reasonably equivalent value when they do pay for" a minor child's more expensive education.

Judge Glenn followed a decision by Chief Bankruptcy Judge Carla E. Craig of the Eastern District of New York, who said that paying tuition satisfies the parents' "'legal obligation to educate their children. . . . It is irrelevant to this determination whether the Debtors could have spent less.'" *In re Akanmu*, 502 B.R. 124, 132 (Bankr. E.D.N.Y. 2013).

Absent "egregious conduct," Judge Glenn granted summary judgment and dismissed claims based on expenses paid before majority.

Given the procedural posture of the case, Judge Glenn did not reach the question of whether the children, the college or the student loan lenders were the initial or subsequent transferees. Likely as not, only the initial transferee would be liable, because subsequent transferees would be entitled to the good faith defense under Section 550(b)(2).

Question: The age of majority varies among the states. With regard to constructively fraudulent transfers under Section 548(a)(1)(B), should federal courts borrow the age of majority in the forum, and if so, on what theory? Or, should the age of majority depend on the residence of the defendant or the residence of the debtor? Or, is there separate federal law for the age of majority in cases under Section 548(a)(1)(B)?

The opinion is *Geltzer v. Oberlin College (In re Sterman)*, 18-01015 (Bankr. S.D.N.Y. Dec. 4, 2018).

Arbitration

Supreme Court's* Epic *decision may end up forcing debtors to arbitrate dischargeability of loans.

Courts Split on Arbitrating Dischargeability of Student Loans

Unless the circuit courts are unanimous, the Supreme Court ultimately will decide whether individual debtors can be forced to arbitrate the dischargeability of student loans. Indeed, if the courts say that dischargeability of student loans must be arbitrated, it won't be long before dischargeability disputes involving loans of all types are taken out of the bankruptcy courts and decided by arbitrators.

And if dischargeability must arbitrated, why can't arbitrators also rule on the allowance of claims?

Bankruptcy Judge Jeffrey J. Graham of Indianapolis has most recently written on a subject where the lower courts are divided. He declined to follow *Williams v. Navient Solutions LLC (In re Williams)*, 564 B.R. 770 (Bankr. S.D. Fla. 2017), where Bankruptcy Judge Erik P. Kimball of West Palm Beach, Fla., required the debtor the arbitrate the dischargeability of a student loan under Section 523(a)(8).

Instead, Judge Graham decided in his November 16 opinion to follow Bankruptcy Judge Elizabeth S. Stong of Brooklyn, N.Y., who refused to enforce an arbitration agreement when the debtor mounted an adversary proceeding to discharge student loans. *Golden v. JP Morgan Chase Bank NA (In re Golden)*, 587 B.R. 414 (Bankr. E.D.N.Y. 2018).

The facts before Judge Graham were not unusual. The debtor had received a general discharge, which, of course, did not include about $36,000 in student loan debt. The student loan agreement contained a provision requiring arbitration of any claim or dispute regarding the debt.

The debtor filed a complaint contending that the student loans were dischargeable under Section 523(a)(8). He alleged that the debt was not a "qualified educational loan," and if it was, he argued that the obligation represented an undue hardship.

In lieu of an answer, the lender responded with a motion to compel arbitration.

To aid Judge Graham in ruling on the enforceability of the arbitration agreement, Supreme Court authority only adds to the confusion.

Until recently, authority from the Supreme Court held that a court could decline to enforce an arbitration agreement if there was an inherent conflict between arbitration and the statute's underlying purpose. *Shearson/American Express Inc. v. McMahon*, 482 U.S. 220, 227 (1987).

In the Supreme Court earlier this year, the justices split 5/4, adopting a seemingly more stringent test by holding that the language of the statute must be "clear and manifest" before a court can override an arbitration agreement. *Epic Systems Corp. v. Lewis*, 138 S. Ct. 1612, 1624 (2018).

Were *Epic* the only authority, Judge Graham said he would enforce the arbitration agreement, because there is no clear congressional intent shown in the Bankruptcy Code to override arbitration agreements. However, he said that *McMahon* is still good law because the Supreme Court cited the decision in *Epic*.

Judge Graham said that *McMahon* remains good law also because *Epic* showed no clear attempt at overruling prior authority.

Judge Graham noted that five circuit courts, in opinions all handed down before *Epic*, held that bankruptcy courts have discretion to disregard an arbitration agreement if the dispute is a core proceeding and arbitration would conflict with the purposes of the Bankruptcy Code.

For two reasons, Judge Graham declined to compel arbitration. First, he said that compelling arbitration would result in "more than an inherent conflict" with the Bankruptcy Code. Arbitrating dischargeability, "the central purpose of the Bankruptcy Code, would effectively allow parties to contractually override the application of federal bankruptcy law."

Second, Judge Graham said that centralizing disputes about a debtor's obligations is a "pillar of federal bankruptcy law."

Judge Graham denied the lender's motion to compel arbitration because enforcement of the clause "would create an inherent conflict with the Bankruptcy Code's fundamental policies of affording debtors a fresh start and centralizing disputes about a debtor's obligations for efficient resolution."

The opinion is *Roth v. Butler University (In re Roth)*, 594 B.R. 672 (Bankr. S.D. Ind. Nov. 16, 2018).

Wages & Dismissal

If the involuntary corporate debtor was deadlocked and unable to act, the dissenter would have permitted a 50% shareholder to seek damage for dismissal of the petition.

Ninth Circuit Bars Third Parties from Seeking Damages for Dismissal of an 'Involuntary'

Over a dissent, the Ninth Circuit held on April 29 that a 50% shareholder of an involuntary debtor cannot seek damages for dismissal of the involuntary petition, even if the debtor itself was deadlocked and unable to act in response to the petition.

The involuntary corporate debtor had two 50% shareholders. A vote of two-thirds of the board or of the shareholders was required for the company to act.

According to the dissent by Circuit Judge Mark J. Bennett, one 50% shareholder wanted to liquidate the debtor over the objection of the other. A creditor, who was a contingent shareholder, filed an involuntary petition.

The debtor corporation was deadlocked and unable to respond to the involuntary petition. The 50% shareholder who opposed liquidation filed a motion to dismiss the petition. According to the dissenter, the opposing shareholder also sought attorneys' fees and damages on behalf of the involuntary debtor.

According to the majority opinion by Fourth Circuit Judge Stephanie Dawn Thacker, sitting by designation, the petitioning creditor conceded at the hearing on the motion to dismiss that dismissal was proper. However, the bankruptcy court ruled that the opposing shareholder who won dismissal lacked standing to seek damages and attorneys' fees.

To read ABI's report on the affirmance in district court ruling that the shareholder could not seek damages, click here.

If the court dismisses a petition, Section 303(i) provides that "the court may grant judgment—

(1) against the petitioners and in favor of the debtor for—
    (A) costs; or
    (B) a reasonable attorney's fee; or
(2) against any petitioner that filed the petition in bad faith, for—
    (A) any damages proximately caused by such filing; or
    (B) punitive damages."

Note that the phrase "in favor of the debtor" appears in subsection (1) but not in (2).

Upholding the lower courts, Judge Thacker in substance ruled for the majority that the case was controlled by *Miles v. Okun (In re Miles)*, 430 F.3d 1083 (9th Cir. 2005). She appeared to read Section 303(i) as meaning that a non-debtor cannot seek damages for dismissal of an involuntary petition.

Judge Thacker based her conclusion on *Miles,* legislative history, an opinion by the Ninth Circuit Bankruptcy Appellate Panel, and the purpose of the statute to "alleviate the consequences that involuntary proceedings impose on the debtor." She said that a third party "does not face those consequences."

Dissenting, Judge Bennett said that the majority read *Miles* to mean that a third party who defeats an involuntary petition "can never request that the debtor be awarded costs, a reasonable attorney's fee, or damages." "*Miles* never went so far," he said. The majority's opinion, in his view, was "inconsistent with both the relevant statutory authority and the policies underlying the Bankruptcy Act." [*sic*.]

Judge Bennett emphasized how the shareholder was seeking damages and attorneys' fees "on behalf of the debtor." He cited a bankruptcy court in Illinois, where someone who was in "a close relationship with the debtor" was permitted to collect damages and fees. *In re Fox Island Square Partnership*, 106 B.R. 962, 968 (Bankr. N.D. Ill. 1989).

The shareholder should have been allowed to seek fees and damages because it "was truly the only party willing and able to act" for the deadlocked corporate debtor. He distinguished *Miles*, because it involved "true third parties." On the other hand, the opposing shareholder, he said, was "not such an independent third party — it was acting as a 50% shareholder during a corporate governance breakdown."

Judge Bennett would have remanded the case for the bankruptcy court to determine whether anyone else could have opposed on behalf of the debtor and whether the petition was filed in bad faith. If the answers came in the right way, he would have allowed the bankruptcy court to fix appropriate fees and damages "in light of the totality of the circumstances."

The opinion is *Vibe Micro Inc. v. SIG Capital LLC (In re 8Speed8 Inc.)*, 921 F.3d 1193 (9th Cir. April 29, 2019).

Copious disclosure required for post-petition payment of fees to be permissible in chapter 7.

Bifurcated Fees for Destitute Chapter 7 Debtors Approved in Utah

To make chapter 7 accessible for those who can't pay fees before filing, Bankruptcy Judge Kevin R. Anderson of Salt Lake City laid down extensive guidelines and disclosure requirements enabling lawyers to use so-called bifurcated fee arrangements, where the debtor pays all costs and fees in installments *after* filing.

Blame the Supreme Court for the Problem

In *Lamie v. U.S. Trustee*, 540 U.S. 526 (2004), the Supreme Court held that a chapter 7 debtor's counsel fees cannot be paid from estate property, and any prepetition obligation for unpaid attorneys' fees is dischargeable. In his April 10 opinion, Judge Anderson said that the "predicament" created by the high court "precipitated the concept of bifurcated fee agreements in consumer cases."

Often, Judge Anderson said, individuals needing immediate chapter 7 relief lack the cash to pay an attorney up front. Those consumers have "three ineffectual options," he said. They can file *pro se*, but 30% never receive a discharge. Second, "and more problematic," they can use a petition preparer.

Third, destitute debtors can file chapter 13 petitions to pay counsel fees through the plan, but they are bound to the bankruptcy process for three to five years when they would be eligible for an immediate chapter 7 discharge had they the resources to pay a prepetition retainer.

For a fourth and effective option, an enterprising attorney in Salt Lake City developed elaborate disclosures and procedures allowing a chapter 7 debtor to pay all costs and attorneys' fees after filing.

The Solution

The lawyer gave the client three options. The client could pay a $2,400 prepetition retainer to cover services throughout the subsequent chapter 7 case. Second, the lawyer could take $500 to prepare and file a bare-bones petition, allowing the client proceed *pro se* or hire another lawyer after filing.

Third, the lawyer offered a bifurcated fee arrangement, also known as a "zero-down option." The client would pay nothing up front, but the lawyer would file a bare-bones petition. After filing, the debtor would sign a retainer agreement calling for 10 monthly payments of $240, to be deducted automatically from a bank account.

Judge Anderson explained how the lawyer gave the client "a multitude of disclosures, explanations and warnings regarding the fee arrangement, the bankruptcy process and the "possible use of . . . a third party [factor] to collect the payments." In addition, the judge said the lawyer gave the client written information and instructions, including 50 paragraphs of disclosures and explanations that the client was required to read and initial.

The client agreed to the bifurcated arrangement and paid nothing before filing. The lawyer filed the petition, and the client received a discharge 115 days later in the course of an uneventful chapter 7 case.

More than one year after the entry of discharge, the U.S. Trustee filed a motion asking the court to cancel the fee arrangement, require the attorney to disgorge all fees, and impose sanctions. At oral argument, Judge Anderson said the U.S. Trustee was more interested in "obtaining guidance from the court" than in sanctioning the lawyer.

Copious Disclosure Is the Key

In a 27-page opinion worthy of reading in full text, Judge Anderson exonerated the debtor's lawyer.

Judge Anderson ruled that bifurcated fee arrangements "to effectuate affordable legal services" in consumer chapter 7 cases are not prohibited *per se* by the Bankruptcy Code, nor do they "*per se* implicate ethical issues and they are not *per se* unfair."

"With appropriate disclosures," Judge Anderson held, "debtors can make informed decisions as to the risks and benefits of incurring a post-petition obligation in order to retain an attorney's services." He said the lawyer "had a reasonable basis to employ bifurcated fee arrangements when clients were unable to pay a full retainer prior to the bankruptcy filing."

Judge Anderson found that "this process did not harm the Debtor. Indeed, it facilitated the Debtor's ability to afford legal counsel to expeditiously receive a discharge."

According to Judge Anderson, the "propriety of using bifurcated fee arrangements" is "directly proportional to the level of disclosure and information" provided to the client. In the case at bar, he said the documents given to the client "satisfy the requirements of full disclosure and informed consent."

Judge Anderson laid down what he called "essential practices" when using a bifurcated fee arrangement.

Naturally, the fee must be reasonable but not necessarily the same that a client would pay up front. Still, the "pricing differential must be based on reasonable and quantifiable factors, and it must not include the cost of pre-petition services," Judge Anderson said.

Judge Anderson found that the fee was reasonable, because the client was paying about $2,000 after deducting the filing fee. The lawyer kept time records, showing that the lodestar fee would have been $2,240.

Finally, Judge Anderson dealt with the factoring arrangement where the collection agency paid the law firm $1,800 for the right to collect $2,400. The lawyer disclosed the discount to the client, but the factoring arrangement was not revealed in the lawyer's disclosure of compensation filed with the court.

Judge Anderson quoted from a state bar association ethics opinion saying, among other things, that the client must consent to the sale of the receivable and be offered the same discount. The judge said he would "discourage" the use of a factoring arrangement "unless it strictly complies with the guidance from" the bar association's ethics opinion.

Judge Anderson granted summary judgment in favor of the lawyer dismissing the U.S. Trustee's motion for sanctions and disgorgement.

The opinion is *In re Hazlett*, 16-30360, 2019 BL 130455 (Bankr. D. Utah April 10, 2019).

Debtors with too much student loan debt are functionally ineligible for any form of bankruptcy relief.

Chicago District Judge Reestablishes Chapter 13 Debt Limits on Student Loans

A district judge in Chicago reversed Bankruptcy Judge Janet S. Baer, who had ruled in December that having student loans exceeding the chapter 13 unsecured debt limit does not require dismissing an individual's chapter 13 petition.

In his August 31 opinion, District Judge Robert M. Dow, Jr. held that the plain language of Section 109(e) makes a debtor with huge student loan debt ineligible for chapter 13 and provides "cause" to dismiss or covert the case under Section 1307(c). When a debtor is ineligible for chapter 13, failing to dismiss is an abuse of discretion, he held.

The chapter 13 debtor owed about $570,000 on student loans and another $22,500 on credit cards. He was living paycheck to paycheck, Judge Baer said. His monthly take-home pay of some $2,700 left him with about $475 in disposable income.

Under an income-based repayment plan, the debtor had been repaying his student loans at the rate of $268 a month. If he continued the payments for 25 years, any unpaid balance would be forgiven. The amount of his monthly payment would increase or decrease depending on a rise or fall in his income.

Section 109(e) provides that "[o]nly an individual with regular income that owes, on the date of filing of the petition, noncontingent, liquidated, unsecured debts of less than $394,725 . . . may be a debtor under chapter 13 of this title." Section 1307(c) says that "the court may" may dismiss or convert a case "for cause." The subsection lists 11 nonexclusive examples of "cause," but excessive unsecured debt is not one of them.

Bankruptcy Judge Baer had rejected the debtor's argument that his student loans were principally contingent debts because a large portion would likely be forgiven. However, Judge Baer said that nothing in Section 109(e) requires dismissal, and Section 1307(c) makes dismissal or conversion discretionary.

Judge Baer denied the motion to dismiss, explaining why chapter 13 was in the best interests of creditors and the debtor. *In re Pratola*, 578 B.R. 414 (Bankr. N.D. Ill. Dec. 27, 2017).

The chapter 13 trustee appealed. In district court, the debtor conceded that his student loans were not contingent.

Saying that he "respectfully disagrees" with Judge Baer, District Judge Dow reversed and remanded the case for the bankruptcy court to choose between dismissal or conversion. One by one, Judge Dow refuted the arguments made by Judge Baer. He said that Congress made a "bright-line rule" in Section 109(e).

Judge Dow said he was "not unsympathetic to the policy concerns raised by the Bankruptcy Court, . . . but the power to create such an exception to Section 109(e) lies with Congress rather than the courts."

In March, Chief Judge Catherine J. Furay of Madison, Wis., agreed with Judge Baer and also declined to dismiss a chapter 13 petition when student loans along exceeded $394,725. Judge Furay concluded that creditors were better off in chapter 13. She also explained why the debtor was not eligible for chapter 7 and that chapter 11 would be infeasible. *See In re Fishel*, 17-14180, 2018 BL 113642 (Bankr. W.D. Wis. March 30, 2018). There was no appeal from Judge Furay's decision.

If a student loan borrower is also ineligible for chapter 7, the debtor has no forum to test the dischargeability of student loans under Section 523(a)(8). In that circumstance, a debtor already in an income-based repayment program might argue that Judge Baer was wrong and that the debt is contingent and therefore does not count toward the chapter 13 debt limit.

To read ABI's discussions of the decisions by Judges Baer and Furay, click here and here.

The opinion is *Stearns v. Pratola (In re Pratola)*, 18-213 (N.D. Ill. Aug. 31, 2018).

Plans & Confirmation

Joining two other circuits, the Fourth Circuit now permits a chapter 13 debtor to strip down a short term home mortgage to the value of the property.

Fourth Circuit Eliminates a Split on Modifying Short Term Mortgages in Chapter 13

Sitting *en banc*, the Fourth Circuit voted 11-3 to overrule its own precedent and held that Section 1322(c)(2) permits a debtor to strip down a claim on a home mortgage that matures before the last payment is due under a chapter 13 plan. In other words, a debtor with an underwater, short term mortgage is only required to pay the value of the home and may discharge the remainder as an unsecured claim.

The 11-3 decision eliminated a split of circuits by aligning the Fourth Circuit with the Eleventh Circuit's opinion in *American General Finance Inc. v. Paschen (In re Paschen)*, 296 F.3d 1203, 1209 (11th Cir. 2002). However, the dissenters in the Fourth Circuit believe that Section 1322(c)(2) only permits modifying the payment schedule in a short term mortgage, not the amount of the claim.

Oddly, the Fourth Circuit had validated the so-called chapter 20 strategy six years ago in *Branigan v. Davis (In re Davis)*, 716 F.3d 331 (4th Cir. 2013), a seemingly more exaggerated employment of the same provisions of the Bankruptcy Code.

In a chapter 20 case, the consumer first files under chapter 7 to extinguish personal liability on an underwater mortgage. Later, the consumer initiates a separate chapter 13 case to strip off the mortgage lien that survived chapter 7 as an *in rem* liability solely against the real property. Although the Supreme Court's 1992 *Dewsnup* decision holds that a mortgage cannot be stripped off in chapter 7, the high court so far has thrown up no explicit roadblock to prevent chapter 20 from stripping off an underwater mortgage.

The Facts

The debtor purchased a home for $136,000, paying $5,000 down and giving the seller a purchase money, 10-year, interest-only mortgage for $131,000. Before bankruptcy, the mortgage matured, but the debtor did not refinance the mortgage or pay off the balance.

The holder of the mortgage initiated foreclosure proceedings that were halted when the debtor filed a chapter 13 petition. The debtor submitted a chapter 13 plan pegging the value of the home at $47,000, the amount shown in a recent appraisal. There was a tax lien of approximately $6,000 on the home.

The plan bifurcated the lender's claim into a secured claim of about $41,000, representing the $47,000 value of the home less the tax lien. The plan called for paying off the $41,000 over the five-year life of the plan with interest at 4.5%.

The plan classified the remainder of the lender's claim as an unsecured claim to receive no payment under the plan.

Bound by the Fourth Circuit's precedent in *Witt v. United Companies Lending Corp. (In re Witt)*, 113 F.3d 508 (4th Cir. 1997), the bankruptcy court sustained the lender's objection to the plan. *Witt* held that Section 1322(c)(2) only permits modifying the payment schedule of a short term mortgage, not the amount of the secured claim.

The district court affirmed and so did a three judge panel of the Fourth Circuit. The appeals court granted rehearing *en banc* and heard oral argument in January.

Nobelman, *Rash* and the Statutory Provisions

Section 506(a) provides for bifurcating a claim of a secured creditor, that is, allowing a secured claim to the extent of the value of the collateral together with an unsecured claim to the extent that the claim exceeds the value of the collateral. Section 1325(a)(5) provides that cramdown is one of the methods for dealing with a secured claim in a chapter 13 plan.

Section 1322(b)(2) allows a chapter 13 plan to modify secured claims, but not "a claim secured only by a security interest in real property that is the debtor's principal residence." In *Nobelman v. American Savings Bank*, 508 U.S. 324 (1993), the Supreme Court interpreted Section 1322(b)(2) to mean that a chapter 13 debtor may not employ Section 506(a) to strip down an undersecured home mortgage, that is, reduce the amount of the mortgage to the fair market value of the residence.

On the heels of *Nobelman* and as part of the Bankruptcy Reform Act of 1994, Congress added 1322(c)(2). "Notwithstanding subsection (b)(2) and applicable nonbankruptcy law," subsection (c)(2) becomes applicable when the last payment on a debtor's home mortgage falls before the last payment under the chapter 13 plan. In those circumstances, subsection (c)(2) permits the chapter 13 plan to "provide for the payment of the claim as modified pursuant to section 1325(a)(5)."

In *Associates Commercial Corp. v. Rash*, 520 U.S. 953, 957 (1997), the Supreme Court ruled that a chapter 13 debtor may cram a plan down on a secured creditor under Section 1325(a)(5) as long as the debtor pays the "total the present value of the allowed secured claim" under Section 506(a).

The Majority's Opinion on Rehearing *En Banc*

Witt was not popular among courts and commentators. In *Paschen*, the Eleventh Circuit declined to follow *Witt*, and the *Collier* treatise disagreed with the result in *Witt*. In his May 24 opinion, Circuit Judge James A. Wynn, Jr., explained why the Fourth Circuit was overruling *Witt* and aligning with "every other court that has considered the issue."

According to Judge Wynn, the "plain text" of Section 1322(c)(2) permits modifying a mortgage when the last payment is due before the last payment under the plan. *Witt*, he said, incorrectly concluded that the subsection was ambiguous.

Judge Wynn defined the question as follows: Does the phrase "payment of the claim as modified pursuant to section 1325(a)(5)" allow the debtor to modify the amount of the secured claim or only the payment schedule? In other words, does the subsection permit reducing the amount of the secured claim to the value of the property or does it only allow the debtor to stretch out payment of the entire claim (secured and unsecured) over the life of the plan?

Judge Wynn said that other courts "universally criticized *Witt's* finding of ambiguity and attendant reliance on the statute's legislative history." For instance, *Collier* said that *Witt* was contrary to canons of statutory construction.

Differing with the conclusion reached by a panel 22 years earlier, Judge Wynn said that the "most natural reading of statutory language" in subsection (c)(2) "allows bifurcation of such claims into secured and unsecured components" when a home mortgage matures before the last payment under the plan. He therefore reversed and remanded, because the statute permits the debtor to strip down a short term mortgage to the value of the property, not merely to modify the payment schedule.

On behalf of the National Association of Bankruptcy Attorneys and the National Consumer Bankruptcy Rights Center, Tara Twomey submitted an *amicus* brief supporting the debtor's petition for rehearing *en banc*.

The Dissenters

Circuit Judge J. Harvie Wilkinson, III, dissented, joined by Circuit Judges Barbara Milano Keenan and Stephanie D. Thacker. They continue to believe that subsection (c)(2) only permits altering the payment schedule on a home mortgage.

Beyond the significance of the case for chapter 13 debtors, the opinions by the majority and the dissent are important for their differing approaches to statutory interpretation when Congress has overruled or modified a decision from the Supreme Court. The dissenters do not believe the

statute itself and its legislative history clearly showed that Congress intended to change the result of *Nobelman* in some situations.

The opinion is *Hurlburt v. Black*, 17-2449, 2019 BL 191177, 2019 Us App Lexis 15603 (4th Cir. May 24, 2019).

By implication, the Eleventh Circuit would allow a general chapter 13 discharge to a debtor who defaults on direct mortgage payments, an issue where lower courts are split.

Direct Mortgage Payments Are Not 'Provided For' in a Plan, Eleventh Circuit Holds

For the first time among the courts of appeals, two judges on an Eleventh Circuit panel held that direct payments by a chapter 13 debtor to a mortgagee are not "provided for by the plan" under Section 1328(a), even if the plan says the payments will be made directly.

However, all three judges agreed that a general chapter 13 discharge did not eliminate the debtor's personal liability for a deficiency on a home mortgage.

The majority's December 6 opinion by Circuit Judge Julie Carnes means that chapter 13 debtors with direct mortgage payments may have lost a battle, but they could have won a larger war.

Whether direct mortgage payments are made under a plan has greater significance in a related context. A chapter 13 debtor who has made "all payments under the plan" is entitled to a discharge under Section 1328(a). If the Eleventh Circuit's holding with respect to debts "provided for by the plan" also applies to "all payments under the plan," then a chapter 13 debtor who has defaulted on direct mortgage payments would still be entitled to a chapter 13 discharge shedding other debts that *were* provided for in the plan.

On the question of a general chapter 13 discharge, the lower courts are split on whether failure to make direct mortgage payments bars a chapter 13 debtor's general discharge. For example, click here to read ABI's discussion of *Simon v. Finley (In re Finley)*, 18-4011, 2018 BL310219 (Bankr. S.D. Ill. Aug. 28, 2018), showing how the bankruptcy courts in Illinois disagree on giving a discharge to a chapter 13 debtor who missed direct mortgage payments.

The Facts

The debtor filed a chapter 13 petition and confirmed a three-year plan. The debtor's home mortgage was current on filing. The plan specifically provided that the debtor would continue making direct payments to the holder of the mortgage and would not route mortgage payments through the chapter 13 trustee, thus avoiding the fee that the trustee would charge.

Shortly after filing, the debtor filed a motion seeking authority to make mortgage payments directly. The order granting the motion terminated the automatic stay as to the mortgage by permitting the mortgagee to seek *in rem* relief against the property if there were a default.

Over the life of the plan, the debtor made total payments of about $5,700, including some $3,600 earmarked for creditors. None of the debtor's payments were for the mortgagee.

According to Judge Carnes, the plan did not specify repayment terms for the mortgage, did not contain a schedule of payments, and did not make any alterations to the mortgage.

About one year after confirmation, the debtor stopped making mortgage payments. However, the debtor made all payments to the trustee and received her chapter 13 discharge.

Meanwhile, the mortgagee foreclosed the home and sought a deficiency judgment against the debtor. A year after discharge, the mortgagee reopened the chapter 13 case and filed suit for a declaration that the debtor's personal liability for a deficiency on the mortgage had not been discharged.

Upheld in district court, Bankruptcy Judge Caryl E. Delano of Tampa, Fla., granted summary judgment in favor of the lender, holding that the deficiency was not discharged.

The debtor appealed to the circuit court, to no avail.

'Provided For By'

Once a debtor completes all payments "under the plan," the last phrase in Section 1328(a) gives a discharge for "all debts provided for by the plan." The debtor thus argued on appeal that the unsecured deficiency claim was discharged because the mere mention of the mortgage in the plan meant it was "provided for by the plan."

Judge Carnes disagreed. To be "provided for," she said, the plan "must, in some way, affect or govern the debtor's repayment."

Although the issue has not percolated to the courts of appeals, Judge Carnes cited three lower court decisions that she characterized as saying that "a plan's mere statement that payments on a debt will be made outside of the plan does not mean that debt is 'provided for' by the plan."

Judge Carnes buttressed her conclusion by citing *Rake v. Wade*, 508 U.S. 464 (1993), where the Supreme Court interpreted "provided for" as it appears in Section 1325(a)(5). In *Rake*, the high court said that "provided for" means "to 'make a provision for' or 'stipulate to' something in the plan." *Id*. at 473.

Because the plan made no provision for the mortgage, Judge Carnes said it was not "provided for," meaning that the deficiency claim was not discharged.

Even if the mere mention of the mortgage meant it was "provided for," Judge Carnes ruled that discharging the deficiency claim would violate the antimodification provision in Section 1322(b)(2), which prohibits a chapter 13 plan from modifying a claim secured only by the debtor's principal residence.

In essence, depriving the mortgagee of the ability "to pursue *in personam* liability against [the debtor] . . . would necessarily modify the [mortgagee's] rights because it strips the [lender] of a right provided by the original loan instruments," Judge Carnes said.

Finally, the debtor argued that the unsecured deficiency claim was discharged because the lender did not file a proof of claim.

The debtor waived the argument, Judge Carnes said, because she raised it for the first time on appeal.

"Even if we were to consider this," Judge Carnes said, "the merits favor" the lender.

Even without a proof of claim, Judge Carnes said, the deficiency liability "passed through bankruptcy unaffected" because it was "nondischargeable under the antimodification provision."

The Implications of the Decision

Being "provided for" in the plan, or not, has another significance: A debtor is entitled to a chapter 13 discharge under the first phrase in Section 1328(a) after completing "all payments under the plan." As we said earlier, the lower courts are split on whether defaulting on direct mortgage payments deprives a debtor of a general chapter 13 discharge, even if the debtor has spent five years religiously making all other payments through the trustee.

It is not a foregone conclusion that Judge Carnes' opinion interpreting "provided for" in the last phrase of Section 1328(a) also governs "payments under the plan" appearing in the first phrase of the section. Does the subtle difference in language convey an entirely different meaning?

Judge Carnes did not miss the issue. In footnote 8, she appeared to say that the debtor would not have been entitled to a discharge under the first phrase in the section if the direct payments were under the plan.

Although the decision is not controlling, the opinion by Judges Carnes should carry weight in the Eleventh Circuit (and perhaps elsewhere) when a debtor wants a general chapter 13 discharge despite having defaulted on direct mortgage payments.

The Concurring Opinion

Circuit Judge Jill Pryor concurred in the judgment, but her separate opinion undercuts the majority's analysis on "provided for by the plan" that would be helpful for a debtor seeking a general discharge after defaulting on direct mortgage payments.

Judge Pryor agreed with the majority's alternative holding that the antimodification provision in Section 1322(b)(2) by itself bars the debtor from discharging a deficiency judgment.

Judge Pryor said she would have affirmed on that basis alone and would not have reached the question of whether the mortgage was "provided for by the plan."

The opinion is *Dukes v. Suncoast Credit Union (In re Dukes)*, 16-16513 (11th Cir. Dec. 6, 2018).

BAP reversed the bankruptcy court's ruling that personal liability on a discharged debt was resurrected in 'chapter 20.'

Ninth Circuit BAP Squarely Upholds 'Chapter 20': No Lien and No Claim Survive

At least when the debtor is eligible for a discharge in chapter 13, the Ninth Circuit Bankruptcy Appellate Panel squarely holds that a debtor may employ so-called chapter 20 to strip off an underwater subordinate mortgage while simultaneously avoiding personal liability for the debt.

The typical chapter 20 case works like this: The consumer first files under chapter 7 to extinguish personal liability on an underwater home mortgage. Later, sometimes the day after receiving a chapter 7 discharge, the consumer files a separate chapter 13 case to strip off the mortgage lien that survived chapter 7 as an *in rem* liability solely against the real property.

Although the debtor may not be eligible for a discharge in chapter 13, the debtor can strip off the subordinate lien by full payment under the plan of whatever unsecured debts she or he has.

Two Supreme Court decisions potentially bear on the issue. The Supreme Court held in 1992 in *Dewsnup* that a mortgage cannot be stripped off in chapter 7. *Dewsnup v. Timm*, 502 U.S. 410 (1992). In *Bank of America N.A. v. Caulkett*, 135 S. Ct. 1995 (2015), the high court held that a debtor may not strip down a mortgage in chapter 7.

So far, the Supreme Court has erected no explicit roadblock to prevent chapter 20 from stripping off an underwater mortgage.

The Facts in the BAP

The facts in the BAP were actually better for the debtor than in the typical chapter 20 case. The debtor was eligible for a chapter 13 discharge because she filed the new petition more than four years after the order for relief in her prior chapter 7 case. *See* Section 1328(f)(1).

The debtor owned a home worth $410,000. It was subject to a $580,000 first mortgage. The home was also subject to a second mortgage of some $300,000, but the debtor's personal liability on the second mortgage had been eliminated by the prior chapter 7 discharge.

On motion by the debtor but without opposition from the holder of the second mortgage, the bankruptcy court valued the lien of the second mortgage at zero.

Later, the holder of the second mortgage filed an unsecured claim for $300,000.

The bankruptcy court overruled the debtor's objection to the unsecured claim, ruling that the valuation of the lien at zero required the debtor to provide for the claim in full in her chapter 13 plan.

The debtor appealed and won in a July 30 opinion for the BAP written by Bankruptcy Judge William Lafferty.

The Circuit and BAP Authorities

Two precedents provided guidance for the BAP.

In *HSBC Bank USA N.A. v. Blendheim (In re Blendheim)*, 803 F.3d 477 (9th Cir. 2015), the Ninth Circuit held that a debtor could strip off a subordinate mortgage in chapter 20. Technically speaking, the appeals court did not rule on whether the holder of the subordinate mortgage enjoyed an unsecured claim that somehow arose from the dead in the subsequent chapter 13 case.

The second, analogous authority came from the BAP itself. *Free v. Malaier (In re Free)*, 542 B.R. 492 (9th Cir. BAP 2015). There, the BAP held that personal liability on an underwater mortgage that had been extinguished in a prior chapter 7 discharge is not counted toward eligibility in subsequent chapter 13 filing.

Reversing the bankruptcy court, Judge Lafferty interpreted the authorities to mean that the unsecured claim of the subordinate lienholder "should have been disallowed." He found "simply no statutory basis for resurrecting the debtor's personal liability or for treating the claim as a claim against the estate."

Furthermore, Judge Lafferty said that the lien claim "was conditionally avoided through the valuation motion." If the debtor were to complete payments under a chapter 13 plan, the lien would be stripped off, and she would continue having no personal liability on the subordinated mortgage debt.

To read ABI's report on the bankruptcy court's decision that was reversed, click here.

The opinion is *Washington v. Real Time Resolution Inc. (In re Washington)*, 18-1206, 2019 BL 284935 (B.A.P. 9th Cir. July 30, 2019).

'Value' doesn't mean 'present value' in Section 1325(b)(1)(A), Judge Lorch says.

Courts Split over Interest on Unsecured Claims in 100% Chapter 13 Plans

On an issue where the lower courts are about evenly divided, Bankruptcy Judge Basil H. Lorch, III of Evansville, Ind., ruled that a chapter 13 debtor who is not devoting all disposable income to the plan can confirm the plan by paying unsecured creditors in full, *without interest*.

The debtor would have disposable income of more than $80,000 over the course of the proposed five-year plan. Timely filed proofs of unsecured claims amounted to some $17,000, and payments under the plan would total about $51,000. Although the chapter 13 plan would pay unsecured claims in full, the debtor was not proposing to pay interest on unsecured claims.

The chapter 13 trustee objected to confirmation, contending that Section 1325(b)(1) requires interest on unsecured claims. The trustee argued that the statutory language in subsection (b)(1), "as of the effective date of the plan," modifies the word "value" in subsection (b)(1)(A) to mean that the plan must pay the present value of the claims and therefore includes interest.

Also relying on Section 1325(b)(1), the debtor contended that unsecured creditors are not entitled to interest. The debtor interpreted the quoted language as modifying both subsections (A) and (B) by specifying the date when the court must make the calculation.

Listing decisions coming down on both sides, Judge Lorch said in his September 13 opinion that the courts are "equally divided." The *Norton* and *Collier* treatises take opposite positions on the outcome, with *Collier* on the debtor's side.

Judge Lorch adopted the approach of Bankruptcy Judge Thomas L. Perkins of Peoria, Ill., in *In re Gillen*, 568 B.R. 74 (Bankr. C.D. Ill. 2017). To read ABI's discussion of *Gillen*, click here.

Like Judge Perkins, Judge Lorch believes that "as of the effective date of the plan" would have appeared immediately after "value" if Congress had intended for plans to pay the present value of unsecured claims.

Also like Judge Perkins, Judge Lorch observed that unsecured creditors in chapter 13 have no right to immediate payment at the beginning of the case, unlike secured creditors or even unsecured creditors in solvent chapter 7 cases.

Requiring interest on unsecured claims would produce an "anomalous result," Judge Lorch said, because Section 1322(a)(2) permits deferred payments on priority claims without interest.

The opinion is *In re McKinney*, 2018 BL 331294, 2018 BL 331294 (Bankr. S.D. Ind. Sept. 13, 2018).

Judge Buchanan collects authorities on all sides of two questions befuddling courts everywhere.

Courts Hopelessly Split on Modifying Mortgages on Mixed-Use Residential Properties

Until the Supreme Court speaks, courts at all levels will remain hopelessly split on the ability of debtors in chapters 11 and 13 to modify mortgages securing properties that are the debtors' principal residences but also generate commercial income.

Bankruptcy Judge Beth A. Buchanan of Cincinnati collected authorities on all sides of the two major questions: (1) May a debtor modify a mortgage on mixed-used property; and (2) what is the date for determining the property's use?

The questions are identical in chapters 11 and 13 under Sections 1123(b)(5) and 1322(b)(2). The statutes provide that a "plan may . . . modify the rights of holders of secured claims, other than a claim secured only by a security interest in real property that is the debtor's principal residence . . . ."

The debtors in Judge Buchanan's case had operated a daycare business in their home for 21 years. The property included a separate building that the debtors had been renting for three years at $600 a month. The mortgage lender had objected to their chapter 13 plan, which would have modified the mortgage. Judge Buchanan sustained the objection in her September 25 opinion, ruling that the debtors could not modify the mortgage, even though the property had longstanding commercial use.

Judge Buchanan first addressed the question of whether a debtor may modify a mortgage on a mixed-use property. She said that the First and Third Circuits and a majority of courts have adopted a bright-line rule allowing modification of a mortgage if residential property also has commercial use. However, the courts reached their conclusions by employing different logic: The First Circuit followed the plain language of the statute, while the Third Circuit analyzed legislative history.

On the other side of the fence, the Ninth Circuit Bankruptcy Appellate Panel and what Judge Buchanan called an "emerging" minority of courts also have a bright-line rule, but they reach the opposite conclusion and preclude mortgage modification on a mixed-use principal residence.

A third set of district and bankruptcy courts take a third approach by analyzing the "totality of the circumstances" to determine the predominant character of the transaction.

Next, Judge Buchanan laid out authorities fixing the date for pegging the property's use. Again, there are three approaches.

A majority of courts, including the Ninth Circuit Bankruptcy Appellate Panel, use the petition date, not the date the mortgage was made. The Third Circuit and other courts use the date the lender took the security interest. A third group of courts examine both the circumstances on the filing date and the underlying agreement.

With respect to the mixed use of the property in this case, Judge Buchanan adopted the filing-date measurement and the bright-line approach precluding modification if the property is the debtor's principal residence.

On the mixed-use question, Judge Buchanan found the statute ambiguous and weighed legislative history giving favorable treatment to home-mortgage lenders. With regard to the measurement date, she saw no ambiguity in the statute's command to use the filing date.

Although there is no "perfect solution," Judge Buchanan said that the rules she employed would result in "greater predictability in the mixed-use property context and [are] less susceptible to manipulation by a debtor." The combination, she said, "best comports with the language and objective underlying Section 1322(b)(2)'s anti-modification provision."

The opinion is *In re Lister*, 593 B.R. 587 (Bankr. S.D. Ohio Sept. 25, 2018).

Valuation

Fifth Circuit notches a victory for chapter 13 debtors retaining mobile homes.

Valuation of a Retained Mobile Home Does Not Include Delivery and Setup Costs

The costs of delivering and setting up a mobile home to be retained by a debtor under a chapter 13 plan "must be excluded from the mobile home's valuation under Section 506(a) of the Bankruptcy Code," according to the Fifth Circuit.

The chapter 13 plan promised to pay the secured value of the mobile home over the life of the plan plus 5% interest. To determine value for cramdown under Sections 1325 and 506(a), the lender argued that the bankruptcy court should include $4,000 in costs that would be incurred in delivering the house to the site, along with expenses in blocking, leveling and anchoring the house as required by state law.

Relying on the Supreme Court's decision in *Associates Commercial Corp. v. Rash*, 520 U.S. 953 (1997), the bankruptcy court overruled the lender's objection to confirmation and held that the valuation should not include delivery and setup costs. The district court affirmed, prompting the lender to appeal a second time.

In her opinion on August 13, Circuit Judge Jennifer Walker Elrod upheld the lower courts. The debtor did not submit a brief, but the U.S. Trustee supported the bankruptcy judge's decision.

The case was governed by Section 506(a)(1) and (a)(2). The former provides that a secured claim is allowed "to the extent of the value of such creditor's interest in the estate's interest in such property." It goes on to say that such "value shall be determined based on the purpose of such valuation and of the proposed disposition or use of such property."

Subsection (a)(2), added by the BAPCPA amendments in 2005, provides that the value of personal property "shall be determined based on the replacement value of such property . . . without deduction for costs of sale or marketing."

Quoting *Rash*, Judge Elrod said that the "'proposed disposition or use' of the collateral is of paramount importance." *Id.* at 962. Rejecting an argument proffered by the lender, she held that subsection (a)(2) "should not be construed to the exclusion of" subsection (a)(1).

Judge Elrod also attached significance to footnote 6 in *Rash*, where Justice Ginsburg said, "A creditor should not receive portions of the retail price, if any, that reflect the value of *items the debtor does not receive* when he retains his vehicle, items such as warranties, inventory storage,

and reconditioning." *Id.* at 965. [Emphasis added.] Judge Elrod also said that the later addition of subsection (a)(2) in the BAPCPA amendments "does not conflict with *Rash*."

Weaving the principles together, especially the idea that setup and delivery costs were not services the debtor would receive, Judge Elrod held that "delivery and setup costs of a mobile home retained by a debtor must be excluded from the mobile home's valuation under Section 506(a)." She said the U.S. Trustee correctly argued that delivery and setup costs are not costs of sales or marketing but, instead, are additional costs like sales taxes and service agreements.

Judge Elrod said her holding "accords with the determination of all courts that have addressed the issue." The lender could cite "no caselaw to the contrary," she said.

The opinion is *21st Mortgage Corp. v. Glenn (In re Glenn)*, 17-60533 (5th Cir. Aug. 13, 2018).

Compensation

Courts split on allowing compensation to a chapter 7 trustee when the case is converted to chapter 13 before distributions were made.

Chapter 7 Trustee Is Paid in a Case Converted to Chapter 13

Courts are split on whether a chapter 7 trustee earns a fee if the case converts to chapter 13 before the trustee makes distributions.

In a case pending before Bankruptcy Judge Elizabeth D. Katz of Springfield, Mass., the chapter 7 trustee and his counsel ran up some $12,000 in time charges investigating the debtor's potentially nonexempt assets. Before the trustee collected any assets or made any distributions, the debtors converted the case to chapter 13 over the trustee's objection.

The trustee sought an allowance of compensation for himself and his attorneys as an expense of administration in the chapter 13 case. Although not contesting the reasonableness of the fees, the debtor argued that the trustee was not entitled to compensation under Section 326(a).

"In a case under chapter 7 or 11," that section provides that the court "may allow reasonable compensation under section 330 . . . for the trustee's services not to exceed" a sliding scale that begins at 25% and shrinks to 3% "upon all moneys disbursed or turned over in the case by the trustee . . . ."

The courts are split, Judge Katz said. A majority allow reasonable compensation based on *quantum meruit* for pre-conversion work. More recently, she said, courts are shifting away from *quantum meruit* and disallowing compensation under Section 326(a) if the trustee has made no disbursements.

Judge Katz took a different tack. She did not read Section 326(a) as precluding an award of compensation in a converted case. The section, she said, "is explicitly reserved for limiting trustee compensation '*[i]n a case under chapter 7 or 11*.'" [Emphasis in original.]

Judge Katz therefore allowed the full amount of compensation sought by the trustee because the debtor had only objected under Section 326(a).

The opinion is *In re Bartlett*, 18-30060 (Bankr. D. Mass. Sept. 19, 2018).

Exemptions

Vigorous dissent argues that the majority misread Ninth Circuit precedent in barring a debtor from exempting post-petition appreciation in a homestead.

Appreciation in a Home Is Exempt in California, but Not in Washington, Circuit Says

Perceiving a pivotal difference between the California and Washington State exemptions, the majority on a Ninth Circuit panel refused to allow a chapter 7 debtor to exempt the post-petition appreciation in the value of her homestead.

District Judge Paul C. Huck of Miami, sitting by designation, wrote a 37-page dissent, decimating the majority's 11-page opinion, in this writer's opinion.

The majority's opinion may not affect practice in California. However, practitioners in Washington State should study the majority opinion carefully and modify their tactics accordingly. Among other things, debtors in Washington should not underestimate the value of their homes when filing schedules initially, because assigning a low value at the filing date could bar the debtor from later realizing the maximum homestead exemption.

The state legislature in Washington could amend the exemption statute to prevent the state's residents from being at a disadvantage compared to residents of other states.

The Facts

The individual debtor filed a chapter 7 petition in December 2013. She scheduled her home as being worth $250,000, subject to a mortgage of about $246,500. Utilizing the Washington State exemption, she claimed a $3,500 exemption to cover all the equity in her homestead.

The case quickly began to unravel, based on a reading of the bankruptcy court's docket rather than the Ninth Circuit opinion. Nine months after filing, the mortgagee filed a motion to modify the automatic stay and alleged that the home was actually worth $325,000.

Meanwhile, the trustee had discovered an undisclosed, prepetition, fraudulent transfer of property. The trustee objected to the debtor's discharge. Eventually, the debtor waived her discharge.

Evidently believing that the trustee would attempt to sell the home because the value had risen or was initially understated, the debtor amended her schedules in July 2016 to list the value of the property as $412,500. She also amended her exemptions to claim an exemption in "100% of fair

market value, up to any applicable statutory limit." The debtor apparently was attempting to exempt $125,000, the maximum homestead exemption under Washington State law.

The trustee objected to the amended homestead exemption. The bankruptcy judge sustained the exemption, holding that the amount of the exemption was frozen at the filing date in the amount of $3,500, because there had been no objection to the value of the home as of the filing date. The district court affirmed.

State Exemption Laws

The majority opinion by Circuit Judge N. Randy Smith saw a pivotal difference in the Washington State homestead exemption compared to the California exemption.

California law, Judge Smith said, allows "an exemption with a fixed dollar value, based on demographic criteria — not home equity."

On the other hand, Judge Smith said that Washington State "applies a sliding scale in which 'the homestead exemption shall not exceed the lesser of (1) the total net value of the [homestead] . . . or (2) the sum of [$125,000] . . . .'"

The Majority Opinion

Comparing the two statutes, Judge Smith said that the Washington State exemption "is tied to the equity in the debtor's home as of the filing date of the petition." On the other hand, the California exemption "is determined by demographic criteria," such as the number of people in the household.

For reasons we cannot adequately explain, Judge Smith concluded that "the homestead amount claimed at filing [in California] may exceed the home equity on the petition date." Consequently, he said that Ninth Circuit precedent allows a California resident to exempt post-petition appreciation in value.

In Washington State, on the other hand, Judge Smith held that the exemption is limited to the equity in the home on the filing date. Because $3,500 was indisputably exempt on the filing date, "[t]hat amount was all that Washington's exemption statute permitted her to exempt."

Judge Smith added, "The fact that some debtors in our California cases were permitted to exempt more than the equity in their homes on the date of their bankruptcy does not establish [the debtor's] entitlement to do the same in Washington."

The Dissent

The majority's opinion did not sit well with Judge Huck, whose dissent synthesizes Ninth Circuit precedent on homestead exemptions. We recommend reading his dissent in full text for a detailed overview of Ninth Circuit exemption law.

Beyond misreading Ninth Circuit precedent, Judge Huck said the majority violated three cardinal principles of bankruptcy law: (1) Exemptions are to be liberally construed in favor of debtors; (2) courts may not deny exemptions for reasons not stated in the statute, citing *Law v. Siegel*, 134 S. Ct. 1188 (2014); and (3) amendments to exemptions are permitted as of right, citing Bankruptcy Rule 1009(a).

Meticulously analyzing pertinent Ninth Circuit cases, he said that "binding and on-point Ninth Circuit precedent mandates that when a homestead appreciates in value postpetition, a debtor is entitled to amend her homestead exemption claim to include a portion of that appreciation in order to exempt from the bankruptcy estate the maximum amount permitted by state or federal law applicable to the debtor's filing date."

Among other authorities, Judge Huck quoted a Ninth Circuit Bankruptcy Appellate Panel opinion, upheld in the Ninth Circuit, as saying that the amount of a homestead exemption is determined when the property is sold rather than being fixed as of the filing date.

Judge Huck said that any differences in the two states' statutes are "illusory," because the attempt at characterizing California law as based on "demographic criteria" was "fashioned from whole cloth." He said there was "no meaningful basis for treating California's capped homestead exemption scheme differently from the federal and other state capped schemes."

Judge Huck challenged the majority's notion that a debtor may only exempt property in existence on the filing date. He said there is "no statute or caselaw [that] limits a debtor's right to exempt only property which entered the estate" on the filing date. He cited authority for the proposition that a debtor may exempt property that comes into the estate after filing.

It therefore "follows," he said, "that because postpetition appreciation is an estate asset, it is then subject to the maximum applicable homestead exemption irrespective of the amount of the exemption initially claimed by the debtor."

As to the so-called snapshot rule for determining exemptions as of the filing date, Judge Huck said there is no case "which has extended the snapshot rule to freeze the amount of an exemption at filing."

The opinion is *Wilson v. Rigby*, 17-35716 (9th Cir. Nov. 27, 2018).

A judicial lien impairing a homestead exemption is avoidable in some states under Section 522(f), but not in others.

A Judgment Lien on Entireties Property Isn't Avoidable in Illinois, Seventh Circuit Says

Most of us would assume that a home owned by a married couple as tenants by the entireties would be exempt in all respects in all states. But no, that is not true in Illinois and states with similar laws, according to the Seventh Circuit.

In Illinois, a homestead owned as tenants by the entireties cannot be foreclosed and sold by a judgment lien creditor of one spouse, but the entireties interest is *not* entirely exempt, the Chicago-based appeals court says.

Consequently, a spouse cannot avoid a judgment lien on his or her contingent future interest in the home because that interest is not exempt in Illinois. In other words, a judgment lien that attached to one spouse's contingent future interest in a homestead survives bankruptcy in Illinois.

In his August 5 opinion for the appeals court, Circuit Judge William J. Bauer warns that state laws vary dramatically on entireties property, so the result will not be uniform throughout the U.S.

The Death of the Wife

Years earlier, creditors filed a $1 million judgment lien against an attorney in the Illinois county where he owned a home with his wife as tenants by the entireties. The lawyer later filed a chapter 7 petition.

The lawyer-debtor claimed that his interest in the home was exempt under Illinois law and Section 522(b)(3)(B). He therefore sought to avoid the judgment lien as an impairment on his exempt property under Section 522(f).

After filing, the debtor's wife died, terminating the tenancy by the entireties and vesting the debtor with fee simple interest in the home. Outside of bankruptcy, the creditors could have foreclosed the judgment lien after the wife's death. Thus, it became imperative for the debtor to avoid the judgment lien.

Bankruptcy Judge A. Benjamin Goldgar of Chicago held that the debtor's contingent future interest as a tenant by the entireties was not exempt under Illinois law. Therefore, Judge Goldgar ruled that the debtor could not avoid the judgment lien.

The district court reversed, but Circuit Judge Bauer reversed once again, focusing on the debtor's contingent interest under Illinois law.

The Significance of State Law

The outcome turned on two sections of the Bankruptcy Code. Section 522(f) allows a debtor to avoid a judicial lien "on an interest of the debtor in property to the extent that such lien impairs an exemption to which the debtor would have been entitled . . . ."

Section 522(b)(3)(B) determines whether the relevant property interest is exempt. The section allows a debtor to exempt "any interest in property in which the debtor had, immediately before the commencement of the case, an interest as a tenant by the entirety . . . to the extent that such an interest as a tenant by the entirety . . . is exempt from process under applicable nonbankruptcy law."

Judge Bauer, of course, said that Illinois exemption law was the "applicable nonbankruptcy law." He said that Illinois courts have not decided whether a judgment lien attaches to "the individual interests (in particular contingent future interests) of a tenant by the entirety." So, he made a so-called *Erie* guess.

Parsing the Illinois statutes, Judge Bauer concluded that "interests held in a tenancy by the entirety or contingent future interests held by tenants by the entirety" are not exempt from judgment. He said that the statutes "merely exempt the *tenancy interest* from the attachment of a judgment lien." [Emphasis in original.]

Judge Bauer therefore held that the judgment lien attached to the debtor's "contingent future interest in the property." Next, he said that the debtor's interest as a tenant by the entirety would be estate property under Section 541(a), at least initially.

Judge Bauer then examined whether Section 522(b)(3)(B) exempted the debtor's contingent future interest in the homestead. Although Illinois would exempt the tenancy interest, he said that "lesser interests" are not exempt in Illinois, such as the debtor's "contingent future interest in the entireties property."

Focusing on "such interest" in Section 522(b)(3)(B), Judge Bauer deduced that a debtor's interest as a tenant by the entirety is "exempt to the extent that those interests the debtor holds as a tenant by the entirety are exempt under state law."

Fitting the pieces together, Judge Bauer said that the creditor obtained a judgment lien on the debtor's contingent future interest that existed on the petition date. Next, he said that Illinois does not make "all interests" immune from process that are held by a tenant by the entirety. Because

Illinois does not exempt "contingent future interests," he concluded that the debtor could not exempt his contingent future interest in the homestead.

Since the debtor's contingent future interest was not exempt, Judge Bauer ruled that the debtor therefore could not avoid the lien on that interest. Although bankruptcy terminated the debtor's personal liability, the creditor presumably could enforce the judgment lien.

Although a contingent future interest is not exempt, Judge Bauer said that the "main protection" in Illinois "is that a creditor is unable to force the sale of the property to collect a debt against only one of the tenants."

Judge Bauer cautioned that laws around the country "are not uniform." For example, he cited Indiana, where the law exempts "any interest" in property held by as a tenant by the entirety.

Another example is found in a decision in February by the Eighth Circuit. There, the appeals court held under Missouri law that a judicial lien is avoidable in Missouri as an impairment of the debtor's homestead exemption. *CRP Holdings A-1 LLC v. O'Sullivan (In re O'Sullivan)*, 914 F.3d 1162 (8th Cir. Feb. 1, 2019). To read ABI's report on *CRP*, click here.

The opinion is *William v. Jaffe (In re Jaffe)*, 18-2726, 2019 BL 289042, 2019 Us App Lexis 23287 (7th Cir. Aug. 5, 2019).

BAP expands* Clark v. Rameker *to cover IRAs transferred in a divorce proceeding.

BAP Holds that an IRA from a Marital Property Settlement Is Not Exempt

Retirement accounts that a debtor received in a marital property settlement are not exempt in bankruptcy, according to an October 16 opinion by the Eighth Circuit Bankruptcy Appellate Panel. The case involved an individual retirement account and a 401(k) belonging to the debtor's wife that he was to receive in a divorce proceeding.

By extension, the principle stated by the BAP would seem to mean that a retirement account inherited from a deceased spouse likewise would not be exempt. Deceased or divorced, the decision cuts against nonworking spouses who end up in bankruptcy.

The appeal turned on *Clark v. Rameker*, 134 S. Ct. 2242 (2014), where the Supreme Court ruled that a retirement account inherited from the debtor's mother was not exempt under Section 522(b)(3)(C). That section exempts "retirement funds to the extent that those funds are in a fund or account that is exempt from taxation" under specified provisions in the Internal Revenue Code.

Writing for the high court, Justice Sotomayor employed what she called an "objective" analysis of "legal characteristics" of an individual retirement account, not whether the bankrupt individual planned to use the IRA for retirement. Saying that the court must analyze the "text and purpose" of the exemption statute, she held that the inherited IRA was not exempt, even though it fell within the enumerated sections of the tax code listed in Section 522(b)(3)(C).

Writing for the BAP, Bankruptcy Judge Anita L. Shodeen of Des Moines, Iowa, quoted Justice Sotomayor as saying that the term "retirement funds," which is not defined in the Bankruptcy Code, is "properly understood to mean sums of money set aside for the day an individual stops working." *Id.*, 134 S. Ct. at 2246.

From that statement, Judge Shodeen said that *Clark* "clearly *suggests* that the exemption is limited to individuals who create and contribute funds into the retirement account. Retirement funds obtained or received by any other means do not meet this definition." [Emphasis added.]

The debtor argued that the IRA represented marital property set aside by his former wife for their joint retirement. Rejecting the argument, Judge Shodeen again quoted from *Clark*, where Justice Sotomayor said that the court should "look to the legal characteristics of the account in which the funds are held, asking whether, as an objective matter, the account is one set aside for the day when an individual stops working."

Judge Shodeen said she "recognized" that the debtor's interest in the retirement accounts "did not arise in the identical manner as the IRA account addressed in *Clark*." However, she said the "distinction is not material to our *de novo* review. Any interest he holds in the accounts resulted from *nothing more* than a property settlement." [Emphasis added.]

Employing the "reasoning of *Clark*," Judge Shodeen upheld the bankruptcy court and ruled that the retirement accounts were not exempt under federal law.

Observation: The holding by the BAP means that a bankrupt nonworking spouse will have nothing after divorce aside from maintenance or support and whatever individual property he or she has that happens to be exempt. If the divorce settlement was structured to transfer retirement accounts in lieu of maintenance or support, bankruptcy could leave a nonworking spouse with nothing at all.

The BAP's holding would presumably also apply to a retirement account that a debtor inherited from a deceased spouse. Indeed, it would not matter how long the spouse's death preceded bankruptcy.

Take the case of a nonworking spouse who ends up in bankruptcy. He or she might have little aside from Social Security and the deceased or former spouse's retirement accounts to provide income. The BAP opinion means that retirement accounts in both situations would not be exempt. The result could leave a nonworking spouse with little aside from his or her Social Security, which might be minimal.

Judge Shodeen saw no significance in the factual distinction between *Clark* and the case on appeal. In *Clark*, the debtor inherited an IRA from the debtor's mother. In future cases, or on appeal to the Eighth Circuit, the debtor might explore the nature of an interest that someone has under state law in a spouse's retirement account.

It may be that the debtor's interest is different if a retirement account was held by a spouse than if the retirement account was held by a non-spouse relative. A spouse may have an inchoate interest in a husband or wife's IRA that does not exist with respect to an inheritance from a non-spouse. It may also matter if the state is a community property state. But should the result under federal law differ if the state is or is not a community property state?

The BAP's decision may very well be the correct or prevailing interpretation of the statute. If it is, this writer suggests that Congress should revisit the issue.

The opinion is *Lerbakken v. Sieloff & Associates PA (In re Lerbakken)*, 18-6018 (B.A.P. 8th Cir. Oct. 16, 2018).

The date of the closing of a case is not a 'specified period' invoking Rule 9006(b)(1) and requiring a debtor to show excusable neglect before amending schedules to claim an exemption.

Without Excusable Neglect, Debtors May Claim Exemption in Reopened Cases

Reversing bankruptcy courts, the Tenth Circuit Bankruptcy Appellate Panel held that a debtor can reopen a closed case to schedule assets and claim exemptions without showing excusable neglect.

Two cases on appeal presented the same fact pattern. The chapter 7 debtors sustained personal injuries before bankruptcy. They did not schedule the personal injury claims. The debtors received their discharges, and their cases were closed.

On motions by the debtors, the bankruptcy judges reopened the cases and allowed the debtors to schedule the claims. However, the bankruptcy courts denied the exemptions because the debtors did not show excusable neglect in failing to amend the schedules before the cases were originally closed.

The debtors appealed and won, in an opinion for the BAP on February 5 by Bankruptcy Judge Michael E. Romero, Colorado's chief bankruptcy judge.

Judge Romero began by laying out the rules. Bankruptcy Rule 1009(a), governing amendments to petitions and schedules, allows a debtor to amend a schedule "at any time before the case is closed." Bankruptcy Rule 9006(b)(1), dealing with enlargements of time, only requires a showing of "cause" to extend a deadline if the application for an extension is made before the "specified period" expires.

Beyond the "specified period," Rule 9006(b)(1) requires a showing of "excusable neglect."

Judge Romero said the BAP "cannot conclude that Rule 9006(b)(1) applies to Rule 1009(b)."

Judge Romero focused on the language in the two rules. He said that "at any time before a case is closed" in Rule 1009(a) is not a "specified time" in Rule 9006(b)(1). Using a "plain meaning" analysis, he said that Rule 1009(a) does not specify a time for amending because it is impossible to know the deadline until the case is actually closed.

Reopening a case is "purely administrative," Judge Romero said. He declined to "read Rule 1009(a)'s language to impose a substantive deadline on the debtor's ability to amend" schedules. He noted that Rule 1009(a) makes no distinction between original and reopened cases.

The BAP remanded the cases for the bankruptcy courts to rule on the merits of the claimed exemptions.

The opinion is *Mendoza v. Montoya (In re Mendoza)*, 595 B.R. 849 (B.A.P. 10th Cir. Feb. 5, 2019).

Former NFL players with neurological impairment can file bankruptcy and exempt payments under league's concussion settlement.

Payments Under the NFL's Brain Injury Settlement Are Held Exempt on Appeal

In the first-ever appeal from the first decision on the question, a district judge in Florida upheld Bankruptcy Judge John K. Olson of Fort Lauderdale by ruling that payments under the National Football League Players' Concussion Injury Litigation Settlement are exempt assets under Section 522(d)(10)(C).

The chapter 7 debtor was a retired 10-year veteran of the NFL. The former All American was a

first-round pick in the 1992 NFL draft. On account of neurocognitive impairment, he claimed that whatever he receives under the concussion settlement will be exempt.

The trustee objected to the claimed exemption. Although Florida does not allow its citizens to take federal exemptions, state law allows Floridians to claim exemptions under Section 522(d)(10). Subsection (C) allows debtors to exempt the right to receive "a disability benefit, illness, or unemployment benefit."

Judge Olson upheld the exemption claim on June 27, 2018, ruling that the payments are exempt assets under Section 522(d)(10)(C). To read ABI's discussion of Judge Olson's decision, click here.

The trustee argued that the concussion settlement was nothing more than a non-exempt litigation settlement of a tort claim. In her March 26 opinion, District Judge Kathleen M. Williams of Fort Lauderdale agreed with Judge Olson that the concussion settlement is an exempt asset, even though it resulted from litigation.

Regardless of whatever led to the concussion settlement, Judge Williams framed the question as whether the payments are a "disability benefit."

According to Judge Williams, there are only three remotely relevant decisions, all from bankruptcy courts. Two favored the debtor. A Florida decision relied upon by the trustee, she said, "is not determinative, or even persuasive." That case involved a $1.2 million payment to settle claims arising from an auto accident that did not involve an employer/employee relationship.

Judge Williams said that Judge Olson was correct in concluding that the "'overall structure [of the concussion settlement] is undeniably indicative of a disability policy.'" Again quoting Judge Olson, she said the settlement "'proceeds are not simple, guaranteed payments, but rather carefully tailored compensation schemes, consistent with and indicative of disability policies.'"

Judge Williams also agreed with the conclusion by Judge Olson that the concussion settlement "'is vastly different from a traditional class action tort settlement.'" The genesis of the settlement in class litigation "is not dispositive because . . . the real issue is whether 'his recovery actually represents a disability payment.'"

As support from her conclusion that it "does not matter that the 'disability benefits' arose from litigation," Judge Williams cited a Michigan bankruptcy court decision holding that a $193,000 lump-sum worker's compensation payment for the accidental amputation of a hand was exempt under Section 522(d)(10)(C).

The opinion is *Salkin v. Williams*, 18-61581, 2019 BL 120010 (S.D. Fla. March 26, 2019).

Courts are divided when an exemption claim collides with the government's right of setoff.

Exemption Claim Overrides the Government's Right of Setoff, District Judge Says

On an issue where the courts are hopelessly divided, a district court in Richmond, Va., ruled in favor of the debtor by barring the Internal Revenue Service from setting off a tax refund when the debtors were claiming an exemption in the refund.

In her September 10 opinion, District Judge M. Hannah Lauck also rejected the government's claim of sovereign immunity.

Twice this week, we have featured Judge Lauck in this column. On September 10, we described how the Fourth Circuit adopted her opinion regarding appellate standing and equitable mootness. *Mar-Bow Value Partners LLC v. McKinsey Recovery & Transformation Services US LLC (In re Alpha Natural Resources Inc.)*, 17-2268, 2018 BL 321354 (4th Cir. Sept. 6, 2018). To read the ABI discussion, click here.

Simple Facts, Difficult Question

A couple filed a chapter 7 petition in May 2014, owing the IRS about $13,500 in unpaid taxes for the years 2008 through 2010. For the year 2013, the couple were entitled to a refund of some $3,000 for overpayment of taxes.

Using Virginia's $5,000 wildcard exemption, the debtors claimed an exemption in the entire $3,000 refund. The IRS did not object to the exemption.

After the debtors filed their 2013 tax return in June 2014, the IRS notified the couple that it was offsetting the refund against the unpaid taxes.

Later, the couple sued the IRS in bankruptcy court, seeking a declaration that their exemption precluded setoff.

On cross motions for summary judgment, Bankruptcy Judge Keith L. Phillips of Richmond ruled in favor of the couple. He concluded that the debtors' exemption took precedence over the IRS's right of setoff and directed the IRS to turn over the $3,000 to the debtors. Judge Lauck affirmed in a 35-page opinion. She agreed with Judge Phillips that the debtors' right to an exemption "supersedes" the government's right of setoff.

Exemption vs. Setoff: Who Wins?

Deciding whether an exemption overrides the right of setoff is "a difficult legal issue," Judge Lauck said. Courts around the country "have taken varying approaches, and reached contrary outcomes, when addressing the interplay of setoffs and exemptions under the Bankruptcy Code." Even federal courts in Virginia do not agree, she said.

Judge Lauck demonstrated that the debtors properly claimed an exemption in the $3,000 under Virginia law and Section 522 of the Bankruptcy Code. On the other hand, the government had a right of setoff under Section 553, which provides that nothing in the Bankruptcy Code, aside from Sections 362 and 363, affects "any right of a creditor to offset a mutual debt . . . ."

Judge Lauck said the courts "have struggled to reconcile Sections 522 and 553, resulting in courts reaching conflicting outcomes."

Significantly, Judge Lauck said that the standard of appeal for disallowance of setoff is abuse of discretion, because the applicability of Section 553 "is permissive, rather than mandatory." A bankruptcy court, she said, "may exercise its equitable discretion to determine whether to apply an offset provision in the Bankruptcy Code."

Similarly, Judge Lauck said that the government's ability to credit an overpayment of taxes against a tax liability is "discretionary" under Section 6402 of the IRS Code.

The government, however, argued that the tax refund never became estate property, precluding the exercise of a right of exemption. Although some courts have ruled otherwise, Judge Lauck agreed with the majority to hold that the right to a refund became property of the estate on the filing date in 2014 because the debtors' right to the refund had vested on December 31, 2013.

Since the refund was estate property, Judge Lauck said the IRS was required to comply with the Bankruptcy Code and could not "unilaterally take property from the bankruptcy estate" by exercising a right of setoff. However, she did not rest her opinion on the government's failure to lodge a timely objection to the exemption claim.

Weighing the government's right of offset against the debtors' right to an exemption, Judge Lauck concluded that the bankruptcy court "did not abuse its equitable discretion in holding that the IRS's right of setoff under Section 553 appropriately gave way to the Debtors' claimed exemption under Section 522."

"Section 553 is permissive in application, not mandatory," Judge Lauck said, and "prioritizing Section 522 over Section 553 best supports the fundamental goals of the Bankruptcy Code." She went on to say that "Section 533's permissive application must yield to Section 522's unqualified authorization to Debtors to exempt property pursuant to its requirements."

Because the standard of appeal was abuse of discretion, Judge Lauck conceivably could have upheld the bankruptcy court even had Judge Phillips reached the opposite legal conclusion. Nonetheless, Judge Lauck said that Judge Phillips "did not err in [his] application of the law."

Judge Lauck gave primacy to the debtors' exemption. Because "Section 553's applicability is permissive, rather than mandatory, and because nothing similarly narrows the scope of Section 522, the Court finds Section 522's exemption rights superior to Section 553's setoff rights. Such an interpretation gives meaning to both sections without nullifying either."

Although Judge Lauck found "persuasive arguments on either side of the debate," she concluded that Judge Phillips did not err on the legal issue "and did not abuse [his] discretion in disallowing the setoff . . . because compelling circumstances exist to disallow setoff."

In a footnote, Judge Lauck said that the Fourth Circuit issued a nonprecedential opinion in 1996 finding that a right of setoff cannot be exercised against an exempt asset.

Sovereign Immunity

The government argued that sovereign immunity divested the bankruptcy court of jurisdiction to bar setoff. According to the IRS, there was no waiver of sovereign immunity under Section 106(a)(1) because none of the 59 listed provisions of the Bankruptcy Code creates a cause of action allowing the debtors to bar an exercise of setoff.

Judge Lauck rejected the government's sovereign immunity argument. She said that the debtors' suit "directly implicates Sections 522 and 553," which are both listed in Section 106(a)(1). Because "resolving the case requires resolving the tensions between Sections 522 and 553" she said "the case squarely falls within the scope of Sections 522 and 553."

The government argued there was no waiver of sovereign immunity, since neither section creates a cause of action. Judge Lauck said that the argument lacked merit, because Section 106(a)(2) allows the court to "hear and determine any issue arising with respect to" the sections enumerated in Section 106(a)(1).

Section 106 waived sovereign immunity, according to Judge Lauck, because the two sections "constitute the heart of the case."

The opinion is *U.S. v. Copley*, 16-207 (E.D. Va. Sept. 10, 2018).

.

Automatic Stay

In the first opinion at the circuit level, the First Circuit latches onto the lousy drafting of Section 362(c)(3)(A) to end the automatic stay entirely, 30 days after the second filing within a year.

First Circuit Terminates the Stay Entirely as to Repeat Filers

On an issue long dividing the lower courts, the First Circuit became the first court of appeals to decide whether the automatic termination of the stay 30 days after a repeat filing only ends the stay as to the property of the debtor.

Adopting the position taken by a minority of lower courts regarding Section 362(c)(3)(A), the First Circuit held on December 12 that the stay automatically terminates as to debtor, property of the debtor, and property of the estate. The First Circuit concluded that Congress so poorly drafted subsection (c)(3)(A) that the canons of statutory construction provide little utility in divining the answer.

The Facts and the Statute

The debtor had filed chapter 13 three times. The third filing occurred a month after the second case was dismissed. The debtor confirmed a five-year chapter 13 plan in his third case.

The debtor was not a total deadbeat. He had made payments three years before the first case was dismissed and two years after filing the second petition.

In the third case, the state taxing authority filed a motion under Section 362(j) for a declaration about the extent of the automatic termination of the stay under Section 362(c)(3)(A).

In terms of drafting, subsection (c)(3)(A) is a hash. It uses the phrase "with respect to" three times. If an individual's case under chapters 7, 11 or 13 has been dismissed within a year, the subsection provides that the automatic stay in Section 362(a) terminates 30 days after the most recent filing "with respect to any action taken with respect to a debt or property securing such debt . . . *with respect to the debtor* . . . ." [Emphasis added.]

Much of the confusion arises from the italicized language. Does it mean the stay only terminates with respect to property of the debtor? In 2006, retired Bankruptcy Judge A. Thomas Small of Raleigh, N.C., said that Section 362(c)(3)(A) "stands out" among the "head-scratching opportunities" found in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, or BAPCPA. *In re Paschal*, 337 B.R. 274, 277 (Bankr. E.D.N.C. 2006).

The Decision by Bankruptcy Judge Fagone

Ruling on the taxing authority's motion, Bankruptcy Judge Michael A. Fagone of Bangor, Maine, declined to follow two decisions by the First Circuit Bankruptcy Appellate Panel.

Instead, Judge Fagone adopted the approach taken by the minority of courts. He saw the 2005 amendments as designed "'to correct perceived abuses of the bankruptcy system,'" including "the problem of successive bankruptcy filings interfering with foreclosures." *In re Smith*, 573 B.R. 298, 303 (Bankr. D. Maine Aug. 18, 2017).

Judge Fagone said that Congress intended "to remedy that problem" by terminating the automatic stay even as to property of the estate. *Id*. The majority approach, he said, "turns myopically upon the meaning of five words in a lengthy and complex statute, while failing to promote the statute's manifest purpose." *Id*.

Judge Fagone was upheld in district court, prompting the debtor to appeal.

The First Circuit Opinion

The question was well presented to the circuit court by the debtor, supported by an *amicus* brief from the National Consumer Bankruptcy Rights Center and the National Association of Consumer Bankruptcy Attorneys. Still, the debtor lost in the 34-page opinion on December 12 by Circuit Judge Sandra L. Lynch.

The appeal presented a "close question," Judge Lynch said. Lacking authority from the courts of appeals, she conceded that a majority of courts around the country believe the stay does not terminate automatically as to property of the estate. The First Circuit BAP twice ruled that the stay does not terminate as to estate property, while two district courts in the First Circuit held that the stay terminates both as to property of the debtor and the estate.

Judge Lynch said that "textual arguments . . . do not resolve the issue." She therefore based her opinion on "the provision's text, its statutory context, and Congress's intent." The broader termination of the stay, she said, "is the only one compatible with the text, seen in light of its context and purpose."

Arguing for a plain-meaning interpretation of the statute, the debtor contended that "with respect to the debtor" limits the termination of the stay to property of the debtor (of which there is almost none in chapter 13). Reading the subsection more broadly, Judge Lynch's opinion is a *tour de force* on the plain meaning doctrine and canons of statutory construction.

Judge Lynch said that the subsection "does not lend itself to one clear reading." Given its "oddities, including redundancy," the "meaning is not plain," she said, because the "language at issue could have different meanings."

For reasons she explained in copious detail, Judge Lynch concluded that "with respect to the debtor" is "superfluous."

Judge Lynch relied on *King v. Burwell*, 135 S. Ct. 2480, 2492 (2015), where the Supreme Court warned against "rigorous application of the canon[s of construction]" when a statute may have been "inartful[ly] drafted."

Judge Lynch followed *King* because, she said, the subsection "deviates" from "assumptions about artful drafting." The statute, she said, "is a collection of 'with respect to' phrases, and it is not obvious how the phrases relate to each other, or how the phrases connect with other related provisions."

The phrase "with respect to the debtor," Judge Lynch said, "does not on its own obviously support or obviously foreclose either party's reading." So, she turned to "statutory context and congressional purpose for further evidence."

Viewing BAPCPA as an attempt by Congress to address abuses of the Bankruptcy Code, Judge Lynch took "the most sensible middle ground." Congress "most likely intended," she said, for "second time filers [to] get the benefit of the stay, but only temporarily."

According to Judge Lynch, the "purpose" of Congress "is best achieved by interpreting Section 362(c)(3)(A) to terminate the entire stay, including estate property." Unless the debtor or a creditor obtains an extension of the automatic stay under Section 362(c)(3)(B), she held that "the entire automatic stay" terminates 30 days after filing "as to actions against the debtor, the debtor's property and property of the bankruptcy estate."

The opinion is *Smith v. State of Maine Bureau of Revenue Services (In re Smith)*, 910 F.3d 576 (1st Cir. Dec. 12, 2018).

Ninth Circuit splits with the First on the interpretation of Section 106(a).

Circuits Split on Sovereign Immunity and Emotional Distress Damages for a Stay Violation

The waiver of sovereign immunity in Section 106(a) allows an individual to collect damages for emotional distress resulting from the government's willful violation of the automatic stay, according to the Ninth Circuit.

The Ninth Circuit created a split of circuits because the First Circuit had held in *U.S. v. Rivera (In re Rivera)*, 432 F.3d 20 (1st Cir. 2005), that Section 106(a) does not waive sovereign immunity for emotional distress damages resulting from a stay violation.

Daniel Geyser of Dallas, who prevailed in the Ninth Circuit on behalf of the debtors, told ABI that "Congress waived sovereign immunity to put the government on equal footing with private parties." The damage award, he said, "holds the government accountable for its actions — just as Congress intended."

The Debtor Wins and Loses Below

After a couple filed their chapter 13 petition, the Internal Revenue Service sent several notices demanding payment of back taxes and threatening to levy on their bank accounts. The bankruptcy judge held the IRS in contempt of the automatic stay and imposed $4,000 in damages for "significant emotional harm."

On appeal, the IRS conceded there was a stay violation but contended that the doctrine of sovereign immunity insulates the government from claims for emotional distress under Section 362(k). A district judge in Oregon agreed, reversed the bankruptcy court, and ordered the complaint dismissed. To read ABI's discussion of the district court opinion, click here.

The debtor appealed and won a reversal in an August 30 opinion written for the Ninth Circuit by District Judge Cynthia A. Bashant, sitting by designation from the Southern District of California.

The Relevant Bankruptcy Code Provisions

Section 106(a)(1) waives sovereign immunity "as to a governmental unit" with regard to 59 provisions in the Bankruptcy Code, including Section 362. Section 106(a)(3) enables the court to "issue" an "order . . . or judgment" against a governmental unit, "including an order or judgment awarding a money recovery, but not including an award of punitive damages."

Section 362(k) provides that "an individual injured by any willful violation of a stay provided by this section shall recover actual damages, including costs and attorneys' fees, and, in appropriate circumstances, may recover punitive damages."

Removing what otherwise would have been an issue on appeal, the Ninth Circuit had held in 2004 that "actual damages" in Section 362(k) includes damages for emotional distress. *See Dawson v. Washington Mutual Bank, F.A. (In re Dawson)*, 390 F.3d 1139, 1148 (9th Cir. 2004).

The Government's Argument

Urging the appeals court to uphold the district court, the government relied on *U.S. v. Nordic Village Inc.*, 503 U.S. 30 (1992), where the Supreme Court ruled that Section 106, as it was then written, did not unequivocally subject the government to claims for monetary relief. At the time, Section 106 only said that the term "creditor" when used in the Bankruptcy Code applies to "governmental units" and that "an issue arising under such a provision binds governmental units."

Congress responded to *Nordic Village* two years later by amending Section 106 to contain an explicit waiver of sovereign immunity. The government argued in the Ninth Circuit that the amendment only permits recovery of money unlawfully in the government's possession.

The Circuit's *Ratio Decidendi*

To analyze whether the waiver of sovereign immunity extends to damages for emotional distress, Judge Bashant began with the Supreme Court's rule that a waiver of sovereign immunity must be "unequivocally expressed." *U.S. v. Bormes*, 568 U.S. 6, 9–10 (2012) (quoting *Nordic Village*, 503 U.S. at 33–34).

Judge Bashant said that the government's argument based on *Nordic Village* "is not plausible in light of the [amended] statute's text." She said that Section 106(a) "plainly waives sovereign immunity for court-ordered monetary damages under the waiver's enumerated provisions, although the damages may not be punitive."

Emotional distress damages, Judge Bashant said, "are a form of monetary relief — compensatory damages — but they are not punitive." Given *Dawson*'s holding that emotion distress damages are permitted under Section 362(k), she held that "Section 106(a) waives sovereign immunity for emotional distress damages under Section 362(k)."

The Split with the First Circuit

Judge Bashant ended her opinion by explaining why the Ninth Circuit would not follow the First Circuit's decision in *Rivera*.

Based on the so-called temporal approach, the First Circuit pronounced a convoluted theory to immunize the government for emotional distress damages sought under Section 105 for a willful stay violation.

The First Circuit understood the 1994 amendments in Section 106 to waive sovereign immunity only as to forms of monetary relief that were understood to exist at the time. Since damages for a willful stay violation in 1994 had not been understood to include emotional distress damages, the First Circuit did not find a clear intent to waive sovereign immunity.

Judge Bashant declined to follow the First Circuit because she said the "plain language of the statute is dispositive."

The First Circuit also latched onto Section 106(a)(5), which provides that nothing in the section creates "any substantive claim for relief . . . not otherwise existing under this title, the Federal Rules of Bankruptcy Procedure, or nonbankruptcy law."

Judge Basant rejected the reliance on Section 106(a)(5), saying it did not "graft a temporal restriction onto the waiver's scope."

Judge Basant reversed the district court and remanded for the district court to consider the government's appeal on the merits.

Is the Issue '*Cert*-worthy'?

Since here is now a split of circuits, the government could file a petition for *certiorari* seeking review in the Supreme Court. The government may not bother because the issue seldom arises given that the IRS does not have a policy calling for violation of the automatic stay.

In view of the remand for the district court to analyze the merits, the judgment in the court of appeals is not a final order and thus may not warrant the granting of *certiorari*. However, the high court will sometimes review a non-final order that raises a pure issue of law not likely to be affected by remand.

All things considered, the Ninth Circuit's decision is not a compelling candidate for a grant of *certiorari*. In terms of a circuit split involving the automatic stay, the Supreme Court will have a far more consequential case in *Lorenzen v. Taggart (In re Taggart)*, 888 F.3d 438 (9th Cir. April 23, 2018) (petition for panel rehearing and rehearing *en banc* filed June 6, 2018). *Taggart* merits Supreme Court review because the First Circuit handed down contrary decision seven weeks later in *IRS v. Murphy*, 892 F.3d 29 (1st Cir. June 7, 2018).

Murphy and *Taggart* raise the question of whether good faith is a defense to sanctions for violating the discharge injunction. The Ninth Circuit held that good faith is a defense, while the

First Circuit held it is not. The Ninth Circuit must deal with the petition for rehearing before there can be a *certiorari* petition. To read ABI's discussion of those cases, click here and here.

The opinion is *Hunsaker v. U.S.*, 16-35991 (9th Cir. Aug. 30, 2018).

The Seventh Circuit's opinion interpreting the amendment to Rule 62 is nonprecedential and prompted a dissent, and it may apply only in some states.

Seventh Circuit Makes Stays Pending Appeal Automatic in Mortgage Foreclosures

Over a dissent, the Seventh Circuit ruled "provisionally" in a nonprecedential opinion that "stays pending appeal should be the norm in mortgage foreclosure appeals" in states where the foreclosure judgment is not final and appealable until the homeowner faces imminent eviction.

The Seventh Circuit's *Townsend* Rule

The Seventh Circuit's opinion on February 6 was an outgrowth from *HSBC Bank U.S.A. N.A. v. Townsend*, 793 F.3d 771 (7th Cir. 2015), where the appeals court held that a foreclosure judgment under Illinois law is not final and appealable until the district court not only has foreclosed the mortgage but has also ordered a sale of the property, confirmed the sale and ordered eviction of the homeowner. Later, the Seventh Circuit extended the foreclosure-finality rule to Wisconsin.

The majority in the February 6 opinion — composed of Circuit Judges Ilana D. Rovner and David F. Hamilton — interpreted *Townsend* to mean that a homeowner's first opportunity to appeal and seek a stay of foreclosure in Illinois and Wisconsin comes 30 days before eviction.

Consequently, the majority said, *Townsend* would require the appeals court to undertake "a quick evaluation of the likely merits of the appeal, where the parties, lawyers, and the judges must act under time pressure of a 30-day eviction deadline." In the application for a stay before the court, the majority framed the question as "whether we should allow normal appellate procedures to work as they would in most other cases."

The majority admitted that most mortgage foreclosures "are likely to be affirmed." But still, the majority said, "there is plenty of room for human and legal error in mortgage foreclosures."

The Facts in the Case on Appeal

The homeowner's appeal was hardly frivolous. The lender began foreclosure in 2007, but the case was dismissed on the parties' agreement. After a few months passed, the lender initiated another foreclosure action, which the state court dismissed two years later for want of prosecution.

After the mortgage was transferred, the new holder of the mortgage began foreclosure in 2013. Invoking *res judicata*, the district court dismissed the foreclosure action because the lender had not refiled the suit within one year. On motion for reconsideration, the district court reinstated the case and later entered a foreclosure order on summary judgment. The homeowner appealed, but the appeal was dismissed under *Townsend* because the summary judgment order was not final.

After the district court entered a foreclosure judgment, the appeals court again dismissed the appeal under *Townsend*. Finally, the district court order a sale and approved the sale to the lender. Facing imminent eviction, the homeowner appealed and sought a stay, which the district court denied.

The homeowner applied to the Seventh Circuit for a stay. The appeals court granted the stay in July 2018, saying that an explanation would follow.

The February 6 order "is the explanation," the appeals court said. In the meantime, Rule 62 of the Federal Rules of Civil Procedure was amended as of December 1, 2018.

The Majority's Rationale

The majority said that the 2018 amendments to Rule 62 "have clarified the law for purposes of this case and made its application simpler and more flexible."

Under the prior version of the rule, the majority said that the lender's mortgage on the property "should ordinarily suffice to protect the lender's rights pending appeal for the purposes of Rule 62," thus entitling the homeowner to a stay pending appeal. A stay may not be proper, the majority said, if taxes or insurance were not being paid or the property was not being "cared for."

The majority interpreted *Townsend* to "clearly" imply "that stays in pending appeals in foreclosure sales should be routine to prevent the irreparable harm of losing one's home."

The amendments to Rule 62, the majority said, "reinforce making a stay pending appeal the norm in mortgage foreclosure cases." For a blackline showing the amendments to Rule 62, click here.

The majority quoted the Committee Notes to the amendments, which say, "The new rule's text makes explicit the opportunity to post security in a form other than a bond."

"Given that flexibility," the majority said, "continuing the security interest . . . should provide adequate security in most cases, at least so long as the property is cared for and protected by insurance and payment of property taxes."

The majority made the opinion nonprecedential for a reason: The "issues have not yet been the subject of a full adversarial presentation," the majority said. The two judges expressed a "willingness to reconsider our thinking, particularly if and when we have the benefit of briefing by counsel on both sides."

The Dissent

Circuit Judge Amy J. St. Eve dissented. She said, "Whatever interest a lender has in a foreclosed piece of property, it seems a stretch to liken it to a bond." She went on to say the amendments to Rule 62 do not "clearly dictate the majority's result."

Judge St. Eve said she also disagreed with the majority's interpretation of the "old" Rule 62. She saw no reason to opine on the new rule when the stay had been granted in July under the old rule.

The opinion is *Deutsche Bank National Trust Co. v. Cornish*, 18-2429 (7th Cir. Feb. 6, 2019).

Municipal Debt Adjustment & Puerto Rico

'Adamant' dissenter argues that condemnation claims arising from eminent domain are excepted from discharge under the Takings Clause.

Equitable Mootness Applies to Chapter 9 Municipal Debt Adjustments, Ninth Circuit Says

Like its Bankruptcy Appellate Panel three years ago, the Ninth Circuit held that an appeal from a chapter 9 municipal reorganization can be dismissed under the doctrine of equitable mootness.

"Adamantly" dissenting, one judge on the three-judge panel would have ruled that a Takings Clause claim for just compensation under the Fifth and Fourteenth Amendments is not subject to the bankruptcy power and is automatically excepted from discharge, regardless of whether the appeal otherwise would be dismissed as equitably moot.

The Condemnation Claim

Two decades ago, the city of Stockton, Calif., exercised its power of eminent domain by condemning property to build a road. Although the owner had accepted $90,000 and waived rights to further compensation, the litigation posture became muddled when the city failed to complete the condemnation proceedings within five years as required by state law.

The owner then commenced a so-called reverse condemnation proceeding to seek greater compensation. However, Stockton filed its chapter 9 petition in 2012, halting proceedings in state court. The city listed the creditor's claim as unsecured, and the creditor filed an unsecured claim for about $4.2 million.

The creditor objected to confirmation of the city's chapter 9 municipal debt-adjustment plan. The creditor contended that his reverse condemnation claim was protected by the Fifth and Fourteenth Amendments and could not be impaired by the plan. Implementing settlements with workers, unions and bondholders, the bankruptcy court overruled the objection and confirmed the plan.

The plan became effective in early 2015. Meanwhile, the creditor appealed the confirmation order but never sought a stay pending appeal.

The Ninth Circuit accepted a direct appeal that was argued in November 2016. One judge on the panel retired before a decision came down, necessitating the appointment of a third judge to break the tie vote. The new judge reviewed the papers, listened to a recording of oral argument, and sided with the chief judge.

The Majority Opinion

Chief Circuit Judge Sidney R. Thomas dismissed the appeal as equitably moot, writing for himself and Circuit Judge Ronald M. Gould, who was added to the panel after Circuit Judge Alex Kozinski retired. Judge Thomas also ruled that the appeal failed on the merits.

Before explaining why, Judge Thomas said that if "there is a confirmed bankruptcy plan that deserves finality . . . it is Stockton's."

Judge Thomas recited Ninth Circuit law on equitable mootness, laid out in *JPMCC 2007-C1 Grasslawn Lodging LLC v. Transwest Resort Properties Inc. (In re Transwest Resort Properties Inc.)*, 801 F.3d 1161 (9th Cir. 2015). For ABI's discussion of *Transwest*, click here.

For an appeal to be equitably moot, four factors come into play under *Transwest*: (1) Did the appellant seek a stay; (2) was the plan substantially consummated; (3) what are the effects on third parties not before the court, and (4) can the court fashion a remedy that will not "knock the props" out from under the plan?

Only the last two factors were in dispute. Regarding the effect on third parties, Judge Thomas said that reversal of confirmation would undermine settlements with unions, bondholders and capital markets creditors, not to mention the citizens of Stockton who depend on the city for services. Although the creditor contended that he only sought monetary relief, Judge Thomas said that the multi-million-dollar claim would question the city's long-term financial plan underlying the debt adjustment.

With regard to the fourth factor concerning a remedy, Judge Thomas rejected the creditor's contention that he was seeking only a monetary recovery. Reversing the confirmation order, the judge said, "would mean dismantling the confirmed reorganization plan, which is the only relief [the creditor] seeks."

Judge Thomas ruled that the appeal must be dismissed as equitably moot because the "reorganization train has left the station. . . . To reverse [confirmation] at this stage would create chaos and undo years of carefully negotiated settlements."

Like the BAP in late 2015, Judge Thomas ruled that a challenge to Stockton's plan was equitably moot, citing *Franklin High Yield Tax-Free Income Fund v. City of Stockton (In re City of Stockton)*, 542 B.R. 261, 264-265 (B.A.P. 9th Cir. 2015).

On the merits, the creditor argued that the Takings Clause exempted his claim from the reorganization. Even assuming the appeal was not equitably moot, Judge Thomas said that the argument was "not viable on this record."

Judge Thomas said that a Takings Clause claim "is only implicated in bankruptcy if the creditor has actual property rights." Evidently conceding that the Takings Clause provides protection to a creditor claiming "actual property rights," he said that a debt can be adjusted in bankruptcy if the creditor only has a right to monetary relief, citing the *Collier* treatise.

With regard to that issue, Judge Thomas noted how the creditor himself had filed only an unsecured claim and claimed no interest in property. In addition, there was a final state court judgment rejecting the creditor's claim to property rights.

According to Judge Thomas, the state court had only left the creditor with "an unliquidated and unsecured monetary damage claim" that could be affected by the chapter 9 plan.

The Dissent

Circuit Judge Michelle T. Friedland dissented, saying up front that "the Fifth Amendment's requirement that the government provide just compensation for any taking of private property constrains the powers granted to Congress by the Bankruptcy Clause of Article I. Takings claims should therefore be excepted from discharge in bankruptcy."

Therefore, Judge Friedland said, "equitable mootness has no role to play here" because the creditor only sought to have his claim excepted from discharge. She thus reached the merits, again disagreeing with the majority and saying that the creditor "should be allowed to proceed" with his inverse condemnation claim in state court.

On the constitutional issue, Judge Friedland believes that municipalities "are obligated to provide just compensation for any taking of private property, regardless of bankruptcy laws." She read *Louisville Joint Stock Land Bank v. Radford*, 295 U.S. 555 (1935), to mean that the Takings Clause "constrains the power conferred by the Bankruptcy Clause of Article I." Similarly, she understood *U.S. v. Security Industrial Bank*, 459 U.S. 70 (1982), to mean that the bankruptcy power is subject to the prohibition against taking private property without just compensation.

Therefore, Judge Friedland concluded that "claims for just compensation should be excepted from discharge, such that they survive any bankruptcy intact."

On the merits, Judge Friedland believed that the creditor had not waived rights to just compensation under state law. To preserve his claims, she said the creditor was only obliged to object to confirmation. The applicability of rights under the Takings Clause did not depend on whether the claim was classified as secured or unsecured, she said.

Furthermore, Judge Friedland said, the Bankruptcy Code does not require a creditor with a nondischargeable claim to file a proof of claim. Citing Bankruptcy Rule 4007(b), she said that a complaint seeking an exception to discharge may be filed at any time.

Recognizing that the creditor never filed a separate pleading to except the debt from discharge, Judge Friedland said he accomplished the equivalent by "unequivocally" maintaining throughout that "his claim for just compensation was 'protected by the Fifth and Fourteenth Amendments'" and could not be impaired by the plan or treated as a mere unsecured claim.

The opinion is *Cobb v. City of Stockton (In re City of Stockton)*, 14-17269 (9th Cir. Dec. 10, 2018).

The appeals court is attempting to avoid chaos despite ruling that the appointment of Puerto Rico Oversight Board members violated the Appointments Clause of the Constitution.

First Circuit Cans the Puerto Rico Oversight Board as Unconstitutionally Appointed

Reversing the district court, the First Circuit threw the Puerto Rico debt restructuring into a cocked hat by declaring that the appointment of the members of the Financial Oversight and Management Board of Puerto Rico violated the Appointments Clause of the Constitution because they were not nominated by the President and confirmed by the Senate.

The appeals court attempted to limit damage by declaring that the ruling will not go into effect for 90 days, allowing the President and the Senate in the meantime to validate the appointments to the Board or to reconstitute the Board in accordance with the Appointments Clause.

Relying on the *de facto* officer doctrine, the First Circuit ruled that its opinion would "not eliminate any otherwise valid actions of the Board prior to the issuance of our mandate in this case." In other words, the appeals court is allowing the Board to continue functioning for 90 days and will not unravel any actions already taken by the Board.

But that's not the end of the story. The bondholders who brought the appeal wanted the First Circuit to dismiss Puerto Rico's debt restructuring and invalidate all of the Board's prior actions.

By having been denied some of the relief they sought, the bondholders are entitled to file a petition for rehearing *en banc* in the First Circuit or, more likely, a petition for *certiorari* in the Supreme Court.

Until a petition for *certiorari* is denied or the First Circuit's opinion becomes final, there will be a pall of uncertainty over the ongoing debt restructuring under the Puerto Rico Oversight, Management, and Economic Stability Act, or PROMESA (48 U.S.C. §§ 2161 *et. seq.*).

The Challenge to the Board

Aurelius Investment LLC and affiliates filed a motion in August 2017 seeking dismissal of Puerto Rico's debt arrangement proceedings, arguing that the filing of the petition on behalf of the Commonwealth of Puerto Rico by the Board under Title III of PROMESA violated the Appointments Clause. Holders of Puerto Rico general obligation bonds joined Aurelius but were

opposed by the Oversight Board, the official unsecured creditors' committee, and COFINA bondholders, among others.

District Judge Laura Taylor Swain, sitting in the District of Puerto Rico by designation, held a hearing in January 2018 and issued a 35-page opinion in July, holding that PROMESA and the Board were properly constituted under the Territories Clause of the Constitution, Article IV, Section 3, Clause 2. *In re The Financial Oversight and Management Board for Puerto Rico*, 17-3283 (D.P.R. July 13, 2018). To read ABI's discussion of the district court opinion, click here.

The bondholders appealed, asking the First Circuit to invalidate the appointment of the Board and suggesting that the appeals court should declare that the Board's actions have been invalid. In a 55-page opinion on February 15 by Circuit Judge Juan R. Toruella, the bondholders won the argument on the Appointments Clause.

The Circuit Court's Rulings

The appeal was a contest between two former Solicitors General, Theodore B. Olson for the bondholders and Donald B. Verrilli, Jr. for the Board. Olson won the day in large part, just as he did in the Supreme Court in *Bush v. Gore*.

The opinion is of greatest significance for constitutional law scholars. Reminiscent of the turmoil created in the bankruptcy courts by *Northern Pipeline*, the remedies portion of the opinion attempts to limit the damage caused by overturning the Board's appointment. *Cf. Northern Pipeline Construction Co. v. Marathon Pipeline Co.*, 102 S. Ct. 2858 (1982).

Differing from the district court, the First Circuit ruled that the Territorial Clause did not displace the Appointments Clause in naming members of the Board. Judge Toruella reasoned that the Appointments Clause is the more specific provision in the Constitution and controls over the more general Territorial Clause.

Next, the appeals court had no difficulty deciding that the Board members were "officers of the U.S.," because they occupy a continuing position and exercise significant authority pursuant to laws of the U.S. In that regard, Judge Toruella noted that major federal appointments to Puerto Rico's civil government in the first half of the 20th century were made under the Appointments Clause, apart from a short period of military administration following the Spanish-American War.

From there, Judge Toruella explained why the Board members were not "inferior officers": because they "are answerable to and removable only by the President and are not directed or supervised by others who were appointed by the President and confirmed by the Senate."

Since they therefore were "principal officers," Judge Toruella found a constitutional violation because they were not appointed by the President and confirmed by the Senate.

The Remedy

Judge Toruella said the bondholders wanted the appeals court to dismiss the PROMESA proceedings. He said they "suggest that we ought to deem invalid all of the Board's actions until today."

The bondholders wanted a constitutionally reconstituted Board to ratify, or not, the unconstitutional Board's actions. (Imagine the complexities and uncertainty in deciding whether to set aside actions taken in reliance on final court orders.)

Judge Toruella said there was "unlikely" to be a "perfect solution." He sought a remedy "to reduce the disruptions that our decision may cause." He found salvation in the severability clause in PROMESA, allowing him to set aside Board appointments without invalidating the entire legislation.

Judge Toruella overruled the bondholders' desire to dismiss the PROMESA proceedings, saying that dismissal would "cast a specter of invalidity over all of the Board's actions until the present day." Instead, he adopted the *de facto* officer doctrine.

Described as an "ancient tool of equity," he said the doctrine confers validity on actions taken by someone acting under an official title even though the appointment is later discovered to be improper.

Declining to dismiss the PROMESA proceedings, Judge Toruella said that the appeals court would "not eliminate any otherwise valid actions of the Board prior to the issuance of our mandate in this case." In that respect, he alluded to the Federal Elections Commission, where the Supreme Court did not invalidate the Commission's past acts, although the members had been appointed in contravention of the Appointments Clause.

Judge Toruella said the appeals court would not issue the mandate for 90 days, giving the President and the Senate time to "validate the currently defective appointments or reconstitute the Board in accordance with the Appointments Clause." In the meantime, he said, "the Board may continue to operate as until now."

What's Next?

Will the President quickly nominate and the Senate confirm the current members of the Board? By their actions so far, the Board members have made as many enemies as they have friends.

And if the President and the Senate do not act, what then? Will the First Circuit extend the deadline? Unlike the situation in *Northern Pipeline*, there can't be a local court rule to serve as a temporary fix.

There is a different President who may not be partial to sitting Board members selected by the former President. And even if the President goes along, will the Senate confirm?

Under PROMESA as written, six members of the Board were selected by the majority and minority leaders of the House and Senate. The initial selection mechanism is now invalid, because the President exercises the power of appointment, not the House and Senate.

And even if the Board is reappointed, uncertainty will remain unless the bondholders allow the First Circuit opinion to become final or the Supreme Court denies *certiorari*. And if the composition of the Board changes, will the members rethink the decisions and policies of their predecessor?

We decline to guess how this mess works out.

The opinion is *Aurelius Investment LLC v. Commonwealth of Puerto Rico*, 915 F.3d 838 (1st Cir. Feb. 15, 2019) (*cert*. granted June 20, 2019 in *Financial Oversight and Management Board for Puerto Rico v. Aurelius Investment LLC*, 18-1334 (Sup. Ct.)).

Dissenter in the First Circuit recommends that the Supreme Court hear and reverse an opinion allowing Puerto Rico to withhold payments from bondholders.

First Circuit Puerto Rico Bondholder Opinion Is Primed for *Certiorari*

Reading like a memorandum directed to the Supreme Court, three judges on the Third Circuit wrote a statement explaining why the justices should deny *certiorari* from a pivotal ruling in the Puerto Rico debt restructuring.

In a pair of opinions handed down on March 26, the First Circuit ruled that Puerto Rico's secured bondholders cannot compel payment before their rights are sorted out under the island commonwealth's debt adjustment plan. In substance, the March opinions preclude bondholders from taking home their collateral immediately, thereby short-circuiting the restructuring.

The bondholders' insurer filed a motion for rehearing *en banc* from one of the opinions. Responding to a vigorous dissent by one circuit judge from denial of rehearing, the judges from the March three-judge panel wrote another opinion explaining why their original interpretation of the statute was correct.

Both appeals arose in Puerto Rico's debt restructuring under the Puerto Rico Oversight, Management, and Economic Stability Act, or PROMESA (48 U.S.C. §§ 2161 *et. seq.*). With modifications, PROMESA incorporates large swaths of chapter 9 governing municipal debt adjustments. Congress was required to enact PROMESA because the Supreme Court ruled that the commonwealth is not eligible for chapter 9 and that Puerto Rico cannot adopt laws to deal with its own insolvency.

The First March 26 Opinion

In one opinion on March 26, Circuit Judge Juan R. Torruella upheld dismissal of a lawsuit by holders of Puerto Rico general obligation bonds who sought declarations that would have restricted Puerto Rico's use of tax revenue. The bondholders did not seek rehearing; the mandate issued; and there was no petition for *certiorari*. *Aurelius Capital Master Ltd. v. Commonwealth of Puerto Rico (In re Financial Oversight and Management Board for Puerto Rico)*, 919 F.3d 638 (1st Cir. March 26, 2019). To read ABI's discussion, click here.

In their suit resulting in the first March 26 opinion, holders of GO bonds wanted the district court to rule that certain tax revenue, known as restricted revenue, could not be used for any

purpose other than the payment of their bonds and other constitutional debt and must be segregated for them alone.

The Second March 26 Opinion

The second opinion on March 26 was also written by Judge Torruella. He again upheld the district court by ruling that nothing in PROMESA enables bondholders to compel payment on their bonds during the course of proceedings and before confirmation of a plan. *Assured Guaranty Corp. v. Financial Oversight and Management Board for Puerto Rico (In re Financial Oversight and Management Board for Puerto Rico, as Representative for the Puerto Rico Highways and Transportation Authority)*, 919 F.3d 121 (1st Cir. March 26, 2019). To read ABI's report, click here.

In April, bondholders responded to Judge Torruella's second March 26 opinion by filing a petition for rehearing and rehearing *en banc*.

Without opposition from Puerto Rico, the First Circuit denied the rehearing motions on July 31. The order did not say whether any circuit judge other than the dissenter would have granted rehearing.

Joined by the two other judges from the original panel, Circuit Judge William J. Kayatta, Jr. issued a statement on July 31 explaining why the March 26 decision was correct. He was responding to Circuit Judge Sandra L. Lynch, who wrote a lengthy dissent from denial of rehearing *en banc*. She believes that further hearing was warranted by the First Circuit, and "if not by this court, then by the Supreme Court."

The statement by Judge Kayatta reads like the panel's memorandum to the Supreme Court explaining why the justices should deny *certiorari*.

Judge Lynch's Dissent

Judge Lynch wrote a 16-page, single-spaced dissent explaining why the three-judge panel was wrong in March. She believes that Puerto Rico "must continue to pay pledged special revenues to bondholders during a bankruptcy proceeding."

Making a case for the Supreme Court to grant *certiorari*, Judge Lynch said that the "issue is of extraordinary importance: it goes well beyond [Puerto Rico's debt restructuring] as to both potential municipal and state defaults, affects special revenue bonds nationwide, and has Constitutional implications."

However, Judge Lynch correctly interpreted the panel's March 26 opinion. She said the "bondholders cannot receive payment of special revenues promised to them . . . unless [Puerto Rico] *voluntarily* makes such payment." [Emphasis in original.]

According to Judge Lynch, the alternative for the bondholders — filing a motion to modify the automatic stay — was a "burden" that Congress "likely" did not intend.

Judge Kayatta's Statement for the Panel

Judge Kayatta's four-page statement for the panel is a skillful explanation of how Sections 922 and 928 work together. In his view, the statute allows, but does not require, a municipal debtor to continue paying special revenue bonds during the course of a proceeding and before adoption of a restructuring plan.

Judge Kayatta seems to say that Judge Lynch wrote what she though the law ought to be, not what Congress wrote.

Judge Kayatta defined the issue as follows: Without a modification of the automatic stay, may bondholders file a lawsuit to compel payment of pledged special revenues? He said that the March opinion explained why Sections 922 and 928 "do not afford creditors a shortcut to bypass the requirement of obtaining traditional stay relief." He said that the statutes do not even "remotely" suggest that a municipality is compelled to pay bondholders.

Instead, Judge Kayatta said that the statutes preserve the bondholders' pre-petition liens, allowing the creditor to "assert its right to those funds during the plan-of-adjustment phase."

Judge Kayatta's interpretation accords with the notion under the Tenth Amendment that the federal government cannot tell states how to use their revenue and with the understanding that the automatic stay is not a taking of property under the Fifth Amendment. The ability of municipalities to pay special revenue bonds, if they wish, allows them to attempt to preserve their creditworthiness.

Any ambiguity in the statute, Judge Kayatta said, "is simply not broad enough to allow one to read these sections as allowing the bondholders to commence a collection action without first obtaining leave of court."

The statement and dissent on rehearing is *Assured Guaranty Corp. v. Financial Oversight and Management Board for Puerto Rico (In re Financial Oversight and Management Board for Puerto Rico, as Representative for the Puerto Rico Highways and Transportation Authority)*, 18-1165, 2019 BL 283933 (1st Cir. July 31, 2019).

The logical court to challenge the constitutionality of PROMESA isn't the PROMESA court itself.

First Circuit Nixes Another Attempt at Unraveling Puerto Rico's Debt Arrangement

On the last page of an 18-page opinion, the First Circuit told Puerto Rico bondholders how they can challenge the constitutionality of the Puerto Rico Oversight, Management, and Economic Stability Act, or PROMESA (48 U.S.C. §§ 2161 *et. seq.*). Under PROMESA, the island commonwealth is restructuring its unsupportable debt.

Curiously, bondholders cannot raise a challenge to the constitutionality of PROMESA in the proceedings in the Puerto Rico District under PROMESA.

The Bondholders' Plight

After the Supreme Court ruled in June 2016 that Puerto Rico's instrumentalities are ineligible for municipal debt adjustment under chapter 9 of the Bankruptcy Code and that the island commonwealth cannot adopt local laws dealing with the insolvencies of its units, Congress adopted PROMESA, which is patterned in large part on the municipal debt arrangement provisions in chapter 9 of the Bankruptcy Code.

The dispute came to the First Circuit on appeal by holders of highway bonds. To secure the debt, Puerto Rico pledged oil and gas tax revenues and highway tolls, among other things. The pledge, however, was not absolute. Puerto Rico had the right to divert the pledged revenues to the payment of general obligation bonds if other revenue sources were insufficient.

Even before commencement of the formal debt arrangement proceedings under PROMESA, Puerto Rico adopted a moratorium that halted the flow of the pledged revenues to the bondholders. The moratorium also barred the bondholders from enforcing remedies.

Next, the Financial Oversight and Management Board of Puerto Rico, established under PROMESA, adopted a fiscal plan calling for the continued diversion of the pledged revenues. The initiation of the debt arrangement proceedings under Title III of PROMESA invoked an automatic stay akin to Section 362 of the Bankruptcy Code.

The Puerto Rico fiscal agency then directed the bondholders' trustee to withhold payments to bondholders from funds already held in trust. A default on the bonds ensued.

The guarantor for the highway bonds filed an adversary proceeding in the PROMESA proceedings district court in Puerto Rico. The suit alleged that the diversion of pledged revenues was in violation of the Contracts, Takings and Due Process Clauses of the U.S. Constitution, among other things. The suit sought a declaration and injunction to restore the flow of revenue to the bondholders.

On a variety of grounds, the district court dismissed the suit last year. *See Ambac Assurance Corp. v. Puerto Rico (In re Financial Oversight & Management Board for Puerto Rico)*, 297 F. Supp. 3d 269 (D.P.R. 2018).

The Circuit's Opinion

In an opinion for the First Circuit on June 24, Circuit Judge William J. Kayatta, Jr. upheld dismissal. Simply stated, two provisions in PROMESA stripped the PROMESA court of jurisdiction or power to grant the relief sought by the bondholders' guarantor.

The first bar appears in Section 106 of PROMESA, 48 U.S.C. § 2126(e), declaring there "shall be no jurisdiction in any United States district court to review challenges to the Oversight Board's certification determinations under this chapter." According to Judge Kayatta, the injunctive relief sought by the bondholders, invalidating the Oversight Board's fiscal plan, "is plainly precluded as a result of section 106."

The second bar to relief for the bondholders flows from Section 305 of PROMESA, 48 U.S.C. § 2165, which provides that "the court may not, by any stay, order or decree . . . interfere with (1) any of the political or governmental powers of the debtor . . . ." Judge Kayatta explained that Section 305 "mimics" Section 904 of the Bankruptcy Code.

"On its face," Judge Kayatta said that "the text of section 305 bars the [PROMESA] court from granting [the bondholders] such relief absent consent from the Oversight Board or unless the Fiscal Plan so provides."

Judge Kayatta reported how the bondholders contended at oral argument that the appeals court's interpretation of Section 305 "would raise due process concerns because [the bondholders] would be left without a venue in which to bring its constitutional claims." Not so, the judge said.

"[N]othing in our holding today," he said, "suggests that [the bondholders] cannot seek traditional stay relief pursuant to 11 U.S.C. § 362 and raise its constitutional and statutory arguments in a separate action." Quoting from *Financial Oversight and Management Board for Puerto Rico v. Ad Hoc Group of Puerto Rico Electric Power Authority Bondholders*, 899 F.3d 13, 21 (1st Cir. 2018), he said that Section 305 does not "impose any such restraint on *another court*." [Emphasis added.]

Observations

Do the bondholders have a ghost of a chance under either route offered by Judge Kayatta? In terms of winning a modification of the automatic stay, it ain't gonna happen, at least not in district court. When is the last time you saw a reorganization court modify the stay in a huge case and wreck the restructuring?

And what about a separate suit in district court, but not in the PROMESA court, attacking PROMESA as unconstitutional on its face or as applied?

At the conclusion of the PROMESA proceedings, the bondholders are assured of the recognition of whatever rights they have under PROMESA and the U.S. Constitution. The bondholders are not being deprived of their right to payment permanently, only temporarily during the course of the PROMESA proceedings. So, it seems unlikely a court will find a deprivation of constitutional rights.

In a number of decisions already, the district court and the First Circuit have rebuffed attempts by other bondholders to short circuit the PROMESA proceedings and take home their marbles immediately. *See, e.g.*, *Assured Guaranty Corp. v. Financial Oversight and Management Board for Puerto Rico (In re Financial Oversight and Management Board for Puerto Rico, as Representative for the Puerto Rico Highways and Transportation Authority)*, 919 F.3d 121 (1st Cir. March 26, 2019). For ABI's discussion of *Assured Guaranty*, click here.

The opinion is *Ambac Assurance Corp. v. Commonwealth of Puerto Rico (In re Financial Oversight and Management Board of Puerto Rico)*, 18-1214, 2019 BL 232204, 2019 Us App Lexis 18763 (1st Cir. June 24, 2019).

First Circuit reverses, upholding the validity of bondholders' security interests in $2.9 billion of collateral.

Puerto Rico Retirement System Bondholders Win Their Security Interest Back

Reversing the district court in part, the First Circuit did not decide whether the Puerto Rico Oversight, Management, and Economic Stability Act, or PROMESA (48 U.S.C. §§ 2161 *et. seq.*), could be used to avoid security interests granted before the enactment of PROMESA.

Perhaps motivated by the venerable legal principle known as rachmones, the First Circuit reversed District Judge Laura Taylor Swain, who had ruled in August that bondholders did not have a perfected a security interest in collateral securing $2.9 billion in bonds issued by the island commonwealth's employee retirement system, commonly known as ERS. (Rachmones is a Yiddish term meaning pity or sympathy. It is sometimes spelled rachmunis or rachmanis.)

Significantly, however, the First Circuit did uphold Judge Swain's ruling under the Uniform Commercial Code that a UCC-1 financing statement cannot describe collateral by reference to a document not found in the filing office.

The Avoidance Litigation

After the Supreme Court ruled that Puerto Rico was ineligible for chapter 9 municipal bankruptcy, Congress quickly adopted PROMESA. Months later, the Financial Oversight and Management Board of Puerto Rico initiated court-supervised debt-restructuring proceedings for Puerto Rico and its instrumentalities in the District of Puerto Rico. The Chief Justice tapped District Judge Swain of New York to oversee the PROMESA proceedings in Puerto Rico.

ERS, Puerto Rico's retirement system, was authorized by statute to issue secured debt. The retirement system issued bonds in 2008 to be secured by ERS's revenue, among other things. The UCC-1 financing statement described the collateral as the property shown on the security agreement that was attached.

However, the security agreement described the collateral as having the meaning defined in the statute that authorized issuance of secured bonds. The statute or its definition of collateral was not attached to the financing statement.

In 2015, UCC-3 continuation statements were filed. Unlike the original UCC-1 in 2008, the 2015 UCC-3s contained complete descriptions of the collateral. However, the continuation statements identified the debtor as ERS but did not use a new name, commonly abbreviated as

RSE. Allegedly, RSE was the new name officially given to ERS in the English translation of an amendment to the statute governing the retirement system. The amendment was enacted after the bonds were issued but before the UCC-3s were filed.

Acting on behalf of the retirement system in Puerto Rico's debt-adjustment proceedings, the Oversight Board sought a declaratory judgment that the bondholders' security interest was unperfected and could be avoided under Section 544(a), incorporated by Section 301 of PROMESA.

In August, Judge Swain granted the Board's motion for summary judgment and declared the security interest to be unperfected and therefore unenforceable.

Judge Swain said that a financing statement need only "reasonably" identify the collateral under UCC § 9-110. The collateral description by reference, she said, may only refer to a document attached to the UCC filing or to another document on file in the UCC clerk's office. She therefore held that the original UCC-1s in 2008 failed to perfect the security interest.

The question remained: Was the security interest perfected by the filing of the UCC-3s in 2015, which did include a description of the collateral?

For Judge Swain, the UCC-3s raised a different question: Was the debtor properly identified because the UCC referred to ERS, not RES?

UCC § 9-503(a)(1) requires that the debtor's name on a financing statement must be the name "on the public organic record most recently filed with or issued or enacted by the registered organization's jurisdiction." A trade name is insufficient under UCC § 9-503(c).

Judge Swain ruled that the UCC-3s failed to perfect the security interest because she concluded that ERS was a trade name, which "Article 9 expressly provides is insufficient." She therefore held that the security interest was also unperfected by the filing of the UCC-3s.

To avoid the loss of secured status, the bondholders contended that the Board could not use Section 544(a) to invalidate a security interest granted before the enactment of PROMESA. However, Judge Swain held that Section 544(a) could be employed retroactively to avoid an unperfected security interest granted before the adoption of PROMESA.

The bondholders appealed.

The First Circuit's Reversal

The First Circuit reversed in part in an opinion on January 30 by Circuit Judge Sandra L. Lynch, who wrote two notable bankruptcy opinions in 2018 regarding the repeat-filing stay modification and the good faith defense to a discharge violation.

Agreeing with Judge Swain, Judge Lynch ruled that the bondholders were not perfected in 2008 because the collateral description was inadequate. Parting company with Judge Swain, Judge Lynch held that the bondholders did become perfected by the UCC-3s in 2015.

With regard to the 2008 financing statements, Judge Lynch said they were "insufficient to perfect the security interest" because: (1) The collateral was "not described, even by type(s)," (2) the 2008 financing statements "do not tell interested parties where to find the referenced documents," and (3) the bond resolution laying out the collateral was "not at the UCC filing office."

Judge Lynch said bondholders were not secured at the outset because the original filings did not give "fair notice to other creditors and the public of a security interest."

On the other hand, Judge Lynch concluded that the bonds became secured on the filing of the UCC-3s in 2015. The opinion will have little precedential value beyond Puerto Rico, because she said the result turned on "a unique confluence of circumstances involving two languages and a translation."

Puerto Rico has two official statutory languages, Spanish and English. The 2013 Spanish language statute allegedly changing the retirement system's official name from ERS to RSE was not officially translated into English until a year later.

Judge Lynch explained that the English language version uses the two terms "seemingly interchangeably." Indeed, RSE is used only three times in the statute, while ERS appears more than 35 times.

Despite the prevalence in the usage of ERS, the Oversight Board contended that the one subsection in the statute using RES was the only provision that governed the retirement system's official name. On that basis, Judge Swain believed that ERS was not the proper name for UCC filings.

Interpreting the language of UCC § 9-503(a)(1), Judge Lynch said that the court was not obliged to follow only one clause in a statute to pinpoint the debtor's name in the "public organic record." Rather, she said, the "UCC provision directs focus to the entire 'public organic record.'"

In addition to the prevalence of the use of ERS in the English version of the statute, Judge Lynch pointed out that ERS was the name "consistently used by the [retirement system] itself, including in court filings, before and after the translation of the amended Act in 2014."

Having concluded that the bondholders were secured after all, Judge Lynch did not reach the question of whether the Bankruptcy Code's avoiding powers can be employed to set aside a transaction that occurred before the adoption of PROMESA.

The appeals court remanded the case to Judge Swain for further consideration in light of the opinion.

The opinion is *Altair Global Credit Opportunities Fund (A) LLC v. Financial Oversight and Management Board for Puerto Rico (In re Financial Oversight and Management Board for Puerto Rico)*, 914 F.3d 694 (1st Cir. Jan. 30, 2019).

First Circuit finds no exceptions to the automatic stay under PROMESA subjecting Puerto Rico to 'ordinary course' litigation.

Automatic Stay Applies to 'Ordinary Course' Litigation in Puerto Rico, Circuit Holds

Reversing the district court, the First Circuit held that the automatic stay applies broadly to "ordinary course" litigation under the Puerto Rico Oversight, Management, and Economic Stability Act, or PROMESA (48 U.S.C. §§ 2161 *et. seq.).* The March 21 opinion also contains significant First Circuit jurisprudence on the "finality" of orders regarding the automatic stay.

The Medicaid Reimbursement Litigation

Puerto Rico has been in litigation with health care providers since 2003 regarding Medicaid reimbursement. Years ago, the district court in Puerto Rico appointed a special master and entered an injunction requiring reimbursement under a formula developed by the master. Periodically, the master and the district court revisit the formula.

In April 2017, about one month before Puerto Rico initiated debt-adjustment proceedings under PROMESA, the special master issued a report proposing changes in the reimbursement formula. One month into PROMESA, a district judge in Puerto Rico (but not the district judge presiding over the PROMESA proceedings) adopted the master's report. The providers appealed.

The circuit court in substance remanded the appeal to the district court to determine whether the automatic stay under PROMESA applied to the proceedings regarding the Medicaid reimbursement formula. In July 2018, Chief District Judge Gustavo A. Gelpí concluded that the automatic stay did not apply. In several opinions reported in this column, Judge Gelpí has been more prone to rule that the automatic stay does not apply to ordinary course litigation.

Puerto Rico appealed the district court's order finding that the stay did not apply. In a 36-page opinion, Circuit Judge David J. Barron reversed. Judge Barron was a clerk for Justice John Paul Stevens and a professor at Harvard Law School.

The First Circuit's Stay Analysis

Naturally, Judge Barron began with the automatic stay in Section 362 of the Bankruptcy Code, incorporated by Section 301(c) of PROMESA. With little ado, he saw no "indication that the automatic stay is not fully applicable here." If the court were to confine its analysis to Sections 362 and 301(c), he said "it would be clear that the automatic stay does apply."

The providers, however, contended that several provisions in PROMESA made the automatic stay inapplicable. Judge Barron analyzed those provisions one by one.

Judge Barron began with Section 304(h) of PROMESA, entitled "Public Safety," which provides that PROMESA "may not be construed to permit the discharge of obligations arising under Federal policy or regulatory laws, including laws relating to . . . public health or safety . . . . This includes compliance with obligations, requirements under consent decrees or judicial orders . . . ."

Seemingly a show-stopper, Judge Barron quickly concluded that Section 304(h) did not apply. Section 304(h), he said, "only bars the 'discharge' — not the 'stay'— of 'compliance obligations.'" Discharge "is not at issue here," he said, "only a stay is."

Judge Barron added an important caveat. If the federal government were enforcing Medicaid laws, the "enforcement action would be excepted from the automatic stay. *See* 11 U.S.C. § 362(b)(4)."

Judge Barron turned to Section 204(d)(1) of PROMESA, entitled, "Implementation of Federal Programs." The section says, "In taking actions under [PROMESA], the Oversight Board shall not exercise applicable authorities to impede territorial actions to — (1) comply with a court-issued consent decree or injunction . . . with respect to Federal programs."

Again, Section 204(d)(1) seemed like a show-stopper — until Judge Barron focused on the statutory language and observed that imposing the automatic stay was not an "action" by the Oversight Board, because "the stay follows automatically, without the Board taking any action."

Ultimately, Judge Barron dealt with Section 7 of PROMESA, which reads, "Except as otherwise provided in [PROMESA], nothing in this chapter shall be construed as . . . relieving a territorial government . . . from compliance with Federal laws or requirements . . . protecting the health . . . of persons in such territory."

Giving "effect to all of the words in the statute," Judge Barron held that the automatic stay in PROMESA falls under the "Except as otherwise" phrase, thus making Section 7 inapplicable to the case at bar.

Appellate Jurisdiction

Was an order finding the automatic stay to be inapplicable a final order bestowing appellate jurisdiction under 28 U.S.C. § 1291? Judge Barron said the First Circuit has not ruled on the question.

All circuits have held that granting relief from the automatic stay is a final order. The circuits to address the issue, Judge Barron said, have held that orders regarding the applicability of the stay are likewise final.

Judge Barron cited a PROMESA decision where the First Circuit held that denial of a motion to modify the stay "is not necessarily a final, appealable order . . . under every circumstance." If there were "rapidly changing circumstances," he said that an order denying a modification of the stay might not be final.

Ultimately, Judge Barron decided that the order on appeal was final under the "more flexible" rules in bankruptcy.

The opinion is *Commonwealth of Puerto Rico v. Migrant Health Center Inc.*, 919 F.3d 565 (1st Cir. March 21, 2019).

Cross-Border Insolvency

Judge Glenn criticizes an 1890 English decision refusing to enforce a foreign discharge of debt.

U.S. Judge Willing to Split with the U.K. over Chapter 15 Foreign Recognition

Why did Bankruptcy Judge Martin Glenn of New York write a 55-page opinion enforcing a Croatian reorganization plan in the U.S. under chapter 15 when there was no creditor opposition?

Answer: He was sending a message to judges in Britain telling them to reconsider an 1890 decision by the U.K. Court of Appeal known as *Gibbs*. The U.K. court ruled in *Gibbs* that a creditor could sue and recover a judgment in England on a contract to be performed in England that was governed by English law, even though the debt owed by the French debtor had been discharged in a French bankruptcy.

Secondarily (or perhaps primarily), Judge Glenn was saying in his October 24 opinion that U.S. courts should grant or deny recognition to foreign proceedings under chapter 9 without regard for how courts abroad might rule in the same case.

The Bankruptcy of Croatia's Largest Business

The case involved a bankrupt Croatian company known as Agrokor. It was the largest company in Croatia, with revenue representing 15% of the country's GDP. Among other businesses, Agrokor operated Croatia's largest supermarket chain.

Insolvent, 77 Agrokor companies filed for bankruptcy reorganization in Croatia last year. There were some 80 other Agrokor companies operating outside of Croatia that were not in bankruptcy anywhere.

In July, nine of the Agrokor companies filed chapter 15 petitions in New York. In September, Judge Glenn recognized the Croatian bankruptcy as the foreign main proceeding. However, he reserved judgment on whether he would recognize and enforce the Croatian reorganization plan in the territorial U.S.

Meanwhile, a court in the U.K. had also recognized Croatia as home to the foreign main proceeding under the U.K.'s version of the UNCITRAL Model Law, which the U.S. adapted as chapter 15. The U.K. court also reserved judgment on recognizing and enforcing the Croatian plan in the U.K. The U.K.'s foreign main recognition has not become final because an appeal is pending.

Switzerland has given final foreign main recognition to the Croatian proceedings, but Bosnia-Herzegovina, Montenegro, Serbia and Slovenia have all denied foreign main recognition.

U.K. Will Determine the Success of the Croatian Plan

Almost two-thirds of the Croatian companies' debt is governed by English law. The other third is governed by New York law.

If *Gibbs* retains vitality and is controlling, the U.K. court will presumably refuse to recognize and enforce the Croatian reorganization plan in the U.K. Judge Glenn noted that the English High Court had followed *Gibbs* in 2018.

Considering "the amount of prepetition debt governed by English law," Judge Glenn said that "a refusal of the English court to enforce parts of the [Croatian reorganization plan] would most certainly cause [the plan] to fail."

The Question for Judge Glenn

The reorganization plan and Croatian bankruptcy law hit all the right buttons typically resulting in recognition and enforcement in the U.S. Judge Glenn said that Croatian law tracks the U.S. Bankruptcy Code "closely," gives creditors "meaningful participation" in the proceedings, is procedurally fair, employs distribution rules "closely" following the priorities in U.S. law, and requires approval by a two-thirds vote of non-insider creditors.

Judge Glenn nonetheless analyzed whether he should consider how the courts in other nations will rule. Specifically, should he enforce the plan in the U.S. if the U.K court rules that the plan is not enforceable in the U.K.?

In particular, Judge Glenn asked whether it would be "appropriate" to extend comity to Croatia by enforcing the plan "if doing so could be seen as a refusal to extend comity" to the U.K., "particularly where a majority of the debt to be modified is governed by the law of" England.

Do What's Right; Don't Count Noses

Judge Glenn wrote a scholarly analysis of *Gibbs*, its history and critical commentary. He explained how Gibbs is an example of 19th century "territorialism," which has been supplanted by "modified universalism," as exemplified by the UNCITRAL Model Law.

Judge Glenn cited a "distinguished professor" of U.K. law who said that the "*Gibbs* doctrine belongs to an age of Anglocentric reasoning which should be consigned to history."

Adding his own commentary, Judge Glenn said that *Gibbs* "would violate the fundamental principle of equality of distribution" by allowing a greater recovery by creditors whose claims are governed by English law.

Declining to follow how the U.K. might rule, Judge Glenn held, "Courts in other jurisdictions will make their own, independent decisions whether to recognize and enforce" the Croatian plan. The fact that the U.K. might refuse to recognize the discharge, he said, is not "a basis for this Court to decline to recognize and enforce the [Croatian plan] within the territorial jurisdiction of the U.S."

Assuming the Croatian plan is upheld on appeal in Croatia, Judge Glenn therefore said he would recognize the Croatian plan "in full within the territorial jurisdiction of the U.S., including the provisions modifying the English law governed debt and the New York law governed debt."

Question: How will the forces at play in Brexit influence how U.K. courts rule on *Gibbs*?

The opinion is *In re Agrokor d.d.*, 18-12104 (Bankr. S.D.N.Y. Oct. 2, 2018).

Court supervision and participation by creditors aren't required for recognition under chapter 15.

Insurance Rehabilitation in Curaçao Given 'Foreign Main' Recognition in New York

A foreign insurance company rehabilitation underscores three principles regarding chapter 15 recognition: (1) The foreign proceeding need not be supervised by a court; (2) participation by creditors is not indispensable; and (3) summarily ousting management from control of the assets does not "manifestly" offend U.S. public policy.

Systemically important to the island's economy, an insurance company in Curaçao had about 50% of the assets of the insurance sector in Curaçao and St. Maarten and was responsible for half of the pensions in Curaçao.

For two years, the island's regulator had been negotiating for the insurance company to improve its liquidity. Ultimately, the regulator revoked the company's insurance license and importuned a court in Curaçao to authorize rehabilitation proceedings.

The regulator ousted the insurance company's management and took over the assets of the insurance company and three asset-management companies that held the insurer's assets, mostly in accounts with brokers in New York City.

The regulator appointed a foreign representative, who filed a chapter 15 petition in New York. The foreign representative intended on returning the assets to Curaçao. The insurance company's non-bankrupt holding company opposed chapter 15 recognition.

In a December 20 opinion, Bankruptcy Judge Martin Glenn of New York overruled the objections and recognized the rehabilitation proceedings in Curaçao as the foreign main proceeding.

To satisfy the definition of "foreign proceeding" in Section 101(23), it must be "a collective judicial or administrative proceeding in a foreign country . . . ." Judge Glenn said the rehabilitation in Curaçao was "collective" because the "plain language" of the Curaçao statute required looking after the interests of "joint creditors."

Citing precedent, Judge Glenn said that the proceedings in Curaçao would be "collective" even if creditors were not allowed to participate because the proceedings considered the interests of more than one party or class of creditors.

The holding company also argued that the rehabilitation was not "collective" because it was not under the supervision of a foreign court. As a matter of fact, Judge Glenn concluded that aspects of the rehabilitation could be appealed to a court in Curaçao and, ultimately, to the Supreme Court of the Netherlands.

Even if there were no court involvement, Judge Glenn nevertheless ruled that the Curaçao proceedings qualified because the statute requires a "judicial or administrative proceeding." He said that the island's regulator "clearly qualifies as an authority competent to control or supervise a foreign proceeding."

The holding company argued that recognition would be "manifestly contrary to the public policy of the U.S." under Section 1506, because it was given little if any notice of the commencement of the rehabilitation proceedings.

Judge Glenn found no conflict with U.S. policy, because the procedures in Curaçao were "largely consistent with the approaches to such issues utilized in this country and in most countries around the world." He cited insurance statutes in Delaware, Ohio and Wisconsin, where regulators can take over an insurance company's assets *ex parte* and without a hearing.

The opinion is *In re ENNIA Caribe Holding N.V.*, 18-12908 (Bankr. S.D.N.Y. Dec. 20, 2018).