Case Law Update: Parts I & II

Prof. Melissa B. Jacoby
University of North Carolina School of Law; Chapel Hill, N.C.

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Bill on Bankruptcy

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Bill Rochelle
Editor-at-Large
American Bankruptcy Institute
bill@abi.org
(703) 894-5909

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

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Congress is the last resort for Puerto Rico to deal with looming debt default.

Supreme Court Invalidates Puerto Rico's Local Law for Municipal Debt Adjustment

The Supreme Court ruled by a vote of 5-2 that Congress both excluded Puerto Rico from chapter 9 municipal bankruptcy and precluded the island commonwealth from adopting local laws to deal with the insolvencies of its instrumentalities, such as municipal power and water companies.

The two dissenters said that "preemption here means that a government is left powerless and with no legal process to help its 3.5 million citizens." They concluded their dissent by saying, "Statutes should not easily be read as removing the power of a government to protect its citizens."

What the Opinion Means

In practical terms, Justice Clarence Thomas' June 13 majority opinion means that legislation by Congress is the last and only hope for Puerto Rico to avert a debt crisis. It is questionable whether Puerto Rico could even use some form of an equity receivership to keep the lights on and the water flowing.

To the dissenters' argument that Puerto Rico and its people "should not have to wait for possible congressional action," Justice Thomas said that "our constitutional structure does not permit this Court to 'rewrite the statute that Congress has enacted.'"

Two weeks in a row, the Supreme Court has handed down opinions allowing Puerto Rico's government to exercise less power than the states. Last week, the high court ruled in *Commonwealth of Puerto Rico v. Sanchez Valle* that the island does not have sovereign power like the states.

In the 6-2 opinion on June 9, Justice Elena Kagan held that Congress was the source of the island's sovereign powers to enact criminal laws, unlike the states, whose sovereign powers antedate the adoption of the Constitution. Consequently, the Court last week ruled that the Double Jeopardy Clause of the federal Constitution prohibits Puerto Rico, unlike a state, from prosecuting someone who had already pleaded guilty in federal court.

How Puerto Rico Was Excluded from Bankruptcy

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Puerto Rico could have authorized its municipalities to use chapter 9 until the 1984 amendments to the Bankruptcy Code. For reasons it did not explain, Congress in that year prohibited Puerto Rico's instrumentalities from filing under chapter 9 when it wrote Section 101(52) of the Code to define "States" as including Puerto Rico, except for the purpose of deciding who is eligible for chapter 9. In turn, Section 109(c), referred to as the "gateway," provides that only a "municipality" can be a debtor in chapter 9. "Municipality" is defined in Section 101(40) as an instrumentality of a "State."

The definitions and cross-references mean that Puerto Rico's municipalities are ineligible for chapter 9, and the commonwealth has not argued otherwise.

No longer having access to federal bankruptcy courts, Puerto Rico still faces Section 903(1) of the Code, which says "State law" cannot bind non-consenting creditors to a debt adjustment.

Puerto Rico's Solution

Puerto Rico's governor admitted that the island is saddled with debts that are "not payable." Ineligible for chapter 9 municipal bankruptcy, Puerto Rico adopted its Public Corporation Debt Enforcement and Recovery Act in June 2014. The statute was structured so the island's public corporations could restructure debt in a manner akin to a chapter 9 debt adjustment.

That same month, bond funds affiliated with Franklin Resources Inc. and others sued the commonwealth in federal district court in Puerto Rico. In February 2015, a district judge in San Juan held that the Recovery Act was preempted by Section 903(1) of the Bankruptcy Code and therefore violated the Supremacy Clause of the U.S. Constitution on its face.

In what amounted to a 2-1 opinion in July 2015, the First Circuit held that the preemption of Puerto Rico's law was evident from the "plain meaning" of the Bankruptcy Code.

The Supreme Court granted *certiorari* at Puerto Rico's request, even though there was no split of circuits. The case was argued on March 22.

Justice Thomas' Majority Opinion

Puerto Rico presented the case to the Supreme Court as a question of statutory interpretation. The commonwealth did not contend there were residual sovereign or constitutional powers justifying the adoption of the Recovery Act. Consequently, the majority opinion does not address any theories other than statutory interpretation, while the dissenters only hint that the result could or should have been different under some notion of Puerto Rico's sovereignty or the equal protection rights of the island's residents.

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Puerto Rico contended that the preemption contained in Section 903(1) does not apply to the commonwealth because nothing in chapter 9 is applicable to its municipalities given the definition in Section 101(52).

Justice Thomas rejected the argument in view of what he called the "plain text" of the statute. Although the 1984 amendment made Puerto Rico's instrumentalities ineligible for chapter 9, he held for the Court that the island "is still a 'State' for the purposes of the preemption provision" in Section 903(1). He said the dissenters' interpretation of the statute was "capacious."

The very first paragraph in Justice Thomas' opinion might be read as slamming the door on any notion that a state not electing chapter 9 eligibility retains some sovereign power to deal with the insolvencies of its instrumentalities. He said that the Bankruptcy Code "pre-empts state bankruptcy laws that enable insolvent municipalities to restructure their debts over the objections of creditors."

That statement may or may not mean that a state cannot impose a moratorium on debt payment. The majority opinion does not explicitly say that a state cannot enact a law compromising the payment of the state's own debt, as opposed to the debt of its municipalities.

Justice Samuel Alito recused himself, leaving seven justices to decide the case.

The Dissenters

Justice Sonia Sotomayor dissented in an opinion joined by Justice Ruth Bader Ginsburg. Because Puerto Rico's instrumentalities are ineligible for chapter 9, they believe that "nothing in the operation of a Chapter 9 case affects Puerto Rico's control over its municipalities." They went further to say that the definition carving out the island "excluded Puerto Rico from Chapter 9 for all purposes — it shut the gate and barred it tight."

By issuing the opinion now, rather than waiting until the Court's term ends at the end of June, the justices are placing the onus on Congress to pass pending legislation to help Puerto Rico restructure its debt under federal oversight.

The opinion is *Commonwealth of Puerto Rico v. Franklin California Tax-Free Trust*, 195 L. Ed. 2d 298, 84 U.S.L.W. 4393 (Sup. Ct. June 13, 2016).

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Supreme Court reverses Fifth Circuit
on 'actual fraud' dischargeability case.

Supreme Court: Misrepresentation Not Required for 'Actual Fraud' Nondischargeability

Reversing the Fifth Circuit, the Supreme Court held in *Husky International Electronics Inc. v. Ritz* that a debt can be nondischargeable for "actual fraud" under Section 523(a)(2)(A) of the Bankruptcy Code in the absence of a fraudulent misrepresentation to the creditor.

Writing the majority opinion on May 16, Justice Sonia Sotomayor held that "actual fraud" subsumes "forms of fraud, like fraudulent conveyance schemes, that can be effected without a false representation." A "fraudulent conveyance of property made to evade payments to creditors" is among the types of actual fraud that can result in a nondischargeable debt, she said.

Dissenting in the 7-1 decision, Justice Clarence Thomas argued that the majority's opinion ignores the plain meaning of the statute. Citing the *Norton* and *Collier* treatises that agree with his interpretation, he said that the "context" of the subsection "dictates that 'actual fraud' ordinarily does not include fraudulent transfers."

The majority's decision means that the debt owing to a creditor who suffers an identical injury will be discharged if that creditor does not mount an objection or holds a debt so small that objecting to dischargeability would be foolish.

The Facts of the Case

A man caused his company to transfer funds to other companies that he owned or controlled. The man later went bankrupt. Husky, owed $164,000 by the company, sued the man in bankruptcy court to hold him liable for the corporate debt and to bar discharge of the debt under Section 523(a)(2)(A).

The bankruptcy judge found that property transferred from the company to the bankrupt was a constructive fraudulent transfer because it was made without adequate consideration. Nonetheless, the bankruptcy judge rejected the request to bar discharge of the $164,000 debt to Husky. Reversing the bankruptcy court in part, the district court held that Husky was entitled to pierce the corporate veil and make the man personally liable for the debt. Nevertheless, the district court agreed with the bankruptcy court by ruling that the debt was dischargeable because the man made no misrepresentation to Husky. In a May 2015 opinion penned by Circuit Judge

Carolyn King, the Fifth Circuit upheld discharge of the debt because there was no misrepresentation to Husky.

Harkening back to the *Prosser* hornbook definition of "actual fraud," the Fifth Circuit held that denial of discharge of a debt under the subsection requires misrepresentation made by the bankrupt to the creditor and reliance by the creditor. Judge King's opinion said there was no authority for the proposition that actual fraud encompasses constructive fraudulent transfers.

Underpinning the Fifth Circuit's holding was the fact that the bankrupt made no misrepresentations to the creditor.

Judge King spent the better part of her opinion explaining why a 2000 decision by Circuit Judge Richard A. Posner in *McClellan v. Cantrell* was wrong. In that case, Judge Posner held that a fraudulent misrepresentation was not the only form of fraud that renders a debt nondischargeable under subsection (a)(2)(A).

In July 2015, the First Circuit decided a similar case and agreed with Judge Posner's conclusion. To resolve a 2-1 split, the Supreme Court granted *certiorari* and heard argument on March 1.

The Statute

Section 523(a)(2)(A) prohibits discharge of debts "obtained by . . . false pretenses, a false representation or actual fraud."

The former Bankruptcy Act barred discharge of a debt obtained by "false pretenses or false representation." When it adopted the Bankruptcy Code in 1978, Congress added "actual fraud." Justice Sotomayor said it was "therefore sensible" to interpret the new language as not meaning "the same thing as 'a false representation.'"

The Majority Opinion

The majority opinion says it is "equally important" under common law that "fraudulent conveyances, though a 'fraud,' do not require a misrepresentation from a debtor to a creditor." As an example, Justice Sotomayor pointed to a transfer to a relative, where the fraud occurs due to "concealment and hindrance," not from "inducing a creditor to extend a debt."

Summing up the first part of the opinion, Justice Sotomayor said that "false representation has never been a required element of 'actual fraud,' and we decline to adopt it today."

Justice Sotomayor next dealt with the debtor's argument that not requiring a misrepresentation would create overlap with subsections (a)(4) and (a)(6), which except debts from discharge for fraud or defalcation while acting in a fiduciary capacity and for willful and malicious injury to property. She admitted there is overlap, but said that "overlap is inevitable." She saw "no reason to craft an artificial definition of 'actual fraud' merely to avoid narrow redundancies in Section 523 that appear unavoidable."

The debtor also argued that a broader interpretation of (a)(2)(A) overlaps with Section 727(a)(2), which can result in denial of discharge of all debts if the debtor committed a fraudulent transfer with actual intent to hinder, delay or defraud within one year of bankruptcy.

Although the two sections "cover some of the same conduct, they are meaningfully different," Justice Sotomayor said. A Section 727 violation is broader by preventing discharge of all debt, but is narrower than subsection (a)(2)(A) regarding timing.

The Dissent

Dissenting, Justice Thomas said that subsection (a)(2)(A) only covers situations where money or property was "obtained by" actual fraud. He said that a violation occurs "only when the fraudulent conduct occurs *at the inception of the debt.*" [Italics in original.] In the case on *certiorari*, the debtor's fraudulent transfers to his companies "did not trick the creditor into selling his goods."

The Application of *Husky* in Practice

Husky entailed fraudulent transfers for lack of adequate consideration that contributed to making the company unable to pay its debts. Even though the transfers were technically made by the debtor's company, the debtor himself would have been denied a discharge of all his debt under established principles had he orchestrated the company's fraudulent transfers within one year of his own bankruptcy with actual intent to hinder or delay the company's creditors.

As a result of *Husky*, an individual who orchestrates his company's fraudulent transfer more than a year before bankruptcy will forfeit dischargeability of debt owing to a particular creditor, so long as that creditor mounts an objection.

A similarly situated creditor who does not bother to object will see that debt discharged, despite suffering an identical injury.

To promote equality of treatment of creditors, will trustees now initiate proceedings on behalf of all similarly situated creditors to preclude the discharge of those debts? Or can one creditor mount a dischargeability objection on behalf of a class of similarly situated creditors?

In either instance, the result, if successful, would be equivalent to a denial of discharge even though the infringing fraudulent transfer occurred more than one year before bankruptcy.

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Were he still alive, Justice Antonin Scalia might have agreed with Justice Thomas and lent a strong voice in favor of upholding the Fifth Circuit. As it is, the lower courts must now struggle with the task of crafting rules so that dischargeability objections do not morph into denials of discharge. They must also confront the task of ensuring that debts owing to deep-pocket creditors are not the only ones discharged when a debtor's conduct could result in the denial of discharge of debts owing to many creditors.

Arguably, the *Husky* opinion finds the Supreme Court making what the majority see as a logical extension of the statute. Justice Scalia might have attacked *Husky* as judicial legislating. In any event, creditors now have a new weapon to use against debtors, and bankruptcy courts must begin crafting new rules to deal with problems created by *Husky*.

The opinion is *Husky International Electronics Inc. v. Ritz*, 136 S. Ct. 1581, 194 L. Ed. 2d 655 (Sup. Ct. May 16, 2016).

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Showing violation of a federal statute might not itself entitle a consumer to sue.

Supreme Court Temporarily Ducks Case on Individuals' Right to Sue

By remanding, the Supreme Court for the time being avoided deciding a case that could preclude bankrupts and consumers generally from suing companies that violate their statutory rights absent proof of "concrete" injury. For example, individual debtors might be disabled from suing for a willful violation of the automatic stay under Section 362(k) without proving "concrete" injury, depending on how the justices eventually rule on the issue.

The high court granted *certiorari* in *Spokeo Inc. v. Robbins*, ostensibly to decide whether Congress can confer standing to sue in federal court based on a bare violation of a federal statute when the plaintiff suffers no concrete harm. Perhaps because the justices would have been split 4-4 on the outcome had they reached the merits, the Court remanded the case for the Ninth Circuit to analyze whether the plaintiff satisfied the "concreteness" aspect of the standing requirements.

The Facts

An individual filed a class suit under the federal Fair Credit Reporting Act of 1970. The statute requires credit reporting agencies to "follow reasonable procedures to assure maximum possible accuracy." For any willful violation, a plaintiff is entitled to actual damages or statutory damages of $100 to $1,000 per violation. In addition, the plaintiff can recover costs, attorneys' fees, and possibly punitive damages.

The defendant, Spokeo Inc., a search engine that aggregates data about individuals, reported that the plaintiff was wealthy, employed and married with children, and had an advanced degree. In fact, the plaintiff was unemployed, unmarried and without children. The plaintiff contended in his complaint that he was injured because the report made him appear overqualified for the jobs he was seeking and implied that he might be unwilling to move given family ties.

The district court dismissed the complaint for lack of standing, but the Ninth Circuit reversed.

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Certiorari Granted Without a Circuit Split

The Supreme Court granted *certiorari*, although no circuit court had held to the contrary, according to the plaintiff and *amici* filing briefs in his support. The Supreme Court's decision to hear the case led to speculation that a majority were bent on further restricting the ability of consumers to mount lawsuits for the recovery of damages for violations created by acts of Congress, when there would have been no cause of action under common law.

The case was argued in November, before the death of Justice Antonin Scalia in February.

The Majority Opinion

Without reaching the merits, the Supreme Court remanded the case to the circuit court by a 6-2 decision handed down on May 16, in the process giving no hint of how a majority of justices would rule on the ultimate question.

The majority opinion, written by Justice Samuel A. Alito Jr., was joined by Justices Anthony M. Kennedy, Clarence Thomas, Stephen G. Breyer, Elena Kagan, and Chief Justice John G. Roberts Jr. Justice Thomas filed a concurring opinion. Justice Ruth Bader Ginsburg dissented in an opinion that was joined by Justice Sonia Sotomayor.

Justice Alito's opinion purports to lay out the Court's traditional jurisprudence on the constitutional aspects of standing, ostensibly to aid the Ninth Circuit on remand. Standing, he said, is rooted in the constitutional requirement for the existence of a case or controversy. Among the three constitutional requirements, there must be "injury in fact." Congress, according to Justice Alito, cannot create standing by statute when none would exist in a constitutional sense.

To establish "injury in fact," the plaintiff must show invasion of a legally protected right that is "concrete and particularized." To be "particularized," it "must affect the plaintiff in a personal and individual way." Particularization is necessary but not enough in itself. The injury, he said, must also be "concrete." To be "concrete," the injury "must actually exist." Nonetheless, "intangible injuries can nevertheless be concrete," Judge Alito said.

Although "Congress is well positioned to identify intangible harms," Justice Alito said that injury-in-fact is not automatically satisfied "whenever a statute grants a person a statutory right and purports to authorize that person to sue." Significantly, he said that constitutional "standing requires a concrete injury even in the context of a statutory violation."

Faulting the circuit court for not analyzing the "concreteness" requirement, Justice Alito remanded the case. The plaintiff, he said, cannot show "concreteness" by proving a "bare procedural violation," such as an incorrect zip code. "It is difficult to imagine how the dissemination of an incorrect zip code, without more, could work any concrete harm," he said.

The Dissenters

Justice Ginsburg wrote a dissenting opinion, joined by Justice Sotomayor. Although Justice Ginsburg agreed "with much of the Court's opinion," she disagreed about the need for remand.

The plaintiff's allegations "carry him across the threshold" of "concreteness," Justice Ginsburg said, because the Court's "particularity" precedents bar "complaints raising generalized grievances, seeking relief that no more benefits the plaintiff than it does the public at large."

For Justice Ginsburg, the plaintiff's complaint was adequate because he did not "seek redress for harm to the citizenry, but for Spokeo's spread of misinformation specifically about him."

After Remand

Although it is clear that Justices Ginsburg and Sotomayor believe there is standing, nothing in Justice Alito's majority opinion reveals how he and the other five justices see the outcome, nor does it imply that the Ninth Circuit misunderstood the law. Consequently, the circuit court is likely to stand by its prior reversal and uphold the plaintiff's standing to sue, giving rise to another petition for *certiorari*.

There is no assurance that the high court will grant *certiorari* a second time. Before Justice Scalia's death, there may have been a majority to reverse the Ninth Circuit and find no standing. The outcome now may depend on the inclinations of whoever replaces Justice Scalia.

If it becomes clear that the new member of the court would form a majority to hold that the plaintiff had constitutional standing, the court might not grant *certiorari* a second time in the continuing absence of a circuit split. Still, the vote of only four justices is required to grant *certiorari*, leaving open the possibility of another argument and a decision on the merits next year in the Supreme Court. In sum, a ruling in 2017 could be the opposite of what it might have been were Justice Scalia still alive, if the new member of the Court does not have Justice Scalia's inclinations.

Implications for Bankruptcy

An ultimate victory for Spokeo could end many lawsuits by consumers and claims by bankrupts for violations of the automatic stay. For example, some judges do not tolerate the slightest transgression of the automatic bankruptcy stay before finding a violation of the Fair Debt Collection Practices Act, or FDCPA.

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The question of whether the Bankruptcy Code is the exclusive remedy for many debtors suing under the FDCPA is now on appeal in several circuits. Even assuming FDCPA suits by bankrupts are allowed to stand, a lack of standing could bar a debtor from suing a creditor under the FDCPA for filing a time-barred claim, absent a showing of concrete damages.

When it comes to filing claims barred by the statute of limitations, other creditors or a trustee might have standing, but not a debtor who enjoys a discharge of the debt in any event.

Likewise, a debtor might be unable to claim damages for violation of the automatic stay without proof of injury.

The opinion is *Spokeo Inc. v. Robins*, 136 S. Ct. 1540, 194 L. Ed. 2d 635 (Sup. Ct. May 16, 2016).

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Next Term

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Having avoided chapter 11 cases, the high court will tackle a major reorganization issue.

Supreme Court Will Review *Jevic* to Rule on Structured Dismissals and Gift Plans

The Supreme Court granted *certiorari* in *Czyzewski v. Jevic Holding Corp.* to decide whether bankruptcy courts are allowed to dismiss chapter 11 cases when property is distributed in a settlement that violates the priorities contained in Section 507 of the Bankruptcy Code.

Although *Jevic* deals with structured dismissals, the high court's decision might also have the effect of allowing or barring so-called gift plans where a secured creditor or buyer makes a payment, supposedly from its own property, that enables a distribution in a chapter 11 plan not in accord with priorities.

Granting *certiorari* was not surprising because there has been a long-standing split of circuits. In *Jevic*, the Third Circuit approved a structured dismissal in May 2015 following the Second Circuit, which had ratified structured dismissals in its 2007 *Iridium* decision.

Conversely, the Fifth Circuit barred structured dismissals in 1984 when it decided *Aweco* and held that the "fair and equitable" test must apply to settlements.

Before acting on the *certiorari* petition, the Supreme Court sought comment from the Solicitor General. In May, the federal government's counsel in the Supreme Court recommended granting review and reversing the Third Circuit.

The *Jevic* petition was on the justices' calendar for review at a conference on June 23. In line with the Court's practice of reviewing petitions at two conferences before granting *certiorari*, the case was reviewed once again at a conference on June 27. The Supreme Court granted the petition on June 28.

Structured dismissals occur when the sale of a company's assets in chapter 11 will not generate enough cash to pay priority claims in full and permit confirmation of a plan. In the unsuccessful reorganization of Jevic Holding Corp., the official unsecured creditors' committee had sued the secured lender and negotiated a settlement calling for the lender to set aside some money for distribution to unsecured creditors following dismissal. The distribution scheme did not follow priorities in Section 507 because wage priority claimants received nothing from the lender through a trust set aside exclusively for lower-ranked general unsecured creditors.

Over the wage claimant's objection, the bankruptcy court's approval of the settlement was upheld in the district court and the Third Circuit. The appeals court's opinion was important because the Third Circuit makes law for Delaware, where many of the country's largest chapter 11s are filed.

The Third Circuit's opinion was 2-1, with the dissenter saying that while structured dismissals are permissible, *Jevic* was not a proper case.

Recommending that the Supreme Court review and reverse the Third Circuit, the Solicitor General said that "bankruptcy is not a free-for-all in which parties or bankruptcy courts may dispose of claims and distribute assets as they see fit." He argued that "nothing in the Code authorizes a court to approve a disposition that is essentially a substitute for a plan but does not comply with the priority scheme set forth in Section 507."

There are powerful arguments in support of the Third Circuit's opinion. To begin with, there is nothing in the Bankruptcy Code explicitly saying that priorities govern settlements under Bankruptcy Rule 9019. Proponents of structured dismissals also rely on the notion that the distribution is the lender's own property, not property of the estate, thus making priorities inapplicable.

The position of the Solicitor General came as no surprise because the government lost a similar case called *In re LCI Holding Co.*, in which the Third Circuit sanctioned so-called gift plans that distribute estate property counter to bankruptcy priorities. The *LCI* and *Jevic* cases were argued the same day in January 2015, but before different panels of the Third Circuit. Although it was the primary objector in *LCI*, the government did not pursue a *certiorari* petition.

While the schedule for *Jevic* was not immediately announced, argument in the Supreme Court might take place in December, with an opinion to be issued in the first quarter of 2017.

The *Jevic* case in the Supreme Court is *Czyzewski v. Jevic Holding Corp.*, 15-649. The opinion in the Third Circuit is *Official Committee of Unsecured Creditors v. CIT Group/Business Credit Inc. (In re Jevic Holding Corp.)*, 787 F.3d 173 (3d Cir. May 21, 2015).

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Reorganization

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Sales & Due Process

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Due process failure exposes New GM to liabilities for Old GM's conduct.

Second Circuit Drubs New GM on Successor Liability for Ignition Switch Defects

The Second Circuit handed a stinging defeat to General Motors Co. (also known as New GM) in an opinion on July 13 that countenances no excuse for failing to give actual notice to creditors of an impending sale when the company in reorganization knows the claims to exist.

It is not entirely clear from the opinion whether a purely third-party purchaser of assets "free and clear" at a bankruptcy sale will be saddled with successor liability on claims of known creditors who were not given notice of an upcoming sale. In the GM case, the auto maker essentially remained in business after the assets were sold in a Section 363 sale, thus making successor liability an easier pill to swallow.

Although the Second Circuit is allowing lawsuits against New GM based on defective ignition switches, the appeals court did not decide whether New GM in fact has successor liability.

The opinion is an important pronouncement on the due process rights of known creditors and the consequences of a lack of notice. The opinion leaves open the question of whether the lack of prejudice can turn a due process violation into harmless error.

The Second Circuit's opinion on July 13 implies that third party-purchasers are well advised to require an escrow to cover claims of creditors who were not given notice.

The GM Bankruptcy and Quick Sale

Old GM, named General Motors Corp. before bankruptcy, was in severe financial distress and likely would have liquidated absent financial assistance from the federal government before and after its chapter 11 filing in June 2009. Within 40 days of bankruptcy, the bankruptcy court in New York approved a sale of the business as a going concern to New GM, which was initially 60% owned by the government.

The sale carved out 10% of the stock and warrants that eventually ended up in the hands of unsecured creditors when Old GM later confirmed a liquidating chapter 11 plan.

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In the bankruptcy court's 2009 sale approval order, New GM agreed to assume responsibility only for specified liabilities, including warranty claims, accidents occurring after the sale, and Lemon Law claims. Otherwise, the sale was supposedly free and clear of claims, thus broadly immunizing New GM from successor liability claims.

In early 2014 – after plan confirmation in 2011 – New GM initiated recalls of millions of vehicles. It was later discovered that Old GM had known about a defect in its ignition switches for several years before bankruptcy.

The defect caused cars and their electrical systems to shut down unexpectedly, in some cases causing accidents. With the electrical system off, air bags would not inflate, resulting sometimes in death or injury.

New GM was hit with a deluge of lawsuits following disclosure of the switch defect. New GM responded with a motion asking the bankruptcy judge to enforce the "free and clear" sale order and bar claims against it based on the switch defect.

New GM also wanted the bankruptcy court to bar plaintiffs from making claims against the trust created for unsecured creditors under the confirmed plan.

Judge Gerber's Opinion

Now-retired Bankruptcy Judge Robert E. Gerber issued his ruling in April 2015. According to the 74-page opinion by Circuit Judge Denny Chin, Judge Gerber found that the "ignition switch claims were known to or reasonably ascertainable by Old GM" and were therefore entitled to actual notice as a matter of due process.

On an issue on which the circuit court disagreed, the bankruptcy judge decided that the plaintiffs suffered no prejudice from the lack of due process because he would have approved the sale in any event.

As a result, the bankruptcy court ruled that New GM could be liable only for its "own wrongful conduct" after the sale, such as failure to disclose the defect sooner. Judge Gerber did not decide whether New GM had any liability for its own conduct. That presumably would be a question for the class action courts.

Judge Gerber also ruled that equitable mootness would bar any claims against the creditors' trust. He certified the case for direct appeal to the Second Circuit.

Bankruptcy Sales and Successor Liability

Whether bankruptcy sales can cut off successor liability was the first issue for Circuit Judge Chin. He agreed with other courts holding that "successor liability claims can be 'interests'" cut off by Section 363.

Although Section 363(f) does not expressly import the definition of "claims" into the concept of "interests," successor liability qualifies as a claim, Judge Chin said.

While requirements of due process do not cover claimants who are "completely unknown or unknowable," Judge Chin held that a Section 363 sale can cut off successorship claims arising from pre-petition conduct, so long as the claimant is "identifiable."

The Second Circuit on Due Process

The bankruptcy court had held that pre-closing accident claims and claims for economic loss were barred by the sale order. The appeals court reversed that holding on due process grounds.

Judge Chin said that "if a debtor does not reveal claims that it is aware of, then bankruptcy law cannot protect it." He also said that "New GM essentially asks that we reward debtors who conceal claims against potential creditors" and observed that "the need for speed did not obviate basic constitutional principles." Those policy statements presaged the holdings to follow.

Given that ignition switch claim holders were known creditors entitled to notice, they were therefore entitled to due process protections.

Despite the failure of due process, the bankruptcy judge had decided there was no prejudice to the plaintiffs because he would have approved the sale regardless. Although he did not decide whether prejudice must be shown to prove a denial of due process, Judge Chin reversed because there was prejudice.

Judge Chin said that "we do not know what would have happened" if plaintiffs with billions in claims were opposing sale approval while negotiating with the government and Old GM. He pointed to states' attorneys general who objected to the sale and ended up with a concession where New GM assumed liability for Lemon Law claims.

Further, he said, "New GM was not a truly private corporation." Since plaintiffs could petition the government for an accommodation on account of their claims, Judge Chin said the plaintiffs also might have negotiated concessions given the cost of bankruptcy and the need to complete the sale quickly.

Given prejudice, the Second Circuit reversed "the bankruptcy court's decision insofar as it enforced the sale order to enjoin claims related to the ignition switch defect." In other words, plaintiffs are at liberty to pursue New GM on successor liability theories.

When a case arises in the future where creditors were not given notice, an innocent purchaser seeking to avoid successor liability can distinguish the GM case on the grounds that the auto maker at the time was a government-owned entity with an endlessly deep pocket. On the other hand, GM today is privately owned, suggesting that public ownership at the time of a due process violation was not the pivotal factor for the Second Circuit.

Reversal on Other Issues

Although believing the sale order even covered claims for New GM's own conduct, the bankruptcy court allowed the plaintiffs to pursue those theories. Judge Chin went a step further and interpreted the sale order as not even barring claims based on New GM's own conduct.

The bankruptcy court also barred purchasers of used cars from suing New GM. The Second Circuit reversed on that ground, too, because there was "no conduct or relationship" between Old GM and used car purchasers.

Equitable Mootness

While the creditors' trust didn't believe it had a dog in the fight, the bankruptcy court nonetheless barred the plaintiffs from pursuing claims against the trust on the grounds of equitable mootness, at New GM's behest. The Second Circuit reversed, holding that the bankruptcy court's decision in that respect was an advisory opinion.

Judge Chin said that there must be an Article III case or controversy "before relief may be equitably moot." In a footnote, he said that the court was not deciding whether the bankruptcy court – as opposed to an appellate court – can invoke equitable mootness.

Since none of the plaintiffs had taken even the first step to collect from the creditors' trust, the circuit court held that the bankruptcy court had improperly issued an advisory opinion because there was no case or controversy. The opinion, therefore, does not say one way or the other whether equitable mootness protects the trust's assets.

The opinion is *Elliott v. General Motors LLC (In re Motors Liquidation Co.)*, 15-2844 (2d Cir. July 13, 2016).

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Jurisdiction & Power

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Bankruptcy failed to insulate the Wyly brothers from an SEC asset freeze.

SEC Can Freeze Assets Without Violating the Automatic Stay, Circuit Holds

Someone accused of securities fraud cannot file bankruptcy to bar the Securities and Exchange Commission from freezing assets in district court, according to the Second Circuit.

Sam Wyly, his deceased brother Charles and their alleged violations of securities laws gave the appeals court occasion on Dec. 18 to draw the contours more clearly delineating the demarcation between the automatic stay and the exception in Section 362(b)(4) allowing governmental enforcement of police and regulatory powers. After a six-week trial in federal district court in Manhattan, a jury decided in May 2014 that the brothers violated securities laws by using offshore trusts to trade secretly in the stock of companies for which they served on their boards.

Without a jury, District Judge Shira Scheindlin in New York concluded in September 2014 that some $300 million was a reasonable approximation of disgorgement of the brothers' ill-gotten gains, measured by the taxes they improperly evaded. The SEC then moved to freeze their assets. While the motion was pending, Sam filed a chapter 11 petition in Dallas in October 2014. Four days later, Caroline Wyly, the widow of Charles, filed a companion chapter 11 petition.

Judge Scheindlin froze Wyly family assets in an opinion in November 2014 in which she concluded that the automatic stay did not apply. While allowing everyone living expenses, she also froze assets of 16 other family members.

On the automatic stay issue, the family appealed and lost in an opinion by Circuit Judge Jose A. Cabranes. Sam did not appeal the decision, nor did Caroline, who had initiated proceedings in Dallas, where the bankruptcy judge ruled that the automatic stay does not preclude an asset freeze.

Judge Cabranes' opinion focused on the Second Circuit's 2000 decision in *SEC v. Brennan*, in which the appeals court found a violation of the automatic stay because the district court had ordered the repatriation of assets following entry of judgment. In that case, the appeals court believed that repatriation was preparatory to collection of a judgment and thus violated the stay.

The Wyly case was different, Judge Cabranes said, because the asset freeze only preserved the status quo and did not "rise to the level of impermissible *enforcement* of a money judgment."

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On statutory and policy grounds, he found that the "pre-judgment asset freeze at issue here thus does not implicate the same concerns as did the post-judgment repatriation and deposit order in *Brennan*."

The result turned in significant part on the contours that Judge Scheindlin gave to the asset freeze. In particular, the freeze will dissolve once the assets are under the bankruptcy court's control. At that point, Judge Cabranes said in a footnote, the "bankruptcy court will continue its work without the involvement of the district court."

The decision was not a total victory for the SEC. With respect to seven family members, the appeals court reversed and remanded, directing Judge Scheindlin to decide whether there was evidence that they had received ill-gotten gains.

The opinion dealt only with the automatic stay and not with the amount of the asset freeze or whether the Wylys violated securities laws.

The opinion is *Miller v. SEC*, 808 F.3d 623 (2d Cir. Dec. 18, 2015).

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Eleventh Circuit allows the government on its own to shut down a health care provider in chapter 11.

Circuits Now Split on Bankruptcy Jurisdiction over Medicare Disputes

Creating a circuit split, the Eleventh Circuit held that bankruptcy courts lack jurisdiction under 11 U.S.C. Section 1334 to compel the federal government to continue Medicare and Medicaid funding.

In practical effect, the appeals court's decision on July 11 enables the government singlehandedly to shut down a health care facility that attempts to reorganize in chapter 11. The Ninth Circuit reached the opposite conclusion in 1991, and the lower courts are split.

The Bankruptcy Court Overrules Medicare/Medicaid

After an inspection, the Department of Health and Human Services notified a nursing home that it was terminating its Medicare and Medicaid provider agreement because conditions in the facility were endangering patient health. When a district judge ruled there was no jurisdiction to enjoin termination of the agreement, the facility immediately filed a chapter 11 petition in Tampa, Fla.

Concluding that he had jurisdiction, Bankruptcy Judge Michael G. Williamson enjoined the government from cutting off funding under Section 1334, the provision in the federal Judiciary Code creating bankruptcy jurisdiction. Later, the bankruptcy court confirmed the nursing home's chapter 11 plan and approved assumption of the provider agreement over the government's objection, again barring the government from shutting off funding.

Government Wins the First Appeal

Although courts are divided on the issue, District Judge James S. Moody Jr. of Tampa held on the first appeal in June 2015 that bankruptcy courts have no jurisdiction over a Medicare or Medicaid dispute by virtue of Section 405(h) of Title 42 of the U.S. Code.

Section 405(h) deprives any federal court of jurisdiction over a suit against the government until the claimant has exhausted administrative remedies. Since there was no exhaustion of administrative remedies, Judge Moody set aside confirmation of the chapter 11 plan.

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The nursing home appealed and lost again in an opinion for the Eleventh Circuit by Circuit Judge Raymond C. Clevenger III of the Federal Circuit, sitting by designation. Judge Clevenger's opinion is a *tour de force* on the law of codification error.

Congress's Mistake in Codification

The nursing home argued that an outcome in its favor was compelled by the plain meaning of Section 405(h), which provides that no one may sue the government "under section 1331 or 1346 of Title 28 to recover on any claim arising under" Medicare or Medicaid law until there is an exhaustion of remedies in the agency. Since the bankruptcy court was acting under power bestowed by Section 1334, not Section 1331, the nursing home contended that Section 405(h) did not apply, thus giving the bankruptcy court power to enjoin, compel assumption of the provider agreement, and decide whether the facility was in compliance with Medicare and Medicaid law and regulations.

In his comprehensive 66-page opinion, Judge Clevenger explained why the plain meaning doctrine must give way to what he called the "particular canon in statutory construction regarding the codification of law."

From 1939 to 1984, Judge Clevenger said it was "undisputed" that bankruptcy courts lacked jurisdiction over Medicare claims because Section 405(h), as adopted in 1939, deprived federal courts of jurisdiction over Medicare suits "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 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. Nonetheless, 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 that bankruptcy courts had no jurisdiction over Medicare and Medicaid disputes.

Congress finally recodified Section 405(h) in a technical corrections bill in 1984. The recodification produced the statute as it now reads, depriving federal courts of jurisdiction over Medicare and Medicaid disputes under Sections 1331 and 1346. The recodification made no mention of Section 1334, the grant of bankruptcy jurisdiction.

Significantly, the legislative history said that the bill was intended only to correct "technical errors." The bill itself recodifying Section 405(h) 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 Law of Codification Error

Judge Clevenger began his analysis of the law by citing Supreme Court precedent from 1884 to mean that a recodification does not effect a substantive change without a clear expression of congressional intent. He devoted the bulk of his opinion to explaining why it was "abundantly clear that Congress expressed no such intention" when it inadvertently omitted Section 1334 from Section 405(h) as the result of a "codification error."

The recodified version of Section 405(h) also omitted Section 1332. Judge Clevenger pointed out that three circuits nonetheless have held that federal courts may not exercise diversity jurisdiction over Medicaid disputes as a result of codification error.

Taking the opposite tack, the Ninth Circuit held in 1991 in *Town & Country Nursing* that the omission of a reference to Section 1334 allows bankruptcy courts to adjudicate Medicare disputes. Differing with the holding in *Town & Country Nursing*, Judge Clevenger noted that the Ninth Circuit did not analyze the legislative history accompanying the recodification.

Judge Clevenger said that the Ninth Circuit is the only appeals court to allow the exercise of bankruptcy jurisdiction in the context of a Medicare dispute. He listed the lower courts that have come down on both sides of the issue. In his district court opinion, Judge Moody said that a majority of lower courts have concluded that bankruptcy courts cannot exercise jurisdiction in view of Section 405(h).

Equitable Mootness

Even if the bankruptcy court should not have exercised jurisdiction, the nursing home argued that the appeal was moot under the doctrine of equitable mootness because the plan had been consummated. Judge Clevenger said that objections to subject matter jurisdiction can never be forfeited or waived.

Therefore, Judge Clevenger rejected the equitable mootness argument, holding that the absence of jurisdiction "precludes the exercise of that discretionary authority."

What the Opinion Means

The bankruptcy judge had said that all creditors aside from the government supported the reorganization, including a secured lender owed $11 million and unsecured creditors asserting $2 million in claims. The Eleventh Circuit's opinion means that the government by itself can overcome the wishes of creditors and the inclinations of the bankruptcy court by shutting down a health care facility when the agency finds violations of Medicare and Medicaid rules.

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The opinion is *Florida Agency for Health Care Administration v. Bayou Shores SNF LLC (In re Bayou Shores SNF LLC)*, 15-13731, 2016 WL 3675462 (11th Cir. July 11, 2016).

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Tender Offers in Bankruptcy

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Third Circuit holds again that equal treatment is not required in settlements.

Tender Offers in Bankruptcy Pass Muster in the Third Circuit

A tender offer that might not be possible outside of bankruptcy court is permissible in the Third Circuit, as the result of a May 4 opinion stemming from the reorganization of Energy Future Holdings Corp., the giant Dallas-based power generator and distributor whose chapter 11 plan was confirmed in December but not yet implemented.

In a decision that "does not constitute binding precedent" under Third Circuit rules, the appeals court held that the tender offer proposed by Energy Future "clearly did not violate the Bankruptcy Code." The opinion by Circuit Judge Patty Shwartz said the offer was not forbidden by any provision in the Bankruptcy Code.

The indenture trustee characterized the process as a tender offer because the company made the proposal to creditors before the procedure was approved by the bankruptcy court. Judge Shwartz said, "[I]t was simply a means to convey a settlement offer to certain creditors." The offering materials were given to creditors without prior approval by the Securities and Exchange Commission.

Energy Future filed for reorganization in April 2014 and got bankruptcy court approval in June 2014 to settle with holders of two issues of first-lien notes issued by the subsidiary that owns 80 percent of the company's regulated Oncor power-line business. In substance, the bankruptcy court approved procedures and the settlement itself after the company had solicited acceptances.

The settlement allowed Energy Future to pay off first-lien debt with 5 percent extra for holders who gave up claims for a so-called make-whole, a premium for investors when their bonds are paid off early. The settlement was financed with a $5.4 billion loan approved by the bankruptcy court at the same time.

The indenture trustee for one of the noteholder groups appealed and contended that the settlement was a coercive tender offer that would not pass muster outside bankruptcy and should not have been allowed in bankruptcy, either. The district court in Delaware upheld the settlement in February 2015 and was affirmed by the Third Circuit over the indenture trustee's objection that the process established a precedent opening "a Pandora's Box of coercive tender offers in chapter 11."

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Although approval of the offer by the bankruptcy court in advance "may be preferable where possible," Judge Shwartz saw "no reason to hold that the order of events dictates whether a settlement achieved by a tender offer is fair and equitable." She examined the standards for approving settlements and found that none were violated.

The indenture trustee also contended that the offer violated the "equal treatment" rule in Section 1123(a)(4) because one set of noteholders got a 62 percent recovery of the make-whole premium, while the return was only 25 percent for the other "identically situated" group.

Citing the Third Circuit's *Jevic* opinion from last year, Judge Shwartz said that the absolute priority and equal-treatment rules "are not categorically applied in the settlement context." A *certiorari* petition in *Jevic* is pending in the Supreme Court.

Even though the bankruptcy court could have approved a settlement with unequal treatment if there were "adequate reason for doing so," the appeals court said that "there was in fact equal treatment" because bondholders who rejected the settlement still had the right to make a claim for the entire make-whole.

"Mere differences in potential final outcomes resulting from choices made by individual creditors do not violate equal treatment protections in Section 1123(a)(4)," Judge Shwartz said.

The opinion is *Delaware Trust Co. v. Energy Future Holdings Corp. (In re Energy Future Holdings Corp.)*, 15-1591, 2016 WL 2343322 (3d Cir. May 4, 2016).

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Circuit erroneously cites Section 1325 as governing in chapter 11 cramdown.

Ninth Circuit Makes Glaring Error in Chapter 11 Cramdown Opinion

The Ninth Circuit wrote a seminal 2-1 opinion on the reorganization of affordable housing projects in chapter 11. Repeatedly, the opinion erroneously cites Section 1325 as the governing cramdown statute, when the appeals court should have been referring to Section 1129.

The court quickly corrected the mistake by changing references to Section 1325 to Section 1129. Nonetheless, the opinion will make reorganization virtually impossible for owners of affordable housing when the lender is bent on taking title, unless the result is modified on rehearing.

The majority admit that the precedent will result in fewer affordable housing units.

The dissent, by Circuit Judge Richard A. Paez, argues that the majority misread the Supreme Court's 1997 decision in *Rash* by basing valuation on the creditor's perspective. Judge Paez also points out that the majority's approach to valuation under Section 506(a) is at odds with the *Collier* bankruptcy treatise.

All three judges agreed that the appeal was not moot, making the Ninth Circuit an even more dangerous forum for purchasers or investors in bankrupt properties.

"The opinion should alert judges that their clerks ought to have taken bankruptcy if they are going to write published opinions on the subject," Prof. Bruce A. Markell of Northwestern Univ. Pritzker School of Law said in an e-mailed statement reflecting on the miscitation of Section 1325. Prof. Markell was a bankruptcy judge in Nevada and a member of the Ninth Circuit Bankruptcy Appellate Panel before he returned to teaching in 2013.

The project had an $8.5 million, government-guaranteed first mortgage and two subordinate mortgages. Following default on the first mortgage, the government paid off the first lien lender and sold the mortgage to a third party for about $5 million. The new owner of the mortgage had arranged to sell the property after foreclosure for about $7.7 million. To halt foreclosure, the owner of the project filed a chapter 11 petition.

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The three mortgages and agreements related to affordable housing all provided that the restrictions related to affordable housing would terminate in the event of foreclosure. The project had not been foreclosed by the time the circuit court issued its opinion on April 8.

The project's owner financed the reorganization with $1.2 million in new equity provided by a new investor who in substance took over ownership when the plan was confirmed and consummated. As confirmed by the bankruptcy court, the plan valued the first lien at $3.9 million. Although not mentioned in the opinion, the lender exercised the Section 1111(b) election. Consequently, the plan gave the lender a new note, with interest, where the full amount of the debt would be paid on maturity of the loan in 40 years.

The new investor agreed to continue operating the property as an affordable housing project. The project's expert conceded that it would be worth $7 million if affordable housing restrictions did not apply.

The lender appealed and was denied stays in the bankruptcy and district courts. The district court later upheld the confirmation order, leading to a reversal in the majority opinion written by Circuit Judge Richard R. Clifton.

The governing Supreme Court authority, of course, is *Rash*, a chapter 13 case involving valuation of a truck under Sections 1325 and 506(a). In the first paragraph of the opinion and later, Judge Clifton cited Section 1325 as containing the relevant cramdown standard, not Section 1129, which should have been applicable because the case entailed an appeal arising from a chapter 11 reorganization.

Judge Clifton said that valuation, governed by Section 506(a), is not measured by the income an owner could generate by operating the property as affordable housing. He said that nothing under Section 1325(a)(5) authorizes "shortchanging the creditor with regard to its current secured value." He said that *Rash* does not authorize reducing the value simply because bankruptcy prohibits the lender from foreclosing, when affordable housing restrictions would end as a matter of contract.

Judge Clifton admitted there will be a "negative effect" by eliminating use of the project as affordable housing. Although that result would be "unfortunate" in "an immediate sense," he said that the lower courts' decisions "would drastically reduce" what the government could gain from selling defaulted mortgages. He added that the government could have designed financing so the property would remain affordable housing even after foreclosure.

Dissenting, Judge Paez said that the "majority errs in several major respects, all relating to its misapplication" of *Rash*. Saying that *Rash* "rejected starting the valuation from the creditor's perspective," he cited *Collier's* statement that the amount paid to a secured creditor under

Section 506(a) "turns on the value of the debtor's proposed use of the relevant property under the plan, not the value achievable in a foreclosure scenario that is not proposed."

Citing the Ninth Circuit's *Transwest* decision from 2015, Judge Paez agreed with the majority in finding that the appeal was not equitably moot.

Conversely, the debtor contended that the appeal was equitably moot because reversal would be unfair to the third party that already had invested $1.2 million and would incur tax penalties were the transaction unraveled. The appeals court said that the new investor "is not the kind of innocent third party the doctrine of equitable mootness is intended to protect." The investor, according to Judge Clifton, knew there were "potential tax risks if something went wrong."

The appeals court also dispensed with the previously imposed requirement that an appellant must pursue a stay pending appeal in the circuit court to avoid equitable mootness. Because the appeals court rarely grants stays in these circumstances, the circuit said that a third futile stay motion was not required.

Transwest, also a 2-1 opinion, held that a buyer who actively participates in reorganization is not protected by equitable mootness. *Transwest*, combined with the new opinion, implies that investors or owners should think long and hard before consummating sales or plans if there is an outstanding appeal in the Ninth Circuit. The opinion gives more ammunition to lawyers advising their clients not to file chapter 11 petitions in the Ninth Circuit.

Unless an existing owner can somehow escape the restrictions associated with affordable housing projects, a lender intent on taking ownership should always be able to defeat a reorganization plan in the Ninth Circuit, taking low-cost units out of the housing market in the process.

The opinion is *First Southern National Bank v. Sunnyslope Housing LP (In re Sunnyslope Housing LP)*, 818 F.3d 937 (9th Cir. April 8, 2016).

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Sixth and Fifth Circuits arguably disagree on what constitutes artificial impairment to confirm a chapter 11 plan.

Sixth Circuit Nixes the Notion of Artificial Impairment for Plan Confirmation

"Artificial impairment" as a means for cramming down a chapter 11 plan on a recalcitrant secured creditor is a theory that does not hold water in the Sixth Circuit when very little unsecured debt takes a haircut, even in the face of an explicit bankruptcy court finding that the plan was proposed in good faith as the result of economic necessity.

The Sixth Circuit's opinion on Jan. 27 is arguably at odds with a 2013 case from the Fifth Circuit.

The debtor owed \$8.6 million on a mortgage securing an apartment building worth \$5.4 million. Aside from the lender, the only creditors were the debtor's accountant and lawyer, whose unsecured claims totaled \$2,400.

To create an impaired class of accepting creditors, the plan proposed paying the unsecured claims in full over 60 days. The bankruptcy court's confirmation order was reversed by the district judge, who set aside findings of fact as clearly erroneous.

The opinion by Circuit Judge Raymond M. Kethledge on Jan. 27 upheld the district court and could be interpreted as a broad rejection of the notion of artificial impairment in the Sixth Circuit.

To uphold rejection of the plan, Judge Kethledge first held that a good faith requirement is not engrafted onto Section 1129(a)(10), which requires acceptance by one impaired class. He said that contrived impairment is "immaterial" because Section 1124(1) only asks whether creditors' interests are altered, not "whether the debtor had bad motives."

Invoking the Fifth Circuit's 2013 *Camp Bowie* decision, Judge Kethledge next held that the debtor's motives instead are the province of Section 1129(a)(3), which requires that plans be proposed in good faith.

At that juncture, Judge Kethledge ran into a potential roadblock because the bankruptcy judge had found that the plan was filed in good faith as a result of economic necessity. The

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circuit court determined that the finding of fact was clearly erroneous because the lender had offered to pay unsecured creditors in full immediately.

The appeals court also said that the debtor's close alliance with the unsecured creditors compounded the appearance that impairment "had more to do with circumventing" Section 1129(a)(10) than with "rationing dollars."

Although Judge Kethledge cited *Camp Bowie*, his opinion may be at odds with the Fifth Circuit's holding. In *Camp Bowie*, the circuit court held that the Bankruptcy Code makes no distinction between adverse effects on claim holders that result from economic necessity and those arising from the bankrupt's discretion.

Like the Sixth Circuit, the Fifth held in *Camp Bowie* that a bankrupt company's ability to pay claims in full remains an issue on the question of whether the plan is proposed in good faith. In the Fifth Circuit case, now-retired Bankruptcy Judge Michael Lynn found good faith.

So why were the results different in the two circuits? Does the Sixth Circuit have a lower standard for reversing findings of fact?

The difference might be attributed to the relative amount of unsecured debt. In *Camp Bowie*, the impaired unsecured debt was 0.2% of the secured debt. In the Sixth Circuit case, impaired unsecured debt was only 0.03% of secured debt. Is that reason enough for a different result? Can a lender defeat a finding of good faith by offering to pay unsecured claims in full?

The two cases may have other important factual distinctions, because the lender in *Camp Bowie* agreed that the owner could remain current on the revised mortgage and that the property was worth more than the debt. In the Sixth Circuit case, the property was worth a fraction of the mortgage debt and would be paid down little during the life of the plan.

Other factual differences may be important, too. In *Camp Bowie*, the bankruptcy judge required the owners to contribute $1.5 million in new equity and precluded them from taking money out until the lenders were fully paid. Nonetheless, the Fifth Circuit said that the plan fit within the "plain meaning of Sections 1124 and 1129(a)(10)" of the Bankruptcy Code.

There can be debate as to whether the two cases are at odds or merely reflect different underlying facts. While there may be no bright-line test to determine when a small amount of impairment is too little, the Sixth Circuit may be quicker to find artificial impairment, at least when the lender is taking a haircut and the debtor's owners are injecting no new capital.

In any event, it does not appear that the two cases are sufficiently inconsistent to warrant Supreme Court review because the two courts' pronounced legal principles are not far apart.

The opinion is *Village Green I GP v. Fannie Mae (In re Village Green I GP)*, 811 F.3d 816 (6th Cir. Jan. 27, 2016).

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No need for venue-shopping between Delaware and New York for undersecured creditors.

Judges Sontchi and Drain Agree on Treatment Among Undersecured Creditors

Neither Delaware nor New York provides better treatment for lienholders with higher interest rates when it comes to distributions among undersecured creditors.

In a 38-page opinion on March 11 in the reorganization of Energy Future Holding Corp., Bankruptcy Judge Christopher S. Sontchi of Delaware agreed with New York Bankruptcy Judge Robert Drain by holding that post-petition interest accruals are not taken into consideration when calculating distributions among undersecured creditors with liens on the same collateral.

The decision turned on Judge Sontchi's interpretation of the intercreditor agreement among first lien creditors whose collateral was insufficient to pay their collective claims in full. Consequently, first lien creditors were not entitled to post-petition interest.

The interest rate on first lien notes was higher than the interest rates on other first lien debt. The indenture trustee for first lien noteholders nonetheless argued that the hypothetical accrual of post-petition interest should be taken into consideration when parceling out distributions under the confirmed chapter 11 plan. Among other things, the plan gave first lien creditors stock in a reorganized company, cash, new debt, and the ability to purchase more stock in an equity rights offering.

Agreeing with Judge Drain's decision in the reorganization of MPM Silicones LLC, also known as Momentive Performance, Judge Sontchi held that property distributed under the plan was not collateral on which the creditors held liens. Therefore, he said, the intercreditor agreement did not apply.

He also held that plan distributions, including cash, did not fall under the intercreditor agreement's definition of "proceeds" because they did not flow from the sale or disposition of collateral.

Judge Sontchi reached the same conclusion with respect to distributions of adequate protection payments under the cash collateral order.

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As a result, undersecured creditors will receive distributions in proportion to what they were owed at the outset of bankruptcy, in the process disregarding hypothetical post-petition interest accruals.

Judge Sontchi said there were no disputed issues of fact. He also held that the intercreditor agreement was unambiguous.

The opinion is *Delaware Trust Co. v. Wilmington Trust Co. (In re Energy Future Holdings Corp.)*, 546 B.R. 566 (Bankr. D. Del. March 11, 2016).

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Posner singlehandedly turns Chicago into a more desirable forum for large chapter 11s.

Seventh Circuit Lays Down an Easy Standard for Enjoining Suits Against Third Parties

Addressing what he called the “immense and immensely complicated” reorganization of casino giant Caesars Entertainment Operating Co. Inc., Seventh Circuit Judge Richard A. Posner penned an important opinion on Dec. 23 reversing the lower courts and establishing an easily satisfied test allowing the bankruptcy court to enjoin lawsuits in other courts against nondebtor third parties, including nonbankrupt affiliates.

Junior bondholders had filed four lawsuits in Delaware state court and a Manhattan federal district court seeking to reinstate the nonbankrupt parent’s guarantees of the noteholders’ bonds. The guarantees had been extinguished in two transactions in 2014 before the casino operating company filed for reorganization.

Upheld in district court in October, the bankruptcy judge had concluded in July that he lacked the power to enjoin the junior bondholders’ suits against the nonbankrupt parent. The bankruptcy judge believed that Seventh Circuit precedent permitted injunctions halting suits by creditors against nonbankrupts only when the creditors were suing on claims also available to the debtors.

In reporting the district court opinion, we noted that Judge Posner was on the panel that heard the appeal on Dec. 10. We said it was “a safe bet that Judge Posner will write the circuit’s opinion, because he seldom misses a chance to make a significant pronouncement on bankruptcy.”

That is exactly what happened. Judge Posner said the lower courts misinterpreted the circuit’s precedents in 1998 and 2009, called *Fisher* and *Teknek*, respectively. To justify an injunction halting suit against a nonbankrupt third party, he established a two-part test.

First, the bankruptcy judge must decide whether an injunction “is likely to enhance the prospects for a successful resolution of the disputes attending its bankruptcy.” Second, the court has power to enjoin under Section 105(a) if denial would “endanger the success of the bankruptcy proceedings.”

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Although Judge Posner said he was not compelling the bankruptcy judge to issue an injunction on remand, he all but told the lower court how to rule. He said the interests of the operating company's creditors would be "furthered" by an injunction if the bondholders' suits outside of bankruptcy court would drain the nonbankrupt parent of capital, leaving "much less money" for other creditors to recover in bankruptcy.

In that regard, Judge Posner seems to have bought into the debtor's argument that the suits, if not enjoined, might enable the bondholders to "jump the line in front of other creditors, including more senior ones."

Defeating the injunction on remand is not an impossible dream for the bondholders, however.

Since the suits in New York are near conclusion, the bondholders can argue that the Manhattan district judge should be permitted to rule on the legality of cancelling the guarantees, with the understanding that an injunction would then kick in, preventing the bondholders from exercising remedies against the nonbankrupt parent.

Even in the absence of an injunction, a judgment in New York reinstating the guarantees would not by itself enable the bondholders to "jump the line" because the parent could then file under chapter 11, putting the bondholders on the same footing as other unsecured creditors.

Judge Posner said that *Fisher* and *Teknek* had more "clear-cut" facts permitting injunctions. Those cases, he said, did not mean that a "less clear-cut case is necessarily beyond the reach of section 105(a)."

The opinion is *Caesars Entertainment Operating Co. Inc. v. BOKF NA (In re Caesars Entertainment Operating Co. Inc.)*, 808 F.3d 1186 (7th Cir. Dec. 23 2015).

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Delaware became less hospitable for debtors following the Third Circuit's opinion on stays pending appeal.

Third Circuit Enhances Appellants' Rights for Stays Pending Appeal

The Third Circuit belatedly wrote an opinion in the *Revel* casino reorganization to clarify the standards for issuing a stay pending appeal. The decision also makes law on the definition of "bona fide dispute," the showing that is required before property can be sold free of an interest under Section 363(f).

In addition, the Sept. 30 opinion by Circuit Judge Thomas Ambro expanded the notion of a final order giving a right of appeal. Judge Ambro was a bankruptcy lawyer before taking the circuit bench in 2000.

In chapter 11 a second time, the Revel casino cost $2.4 billion to build and was sold this year for a disappointing $82 million. The sale motion sought authority to sell the facility free and clear of the lease of a tenant that operated two nightclubs.

The lease was unusual because the tenant contributed $16 million toward $80 million in construction costs. There was no fixed rent; instead, the tenant paid a percentage of its revenue.

Revel convinced the bankruptcy judge that the power to sell free and clear trumped a tenant's rights under Section 365(h)(1)(A)(ii) to remain in possession after rejection of the lease.

Rejecting another tenant argument, the bankruptcy judge decided that there was a bona fide dispute over the validity of the lease, allowing sale of the property free of the lease under Section 363(f).

The bankruptcy judge and a district judge both denied the tenant's application for a stay pending appeal. In a terse order on Feb. 6, the Third Circuit granted a stay, but only to the extent that Revel could not evict the tenant. Otherwise, the appeals court allowed the sale to proceed in a 2/1 order. Despite Revel's argument that any stay would crater the sale, the purchaser later decided to close the deal despite the stay.

Again for a 2/1 majority, Judge Ambro wrote a 41-page opinion on Sept. 30 to explain why the circuit granted the stay in February and to clarify how courts should balance the four factors to determine whether an appellant is entitled to a stay pending appeal. The four issues are: (1) the appellant's likelihood of success on appeal; (2) whether the appellant will suffer irreparable harm without a stay; (3) the harm to other parties from a stay; and (4) whether a stay is in the public interest.

Judge Ambro said that factors 1 and 2 are the most important. On likelihood of success, he said the appellant must show "a reasonable chance, or probability, of winning." However, the appellant is not required to establish that winning is "more likely than not."

On irreparable harm, Judge Ambro said that the appellant must show "more than a mere possibility." He said the court must evaluate the first two factors on a sliding scale. The more likely the appellant is to win, the less heavily the balance of harms must weigh in its favor, he held.

If the appellant does not prevail on the first two factors, Judge Ambro ruled that the last two factors do not matter "and the stay should be denied without further analysis."

Applying the first two factors to the *Revel* case, Judge Ambro made law on Section 363(f)(4), which allows selling free and clear if there is a bona fide dispute over the validity of an interest in property.

Revel claimed there was a bona fide dispute regarding its contention that the lease was not a "true lease," but rather some sort of a joint venture or profit sharing arrangement. To buttress the argument, Revel pointed to the adversary proceeding that the tenant filed for a judgment declaring that the lease was a true lease. The initiation of the suit by itself demonstrated the existence of a bona fide dispute, according to Revel's argument.

Although the two lower courts bought Revel's theory, Judge Ambro did not. He said that "Revel failed to cite a single authority suggesting that a percentage-lease clause disqualifies a purported lease from being one." He also quoted the lease itself, which said it could not be construed to create a partnership or joint venture. He characterized Revel's argument as "fanciful if not disingenuous."

Circuit Judge Patty Shwartz dissented. To win a stay, she interpreted Third Circuit law as requiring the appellant to prevail on all four elements. She also argued that the "sliding scale approach" is contrary to Third Circuit law.

In his prevailing opinion, Judge Ambro said his court had "explicitly disavowed" the notion that an appellant must prevail on all four factors. To require winning across the board would be "deeply unfair," he said.

Judge Ambro faulted Judge Shwartz for relying on later Third Circuit opinions that differed from authorities he cited. If there is a conflict, Judge Ambro said, "the earlier is controlling authority and the latter is ineffective as precedent."

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Of perhaps equal importance, Judge Ambro held there was appellate jurisdiction despite Revel's argument that denial of a stay pending appeal was not a final order.

Judge Ambro conceded that denial of a stay pending appeal "is not technically a final judgment." In a "practical sense," he said, it was final because Section 363(m) would have prevented the court from later reaching the merits if there were no stay.

The ruling on finality is arguably at odds with the Supreme Court's decision this year in *Bullard*, which limits the definition of "finality" in the context of an order denying confirmation of a chapter 13 plan.

The *Revel* opinion is also arguably in conflict with the Second Circuit's terse ruling last year following confirmation of a chapter 11 plan by MPM Silicones LLC. Creditors went to the circuit court after they were denied stays pending appeal in both the bankruptcy court and the district court. In a terse, unreported opinion on Oct. 31, 2014, the New York circuit court dismissed the 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."

The Third Circuit opinion is *In re Revel AC Inc.*, 802 F.3d 558 (3d Cir. Sept. 30, 2015). The Second Circuit case is *BOKF NA v. Momentive Performance Materials Inc.* (*In re MPM Silicones LLC*), 14-3531 (2d Cir. Oct. 31, 2014).

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Equitable Mootness

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Another circuit joins the trend toward limiting the doctrine of equitable mootness.

Second Circuit May Be Trimming Back Doctrine of Equitable Mootness

The Second Circuit trimmed back the doctrine of equitable mootness used to dismiss appeals from chapter 11 plans that have been consummated.

The appeal was brought by an 8% shareholder from confirmation of the LightSquared Inc. reorganization plan. The unsigned, summary opinion on March 22 held that the appeal was “presumed equitably moot” because the plan had been substantially consummated.

The appeals court held that the shareholder satisfied all five tests required for overcoming the presumption of mootness. On the critical test, the circuit court said it could grant “at least some effective relief in the form of monetary damages in this case – even as little as one dollar – without knocking the props out from under the completed transaction.”

Avoiding dismissal ultimately failed to help the shareholder because the circuit court proceeded to rule on the merits by finding that LightSquared’s plan did not violate the “fair and equitable” rule. The bankruptcy judge made an adequately based finding that the reorganized company had no equity for “old” shareholders.

The Second Circuit opinion could be read as bringing that court more in line with other appeals courts that have been narrowing the doctrine of equitable mootness. The Second Circuit approvingly cited the Fifth Circuit’s 2013 decision in *Texas Grand Prairie Hotel Realty LLC*, where the New Orleans-based court took a “narrow view” of equitable mootness, “particularly where pleaded against a secured creditor.” *Texas Grand Prairie* said that equitable mootness only protects creditors who are not parties to the appeal.

The Second Circuit also approvingly cited the Ninth Circuit’s *Transwest Resort Properties* decision from 2015. In that case, the Ninth Circuit held, over a vigorous dissent, that a buyer who actively participates in reorganization is not protected by equitable mootness. The Ninth Circuit denied motions for rehearing *en banc*.

By citing the other two circuits, it is far from clear, however, that the Second Circuit is going equally far in trimming back equitable mootness. The significance of the opinion is also limited because it was a summary order intended to have limited precedential effect.

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The Second Circuit opinion is *Ahuja v. LightSquared Inc.*, 15-2480, 2016 WL 1105109 (2d Cir. March 22, 2016).

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The Ninth Circuit provides another reason to avoid reorganizing on the west coast.

Ninth Circuit Won't Protect Purchasers with Equitable Mootness

The Ninth Circuit is now more firmly ensconced as a jurisdiction an investor should avoid when bent on buying a company through chapter 11.

In July, a three-judge panel held 2-1 that a buyer who actively participates in reorganization is not an innocent third party protected by the doctrine of equitable mootness, a judge-made rule of law allowing dismissal of an appeal without reaching the merits.

The reorganized company filed a motion for panel rehearing and rehearing *en banc*. The original three-judge panel withdrew its July opinion and issued a new opinion on Sept. 15, reaching the same result by the same rationale and by the same 2-1 vote. The revised opinion only made matters worse for investors arguing in the future in the Ninth Circuit that a confirmation appeal is moot after consummation of a plan.

The circuit nailed the coffin shut on Oct. 23 by denying the motion for *en banc* rehearing. No judge even sought a vote regarding *en banc* rehearing. Some debtors already avoid reorganizing in the Ninth Circuit because that court categorically precludes third-party releases.

The case involved a real estate project in which the lender exercised its option under Section 1111(b) of the Bankruptcy Code to keep the full amount of its lien on the property with an agreed value of $92 million. The due-on-sale clause in the mortgage, coupled with the election, would ordinarily mean that the lender could collect all sale proceeds were the property to be sold after emergence from chapter 11 because the claim was several times the value of the project.

The plan was confirmed over the lender's objection. It provided that the lender would not receive all sale proceeds that were the project sold between the fifth and fifteenth years after confirmation. The plan was sponsored by a purchaser who was committed to investing $30 million in the property after bankruptcy.

The lender quickly, though unsuccessfully, sought stays of the confirmation order in both the bankruptcy court and the district court. After the district court denied a stay pending appeal, the judge dismissed the appeal on the ground of equitable mootness. The lender was contesting the 10-year hole in the due-on-sale clause.

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The lender appealed to the circuit and won in a revised panel opinion on Sept. 15. Writing the opinion for the majority, Circuit Judge Michelle T. Friedland reinstated the appeal and sent it back to the district court to consider the merits and decide how to modify the plan if the lender succeeded in overturning the confirmation order. Because the buyer had already invested to upgrade the property, Judge Friedland said that relief on appeal could be less than reinstatement of the entire due-on-sale clause.

Judge Friedland said the purchaser, despite its obligation to invest $30 million, is not "the type of an innocent third party that the equitable mootness doctrine is meant to protect" because the buyer participated "at every stage of these proceedings."

Citing the Fifth Circuit's 2009 opinion in *Pacific Lumber*, Judge Friedland said that "appellate consequences are foreseeable" when a sophisticated investor crafts a plan that "presses the limits" of bankruptcy law.

Judge Friedland declined to adopt a presumption, used by other circuit courts, that a plan is moot once implemented.

Circuit Judge Milan Dale Smith Jr. dissented, saying the result was "grossly inequitable." He believes the majority's opinion "discourages potential investors from relying on the finality of bankruptcy court confirmation orders."

The majority's new opinion corrected a mistake in the original July decision, in which the appeals court had said that the investor was a party to the circuit court appeal. Even though it did not participate in the appeal, the majority said the investor still was not an innocent third party protected by equitable mootness, in part because it went ahead with plan confirmation in the face of the lender's objection.

The opinion is *JPMCC 2007-C1 Grasslawn Lodging LLC v. Transwest Resort Properties Inc.* (*In re Transwest Resort Properties Inc.*), 801 F.3d 1161 (9th Cir. Sept. 15, 2015).

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Safe Harbor

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***Judge Gross finds Judge Gerber in* Lyondell *more persuasive than the Second Circuit in* Tribune.**

Delaware's Judge Gross Differs with Second Circuit on the Safe Harbor

In March, the Second Circuit handed down *Note Holders v. Large Private Beneficial Owners (In re Tribune Co.)*, slamming the door on virtually every theory finding a loophole in Section 546(e), one of the safe harbor provisions in the Bankruptcy Code barring suits to recovery payments made in securities transactions.

Bankruptcy Judge Kevin Gross in Delaware wrote a decision on June 20 where he disagreed with *Tribune*. Saying that Second Circuit authority is not binding on him, Judge Gross adopted the approach taken in the 2014 *Lyondell Chemical Co.* opinion, where former Bankruptcy Judge Robert E. Gerber of Manhattan held that the safe harbor only bars trustees from suing, not creditors from asserting claims of their own.

Judge Gross' opinion reads like a brief to the Third Circuit, distinguishing *Tribune* and explaining why the Second Circuit was wrong by holding that Congress intended to preempt state laws in adopting Section 546(e).

The Facts in *Physiotherapy*

A company called Physiotherapy Holdings Inc. filed under chapter 11 not long after being acquired in a leveraged buyout where two controlling shareholders sold 90% of the stock they controlled. A litigation trust filed suit against the controlling shareholders to recover almost $250 million they received by selling their stock in the LBO.

Pre-LBO senior noteholders assigned their claims to the litigation trust, constituting the backbone of the suit. The complaint alleged that the LBO was both a constructive fraudulent transfer and a fraudulent transfer with "actual intent." The complaint asserted claims under both Section 548 and parallel provisions in Pennsylvania's Fraudulent Transfer Act.

According to the complaint, the defendants were not innocent selling shareholders. The trust alleged that the controlling shareholders knew the company was issuing false financial statements grossly overstating net income, thus enticing the purchaser to acquire the company in the LBO.

The selling shareholders filed a motion to dismiss. Judge Gross denied the motion with respect to the actual fraud claim under Section 548(a)(1)(A) and the senior noteholders' constructive fraud claim under state law. He dismissed the complaint's claims for constructive fraudulent transfers under Section 548(a)(1)(B) and the trustee's claims for actual and constructive fraudulent transfers under state law.

The Safe Harbor and *Tribune*

The safe harbor in Section 546(e) provides that "the trustee may not" sue for recovery of a "settlement payment" made in connection with a "securities contract" unless the suit is brought under Section 548(a)(1)(A) for recovery of a fraudulent transfer within two years of bankruptcy made with actual intent to hinder, delay or defraud creditors.

The statute's reference to a trustee prompted litigation contending that the safe harbor does not bar suits based on the creditors' own claims, as opposed to claims brought by a trustee. Judge Gross' opinion analyzes the decisions coming down on both sides of the issue. His focus, of course, is on *Tribune* and *Lyondell*.

In *Tribune*, the bankruptcy judge had allowed company retirees, along with pre-LBO unsecured bondholders, to sue selling shareholders using constructive fraudulent transfer theories. After plan confirmation, the litigation trust took over prosecution of the creditors' claims. In the Second Circuit's March decision, the appeals court dismissed the creditors' state law claims under Section 546(e) on a theory of implied preemption of state law.

The Second Circuit held that state law constructive fraudulent transfer claims were preempted because "unwinding settled securities transactions" would "seriously undermine" the markets.

The *Tribune* opinion effectively overruled *Lyondell*, which held that the safe harbor does not preclude fraudulent transfer suits based on state law, nor does it protect selling shareholders who ultimately received proceeds from allegedly fraudulent transfers.

Judge Gross' Analysis

Saying that *Lyondell's* reasoning was "more persuasive" than *Tribune*, Judge Gross adopted *Lyondell's* holding. He said that *Lyondell* "more accurately addresses the history and function of the safe harbor." He cited the Supreme Court's *Wyeth* decision from 2009, which said that the states' police powers cannot be superseded "unless that was the clear and manifest purpose of Congress."

Quoting from the American Bankruptcy Institute's Commission to Study the Reform of Chapter 11 with regard to the history and purpose of Section 546(e), Judge Gross said the safe harbor was designed to avoid a "ripple effect" in the securities markets if transfers of securities were set aside in bankruptcy.

Judge Gross does not believe that allowing state law claims to proceed would destabilize the securities markets. He pointed out that that no public shareholders were involved, and the controlling shareholders had 90% of the stock. He also said that the statute only limits a trustee's ability to sue and is "silent with regard to a creditor's ability to bring such a claim."

In contrast to his case where the selling shareholders allegedly were aware of false financial statements enabling the LBO, Judge Gross noted that the selling shareholders in *Tribune* "were not alleged to have acted in bad faith." Therefore, he said that barring suit would "run counter to Congress' policy of providing remedies for creditors who have been defrauded by corporate insiders."

The language of the statute nonetheless constrained Judge Gross to dismiss claims explicitly precluded by the safe harbor.

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

The opinion is *PAH Litigation Trust v. Water Street Healthcare Partners LP (In re Physiotherapy Holdings Inc.)*, 15-ap-51238, 15-ap-51238 (Bankr. D. Del. June 20, 2016).

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Creditors, not just trustees, are also barred from suing by Section 546(e).

Second Circuit Closes Loopholes in 'Safe Harbor' to Protect Selling LBO Shareholders

[Note: The opinion, originally issued on March 24, was "filed in error and stricken from the record" by a docket entry on March 28. The next day, the appeals court reissued the opinion with immaterial changes. The circuit denied rehearing *en banc* on July 22.]

Broadly interpreting the safe harbor for "settlement payments" provided by Section 546(e) of the Bankruptcy Code, the Second Circuit triple-locked the door against individual creditors trying to sue shareholders for the recovery of payments received in a leveraged buyout before the company filed bankruptcy.

In a March 24 opinion by Circuit Judge Ralph K. Winter Jr., the appeals court foreclosed virtually any argument that creditors individually or collectively can sue shareholders on a constructive fraudulent transfer theory seeking recovery of payments received in a leveraged buyout for stock in a company that later files bankruptcy.

The case arose in the chapter 11 reorganization of newspaper publisher Tribune Co. and centered around Section 546(e), which provides that "the trustee may not" sue for recovery of a "settlement payment," unless the suit is brought under Section 548(a)(1)(A) for recovery of a fraudulent transfer within two years of bankruptcy made with actual intent to hinder, delay or defraud creditors.

The Second Circuit in substance was called on to decide whether there are any loopholes allowing creditors to sue for recovery of constructive fraudulent transfers when an LBO goes sour. The district court in the opinion on appeal had opened the door a crack, and a bankruptcy judge in the reorganization of Lyondell Chemical Co. had also found loopholes.

In Tribune's reorganization, the official creditors' committee was authorized to sue selling shareholders for allegedly receiving fraudulent transfers with "actual intent." Prosecuted after plan confirmation by a creditors' trust, that suit remains pending in bankruptcy court in Manhattan.

When the two-year statute of limitations was about to expire, Tribune's bankruptcy judge modified the automatic stay by allowing company retirees, along with pre-LBO unsecured bondholders, to sue selling shareholders using constructive fraudulent transfer theories. In

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modifying the stay, the bankruptcy judge did not rule on whether individual creditors had standing or whether a suit would be barred by Section 546(e)'s safe harbor. The individual creditors' suit ended up in district court in Manhattan, where the selling shareholders moved to dismiss.

Granting the motion to dismiss, the district court held that individual creditors lacked standing because the creditors' trust was simultaneously suing on fraudulent transfer grounds, albeit on a different theory. The judge also held that the safe harbor only bars suits by a trustee and does not preclude creditors from suing under state law.

Judge Winter reversed the district court on both scores, with dismissal still the result. He made short shrift of the district court's holding that the automatic stay deprived individual creditors of standing when the creditors' trust was suing to recover the same transfers as fraudulent transfers with "actual intent." The judge pointed out how the bankruptcy court on at least three occasions had modified the stay so individual creditors could sue.

Although he gave them back the right to sue, Judge Winter nonetheless knocked them out of the box under Section 546(e) on a theory of implied preemption. He said that implied preemption results when "state law stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress."

He rejected the argument that only trustees are barred from suing by the safe harbor. Although the meaning of Section 546(e) is not "plain," Judge Winter said the creditors' arguments rely on "adhering to statutory language only when opportune and resolving various ambiguities in a way convenient to that theory." Ultimately, he said that the creditors' theory was in "outright conflict" with the section.

The creditors contended that fraudulent transfer claims revert to creditors if the trustee does not file suit within the two-year statute of limitations or if the automatic stay is lifted to allow suing. Judge Winter said that a reversion of fraudulent transfer claims "is not based on the language of the Code."

Although he conceded that Section 546(e) is ambiguous, Judge Winter said in his 53-page opinion that "unwinding settled securities transactions" would "seriously undermine" the markets. For reasons developed at length about the congressional policy shown in the safe harbor, the appeals court held that state law constructive fraudulent transfer claims are preempted.

The *Tribune* opinion cuts the ground from underneath a decision by the *Lyondell* bankruptcy judge in January 2014 holding that the safe harbor does not preclude fraudulent transfer suits based on state law, nor does it protect selling shareholders who ultimately received proceeds from allegedly fraudulent transfers.

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Judge Winter's opinion contains a useful discussion of how to determine whether a statute's meaning is plain.

The opinion is *Note Holders v. Large Private Beneficial Owners (In re Tribune Co.)*, 818 F.3d 98 (2d Cir. March 29, 2016).

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Executory & Union Contracts

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Bankrupt employers get a boost from the Third Circuit for negotiations with labor unions.

Expired Union Contract Can Be Rejected, Third Circuit Holds in Trump Chapter 11

Labor unions lost a major battle when the Third Circuit held that the bankruptcy court retains power to reject a labor contract even after it expired by its own terms.

The Third Circuit was the first appeals court to decide the issue. Lower courts are split. The debtor-friendly opinion on Jan. 15 is yet another reason for companies to file for reorganization in Delaware because the Philadelphia-based Third Circuit makes law for that district.

Rather than a tortured parsing of the statutory language to arrive at a result, the Third Circuit's opinion is a refreshing exercise in finding the best answer by focusing on the purpose of the law, since that Congress may not have had the precise facts in mind when adopting the statute.

The appeal arose from the reorganization of two casinos in Atlantic City, New Jersey, owned by Trump Entertainment Resorts Inc. Unite Here Local 54 wanted the Third Circuit to reverse an October 2014 decision by Bankruptcy Judge Kevin Gross in Delaware who sided with the casino operator and held there was power to reduce wages or benefits in expired contracts. Judge Gross allowed a direct appeal to the circuit.

In the *Hostess Brands Inc.* reorganization, Bankruptcy Judge Robert Drain from White Plains, New York, held in 2012 that power to terminate a collective bargaining agreement ends when the contract expires. Bankruptcy Judge Donald H. Steckroth from Newark, New Jersey, reached the same result as Judge Gross in a case called *710 Long Ridge Road*.

In her opinion deciding the Trump appeal in favor of the debtor, Circuit Judge Jane R. Roth said she would "not embark, as the parties do, on a hyper-technical parsing of the words and phrases that comprise Section 1113," the provisions in the Bankruptcy Code that govern rejection of labor contracts. Instead, she focused on the objectives of chapter 11 and the intent of Congress in adopting Section 1113 to overrule the Supreme Court's *Bildisco* decision.

The union argued that the expiration of a collective bargaining agreement meant there was no longer any contract in existence and thus nothing to reject. Were the union correct, the National

Labor Relations Act would kick in, compelling the company to continue operating under the expired contract until NLRB declared an impasse in negotiations on a new contract.

Judge Roth noted that Section 1113 does not restrict its application to an executory contract. She went on to find that Congress intended "to incorporate expired collective bargaining agreements into the language of Section 1113."

She also held that allowing rejection of an expired contract is "consistent with the purpose of the Bankruptcy Code." Not allowing rejection, she said, "would impede that overriding goal" and "undercut the rehabilitative function of chapter 11."

Where bankruptcy courts can move quickly to modify union contracts when a company's survival is at stake, the NLRB can be slow to declare an impasse and thus allow an employer to impose new terms of employment. Judge Roth's opinion therefore gives a corporate debtor an important weapon for use against a labor union reluctant to grant concessions.

If expired contracts were beyond the reach of the bankruptcy court, some insolvent companies might be unable to survive the additional time required for NLRB proceedings and thus could be pressured into giving workers more than they might get under Section 1113.

Despite the Third Circuit's decisions, workers are not bereft of all power, because they can still determine whether a bankrupt company survives. Except for airline and railroad employees who cannot strike even if their wages are reduced, workers in other industries are at liberty to shut a company down if they dislike the wages imposed by the bankruptcy court.

Trump Entertainment filed for chapter 11 protection in Sept. 2014, seeking immediate relief from the labor contract at the 2,000-room Trump Taj Mahal. Its 906-room Trump Plaza had already closed. Carl Icahn, the dominant holder of $285.6 million in first-lien notes, aimed to buy the properties in exchange for debt, although only if labor and benefit costs were reduced.

The company confirmed a chapter 11 plan in March 2015. Consummation of the plan will not occur until rejection of the union contract is final.

The opinion is *In re Trump Entertaiment Resorts Inc.*, 810 F.3d 161 (3d. Cir. Jan. 15, 2016).

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Compensation

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Artful drafting cannot evade ASARCO to reimburse counsel for defense of fees.

Delaware Judge Categorically Bars All Counsel from Compensation for Defense of Fees

Bankruptcy Judge Mary F. Walrath in Delaware categorically barred lawyers from circumventing the Supreme Court's opinion in *Baker Botts LLP v. ASARCO LLC* by refusing to approve a retention application requiring the debtor to compensate committee professionals for successfully defending their fees.

In June, the Supreme Court held 6-3 in *ASARCO* that debtors' counsel in bankruptcy cases cannot be paid for successfully defending their fee requests. In Delaware, the reorganization of Boomerang Tube LLC became a test case to decide whether lawyers could sidestep *ASARCO* by incorporating the reimbursement of defense costs into a retention agreement approved up front by a bankruptcy judge.

In a footnote at the very end of her opinion, Judge Walrath in substance said that no form of artful drafting, even by the debtor's lawyers, will pass muster because using estate funds to pay fee defense costs "are not reasonable terms of employment of professionals."

Theoretically, the *Boomerang* decision does not bind the other Delaware bankruptcy judges. However, judges ordinarily discuss important decisions with their brothers and sisters on the bench in the same district. It would therefore be surprising if another Delaware bankruptcy judge reached a different result.

The proposed retention agreement between the Boomerang creditors' committee and its lawyers would have required the debtor to pay the cost of a successful defense of fees. Committee counsel contended that providing for defense costs as a term of employment under Section 328(a) was permissible because *ASARCO* only barred reimbursement in the allowance of fees under Section 330(a). Judge Walrath did not buy that theory and knocked down every other argument proffered by committee counsel.

She barred the use of Section 328 as a vehicle for paying defense costs because it, like Section 330(a), was not a "specific and explicit statute" overriding the American Rule against fee-shifting. Judge Walrath said that while Section 328 does not prohibit defense costs, "it simply does not authorize them."

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Next, the committee contended that the engagement agreement fell under the so-called contract exception to the American Rule, allowing parties by contract to agree that the losing side pays everyone's lawyers. The argument was flawed, she said, because the debtor was not a party to the retention agreement. Even if the contract exception applied, Judge Walrath said she could not approve because fee-defense costs would not entail any services for the committee, only benefit the lawyers themselves.

Although *dicta*, Judge Walrath included a footnote at the very end of the opinion announcing she would not approve fee-shifting "in a retention agreement filed by any professional under Section 328(a) — including one retained by the debtor," because they would not be "reasonable terms of employment."

The opinion is *In re Boomerang Tube Inc.*, 548 B.R. 69 (Bankr. D. Del. Jan. 29, 2016).

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Fraudulent Transfers

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Posner pens a gem warning banks about ignoring signs of fraud.

Seventh Circuit Reverses District Court Again, Lowering Standard for 'Inquiry Notice'

The Seventh Circuit is no safe haven for banks holding information that should lead them to suspect that their customers are up to no good.

Circuit Judge Richard A. Posner reversed a Chicago district judge a second time in the chapter 11 liquidation of Sentinel Management Group Inc., a money-manager that improperly used customers' supposedly segregated funds for its own trading. When the case returned to the Seventh Circuit in August 2013 on a motion for rehearing *en banc*, a different three-judge panel reversed, saying the trustee "should be able" to void the bank's lien and recover $312 million paid on a loan.

On remand, District Judge James B. Zagel did not take the hint. In an opinion in December 2014, he once again upheld the security interest, despite evidence that the bank suspected fraud was afoot. Reversing again in an opinion on Jan. 8, Judge Posner said that "the first panel's opinion may have been unduly deferential in remanding this issue rather than reversing outright."

The case is about "inquiry notice" and the consequences of ignoring red flags. In the Seventh Circuit, mere negligence in failing to inquire into possible fraud can result in the loss of a bank's security interest.

Sentinel provided cash-management services and promised customers that their funds would be segregated. Using a secured line of credit with a bank, Sentinel traded for its own account. Following market reverses in 2007, Sentinel began improperly taking customer funds to use as collateral for its own bank loan. After Sentinel filed under chapter 11 in August 2007, the bank had a secured claim for $312 million, collateralized by money that should have been segregated for customers. Sentinel sought a trustee four days after the chapter 11 filing.

Pursuant to Sentinel's chapter 11 plan, the trustee sued the bank in district court to void the security interest and subordinate the bank's debt. The trustee contended that transferring customer funds to the bank was a fraudulent transfer with "actual intent" under Section 548(a)(1)(A). The bank could retain the collateral if it was in "good faith" as required by Section 548(c), Judge Posner said.

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After a lengthy trial, District Judge Zagel exonerated the bank, saying that an attempt to "stay in business" by stealing from one creditor to pay another represented a motive not constituting intent to defraud. Writing for the appeals court on the first appeal, Circuit Judge John D. Tinder said that "someone who has the best intentions can still possess actual intent to defraud."

Sending the case back to the district court on remand, Judge Tinder said the bank could raise defenses, such as having made the loan to Sentinel in good faith. He also said the so-called good-faith defense is unavailable to someone with "sufficient knowledge to place him on inquiry notice of the debtor's possible insolvency."

Judge Tinder went on to add that the bank "will have a very difficult time proving that it was not on inquiry notice of Sentinel's possible insolvency."

On remand, District Judge Zagel stuck by his guns and let the bank off the hook a second time. When the case came up again, Circuit Judge Posner said that Judge Zagel misunderstood "the concept of inquiry notice." Establishing an objective standard, he said that inquiry notice "is not knowledge of fraud or other wrongdoing but merely knowledge that would lead a reasonable, law-abiding person to inquire further."

The damning evidence was a banker's message to a subordinate asking whether the bank had rights to the collateral and how Sentinel could post $300 million when it only had $20 million in capital. The banker got an evasive answer from the underling, and the inquiry went no further.

That "puzzlement," according to Judge Posner, was enough to put the bank on inquiry notice. He went on to say that "knowing or turning a blind eye" to misconduct would make the bank guilty of fraud "but was not required to establish inquiry notice."

Although the bank lost on the fraudulent transfer question, thus voiding its security interest, the second question on appeal dealt with equitable subordination, which the bank won. On that issue, Judge Posner upheld the district court, allowing the bank to retain an unsecured claim for $312 million.

Judge Posner said that reason to suspect wrongdoing is negligent, but negligence is not enough for equitable subordination, which requires conduct that is egregious or tantamount to fraud.

The opinion rejected two other defenses proffered by the bank. Judge Posner said that Section 550(b)(1) does not apply because voiding a lien is not the same as recovering an asset. He also barred the use of Section 550(d) because there was no double recovery by the trustee.

The Sentinel appeals hint at intrigue behind the scenes in the Seventh Circuit. The first time the case came up on appeal, the original three-judge panel upheld Judge Zagel in August 2012.

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After the trustee filed a motion for rehearing *en banc*, the three judges withdrew their first opinion, reversed, and remanded in August 2013, as described above. One wonders whether other judges on the circuit suggested to the original panel that they should reconsider to avoid a reversal *en banc*.

The Jan. 8 opinion is noteworthy because Circuit Judge Frank Easterbrook was on the panel. Judges Posner and Easterbrook often author the Seventh Circuit's most important bankruptcy opinions. Only Circuit Judge Ilana D. Rovner was on both panels.

The opinion is *Grede v. Bank of New York Mellon Corp.*, 809 F.3d 958 (7th Cir. Jan. 8, 2016).

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Later bankruptcy is no proof of prior inadequate capitalization.

Subjective Test Without Hindsight Employed to Determine Adequate Capitalization

In evaluating a constructively fraudulent transfer claim, the Third Circuit held that a debtor's subjective belief is pivotal in deciding whether the debtor had sufficient capital.

The appeal arose in the aftermath of the confirmation of SemGroup LLP's chapter 11 plan. A creditors' trust established by the plan sued for the recovery of distributions to shareholders made within two years of bankruptcy. Upheld in district court, the bankruptcy court conducted a trial and found that the creditors' trustee did not prove that SemGroup had inadequate capital at the time of the distributions.

The Third Circuit affirmed in a non-precedential opinion on April 28 written by Circuit Judge Thomas I. Vanaskie.

The trustee conceded that the company had adequate capital if it could borrow under the bank credit agreement. To overcome the fact that the company in fact borrowed after the distributions were made, the trustee argued that SemGroup would have been unable to borrow had the banks known about the company's "allegedly improper trading strategy."

The bankruptcy and district courts declined to speculate about what the banks might have done had they known about the trading. Agreeing, Judge Vanaskie said, "Absent the bias of hindsight, it simply cannot be said that SemGroup was likely to be denied access to a credit facility," given the banks' alternatives such as restructuring the loan or requiring the sale of assets. On the facts shown at trial, it was significant, Judge Vanaskie said, that the trading strategy was not cited by the banks when they declared a default later.

The opinion is perhaps most important for its focus on the borrower's subjective belief. The opinion said that the trustee did not "show that SemGroup could reasonably foresee either that its trading strategy would fail or that the bank group would declare a default based upon that trading strategy."

The opinion mentions several times that the outcome might have been different were there fraud or deception. "The trustee presented no evidence that SemGroup tried to disguise its trading strategy from the bank group or acted deceptively," the opinion says.

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The opinion is *In re SemCrude LP*, 14-4356, 2016 BL 135006 (3d Cir. April 28, 2016).

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Preferences, Claims & 'Flip Clauses'

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Seventh Circuit lauds Judge Lane's
Quebecor World ***preference opinion.***

Seventh Circuit Broadens 'Ordinary Course' Defense to Benefit Suppliers

The Seventh Circuit, reversing the bankruptcy court, interpreted the so-called ordinary course defense to benefit suppliers by helping them fend off preference suits.

According to the June 10 opinion by Circuit Judge Diane S. Sykes, the bankruptcy court should have allowed the defense for payments in the preference period that fell within the range representing 88% of payments before the onset of financial difficulties.

In a chapter 11 case, the creditors' committee sued a supplier for $587,000 in preferences on 23 invoices paid within 90 days of bankruptcy. The bankruptcy judge held that the creditor received about $306,000 in preferences after applying the ordinary course defense in Section 547(c)(2)(A), which absolves a creditor from liability for receipt of a preference made in the ordinary course of business or made according to ordinary business terms. Subtracting some $63,000 in new value defenses, the bankruptcy judge entered judgment for about $243,000 against the creditor.

When Judge Sykes got through explaining why the bankruptcy judge misapplied the ordinary course defense, the creditor had no liability whatsoever.

The "subjective ordinary course defense," according to Judge Sykes, inquires as to whether payments to the creditor during the preference period "are consistent with the parties' practice *before* the preference period." The court therefore must establish a "baseline" to "reflect the payment practices that the companies established before the onset of any financial difficulties."

To determine the baseline, Judge Sykes said that courts either use the "average lateness method" or the "total-range method." The average approach uses the average invoice age in the historical period, while the total-range method "uses the minimum and maximum invoice ages during the historical period to define an acceptable range of payments." She said it was not error for the bankruptcy judge to have used the average age method.

To establish a baseline for payments before the onset of financial trouble, the bankruptcy judge calculated the average invoice age as 22 days and added six days to both ends. Consequently, payments were not eligible for the ordinary course defense unless they were made within 16 to 28 days, according to the bankruptcy judge.

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Judges Sykes said the bankruptcy court erred in applying the average age method. She said it was "clear error" to limit the defense to six days on either side of the average, because that spread would cover only 64% of payments in the historical period. Significantly, she said the bankruptcy judge gave "no explanation" for the narrow range.

By adding two days to the bankruptcy court's spread, thus making the defense applicable to payments within 14 and 30 days, 88% of payments in the historical period would have been immunized. Judge Sykes thus concluded that the 16- to 28-day window was "not only excessively narrow but also arbitrary."

Even the 14- to 30-day window was not inflexible. Judge Sykes held that payments "just outside" of that time frame are also covered by the defense. As a result, she made the defense applicable to a payment in 31 days.

In conclusion, Judge Sykes held that the defense did not apply only to payments 37 and 38 days after the invoices were issued, making the creditor liable for about $61,000. Since the creditor had some $63,000 in new value defenses, the creditor walked away from the appeal with no liability at all.

Bankruptcy Judge Sean H. Lane of Manhattan came off looking good. Judge Sykes approvingly cited his *Quebecor World* opinion several times for his approach to the ordinary course defense.

The opinion is *Jason Foods Inc. v. Unsecured Creditors' Committee*, 2016 WL 3213096 (7th Cir. June 10, 2016).

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Debtor-friendly opinion validates strategy for cramming down on secured lender.

Claim Buyer Doesn't Acquire Seller's Insider Status, Ninth Circuit Holds

Over a cogent dissent, the Ninth Circuit approved a strategy for cramming down a plan by manufacturing an accepting creditor class eligible to vote "yes."

The corporate debtor in this case had a problem: There were only two creditors. One was a bank with a $10 million secured claim. The other was the debtor's general partner, which had a $2.8 million unsecured claim.

As an insider, the general partner's vote in favor of the plan could not be counted under Section 1129(a)(10). For lack of an accepting class, the plan could not have been confirmed and crammed down, because the bank opposed the plan.

To solve the problem, the general partner sold its claim for $5,000 to a close friend of one of the owners of the general partner. The plan called for a $30,000 distribution on the unsecured claim.

The bankruptcy judge ruled that the buyer automatically became an insider upon purchasing the claim. The Bankruptcy Appellate Panel reversed and was upheld in a 2-1 opinion, with Circuit Judge N. Randy Smith writing for the majority.

The case turned on the definition of "insider" contained in Section 101(31), which names several types of people, known as statutory insiders, who are automatically insiders. By the definition's use of the word *including*, Judge Smith said that others become "non-statutory insiders" if they have "a sufficiently close relationship with the debtor to fall within the definition."

In the principal holding of the case, all three judges, including the dissenter, agreed that a "person does not become a statutory insider solely by acquiring a claim from a statutory insider." Judge Smith said that the Code distinguishes between the status of a claim and the status of a creditor. Insider status, he said, pertains only to the claimant.

Consequently, Judge Smith said that status as an insider entails a "factual inquiry that must be conducted on a case-by-case basis." To become an insider, a claim buyer "must have a close relationship with the debtor and negotiate the relevant transaction at less than arm's length," he said.

If a buyer were automatically an insider, Judge Smith said that the purchaser would be foreclosed from voting even if the transaction was negotiated at arm's length.

The bankruptcy judge had determined that the buyer was not an insider based on his conduct and relationship with the debtor and its owners. Since the buyer as a matter of law did not become an insider by purchasing the insider's claim, the majority on the circuit court upheld the appellate panel because the bankruptcy judge's findings of fact on insider status were not clearly erroneous.

Circuit Judge Richard R. Clifton dissented in part. To him, it was "clear" that the buyer should have been deemed an insider. In his view of the facts, the sale was not negotiated at arm's length.

The case had an interesting twist that is likely to arise in similar situations. During pretrial discovery, the bank offered to purchase the claim from the buyer for $50,000 and later raised the offer to $60,000. The offer was not accepted and eventually lapsed.

Neither the appellate panel nor the circuit judges bought the bank's argument that refusing the offer showed bad faith.

The opinion is *U.S. Bank NA v. The Village at Lakeridge LLC (In re The Village at Lakeridge LLC)*, 13-60038, 634 Fed.Appx. 619 (9th Cir. Feb. 8, 2016).

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Judge Chapman rejects former Judge Peck's opinion invalidating flip clauses in swaps.

Two New York Judges Disagree on Anti-*Ipso Facto* Law and Lehman Flip Clauses

Despite the anti-*ipso facto* clause in the Bankruptcy Code, a properly drafted flip clause can be enforceable when terminating a swap agreement even after bankruptcy, according to an opinion by Bankruptcy Judge Shelley C. Chapman, who disagrees with former Bankruptcy Judge James M. Peck from whom she inherited the Lehman Brothers bankruptcy.

Even if there were a violation of the *ipso facto* clause, Judge Chapman ruled in her 55-page opinion on June 28 that a flip clause is enforceable under the exception to the automatic stay in Section 560 of the Bankruptcy Code, again disagreeing with decisions Judge Peck handed down before he retired from the bench in 2014.

After former Judge Peck's first decision on the issue in 2010, it looked as though flip clauses were unenforceable in bankruptcy. Resulting in part from intervening Second Circuit authorities, the tables turned 180 degrees, making flip clauses now generally valid, assuming Judge Chapman's analysis holds up on appeal.

Lehman and Flip Clauses

On filing for chapter 11 protection in September 2008, Lehman Brothers Holdings Inc. and its subsidiaries had thousands of swaps in their portfolios, some including so-called flip clauses. The flip provisions came into play when Lehman was "in the money" at the outset of bankruptcy and stood to recover from termination of the swaps.

Without going into detail about the alternative ways in which flip clauses were drafted, suffice it to say that the provisions provided that collateral ordinarily would go first to Lehman subsidiary Lehman Brothers Special Financing Inc. (known as LBSF) as the swap counterparty in an ordinary maturity or termination.

On the other hand, if the Lehman parent or LBSF were to file bankruptcy, thus creating an event of default, the swap counterparty could terminate the swap prematurely. In those situations where Lehman or LBSF was the defaulting party, the flip clause would kick in and send the collateral proceeds first to noteholders. Since noteholders were never paid in full, LBSF got nothing when the flip clauses were invoked.

In 2010, Lehman sued 250 defendants in bankruptcy court, contending that the flip clauses violated anti-*ipso facto* provisions in Sections 365(e)(1), 541(c)(1)(B) and 363(l) of the Bankruptcy Code. Lehman contended that flip clauses were invalid because those subsections say that contractual provisions are unenforceable if they become effective on insolvency or bankruptcy.

In different adversary proceedings involving different counterparties, Judge Peck wrote decisions in 2010 and 2011 where he agreed with Lehman and concluded that flip clauses violated the anti-*ipso facto* statutes. He also decided that § 560 did not apply. Neither of those decisions went up on appeal, and no other court in the meantime has pronounced on the validity of flip clauses in bankruptcy.

When Judge Peck left the bench, Judge Chapman took over the Lehman bankruptcy, including the adversary proceeding that gave rise to her decision in late June.

Judge Chapman's Rationale

The defendants filed motions to dismiss, which Judge Chapman granted except for a pair of transactions with different facts where the defendants had not filed Rule 12(b)(6) motions. Judge Chapman disagreed with Judge Peck because she interpreted the Bankruptcy Code differently.

Among the defendants, there were important factual differences, allowing Judge Chapman more easily to dismiss as to some of them. The factual distinctions arose because the Lehman parent filed bankruptcy 18 days before LBSF. In all the transactions, LBSF was the swap party, and the Lehman parent was the guarantor of LBSF's obligations. The first bankruptcy filing by the Lehman parent was a default giving the right to terminate the swaps with LBSF.

Some of the defendants terminated the swaps after the parent's bankruptcy but before LBSF's, and in others, the termination did not occur until after LBSF's own chapter 11 filing. For Judge Peck, timing was important. In his 2010 decision, a termination after LBSF's bankruptcy made it easier for him to rule that invoking the flip clause violated anti-*ipso facto* law. In *dicta*, however, Judge Peck said the result would have been the same even for terminations that came before the LBSF bankruptcy.

Analyzing § 560, which permits termination of swaps, Judge Chapman said it did not matter whether termination was before or after LBSF's bankruptcy.

Judge Chapman divided the cases into two groups. Depending on how the swaps were written, one set of cases, the majority, did not even involve flip clauses, she said.

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In what she called Type I cases, the swaps were written so LBSF would get the collateral on termination. The Type I agreements contained flip provisions switching the priority in collateral distribution to the counterparties if Lehman were the defaulting party.

Type II agreements contained no flip clauses, Judge Chapman said. Instead of changing the priority of distribution, Type II swaps had two different distribution regimes, one when Lehman filed bankruptcy and the other when Lehman did not default.

According to Judge Chapman, Type II agreements had no flip clauses because there was no modification of Lehman's rights, just the application of the appropriate distribution regime. Consequently, counterparties with Type II agreements could terminate swaps under § 560 without running afoul of anti-*ipso facto* provisions because there were no flip clauses in the first place. In other words, adroit drafting could result in a different result without changing the substance of the underlying agreements.

Even if Type II agreements were interpreted as having flip clauses, Judge Chapman next held that the flip clauses were enforceable under § 560 if termination took place before the LBSF bankruptcy, even if distribution of proceeds occurred after LBSF's bankruptcy. She held that the language in §§ 365(e)(1), 541(c)(1)(B) and 363(l) only bars modifications of debtors' rights for actions taking place after bankruptcy.

Debunking the 'Single Event' Theory

Judge Peck invalidated terminations and distributions that occurred before LBSF's bankruptcy using what he called the "single event" theory. He focused, for instance, on the language in § 365(e)(1)(B) which bars modification of rights based on commencement of "a" bankruptcy case, not "the" bankruptcy of "the" debtor invoking the anti-*ipso facto* laws.

Judge Chapman disagreed. She said the statutory references to "the case" can refer "only to the case of the debtor who is a party to the relevant executory contract."

Consequently, Judge Chapman declined to adopt the single event theory and exercised discretion not to follow Judge Peck's decisions as law of the case.

Section 560 Validates Flip Clauses in Any Event

Even if he had been correct up to this point, Judge Chapman again disagreed with Judge Peck and still validated the flip clauses under § 560. She said that Judge Peck's narrow interpretations of § 560 preceded decisions from the Second Circuit giving safe harbors "broad and literal interpretation." Among the decisions she cited was *Tribune*, decided in March. To read ABI's discussion of *Tribune*, click here.

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Lehman argued that § 560 does not apply to flip clauses because that section pertains only to "liquidation, termination, or acceleration" of swap agreements. In Lehman's view, altering the priority of distribution was neither liquidation, termination, nor acceleration.

Given how the Second Circuit believes that safe harbors must be interpreted broadly, Judge Chapman declined to give § 560 a narrow interpretation.

Where Do We Go Next?

With the amount of money involved, Lehman is unlikely to roll over and play dead following Judge Chapman's decision. However, the time for appeal has not arrived because dismissal orders are yet to be entered.

If there is an appeal, Lehman can argue that Judge Chapman's decision elevates form over substance by holding that adroit drafting can turn a flip clause into something else.

Even victory on that issue will not carry the day unless Lehman can turn the tide in the Second Circuit by convincing the appeals court to reverse course and narrowly construe a safe harbor.

Very possibly, Lehman's fate is sealed in the Second Circuit. To succeed, Lehman may need another appeals court to create a conflict of circuits on the safe harbors, so the Supreme Court can take up the issue.

The opinion is *Lehman Brothers Special Financing Inc. v. Bank of America NA (In re Lehman Brothers Holdings Inc.)*, 10-ap-3547 (Bankr. S.D.N.Y. June 28, 2016).

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BAPs, Subordination & Dismissal

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BAPs weren't created by Congress,
Ninth Circuit holds over vigorous dissent.

BAPs Lack Jurisdiction to Issue *Mandamus* Writs, Ninth Circuit Majority Holds

[The Ninth Circuit granted rehearing *en banc* in this case. Consequently, the panel opinion discussed below was withdrawn. The *en banc* decision expected next year will resolve or raise significant constitutional issues regarding Bankruptcy Appellate Panels.]

Over a vigorous dissent, the Ninth Circuit held that Bankruptcy Appellate Panels were not "established by an Act of Congress" and thus lack jurisdiction to issue writs of *mandamus* under the All Writs Act contained in 28 U.S.C. Section 1651(a).

Circuit Judge Jay S. Bybee "emphatically" dissented. Although he agreed with the judgment, Judge Bybee "vigorously" disagreed "with everything else" in the majority's opinion written by Circuit Judge J. Clifford Wallace.

The appeal arose from a home foreclosure 15 years ago. *Pro se*, the homeowner filed multiple, uniformly unsuccessful proceedings in bankruptcy court and on appeal, alleging that foreclosure violated the automatic stay. His most recent loss was in 2012, when the Ninth Circuit's Bankruptcy Appellate Panel denied his *mandamus* petition after the bankruptcy court held there was no jurisdiction to adjudicate an alleged stay violation long after the bankruptcy case had been closed.

Without briefing from the parties or seeking *amicus* briefs on the issue, the Ninth Circuit *sua sponte* held in Judge Wallace's opinion on March 25 that BAPs were not "established by an Act of Congress." Instead, the majority concluded that BAPs were created at the "discretion" of the "judicial council of each circuit" under 28 U.S.C. Section 158(b)(1).

The majority said that BAPs are created "on a temporary basis" and have "none of the permanency of a court." Rather than having been created by Congress, they result from the "independent action" of a "third party," namely, the judicial councils in each circuit, and thus lack jurisdiction to entertain *mandamus* petitions.

Dissenting, Judge Bybee said that BAPs are "plainly a court established by an Act of Congress." He would have reached the merits and upheld dismissal of the *mandamus* petition on several grounds, such as *res judicata*, since the debtor had lost the same argument several times before.

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Judge Bybee said the majority altered the All Writs Act by requiring that courts be "directly" created by Congress as a condition to having jurisdiction for issuing writs. That conclusion, he said, "grinds an axe with which to cut the BAP off at the knees."

The majority's opinion, he said, "raises serious constitutional concerns with the separation of powers" and "is going to cause us major constitutional headaches."

In his view, BAPs are not "some mere tribunal or administrative adjunct." They are, he said, an "alternative to federal district courts" and are "treated by statutes as equal in authority to the district court." He pointed out how three circuits have held that bankruptcy courts themselves can issue writs of *mandamus*. The majority, he said, "left the BAP out in the cold."

By holding that BAPs are established by a circuit's judicial councils, Judge Bybee said the majority raised a "troubling question: Can Congress delegate its power to create courts to the judicial branch?" Judge Bybee said he was "deeply skeptical of the constitutionality of such an arrangement."

In view of the Ninth Circuit's 1992 holding in *Perroton v. Gray*, "It is bizarre that a circuit that is the most supportive of BAPs is the most restrictive of its powers," said Prof. Bruce A. Markell of the Northwestern Univ. Pritzker School of Law. In an e-mail, Prof. Markell explained how the Ninth Circuit BAP had to perform "mental gymnastics" whenever a litigant would ask for *in forma pauperis* status. The BAP was forced to call on district judges to grant so-called IFP status since that ability was restricted by *Perroton* to "courts of the United States." Prof. Markell was a bankruptcy judge in Las Vegas and a panelist on the Ninth Circuit BAP before returning to teaching.

The majority's opinion does not address the ability of bankruptcy courts or BAPs to issue writs under the version of the All Writs Act contained in Section 105(a) of the Bankruptcy Code. The majority overruled a 2002 decision by the Ninth Circuit's BAP, which had held they had power to issue writs.

The opinion is *Ozenne v. Chase Manhattan Bank (In re Ozenne)*, 818 F.3d 514 (9th Cir. March 25, 2016).

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Lehman co-underwriters are stuck with worthless contribution claims.

Second Circuit Broadly Reads Claim Subordination Under Section 510(b)

Co-underwriters with Lehman Brothers Inc. do not have contribution claims against the liquidated investment bank arising from offerings in which the Lehman broker was the lead underwriter in the sale of its parent's securities, according to a Dec. 14 decision in the Second Circuit upholding two lower courts.

The appeals court decision, by Circuit Judge Dennis Jacobs, revolved around an interpretation of Section 510(b), which subordinates claims based on the purchase or sale of securities to the same level as the securities themselves. *Lehman* presented a twist on the typical case because the co-underwriters were raising claims against the Lehman broker that was not the issuer of the securities.

Bankruptcy Judge James M. Peck ruled in January that hedge fund managers and underwriters in substance do not have claims to be paid in the Lehman brokerage liquidation under the Securities Investor Protection Act. Judge Peck's opinion was upheld in September 2015 by District Judge Shira A. Scheindlin in Manhattan. Judge Jacobs' opinion for the appeals court adopted Judge Scheindlin's rationale.

The underwriters filed contribution claims against the Lehman broker as lead underwriter, claiming that the bankrupt brokerage was liable to them for its share of the costs of defense and settlements after being sued for misstatements when the Lehman parent sold its securities. One underwriter claimed $78 million, while another sought $250 million.

The underwriters argued that Section 510(b) did not apply because the securities were sold by the Lehman parent, not by the Lehman brokerage itself. Judge Jacobs rejected the underwriters' narrow reading of the statute. The circuit's opinion is based on both the rules of statutory construction and legislative history.

Judge Jacobs held that "claims arising from securities of a debtor's affiliate should be subordinated in the debtor's bankruptcy proceeding to all claims or interests senior or equal to claims in the bankruptcy proceeding that are of the same type as the underlying securities."

In the affiliate context, the underwriters unsuccessfully contended that Section 510(b) is invoked only if the affiliated companies are substantively consolidated or if one affiliate guaranteed payment of another's obligation. Judge Jacobs saw no "textual hook" for a narrow reading of the statute.

The *Lehman* decision shows how a law review article can be pivotal more than 40 years after publication. In discerning congressional intent, Judge Jacobs relied heavily on a 1973 article by Profs. Homer Kripke and John Slain advocating for the "risk-allocation rationale" that was eventually adopted in Section 510(b).

Quoting the circuit's 2006 *Enron* decision, Judge Jacobs said that the rationale behind Section 510(b) prevents "disappointed shareholders from recovering their investment losses by using fraud and other securities law claims to bootstrap their way to parity with general unsecured creditors." He added that every lower court to confront the affiliate-securities issue reached the same result.

When affiliates have differing capital structures, Judge Jacobs said it could be "messy" to figure out where the subordinated claims should lodge in the distribution waterfall. Since the bankruptcy court is a court of equity, and bankruptcy judges have experience in deciding how to classify claims, Judge Jacobs said that bankruptcy courts are "best situated" to pigeonhole subordinated claims into distribution schemes. In the *Lehman* case, he said, it won't much matter because unsecured creditors, whose claims have priority over the underwriters' subordinated claims, will consume the entire unsecured estate.

The opinion is *BMO Capital Markets Corp. v. Giddens (In re Lehman Brothers Inc.)*, 808 F.3d 942 (2d Cir. Dec. 14, 2015).

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Third Circuit ditches an otherwise proper involuntary petition for creditors' bad faith.

Third Circuit Widens Split on Bad-Faith Dismissal of Involuntary Petition

The Third Circuit split with the Ninth and sided with the Fourth in holding that bankruptcy courts can dismiss involuntary petitions if the petitioning creditors did not file them in good faith.

The case entailed typically protracted litigation between two companies. Three related creditors won a $300,000 judgment in arbitration but were facing a lawsuit in which the alleged bankrupt was seeking $5 million. Before the lawsuit came to trial, the creditors filed an involuntary chapter 7 petition against their adversary.

At trial, the bankruptcy judge found that the petitions satisfied the tests in Section 303 for ordering relief in the involuntary case. Nonetheless, the bankruptcy judge dismissed the petition based on the petitioners' bad faith.

The bankruptcy judge found the creditors in bad faith because they were trying to frustrate the debtor's pending lawsuit and were attempting to collect the arbitration award.

The district court affirmed dismissal, and so did the Third Circuit in an Oct. 16 opinion by Circuit Judge Julio M. Fuentes.

The creditors argued unsuccessfully that the bankruptcy court "shall order relief" if the requirements of Section 303(h)(1) have been met. Judge Fuentes disagreed with the Ninth Circuit and lower courts that are "receptive to this position."

The Third Circuit's holding was buttressed by Section 303(i)(2), which permits an award of damages against creditors who file involuntary petitions in bad faith. The appeals court interpreted the section as allowing bad faith to serve as the basis for dismissal, as well as damages.

To ignore a petitioner's bad faith would "overlook the equitable nature of bankruptcy," Judge Fuentes said. He went on to observe that courts display a "dizzying array" of standards to determine whether a petition was filed in bad faith. The opinion adopts a "totality of the circumstances" test because it is the "most suitable for evaluating the myriad ways" a creditor can act in bad faith.

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The case is *In re Forever Green Athletic Fields Inc.*, 804 F.3d 328 (3d Cir. Oct. 16, 2015).

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Fair Debt Collection Practices Act

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Eighth Circuit says bankruptcy adequately protects debtors from assertion of stale claims.

Circuits Starkly Split on Filing Time-Barred Claims as Violations of the FDCPA

There is now a stark split among the circuits on the question of whether the filing of a claim based on a time-barred debt violates the federal Fair Debt Collection Practices Act, or FDCPA.

In 2014, the Eleventh Circuit held in *Crawford v. LVNV Funding LLC* that filing a proof of claim barred by a statute of limitations violates the FDCPA. On July 11, the Eighth Circuit ruled to the contrary, holding that filing an accurate proof of claim is no violation of the FDCPA even though, the court implies, attempting to collect a similarly time-barred debt outside of bankruptcy would give rise to FDCPA liability.

In *Crawford*, the Eleventh Circuit said it was bent on stemming what it called a "deluge" of claims filed in bankruptcies that attempt to collect "debts deemed unenforceable under state statutes of limitations."

The Eleventh Circuit analyzed the issue in part by focusing on the effect that the filing of stale claims has on the bankruptcy process and on creditors. Because they ordinarily will not benefit from expunging claims, debtors in chapter 7 cases have no incentive for objecting to stale claims, the Atlanta-based circuit court said.

The Eleventh Circuit noted that chapter 7 trustees also may not object, given their meager compensation. Likewise, chapter 13 debtors with so-called pot plans similarly have no incentive for objecting to time-barred claims. Consequently, creditors with enforceable claims will have diminished recoveries if creditors with stale claims receive distributions from limited funds, because trustees and debtors do not object comprehensively to claims.

The Eighth Circuit's opinion by Circuit Judge Duane Benton said that the Eleventh Circuit's *Crawford* decision "ignores the differences between a bankruptcy claim and actual or threatened litigation."

Judge Benton interpreted the Eleventh Circuit as holding that filing a claim stemming from a stale debt violates the FDCPA's "prohibitions against unfair, unconscionable, deceptive, or misleading conduct." Disagreeing with *Crawford*, Judge Benton said that the "bankruptcy process protects against such harassment and deception."

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"Unlike defendants facing a collection lawsuit," Judge Benton said that "a bankruptcy debtor is aided by 'trustees who owe fiduciary duties to all parties and have a statutory obligation to object to enforceable claims.'" He also said that "debtors have less at stake than a collection defendant" because their liabilities are capped by the loss of non-exempt property.

"There is no need to protect debtors who are already under the protection of the bankruptcy court, and there is no need to supplement the remedies afforded by bankruptcy itself," Judge Benton said.

One or more FDCPA cases may be headed for the Supreme Court, as early as the term to begin in October, because the Eleventh Circuit handed down *Johnson v. Midland Funding LLC* on May 24, holding, contrary to Second and Ninth Circuits, that the later-adopted Bankruptcy Code did not impliedly repeal the FDCPA with respect to debt collectors who file claims barred by statutes of limitations.

The Eleventh Circuit in *Johnson* sided with the Seventh Circuit's *Randolph* decision from 2004, which had held that debt collectors can comply with both the Bankruptcy Code and the FDCPA. In *Johnson*, there is a pending petition for rehearing *en banc*. To read ABI's analysis of *Johnson*, click here.

The opinion is *Nelson v. Midland Credit Management Inc.*, 15-2984, 2016 BL 221120 (8th Cir. July 11, 2016).

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Appeals court finds no 'irreconcilable conflict' between the FDCPA and the Bankruptcy Code.

Eleventh Circuit Rules Against Debt Collectors, Deepening Split of Circuits on the FDCPA

Differing with the Second and Ninth Circuits, the Eleventh Circuit deepened an existing split of circuits, opening the door for the Supreme Court to decide whether the Bankruptcy Code impliedly repealed the federal Fair Debt Collection Practices Act to the extent of allowing debt collectors to file claims that are barred by statutes of limitations.

The ruling by Circuit Judge Beverly B. Martin on May 24 was not a surprise, because the Eleventh Circuit had held in 2014 in *Crawford v. LVNV Funding LLC* that filing a stale claim barred by a statute of limitations violates the FDCPA. In *Crawford*, the appeals court did not consider and explicitly left open the question of whether the later-adopted Bankruptcy Code impliedly repealed the FDCPA, thereby allowing the filing of claims based on stale debts.

Judge Martin's opinion, which came down less than six weeks after oral argument, answered the unresolved question by holding that there is no irresolvable conflict between the two statutes because they "can be construed together in a way that allows them to coexist."

While the Bankruptcy Code "certainly allows all creditors to file proofs of claim in bankruptcy cases," Judge Martin said that the "Code does not at the same time protect those creditors from all liability." Consequently, she said that a "particular subset of creditors – debt collectors – may be liable under the FDCPA for bankruptcy filings they know to be time-barred." As a result, she reversed the lower court in two cases where District Judge William H. Steele from Mobile, Ala., dismissed FDCPA suits on the theory that the Bankruptcy Code allows the filing of stale claims.

The policy underpinning *Crawford* was impossible to ignore. In that case, the appeals court said it was bent on stemming what it called a "deluge" of claims filed in bankruptcy attempting to collect "debts deemed unenforceable under state statutes of limitations."

Because they do not stand to benefit, debtors in chapter 7 cases have no incentive for objecting to stale claims. Given their meager compensation, chapter 7 trustees similarly may not object. Likewise, chapter 13 debtors with so-called pot plans also have no incentive for objecting to time-barred claims. Consequently, creditors with enforceable claims will have diminished recoveries. It is also noteworthy that an industry was created where a few companies pay

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miniscule sums to buy stale claims in bulk, knowing that even a few recoveries will make their businesses profitable.

Judge Steele declined to follow *Crawford*'s policy insinuation because, in his opinion, "[a] clearer demonstration of irreconcilable conflict would be difficult to imagine." He analyzed Alabama law as meaning that the statute of limitations only extinguishes the remedy, not the debt itself. He then surveyed the Bankruptcy Code and its broad definition of "claim," and concluded that it permits the filing of a claim barred by a statute of limitations. Judge Steele then held that the Bankruptcy Code impliedly repealed the FDCPA when it comes to filing stale claims.

On the issue of implied repeal, Circuit Judge Martin cited older Supreme Court authority for the proposition that implied repeal results when there is an "irreconcilable conflict" between two federal statutes. She then cited the Supreme Court's 2007 *National Association of Home Builders* opinion for the principle that implied repeal is "not favored" and will not be presumed "unless the intention of the legislature to repeal is clear and manifest."

Given that the FDCPA makes only debt collectors liable for filing stale claims, Judge Martin reversed Judge Steele because there is no "irreconcilable conflict" between the two statutes.

Although Judge Martin's decision does not mention, cite or criticize the circuits that have held to the contrary, her opinion refutes the principal arguments espoused by those who believe there is implied repeal. The Eleventh Circuit is not alone. The Seventh Circuit held in *Randolph* in 2004 that the two statutes are not in irreconcilable conflict, although *Randolph* did not deal with stale claims; it involved FDCPA sanctions for violating the automatic stay.

The Eleventh Circuit decision therefore becomes a prime candidate for Supreme Court review. How soon that might occur is open to doubt because the losing debt collector can file a motion for rehearing *en banc*. The odds of success do not seem great because the circuit court denied *en banc* rehearing in *Crawford*, with no judge even requesting that the judges be polled. A *certiorari* petition was also denied. The new case is a better candidate for *certiorari* because *Crawford* did not raise the question of implied repeal.

The opinion is *Johnson v. Midland Funding LLC*, 15-11240, 2016 WL 2996372 (11th Cir. May 24, 2016).

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Circuit split grows on the conflict between the Bankruptcy Code and the FDCPA.

Second Circuit Charts a New Course Favoring Debtors on the FDCPA

The Second Circuit handed down a debtor friendly opinion on Jan. 4 accentuating an existing split of circuits and laying the foundation for the Supreme Court to decide whether the Bankruptcy Code precludes claims to any extent under the federal Fair Debt Collection Practices Act, or FDCPA.

A woman confirmed a five year Chapter 13 plan with monthly payments on her home mortgage, including payments to cure arrears. After completing her plan payments, she got a discharge in 2013 and soon thereafter defaulted on the mortgage.

The loan servicer dunned her for pre-discharge arrears and post-discharge payments she missed. The woman responded by suing for violations of the FDCPA, contending the lender was attempting to collect personal obligations on the mortgage that were discharged.

A district judge in Rochester, N.Y., dismissed the suit, holding that the Bankruptcy Code provided the debtor's exclusive remedy for attempting to collect a discharged debt. The district judge believed the proper procedure would have been a motion for contempt of the discharge injunction under Section 105(a).

Circuit Judge Jon O. Newman reversed and reinstated the suit in an opinion largely focusing on the concept of implied repeal.

One federal statute does not supersede another. Instead, when there is an "irreconcilable conflict" between two federal statutes, Judge Newman said the question is whether all or part of the earlier law was repealed "by implication," a concept that is "disfavored."

Judge Newman's opinion was constrained by the circuit's 2010 decision *Simmons v. Roundup Funding* which barred FDCPA claims during the pendency of a bankruptcy. He interpreted *Simmons* to mean that the FDCPA was inapplicable to claims during bankruptcy. That case, he said, did not mean that the FDCPA was impliedly repealed.

Judge Newman was able to reach a different result, and reinstate the FDCPA suit, by distinguishing the facts in *Simmons*, where the claim arose before discharge. The new case, argued in October, was based on actions taking place after discharge, when the debtor no longer had protection from the bankruptcy court, the circuit opinion said.

There is an extant conflict among the circuits, according to Judge Newman. The Ninth Circuit in 2002, he said, precludes FDCPA claims brought during bankruptcy. The Seventh Circuit, in 2004, said the statutes only "overlap" and lack any "irreconcilable conflict," enabling debt collectors able to comply with both simultaneously.

The Third Circuit similarly found no implied repeal.

Distinguishing *Simmons*, the Jan. 4 decision holds that the Bankruptcy Code did not "broadly repeal" the FDCPA for claims based on alleged violation of the discharge injunction.

Distinguishing the facts in *Simmons* rests tenuously on the notion that a debtor has no protection from the bankruptcy court after discharge. In reality, the debtor could reopen the case to enforce the discharge injunction and seek damages for contempt. In that respect, the new case and *Simmons* lay the groundwork for rehearing *en banc*, where all active circuit judges could consider if the Bankruptcy Code ever precludes claims under the FDCPA, since the Second and Seventh Circuits are not on the same page.

When debt collectors allegedly violate either the automatic stay or the discharge injunction, debtors prefer using the FDCPA because it carries more favorable remedies, including the automatic recovery of the plaintiff's attorneys' fees if the claim is upheld.

The opinion is Garfield v. Ocwen Loan Servicing LLC, 811 F.3d 86 (2nd Cir. Jan. 4, 2016).

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Georgia district judge confronts creditors who file claims based on stale debts.

An Allowed Claim Doesn't Bar an FDCPA Suit from Attacking the Same Debt

Assume that a creditor files a claim in a chapter 13 case, and neither the trustee nor the debtor objects. Can the debtor later mount a lawsuit against the creditor for filing a stale claim under the federal Fair Debt Collection Practices Act, or does *res judicata* preclude the FDCPA claim?

District Judge J. Randall Hall of Augusta, Ga., ruled on July 13 that *res judicata* does not apply.

A debtor had not made a payment on a debt since 1996 when she filed a chapter 13 petition in 2014. The creditor filed a proof of claim, even though collection would be barred by the statute of limitations. Neither the debtor nor the chapter 13 trustee objected to the claim.

After the bankruptcy court confirmed the plan, the debtor initiated a class suit in state court, alleging the creditor's routine filing of time-barred claims violates the FDCPA.

The creditor filed a motion to dismiss, which Judge Hall held in abeyance until the Eleventh Circuit decided *Johnson v. Midland Funding LLC* in May, creating a split of circuits by holding that the later-adopted Bankruptcy Code did not impliedly repeal the FDCPA with respect to debt collectors who file claims barred by statutes of limitations.

Naturally, Judge Hall ruled that *Johnson* "completely foreclosed" the lender's contention that the Bankruptcy Code supersedes the FDCPA because the Code permits filing stale claims. He still had to deal with the creditor's argument that the bankruptcy court's confirmation of the plan was a final judgment on the validity of the claim, thus barring the FDCPA suit on the grounds of *res judicata*.

Citing another court on the same issue, Judge Hall said that an "'FDCPA claim is an independent claim that has nothing to do with whether the underlying debt is valid.'" Where plan confirmation dealt with the validity or amount of the debt, he said the suit before him "is about whether defendants violated the FDCPA when they filed the proof of claim."

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He also said that the FDCPA claim does not arise from the same facts and "does not involve the same cause of action."

The creditor wanted the suit referred to the bankruptcy court if its motion to dismiss were denied. Employing the concept of permissive withdrawal of the reference, Judge Hall kept the class suit, saying that litigation in district court would conserve the parties' and judicial resources. He also said that the district court was better situated to handle the litigation because it was a class action where the plaintiff demanded a jury trial.

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

The opinion is *Willis v. Calvary Investment LLC*, 14-227 (S.D. Ga. July 13, 2016).

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Dischargeability

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High court should revisit* Kelly v. Robinson *from 1986, circuit court says.

Ninth Circuit Says 1980s Supreme Court Opinion Out of Step with Plain Meaning

The Ninth Circuit wrote an opinion on April 14 indirectly saying that the Supreme Court should overrule *Kelly v. Robinson*, where the high court held in 1986 that criminal restitution imposed as a condition for probation is nondischargeable under Section 523(a)(7).

Writing for the appeals court, Circuit Judge John B. Owens said that *Kelly* “untether[ed] statutory interpretation from the statutory language.” That approach, he said, “has gone the way of *NutraSweet* and other relics of the 1980s and led to considerable confusion.” He then went on to cite circuit court decisions from around the country that distinguish *Kelly* to the vanishing point.

Section 523(a)(7) bars the discharge of “a fine, penalty, or forfeiture payable to and for the benefit of a governmental unit” that is not compensation for “actual pecuniary loss.”

Although restitution in *Kelly* was payable to the victim of the crime and therefore seemingly outside of the boundaries of Section 523(a)(7), the Supreme Court nonetheless held that the debt was nondischargeable based on a “deep conviction” that bankruptcy courts should not invalidate state criminal proceedings.

The case before the Ninth Circuit involved a lawyer who violated state law by charging a client in advance for a mortgage modification. The client fired the lawyer and got an arbitration award requiring repayment of the entire fee. When the lawyer did not pay, the state bar suspended the lawyer’s license to practice until she repaid the fee.

Filing a chapter 7 petition, the lawyer sued the state bar in bankruptcy court under Section 525(a) for revoking a license “solely because” she had not paid a dischargeable debt. The bankruptcy court and the district court both held that the debt was nondischargeable.

On appeal, Judge Owens ruled that the fee was a dischargeable debt and reversed the lower courts. He relied in significant part on the Ninth Circuit’s 2010 decision in *Findley*, which held that the costs associated with state bar disciplinary proceedings are nondischargeable.

In the case on appeal, Judge Owens said, there were no costs payable to the state that were assessed for disciplinary proceedings, only a debt for receiving a fee improperly from a client. Furthermore, the debt was "compensation for actual loss," not a fine or penalty.

If the debt were not dischargeable, Judge Owens said that fee disputes with other licensed professionals like doctors, dentists or barbers would lead to nondischargeable debts.

The opinion is *Scheer v. State Bar of California (In re Scheer)*, 819 F.3d 1206 (9th Cir. April 14, 2016).

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Posner chides bankruptcy judge for reluctance to enter money judgment.

Power to Issue Money Judgment for Nondischargeable Debt Survives after *Stern*

Seventh Circuit Judge Richard A. Posner reassured bankruptcy judges that they do not commit constitutional error by granting a money judgment for a debt declared nondischargeable.

The bankruptcy judge, upheld in district court, ruled that a debt owing by an individual chapter 7 debtor was nondischargeable. Doubting whether he had constitutional power to issue a final judgment, the bankruptcy judge refused to enter a money judgment for the nondischargeable debt and was again upheld on appeal.

Judge Posner said there is jurisdiction to enter judgment for a nondischargeable debt because the proceeding is "related to" the bankruptcy case. That leaves open the question of whether the bankruptcy court has power to enter a final judgment in view of *Stern v. Marshall*.

Remanding the case, Judge Posner said there are two alternatives the bankruptcy judge "should consider." First, the bankruptcy court could determine whether the parties consented to entry of a final money judgment, thus invoking *Executive Benefits v. Arkison*. Second, the bankruptcy judge could make proposed findings of fact and conclusions of law for review in district court.

Indeed, the parties may have already consented, either impliedly or explicitly. The creditor filed the nondischargeability suit and thus may have impliedly or even explicitly consented to entry of judgment for the debt, and the debtor may have impliedly or explicitly consented by filing the chapter 7 petition in the first place. Both raise interesting questions about consent in the wake of *Executive Benefits*.

Judge Posner's opinion also establishes a precedent regarding appellate practice, because entering a money judgment in a dischargeability suit is ordinarily considered discretionary. Judge Posner, though, did not say whether he was remanding for abuse of discretion or commission of a legal error.

Judge Posner may have believed, without saying so directly, that doubting the bankruptcy court's constitutional power to enter a money judgment was legal error not requiring the appellate court to find an abuse of discretion. Or, perhaps Judge Posner believes that failing even to consider entry of a money judgment in itself was an abuse of discretion.

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The appeal entailed a separate issue *sub judice* in the Supreme Court involving dischargeability for actual fraud under Section 523(a)(2)(A). In *Husky v. Ritz*, the high court will decide whether there must be a misrepresentation made to the creditor to justify a finding of nondischargeability for actual fraud.

Although the Fifth Circuit in *Husky* required the existence of a misrepresentation to the creditor, a 2000 decision by Judge Posner in *McClellan v. Cantrell* did not.

In the Seventh Circuit case decided on April 5, the bankrupt arguably made a fraudulent transfer with actual intent to defraud. The creditor was unaware of the transfer, and the bankrupt had made no representation to the creditor about it.

The bankruptcy judge held that a pre-existing debt owing to the creditor was not rendered nondischargeable by the subsequent transfer with actual intent to defraud that made the debtor unable to repay the pre-existing debt.

Judge Posner also remanded the case to the bankruptcy court to await the outcome of *Husky*. If the Supreme Court reverses the Fifth Circuit and holds that a misrepresentation to the creditor is not required by Section 523(a)(2)(A), the high court will have vindicated Judge Posner's *McClellan* decision, and additional debts will become nondischargeable in the case decided this week.

The opinion is *Siragusa v. Collazo (In re Collazo)*, 817 F.3d 1047 (7th Cir. April 5, 2016).

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Lawyer's malpractice can satisfy* Bullock*'s recklessness standard for nondischargeability.

Seventh Circuit Allows Using Objective Evidence to Prove Subjective Recklessness

The Seventh Circuit expounded on the definition of "defalcation," which the appeals court said is "a word that only lawyers and judges could love."

The case allowed Circuit Judge David F. Hamilton to apply *Bullock v. BankChampaign NA*, the 2013 Supreme Court decision on Section 523(a)(4) holding there is no "defalcation" while acting in a "fiduciary capacity" unless the bankrupt had knowledge that the conduct was improper or there was gross recklessness about the improper nature of the action.

A lawyer filed bankruptcy after being socked in state court with a malpractice judgment for what Judge Hamilton called "egregious breaches of fiduciary duty." The lawyer claimed it was error to except the debt from discharge, contending that the bankruptcy judge applied an objective test.

Judge Hamilton's March 18 opinion is a scholarly exploration of "defalcation." In applying its definition to the facts of a case, he said it is permissible for the bankruptcy court to base its findings on circumstantial evidence. Although the judge could draw inferences about the lawyer's state of mind from objective circumstances, "the court applied the correct subjective standard," the opinion states.

"The bankruptcy court's finding of subjective recklessness," Judge Hamilton said, "was a reasonable finding from the circumstantial evidence."

The case is a reminder that lawyers must pay attention to ethical precepts even in small matters. As a consequence of receiving $400 for preparing documents for a real estate closing, the lawyer ended up with a $26,000 nondischargeable judgment for malpractice.

The opinion is *Estate of Stanley Cora v. Jahrling (In re Jahrling)*, 816 F.3d 921 (7th Cir. March 18, 2016).

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Eighth Circuit B.A.P. majority allows collection of disallowed priority claims.

Disallowance of Nondischargeable Debt Does Not Bar Later Collection, B.A.P. Says

In a split decision, the Eighth Circuit Bankruptcy Appellate Panel seemingly held that the holder of a priority domestic support claim can ignore a bankruptcy court order reducing the amount of the claim and, after discharge, collect the disallowed portion of the claim without violating the discharge injunction.

The majority opinion on June 13 was written by Bankruptcy Judge Robert J. Kressel of Minneapolis. The dissenter was Bankruptcy Judge Thomas L. Saladino of Lincoln, Neb.

The opinion could be read as encouraging priority creditors to ignore bankruptcy court orders reducing or disallowing their claims. On the other hand, the opinion might be understood more narrowly to mean that the creditor was able to collect a disallowed debt only because the bankruptcy court failed to formulate its opinion and order correctly.

A man filed a chapter 13 petition, listing his former wife as the holder of a priority unsecured domestic support obligation. The Missouri Division of Child Support Enforcement initially filed an unsecured priority claim for about $36,000. Later, the Division learned that it had incorrectly calculated the monthly support obligation and filed an amended claim for more than $88,000.

The debtor objected to the amended claim. The bankruptcy court held a hearing and disallowed the $88,000 claim while allowing the claim for $36,000, ruling that the Department had waived the excess under Missouri law by acquiescing to the lower payments after the children were emancipated.

The debtor confirmed his plan, paid the entire $36,000 allowed claim over his five-year plan and got a discharge. The Department never appealed the disallowance order or the plan confirmation order, so those orders became final.

After discharge, the Department began garnishing the debtor's salary to collect the disallowed portion of the domestic support claim. The debtor filed a contempt motion in bankruptcy court.

Finding the Department in willful contempt of the discharge injunction, the bankruptcy court held that the support obligation had been paid in full and directed the Department to cease

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collection activities. The bankruptcy court also imposed a $1,300 sanction on the state in compensation for the debtor's attorney's fees. The Department appealed and persuaded the majority on the B.A.P.

In a holding with which some may disagree, Judge Kressel for the majority said that the "discharge injunction does not apply to a nondischargeable domestic support obligation, even the disallowed portion."

The debtor argued that the doctrines of *res judicata* and collateral estoppel barred the state from contesting the amount of the claim. "While that may be true," the majority said they would not reach those theories "based on our conclusion that the Division did not violate the discharge injunction."

"Why even have a claim determination, then?," Prof. Bruce A. Markell asked after reading the majority's opinion. In a note to ABI, he mentioned how the appellate panel explicitly held, "[T]he bankruptcy court had jurisdiction to determine the Division's claim." He also noted that "the court precluded the debtor, as appellee, from raising an issue contained in the record because he hadn't raised it before the bankruptcy court. That's contrary to standard appellate practice; while appellants don't get to raise new issues on appeal, appellees usually can raise any issue found in the record that supports the judgment." Prof. Markell is the Professor of Bankruptcy Law and Practice at Northwestern Pritzker School of Law. He was a member of the Ninth Circuit B.A.P. before he returned to teaching.

Even though the bankruptcy court had jurisdiction to fix the amount of the claim for plan purposes, the B.A.P. majority evidently believe that the disallowed portion of the debt was a nondischargeable claim that survived bankruptcy.

The B.A.P. majority based their holding on the notion that the bankruptcy court only ruled about contempt of the discharge injunction and did not base its decision on violation of the prior order disallowing the claim. The dissenter, Judge Saladino, criticized the majority for characterizing the debtor's motion and the bankruptcy court's order "too narrowly." He said the bankruptcy court was clearly sanctioning the Division for trying to collect a debt that was fully paid, whether it was dischargeable or not.

The majority did not discuss the Supreme Court's 2010 *Espinosa* opinion, which held that a bankruptcy court order discharging student loan debt was enforceable even though the court employed the incorrect procedure.

The B.A.P. should consider granting rehearing at least to clarify the opinion, even if the result is the same. Did the B.A.P. mean to say that a bankruptcy court can trim down the amount of a nondischargeable priority claim only with respect to payments under a plan, leaving the creditor free to litigate the amount of the claim again in another court after the discharge is entered? The B.A.P. might also explain why the bankruptcy court, if it has jurisdiction, cannot determine the amount of a priority claim with binding force.

Or, if the majority only meant to say that contempt was improper, then the B.A.P. should consider narrowing the language in its opinion.

The opinion is *State of Missouri v. Spencer (In re Spencer)*, 550 B.R. 766 (B.A.P. 8th Cir. June 13, 2016).

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Getting punched out in a bar fight might not result in a nondischargeable debt.

How the Bankruptcy Code Determines the Winner of a Bar Fight

The Sixth Circuit's Bankruptcy Appellate Panel laid down rules for deciding who wins a bar fight, and the winner in court is not necessarily the one who got his lights punched out.

The case involved a late-night altercation fueled by copious amounts of alcohol consumption. The evidence was typically conflicting, with everyone claiming to be the victim rather than the aggressor.

Although one combatant outweighed the other by 60 pounds, the larger pugilist ended up on his back, with broken facial bones caused by one punch from his smaller opponent.

The winner of the fight was arrested and pleaded *nolo contendere* to a criminal charge of assault and battery. He filed bankruptcy after being sued for damages.

The loser in the fight, who happened to be a lawyer, filed an adversary proceeding to declare that his damages from sustaining willful and malicious injuries were not dischargeable under Section 523(a)(6). After trial, the bankruptcy judge discharged the debt, concluding that the bankrupt did not inflict the injury willfully because he did not know it would cause the damage that resulted.

On appeal, the appellate panel reversed in an opinion by Bankruptcy Judge Joan A. Lloyd from Louisville, Ky. She held that the bankruptcy judge misapplied the law, although the findings of fact were unassailable under the clearly erroneous standard.

The law is clear, according to Judge Lloyd. Anyone who throws a punch automatically satisfies the willfulness requirement in Section 523(a)(6). The plaintiff need not prove that the aggressor intended to cause the resulting injury.

In a bar fight, the determinative issue instead is the "maliciousness" half of the dischargeability question. Judge Lloyd said that "self-defense can constitute a justifiable excuse for a defendant's actions and negate a claim of malice."

Remember this when contemplating a fistfight in Michigan: According to state law and the similar Restatement (Second) of Torts, someone not engaged in a crime may use non-deadly force whenever he or she "reasonably believes" that force is required to defend against "imminent unlawful use of force by another individual," even if retreat is possible. (Try going through that checklist if you are inebriated and someone is about to punch you in the kisser.)

The appellate panel reversed and remanded, directing the bankruptcy judge to apply the law of self-defense on the question of malice, with the debtor bearing the burden of proof on that issue.

Judge Lloyd said that the plea of *nolo contendere* is inadmissible in evidence under Rule 410 of the Federal Rules of Evidence.

The opinion is *Juett v. Casciano (In re Casciano)*, 15-8013, 2016 BL 5960 (B.A.P. 6th Cir. Jan. 11, 2016).

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Question left open in* Harris v. Viegelahn *decided against debtor in chapter 11.

Courts Split on Allowing Individual Debtors to Retain Wages on Conversion from 11 to 7

The courts are split on the fate of wages earned by an individual in chapter 11 whose case converts to chapter 7. Can the debtor retain the wages, or does the money go to the chapter 7 trustee for distribution to creditors?

In *Harris v. Viegelahn*, the Supreme Court held in 2015 that an individual's undistributed earnings in the hands of a chapter 13 trustee go to the debtor when the case converts to chapter 7. Does the same rule apply when an individual's case converts from chapter 11 to chapter 7?

Disagreeing with the *Collier* bankruptcy treatise, District Judge John Z. Lee of Chicago came down the side of lower courts holding that the money is for the chapter 7 estate. Similarly, Bankruptcy Judge Robert D. Martin of Madison, Wis., gave the money to the chapter 7 trustee, saying that *Harris* answered a "narrow question" and does not "stand for the proposition that all post-petition earnings revert to a debtor when a case is converted from *any* chapter to a chapter 7."

No circuit court has decided the issue.

Several provisions in the Bankruptcy Code dance around the question, but none answers it for conversions from chapter 11 to chapter 7.

Section 1115 was amended in 2005 to provide that money earned by an individual while in chapter 11 is part of the bankrupt estate, not separate property the individual can keep regardless. On the other hand, Section 348(f)(1)(A) expressly says that earnings while in chapter 13 go to the bankrupt if the case is converted to chapter 7.

The statute is silent about conversions from chapter 11 to chapter 7.

In a 2014 decision called *Markosian v. Wu (In re Markosian),* the Ninth Circuit Bankruptcy Appellate Panel let the debtor keep the earnings, seeing no reason for treating bankrupts differently if their cases were converted from chapter 11 than if they were converted from chapter 13. The panel also cited Section 541(a)(6), which provides that money earned after filing in chapter 7 belongs to the bankrupt.

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Employing the *expressio unius* doctrine of statutory interpretation, Judge Lee reached the opposite conclusion in his March 11 opinion, saying it was "significant" that Congress only dealt with conversions from chapter 13 and not from chapter 11 in amending Section 348(f)(1)(A).

Seeing chapters 13 and 11 as "replete with policy considerations," Judge Lee said that Congress "is better equipped at making these policy choices than the courts."

In his opinion on April 8, Judge Martin declined to follow *In re Markosian*. He based his decision in part on the statute's silence about conversions from chapter 11 to chapter 7. That is, there is no counterpart to Section 348(f)(1)(A) for cases converting from chapter 11. He therefore applied cases decided before *Harris*.

The opinions are *Meier v. Katz (In re Meier)*, 15-3434 (N.D. Ill. March 11, 2016), and *In re Gorniak*, 549 B.R. 721 (Bankr. W.D. Wis. April 8, 2016).

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Plans

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Appeals court narrowly reads* Bullard *on finality.

Seventh Circuit Requires Chapter 13 Payments Beyond Five Years

The Seventh Circuit handed down a decision creating long-lasting uncertainty in the lives of chapter 13 debtors with increasing income. The June 23 opinion can result in requiring chapter 13 debtors to make payments for more than five years and gives a narrow reading to the Supreme Court's *Bullard* decision on finality of bankruptcy court orders.

The Seventh Circuit's opinion means that chapter 13 debtors cannot rely on orders denying increases in plan payments. In this case, the debtors face a potential loss of discharge even though they paid more than $40,000, having relied on the bankruptcy court's order saying they were not required to pay an extra $15,000.

The Facts

A couple confirmed a chapter 13 plan calling for payments of $670 a month, paying unsecured creditors and providing $22,000 in distributions to unsecured creditors.

About two years after confirmation, the trustee got a tax return showing that the debtors' annual income had increased $50,000 in the year following plan approval. The trustee filed a motion asking the bankruptcy court to require an increase in the monthly payments to $1,416 for the remaining two years in the plan.

In opposition, the debtors argued that their expenses also had increased.

The bankruptcy judge denied the trustee's motion, saying that the Bankruptcy Code has no provision allowing an increase in payments for the reasons given by the trustee. Even if there were power to increase payments, the bankruptcy judge said that the facts did not support the trustee's motion.

On the first appeal, the district court affirmed the bankruptcy court, finding no statutory authority to increase the payments. The district judge did not reach the question of whether the facts supported an increase.

The debtors appealed to the Seventh Circuit.

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Appealability

In *Bullard*, the Supreme Court held in 2015 that denying confirmation of a chapter 13 plan is not a final order giving a right to appeal, unless the bankruptcy judge also dismisses the case. The debtors therefore contended that denial of the trustee's motion to modify the plan was not a final order giving the Seventh Circuit appellate jurisdiction under 28 U.S.C. Section 158(d)(1).

In his June 23 opinion for the circuit court, District Judge Lynn S. Adelman of Milwaukee, sitting by designation, held that denial of a plan modification motion is a final order.

He said that denial of plan modification was a final order because it was not based on a technical mistake or some other factor that could be cured by an amended motion. In other words, if denial of the motion precludes filing a new motion on the same grounds, the order is final. The circuit court's opinion endeavored to explain why the same analysis does not apply to denial of confirmation orders.

Although the opinion in this instance was anti-debtor, the finality reasoning can be helpful for debtors in other cases. If, for example, a debtor's motion to lower plan payments is denied, denial of the motion would be appealable in a circuit that follows the Seventh.

The opinion suggests that courts will read *Bullard* narrowly when convinced that the bankruptcy court made a mistake.

Mootness

The debtors next argued that the appeal was moot because it came to the circuit court after the debtors had made all payments under their five-year plan. They relied on Section 1329(c), which provides that the court may not approve a plan modification calling for payments over a period exceeding five years.

There was a live dispute, and no mootness, Judge Adelman said, because the bankruptcy court on remand could still find the debtors in default and deny their discharges.

The opinion throws the debtors a lifeline by saying that the bankruptcy court "might allow" the debtors to cure the default by paying the extra $15,000 that creditors would have received had the bankruptcy judge granted the trustee's motion initially.

Although the debtors would be making payments outside the five-year commitment period, Judge Adelman said that those payments would not be "provided for" by the modified plan, thus not bringing Section 1329(c) into play. Rather, he said, the payments would be made to cure default. In that respect, the opinion cites cases allowing chapter 13 debtors to cure payment defaults after the five-year period has expired.

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The debtors next argued that the appeal was moot because Section 1329(a) provides that a plan may only be modified "before the completion of payments." Judge Adelman interpreted the section to mean, however, that the bankruptcy court may approve a modification outside the five-year period so long as the motion to modify was made within the period.

Again, the ruling on mootness can benefit debtors in other cases, for instance, if the bankruptcy court denies a motion to lower payments and an appellate court reverses after plan payments were completed. In the meantime, however, the debtors have been making payments they cannot afford, or they might have seen their case dismissed if they did not pay. And if the debtors win on appeal, must the trustee recover payments from creditors, or is the trustee personally liable? A prudent trustee might hold back the excess payments pending appeal.

The Merits

Reaching the merits, the appeals court noted how the debtors conceded that the bankruptcy court has power to increase plan payments in a proper case.

The circuit court said that Section 1329, on plan modifications, does not contain "explicit standards" for deciding when a plan can be modified. Instead, Congress "left the development of those standards to the courts." Here, the trustee sought modification because the debtors' income had increased "substantially."

In its holding on the merits, the Seventh Circuit said that a bankruptcy court has discretion to raise plan payments if "a change in the debtor's financial circumstances makes an increase in payments affordable." The appeals court preceded the holding by citing cases that permit alteration of plan payments when the debtors' financial circumstances have changed.

On Remand

Because the district court had not decided whether an increase in payments was factually warranted, the circuit court remanded, presumably for the district judge to decide whether the bankruptcy court's findings of fact were reversible.

Reversing and remanding does not necessarily mean that that the debtors will be required to pay the additional $15,000 because the holding on the merits appears to enable the debtors to argue that an increase is not "affordable."

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The Debtor's Counsel

On appeal, the debtors were represented *pro bono* by former Bankruptcy Judge Eugene R. Wedoff. Retired from the bench, Judge Wedoff is taking cases without fee that raise important issues in bankruptcy law.

The opinion is *Germeraad v. Powers*, 15-3237, 2016 BL 201326 (7th Cir. June 23, 2016).

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Bar to modification of a home mortgage trumps ability to cure in chapter 13.

Fourth Circuit Says Chapter 13 Can't Reinstate Non-Default Rate on Home Mortgage

In a defeat for consumers, the Fourth Circuit held that the power to "cure" does not allow a chapter 13 debtor to lower the interest rate on a home mortgage to the non-default rate.

A couple defaulted on their home mortgage before bankruptcy. The mortgage called for the interest rate to climb two percentage points after default. Also before bankruptcy, the lenders gave notice invoking the higher rate.

The debtors' chapter 13 plan called for curing the defaults within the five-year duration of the plan. The plan reinstated the contractual maturity date and provided that the interest rate on the cure payments and the regularly monthly payments would be the lower non-default rate.

The bankruptcy court sustained the lender's objections to the plan. The plan confirmed by the court required the higher default rate for all payments on the mortgage and the arrears. The debtors appealed. They lost in district court and lost again in an April 27 opinion by Circuit Judge J. Harvie Wilkinson III.

Judge Wilkinson framed the question as whether the ability to cure default under Sections 1322(b)(3) and (5) trumps Section 1322(b)(2), which precludes modifying a "claim secured only by a security interest in real property that is the debtor's principal residence." In ruling that the debtors could not reinstate the lower non-default rate, he held that subsections (3) and (5) do not undo a "residential mortgage lender's fundamental rights."

Analyzing the legislative history and the language of the statutes, Judge Wilkinson concluded that Congress drew a "clear distinction between plans that merely cure defaults and those that modify the terms of residential mortgage loans." Lowering the interest rate, he said, would modify the loan. He also said that the inability to impose default rates of interest might "motivate fewer lenders to engage in mortgage lending in the first place."

Neither the circuit court's opinion nor the debtors' briefs cited cases on the ability in chapter 13 to reinstitute the lower contract rate on a home mortgage once a default rate has been imposed before bankruptcy.

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The opinion is *Anderson v. Hancock (In re Anderson)*, 820 F.3d 670 (4th Cir. April 27, 2016).

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Sloppy drafting in BAPCPA puts individuals at the mercy of dominant creditors in chapter 11.

Congress Did Not Abrogate Absolute Priority for Individuals, Five Circuits Now Hold

All five courts of appeals to consider the question agree that the absolute priority rule still applies to an individual in chapter 11, despite what appeared to be an effort by Congress in 2005 to amend the statute by allowing individuals to retain property they owned before bankruptcy when cramming down a plan on a dissenting class.

On Jan. 28, the Ninth Circuit overruled its own Bankruptcy Appellate Panel's *Friedman* opinion from 2012, which had been the leading judicial authority for the proposition that the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, or BAPCPA, abrogated the absolute priority rule for individuals in chapter 11.

The decisions by the courts of appeals are a burden for owners of small businesses in chapter 11 because they give an effective veto power to a dominant creditor.

If there is one creditor with a large enough claim opposing a plan, the bankrupt is effectively barred from using cramdown to win confirmation. Consequently, the owner of a small business can be forced by one creditor with a large claim to liquidate or sell the business, even if the plan might have paid more than liquidation.

Originally engrafted by the courts onto the former Bankruptcy Act, which had been silent on the issue, the absolute priority rule was intended to prevent shareholders from receiving a distribution in chapter 11 if the plan was being crammed down on a dissenting class of creditors. When Congress codified the absolute priority rule in the 1978 Bankruptcy Code, it meant that individuals in chapter 11 using cramdown could not keep property.

To some observers, Congress intended in BAPCPA to change the rule by amending Section 1129(b)(2)(B)(ii) to create an exception to the absolute priority rule for individuals. BAPCPA at the same time added entirely new Section 1115, which brings property that was acquired after bankruptcy into the estate.

In the case before the Ninth Circuit, Bankruptcy Judge Thomas C. Holman of Sacramento, Calif., had bravely parted company with the Ninth Circuit appellate panel's *Friedman* decision by holding that absolute priority remains a condition to cramming down a plan in an individual in chapter 11. Although he held that appellate panel opinions were not binding on him, the Ninth Circuit did not reach that issue when it overruled *Friedman*. Judge Holman authorized an appeal directly to the court of appeals.

The appeals court's opinion by Circuit Judge Andrew D. Hurwitz acknowledged a "significant split of authorities" among lower courts, although the Fourth, Fifth, Sixth and Tenth Circuits all held that BAPCPA did not change the law. Those circuits rejected the broad view adopted by *Friedman* and several other lower courts that Congress intended in BAPCPA to abrogate absolute priority for individuals in chapter 11.

Judge Hurwitz followed what he called the narrow view, where courts interpret BAPCPA's amendments to mean that an individual cannot cram down a plan on a dissenting class and retain pre-petition property of the estate. The amendments, he said, only allow an individual debtor to keep property acquired post-petition when cramming down a plan.

In substance, Judge Hurwitz and the other courts of appeals believe that Section 1115 put pre-petition property back that Section 1129(b)(2)(B)(ii) had taken out. Some commentators believe that BAPCPA includes a scrivener's error that has an opposite effect from what Congress intended.

The Ninth Circuit conceded that the narrow view works a "double whammy" because an individual debtor must use post-petition income to pay creditors' claims under the plan, while pre-petition property must also go to creditors. If Congress had intended to abrogate absolute priority for individuals, Judge Hurwitz said it could have done so "in a far more straightforward manner." To overrule a judicially created concept, he said, Congress must make its intent "specific."

The opinion is *Zachary v. California Bank & Trust (In re Zachary)*, 811 F.3d 1191 (9th Cir. Jan. 28, 2016).

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Bill on Bankruptcy

Ninth Circuit B.A.P. and Third Circuit duke it out over Section 1123(b)(5).

Courts Split on Stripping Down Residential Mortgages in Chapter 11

Courts are split on whether an individual chapter 11 debtor can strip down a home mortgage when the property is used in part to generate income.

At issue is Section 1123(b)(5), which provides that a plan may strip down a secured claim, but not "a claim secured only by a security interest in real property that is the debtor's principal residence."

Interpreting that section pits the Third Circuit on one side of the answer and the Ninth Circuit Bankruptcy Appellate Panel on the other. District Judge Richard Seeborg of San Francisco had to decide which court had the better answer. He sided with his circuit's appellate panel on one issue in the case and with the Third Circuit on another.

In a 2006 case called *Scarborough*, the Third Circuit concluded that "only" defines both "security interest" and "principal residence." In other words, a debtor could strip down a mortgage if the property was secured only by a lien on real property and only if the property was the principal residence.

The Ninth Circuit BAP reached the opposite conclusion in 2014 in *In re Wages*. The panel held that plain meaning bars bifurcation even if the property is used for more than just the debtor's principal residence.

Judge Seeborg adopted the appellate panel's *Wages* approach, holding that "only" defines only "security interest," not also "principal residence." He thus held that a debtor cannot bifurcate a home mortgage even if the property has a dual use.

The judge nonetheless declined to follow the appellate panel on the second issue in the case: whether the bar to bifurcation applies when the lien covers personal property as well as real property.

In the case at bar, the mortgage was a construction loan with liens on the real property as well as on virtually all personal property on the premises. In *In re Lee*, the Ninth Circuit BAP had held in 2007 that the bar to bifurcation applies if the lender also has a lien on personal property of "little independent value."

Following what he saw as the statute's plain language, Judge Seeborg parted company with the appellate panel, this time following the Third Circuit's 1994 *Hammond* opinion allowing modification of a mortgage also secured by personal property like machinery and equipment.

The opinion is *Utzman v. SunTrust Mortgage Inc.*, 15-cv-4299 (N.D. Cal. March 1, 2016).

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Ninth Circuit permits chapter 20 end run on **Dewsnup.**

Circuits Remain Unanimous in Permitting Chapter 20 Strip-Off

The Ninth Circuit joins two other courts of appeals and three bankruptcy appellate panels in holding that a mortgage can be "stripped off" through use of so-called "chapter 20."

A chapter 20 strip off typically arises when someone first goes through chapter 7 and gets a discharge while owning a home where debt on the first mortgage is more than the value of the house. Although a bankrupt's personal liability on a valueless second mortgage is eliminated by discharge, the second lien remains on the home as a result of the U.S. Supreme Court's 1993 *Dewsnup* decision, thus leaving the homeowner vulnerable to foreclosure of the second mortgage after chapter 7.

When the same homeowner files a subsequent chapter 13 petition, some bankruptcy courts and district courts do not permit strip off, or elimination of the second mortgage, usually reasoning that strip off is unavailable because the debtors aren't entitled to a discharge in chapter 13.

In an Oct. 1 opinion, Ninth Circuit Judge Jay S. Bybee sided with the Fourth and Eleventh Circuits by holding that a lien can be stripped off in chapter 20. In a case called *Boukatch*, the Ninth Circuit Bankruptcy Appellate Panel allowed strip off in chapter 20.

In the case before the Ninth Circuit, the consumer debtors first filed under chapter 7. They then filed a chapter 13 petition one day after receiving their chapter 7 discharge, which removed the first mortgage on their home as a personal liability. Because liens ride through chapter 7, the mortgage remained on their home. The chapter 13 petition was designed to prevent or delay foreclosure.

In a holding significant for the typical chapter 20 cases, Judge Bybee held that debtors can avoid liens in subsequent chapter 13 cases even though they are not eligible for discharge.

The bank argued unsuccessfully that the chapter 13 case must end in either conversion to chapter 7 or dismissal because the debtors were barred from another discharge since the chapter 7 discharge occurred within four years. Judge Bybee said the Bankruptcy Code is "devoid" of any requirement that a subsequent chapter 13 case must be converted or dismissed when the debtor cannot have a discharge. He also rejected the bank's argument that stripping off a lien in chapter 20 would circumvent Congress's intent to prohibit successive discharges.

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Judge Bybee's decision did create a split of circuits on a subsidiary issue. The bank relied on a 2005 Seventh Circuit decision called *Sidebottom* for the proposition that one debtor cannot have chapter 7 and chapter 13 cases pending simultaneously. He followed the Eleventh Circuit's 1989 *Saylors* opinion, which found no per se rule prohibiting simultaneous bankruptcies.

Judge Bybee upheld the bankruptcy court's finding of no bad faith filing because preventing foreclosure is a legitimate use of chapter 13.

To accomplish a chapter 20, the bankrupts must pay their remaining debts in full in their subsequent chapter 13 case, although they are not required to pay the mortgage debt because it would have been eliminated as a personal liability in their prior chapter 7 case.

The Ninth Circuit case was atypical because the debtors were not stripping off a subordinate mortgage. Instead, a mistake by the bank allowed them to eliminate the first mortgage on their $450,000 home.

In the chapter 13 case, the debtors objected to the bank's secured claim, contending that their signatures had been forged. Perhaps thinking that the lien nonetheless would pass through chapter 13, the bank did not object, and the bankruptcy court entered an order disallowing the secured claim. Using Section 506(d), Judge Bybee said the bank's lien therefore became invalid once the chapter 13 plan was confirmed and the debtors completed payments.

In subsequent cases, lenders might argue that ratification of chapter 20 strip off is *dicta* because the case could have been decided purely on Section 506(d). That argument might not hold weight, however, because the bank argued unsuccessfully in the circuit that the chapter 13 case should have been dismissed.

The opinion is *HSBC Bank USA v. Blendheim* (*In re Blendheim*), 803 F.3d 477 (9th Cir. Oct. 1, 2015).

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Surrender & Forced Vesting

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Florida judge closes loophole on a debtor's duty to "perform his intention" regarding surrender.

Surrendering Property Precludes a Debtor from Opposing Foreclosure

After a statement of intention to surrender a homestead, the chapter 7 debtor must turn over possession to the mortgage-holder and may not oppose foreclosure, even if the trustee in the meantime has abandoned the property and title reverted to the debtor.

That was the teaching in a Nov. 23 decision by District Judge Kenneth A. Marra in West Palm Beach, Fla., upholding the bankruptcy court.

The debtors admitted that the mortgage debt exceeded the value of their home and stated their intention to surrender the property, which the trustee abandoned. Meanwhile, the bank initiated foreclosure.

The debtors contended that the trustee's abandonment of the property gave them title again and restored their prepetition rights, including the ability to oppose foreclosure. Judge Marra agreed with the bankruptcy judge and disagreed with the debtors.

The question on appeal was whether the debtors fully discharged their obligations when they abandoned the property to the trustee. Judge Marra said they did not.

Although "surrender" is not defined in the Bankruptcy Code, Judge Marra said it means that the debtor abandons any interest in the property as to the trustee and a lienholder. Although the debtor is not required to deliver physical possession to the lender, Judge Marra held that the owner cannot "interfere with the secured creditor's ability to obtain legal title to, and possession of, the property through legal means."

Some might question Judge Marra's next statement that "defending against a foreclosure proceeding relating to the secured property would be inconsistent with the debtor's stated intention to surrender the property."

Judge Marra concluded the opinion by holding that a trustee's abandonment of a property only restores title to the bankrupt and "does not affect other aspects of the debtor's rights and responsibilities relative to the property."

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The decision might also be questioned for its lack of exploration of the last clause in Section 521(a)(2)(B), which provides that a decision to surrender "shall [not] alter the debtor's or the trustee's rights with regard to such property."

The opinion is *Failla v. CitiBank NA*, 542 B.R. 606 (S.D. Fla. Nov. 23, 2015).

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Gutsy Judge Laurel Isicoff disagrees with district and bankruptcy judges in her district.

Courts Split on Whether Surrender Entails Waiver of Defenses to Foreclosure

Disagreeing with bankruptcy and district judges in Florida, Bankruptcy Judge Laurel M. Isicoff of Miami ruled that a statement of intention to surrender a home does not compel a chapter 7 debtor to withdraw defenses to foreclosure.

As Judge Isicoff said in her Feb. 29 opinion, there is "an ongoing debate about the meaning of 'surrender' and what the consequences of surrender are."

Like similar cases in Florida and elsewhere, the chapter 7 debtor filed a timely statement of intention to surrender his home under Section 521(a)(2). He did not schedule the mortgage debt as disputed. He got his discharge, but the trustee did not "administer" the home, so it was automatically "abandoned to the debtor" under Section 554(c).

The lender sought and obtained a modification of the automatic stay, but the debtor took discovery and submitted defenses in the foreclosure proceeding. The lender filed a motion to reopen the bankruptcy case and compel the debtor to drop defenses to foreclosure. Judge Isicoff declined to reopen the case and denied the motion to compel.

In Florida, Bankruptcy Judges Paul G. Hyman Jr., Eric P. Kimball and Michael G. Williamson have held that a statement of intention to surrender a home bars a debtor from opposing foreclosure. District Judge Kenneth A. Marra in West Palm Beach upheld Judge Hyman in *Failla v. CitiBank NA.* To read ABI's write-up on *Failla*, **click here. [insert link]**

Judge Isicoff said that District Judge Marra "did not cite to any Bankruptcy Code section" for his conclusion that a statement of intention to surrender abandons any interest in property or claim against the lender.

She also said that the Code nowhere says that property surrendered by a debtor is surrendered to the lender. Rather, she said, the debtor surrenders the property to the trustee, and the trustee abandons the property to the debtor if it is not administered.

Judge Isicoff pointed out how the Code gives recourse to the lenders, such as moving to modify the stay or compel the trustee to abandon the home. "What the Bankruptcy Code does not

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allow," she said, is for the lienholder "to wait three years or even three months, and then come back to the bankruptcy court and seek relief to which it is not entitled."

Near the end of her opinion, Judge Isicoff said that the discharge of personal liability does not "dictate a punitive response if the right to surrendered property reverts" to the debtor. If there is to be a change in the law, she said, it's "up to Congress, not the courts."

The opinion is *In re Elkouby*, 14-23934, 2016 WL 798177 (Bankr. S.D. Fla. Feb. 29, 2016).

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Split in lower courts now tilts toward precluding forced title vesting in chapter 13.

New York District Court Bars Forced Vesting of Title Through a Chapter 13 Plan

Lower courts are split on the question of whether a chapter 13 plan can force a lender to take title to real property.

Reversing the bankruptcy court, District Judge Arthur D. Spatt of Central Islip, N.Y., followed what he saw as the "clear weight of authority" and held that a chapter 13 plan cannot convey title to a lender absent the lender's consent.

The issue brings two chapter 13 provisions into play. As one of the alternatives for dealing with a secured claim, Section 1325(a)(5)(C) allows the debtor to surrender property to the lender. Section 1322(b)(9) provides that a plan "may" vest title to property of the estate. Judge Spatt rested his decision in part on the notion that the vesting of title under Section 1322(b)(9) is permissive, not mandatory, while employing one of the three alternatives in Section 1325(a)(5) is mandatory.

Judge Spatt's April 12 opinion contains a valuable survey of all decisions throughout the country coming down on both sides of the question. He noted that two bankruptcy judges in Manhattan held that a plan may not force a lender into taking title.

A lender's rights include the right not to take title, or refrain from foreclosing, Judge Spatt said. He saw "no principled basis for exalting" the debtor's right to a fresh start over the "well-settled property rights of secured lenders."

He also said that the right of a lender to "control its own remedies" cannot be "subordinated to the debtors' interest in achieving a fresh start in bankruptcy."

There would be "irreconcilable legal implications," the judge said, if a plan both surrendered and vested title over a lender's objection.

The opinion is *HSBC Bank USA NA v. Zair*, 15-4958 (E.D.N.Y. April 12, 2016).

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Massachusetts judges disagree on 'forced vesting' in chapter 13 plan.

Lenders Win Again, Beating Back Forced Vesting of Title Through Chapter 13

Bankruptcy Judges Melvin S. Hoffman and Henry J. Boroff, both from Massachusetts, disagree on forcing a mortgage-holder to take title to property under a chapter 13 plan.

Last year, Judge Hoffman held that the chapter 13 plan in a case called *Sagendorph* could force a lender to take title. Otherwise, the debtor would be stuck with nondischarged post-petition costs for maintaining and insuring the property until the lender forecloses.

Judge Boroff reached the opposite result in an opinion on Jan. 13 and refused to confirm a plan calling for so-called forced vesting. He listed lower court decisions from around the country reaching different results on the issue.

Previously, Judge Boroff held that Section 1325(a)(5), which lists mandatory plan provisions, bars forced vesting unless a lender consents. He held in the new case that Section 1322(a)(9)'s optional provisions do not change the result, even though he was sympathetic to the plight of communities suffering from a blight of abandoned homes.

The opinion is *In re Weller*, 548 B.R. 392 (D. Mass. Jan. 13, 2016).

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Late-Filed Tax Returns

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Eleventh Circuit keeps taxpayer on the hook for late-filed tax returns.

Circuit Splits Widen on Dischargeability of Tax Debts on Late-Filed Returns

The Eleventh Circuit charted a different course from three other circuits in holding that the debt shown on a late-filed tax return is not dischargeable under Section 523(a)(1)(B)(i) and the so-called hanging paragraph added by Congress along with the 2005 amendments.

Three circuits — the First, Fifth and Tenth — ended up with what's been called the one-day-late rule: If a return is filed even one day late, the underlying debt can never be discharged, employing a complicated application of case law, several federal statutes and the Bankruptcy Code. It has been said by commentators such as Prof. Ronald J. Mann from Columbia Law School that even the Internal Revenue Service will not support that interpretation.

In a March 30 decision by Circuit Judge R. Lanier Anderson, the Eleventh Circuit held a tax debt nondischargeable using a different theory.

In this case, the debtor did not file tax returns for the years 2000 through 2003. The IRS gave notice of deficiency and assessed taxes in 2006. The taxpayer filed tax returns for those years in 2007, followed by a chapter 7 petition in 2011. The bankruptcy judge held that the tax debt was nondischargeable, and the district court agreed on appeal.

Assuming without deciding that the one-day-late rule is wrong, Judge Anderson used a different approach that still kept the debtor on the hook for the tax debt.

Judge Anderson invoked the four-part test resulting from a 1984 Tax Court decision known as *Beard*. His opinion focused on the fourth *Beard* test: Was there an honest and reasonable attempt to satisfy the requirements of tax law?

On that question, there is a split of circuits. The Eleventh Circuit chose to follow the majority, which requires "analysis of the entire time frame relevant to the taxpayer's actions." A minority of one, the Eighth Circuit held that "honesty" should be determined exclusively from the face of the tax return. In a dissenting opinion in the Seventh Circuit, Circuit Judge Frank Easterbrook saw the law as the Eighth Circuit did.

In following the majority, Judge Anderson relied on the notion that our tax system depends upon "honest self-reporting."

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Although declining to adopt a *per se* rule, Judge Anderson held that there is no "honest and reasonable effort" to comply with tax law when the taxpayer files a return "years late, without any justification at all, and only after the IRS has issued notices of deficiency and has assessed his tax liability."

The opinion does not hint as to whether a tax claim could be discharged if, for instance, the debtor filed a late return before the IRS levied an assessment. In that case, the Eleventh Circuit might have to decide whether three circuits made good or bad law with the one-day-late test.

The opinion is *Justice v. U.S. (In re Justice)*, 817 F.3d 738 (11th Cir. March 30, 2016).

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Ninth Circuit avoids the one-day-late rule for nondischargeability of tax debts.

Circuit Split Widens on Test for Nondischargeability from Late-Filed Tax Returns

The Ninth Circuit entered the fray on the question of whether a debtor can discharge a tax debt when the return was filed late. The San Francisco-based court puts itself in the faction where a debtor at least has a glimmer of hope about discharging the debt shown in a late-filed return.

The courts of appeals fall into two camps. The First, Fifth and Tenth Circuits employ the one-day-late rule: If a return is filed even one day late, the underlying debt can never be discharged, employing a complicated application of case law, several federal statutes and the Bankruptcy Code.

The Fourth, Sixth, Seventh, Eighth and Eleventh Circuits follow the four-part test resulting from a 1984 Tax Court decision known as *Beard*. Courts invoking the *Beard* test ordinarily focus on the fourth factor: Was there an honest and reasonable attempt to satisfy the requirements of tax law?

Among those circuits, all but the Eighth analyze all the surrounding facts to decide the "honesty" factor. A minority of one, the Eighth Circuit held that "honesty" should be determined exclusively from the face of the tax return. In a dissenting opinion in the Seventh Circuit, Circuit Judge Frank Easterbrook saw the law as the Eighth Circuit did.

In its decision on July 13, the Ninth Circuit embraced the *Beard* test while rejecting the Eighth Circuit's approach of analyzing only the face of the late-filed return. Columbia University Law Professor Ronald J. Mann told ABI in a message that the opinion "is another court of appeals applying a multi-factor test with no obvious relation to the language of the statute."

The Ninth Circuit's case involved a man who did not file a 2001 tax return. Using information from third parties, the Internal Revenue Service issued a $70,700 deficiency notice in 2006. Three years later, the taxpayer filed a Form 1041 for 2001 showing a larger tax liability. The IRS added the additional tax to the deficiency.

After he filed bankruptcy, the taxpayer persuaded the bankruptcy court to rule that the taxes were dischargeable. The district court reversed and was upheld in the opinion by Circuit Judge Morgan Christen.

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Judge Christen held that the return, filed eight years late and three years after the IRS's deficiency notice, "was not an honest and reasonable attempt to comply with the tax code." She added that "many of our sister circuits have held that post-assessment tax filings are not 'honest and reasonable' attempts to comply and therefore are not 'returns' at all."

"Because the court views this taxpayer's behavior as so reprehensible, the decision doesn't do much to clarify the law about 'returns,'" Prof. Mann said. "It specifically declines to address the government's bright-line rule that nothing filed after an assessment can qualify as a 'return.'" The professor added that "it doesn't even mention the idea, accepted by some courts, that the reference to 'filing requirements' in the definition of 'return' means that no late filing can qualify as a return."

Prof. Mann attempted to take the Tenth Circuit's one-day-late case to the Supreme Court in 2015. The high court denied *certiorari*. Prof. Mann said that the circuit court had "ruled against the taxpayer on a ground that the Internal Revenue Service won't defend." There is little prospect of Supreme Court review, he said, "until a taxpayer wins one of these cases in the courts of appeals."

Regardless of the approach a court employs, the issue regarding dischargeability of tax in connection with a late-filed return turns on Section 523(a)(1)(B)(i) and the so-called hanging paragraph added by Congress along with the 2005 amendments.

The Ninth Circuit's opinion is a vindication for the Ninth Circuit Appellate Panel's December decision in *U.S. v. Martin (In re Martin)*. There, the B.A.P. rejected the one-day-late rule by holding that the hanging paragraph did not alter two Ninth Circuit cases that adopted a version of the *Beard* test, which defines the term "return" in the context of determining nondischargeability of tax debts.

In *Martin*, the B.A.P. reversed and remanded for the bankruptcy judge to apply the Ninth Circuit's modified *Beard* test, which inquires into whether the document purports to be a return that was signed under penalty of perjury, contained sufficient information to allow calculation of the tax, and was an "honest and reasonable" attempt to satisfy the requirements of tax law.

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

Before the Ninth Circuit's opinion, the most recent circuit court decision came from the Eleventh Circuit in March in *Justice v. U.S. (In re Justice)*. To read ABI's discussion of *Justice*, click here.

The opinion is *Smith v. I.R.S. (In re Smith)*, 14-15857, 2016 BL 224521 (9th Cir. July 13, 2016).

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Gutsy Ninth Circuit B.A.P. importunes the Supreme Court to rule on late-filed tax returns.

Ninth Circuit B.A.P. Splits with Three Circuits on Dischargeability of Tax Debts

The Ninth Circuit Bankruptcy Appellate Panel is trying to foment a split of circuits so the Supreme Court can decide whether a tax debt can never be discharged if the return is filed even one minute after the deadline.

So far, the Fifth, First and Tenth Circuits have all employed what Bankruptcy Judge Frank L. Kurtz, in his opinion for the Ninth Circuit appellate panel, called a literal construction of the so-called hanging paragraph added by Congress to the end of Section 523(a) in the 2005 BAPCPA amendments. In his Dec. 17 opinion, Judge Kurtz called it the "unforgiving view of congressional intent," because someone who files a late tax return can never discharge the underlying debt.

Columbia University Law Professor Ronald J. Mann attempted to take the Tenth Circuit case to the Supreme Court in 2015. The high court denied *certiorari*. Prof. Mann said that the circuit courts "ruled against the taxpayers on a ground that the Internal Revenue Service won't defend."

"Every appellate court to consider the question after BAPCPA has adopted the bright-line rule that no late filing ever can be a return," Prof. Mann told ABI. Judge Kurtz's opinion, he said, "provides a roadmap for the Ninth Circuit to reject that growing consensus. And that, in turn, would make the likelihood of Supreme Court review almost certain."

Judge Kurtz's opinion meticulously picks apart the shortcomings inherent in literal interpretation. He concludes that the hanging paragraph did not alter the two Ninth Circuit cases that adopted a version of the *Beard* test, which defines the term "return" in the context of determining nondischargeability of tax debts.

The literal approach, he said, would bar a debtor from discharging a tax debt if the return were filed even a minute late, "whereas a debtor taxpayer who never bothers to file his or her own tax return can discharge his or her associated tax debt if the IRS fortuitously prepares a tax return on that person's behalf." Judge Kurtz also points out how the IRS itself does not follow the literalist interpretation.

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Judge Kurtz reversed and remanded the case for the bankruptcy judge to apply the Ninth Circuit's modified *Beard* test, which inquires into whether the document purports to be a return that was signed under penalty of perjury, contained sufficient information to allow calculation of the tax, and was an "honest and reasonable" attempt to satisfy the requirements of tax law.

It is unclear whether Judge Kurtz's opinion is an appealable final order, because he remanded for the bankruptcy judge to perform more than ministerial functions.

The circuit court cases are *Fahey v. Massachusetts Department of Revenue (In re Fahey)*, 779 F.3d 1 (1st Cir. 2015); *In re Mallo*, 774 F.3d 1321 (10th Cir. 2014); and *McCoy v. Mississippi State Tax Commission (In re McCoy)*, 666 F.3d 924 (5th Cir. 2012).

The Ninth Circuit appellate panel opinion is *U.S. v. Martin (In re Martin)*, 542 B.R. 479 B.A.P. 9th Cir. Dec. 17, 2015).

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Prepaid Fees, Claims & Eligibility

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Ninth Circuit B.A.P. highlights discrimination against chapter 7 debtors.

Chapter 7 Debtors' Access to Counsel Threatened by B.A.P. Opinion

The Ninth Circuit Bankruptcy Appellate Panel handed down an opinion possibly meaning that debtors in Arizona, and perhaps elsewhere, cannot pay for post-petition legal services before they file chapter 7 petitions. If the decision is taken to its logical conclusion, consumer debtors in the Ninth Circuit cannot rely on having lawyers to defend objections to discharge or dischargeability and to provide other services after filing.

The B.A.P. could be faulted for misinterpreting a 1998 Ninth Circuit opinion called *In re Hines*.

Rather than drawing a roadmap for trustees to recover retainers, the appeals court in *Hines* went out on a limb by creating a judge-made exception to the automatic stay, thereby enabling some chapter 7 debtors to prepay post-petition legal services. The result in the B.A.P. was the opposite of what the Ninth Circuit aimed to accomplish in *Hines*.

The Facts

When a man filed his chapter 7 petition, a bank was suing him in state court, seeking $3.6 million in damages for fraud. The bank had told him it would challenge the dischargeability of the debt were he to file bankruptcy.

Before filing, the man paid a law firm a $60,000 flat fee to cover all services in connection with dischargeability litigation. The retainer agreement provided that the $60,000 would immediately become the law firm's property and would go into the firm's general business account, not an escrow account.

The bank made good on its threat and filed a dischargeability complaint four days after the chapter 7 filing. Six months later, the chapter 7 trustee sued the law firm, contending that the retainer agreement was an executory contract that was automatically rejected under Section 365(d)(1). The trustee demanded that the law firm turn over the $60,000 retainer.

Protecting the debtor's ability to mount a defense to the bank, the bankruptcy judge dismissed the trustee's complaint after ruling that the retainer agreement was not an executory

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contract. The trustee appealed to the B.A.P. and won in an opinion on June 9 by Bankruptcy Judge Frank L. Kurtz, relying in large part on *Hines*.

The Appellate Panel's Opinion

The appellate panel focused on language in *Hines* that said, in the context of prepaid fees, that "the trustee can liquidate the debtor's right to legal services by rejecting the contract with the attorney and demanding a refund of the unearned fees."

Applying the so-called Countryman test, the B.A.P. said that the law firm was required to defend while the debtor remained obligated to pay the law firm's out-of-pocket expenses. Consequently, the B.A.P. held that the agreement remained executory because both sides still had substantial unperformed obligations.

To decide how much in fees the firm was obliged to return, the B.A.P. said the record was inadequate because the bankruptcy judge had not decided when the trustee gave notice of termination to the law firm.

The appellate panel remanded the case to determine when the trustee gave notice of termination so the bankruptcy judge could decide whether the trustee "was entitled to any fee refund based on the value of services provided before termination."

Scholarly Commentary

"This decision puts the debtor in a very tough position," Prof. Nancy Rapoport told ABI. According to a message that Prof. Bruce A. Markell sent to ABI, "it seems that Arizona debtors won't be able to pay prepetition for any possible nondischargeability litigation. That raises real problems."

In light of the B.A.P. opinion, Prof. Rapoport asked, "What, then, is the best way for the debtor to pay for a defense in an adversary proceeding?"

The answers to the problems identified by the two professors are not immediately apparent, unless the appellate panel misinterpreted *Hines*, or unless there is no answer absent an amendment to the Bankruptcy Code.

Prof. Rapoport is a professor at the Univ. of Nevada at Las Vegas William S. Boyd School of Law, where she is an expert on legal ethics. Prof. Markell is the Professor of Bankruptcy Law and Practice at Northwestern Univ. Pritzker School of Law. He was a member of the Ninth Circuit B.A.P. before he returned to teaching.

What the Opinion Means

The debtor in the B.A.P. appeal might come out relatively unscathed if the law firm had already performed most of the services in the dischargeability litigation. Other chapter 7 debtors might not be so lucky, especially if trustees begin automatically sending termination notices to consumers' attorneys immediately after the petitions are filed.

Assuming the B.A.P. correctly interpreted *Hines*, the trustee could have recovered almost all of the $60,000 had the trustee given notice of termination immediately after the trustee was appointed. The $60,000 would have gone into the estate, leaving the debtor required to pay defense costs out of post-filing income. Although the debtor ultimately might win back some of the $60,000 by claiming exemptions, the allowed exemptions would likely represent only a fraction of defense costs, and the debtor probably would not receive a distribution on account of his exemptions in time to pay legal fees.

The B.A.P.'s opinion discriminates against chapter 7 debtors because individual debtors in chapters 13 and 11 can pay their attorneys from their plans or through interim allowances by using property of the estate that otherwise would go to creditors.

Who Is to Blame?

Blame for the predicament of chapter 7 debtors could be laid at the doorstep of the Countryman definition of executory contracts and its focus on remaining duties. Perhaps the Countryman definition does not work when one side's remaining duties are miniscule compared to the other's unperformed obligations.

The Ninth Circuit is hardly to blame for chapter 7 debtors' dilemma. In the first paragraph of *Hines*, the appeals court identified the very same problem in personal bankruptcies when the court said that the status of "postpetition services does not fit comfortably within the provisions of the Bankruptcy Code." The court went on to say that "Congress has been delinquent in failing to deal expressly with the always-present problem of arranging in advance for payment of services to be rendered after the filing in bankruptcy."

To secure payment of fees before filing, the circuit court said that chapter 7 debtors' counsel use two constructs, but both "are potentially subject to disruption by the operation of the Code."

In *Hines*, the Ninth Circuit recognized that chapter 7 debtors must have a legally enforceable mechanism to prepay for legal services, otherwise, the court said, there could be a "massive breakdown" in the "entire system."

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The Ninth Circuit therefore came up with a judge-made exception to the automatic stay to solve the problem in *Hines*. That solution, however, does not suit the needs for this year's case in the B.A.P.

Taking a cue from *Hines*, the B.A.P. should have felt at liberty under *Hines* to adopt a construct allowing prepayment for post-petition services.

As the concurring judge said in *Hines*, Congress, rather than the courts, should level the playing field. Otherwise, the right to file bankruptcy can become illusory.

Taken to its logical conclusion, the B.A.P. opinion is heading in the direction of allowing chapter 7 debtors only to pay counsel in advance for services to be performed before filing. The right to discharge debts will mean little if chapter 7 debtors cannot afford lawyers. Likewise, chapter 7 trustees could compel repayment of fees intended for ordinary post-petition services such as attending creditors' meetings and filing amended schedules and statements.

Hines in any event is not the solution nationwide. In 2003, the Seventh Circuit rejected *Hines* in *Bethea v. Robert J. Adams & Associates*.

Until Congress solves the problem by allowing chapter 7 debtors to pay their lawyers in advance, courts might protect individual bankrupts by ruling that prepaid retainers are fully earned and thus nonrefundable given the lawyers' promise to provide fixed-fee services. Judges could still police the lawyers by ensuring they gave value for the fees they received. Finding a solution could be more problematic when lawyers charge by the hour with a promise to refund unused retainers.

State legal ethics rules are also a problem because they are designed to protect clients from unscrupulous lawyers who charge up front and provide little later. States could fashion laws specifically for bankruptcy to ensure that individuals will have legal representation, but that would not solve the problem nationwide.

The opinion is *Ulrich v. Schian Walker PLC (In re Boates)*, 2016 BL 185297 (B.A.P. 9th Cir. June 9, 2016).

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Creditors, rejoice! Substantial contribution is rewarded, at least in the Sixth Circuit.

Sixth Circuit Splits with Third on Substantial Contribution in Chapter 7

The Sixth Circuit disagreed with a sister appeals court by allowing creditors in chapter 7 to have an administrative claim for a "substantial contribution," even though Section 503(b)(3)(D) only lists chapters 9 and 11 as the types of cases where they are allowed.

The Sept. 21 opinion by Circuit Judge Bernice B. Donald evidently represents the minority view. According to the dissent by Circuit Judge Kathleen M. O'Malley, the Third Circuit and at least 25 lower courts have held that a creditor's substantial contribution claim can succeed only in chapters 9 and 11.

Three creditors contributed to a chapter 7 case by initiating proceedings that resulted in removing the trustee. The substitute trustee sued the former trustee and an insurance company, resulting in a settlement characterized by the bankruptcy judge as contributing in part to a "substantial benefit" to the estate and creditors. The bankruptcy judge nonetheless denied a substantial contribution claim, saying it was not authorized by subsection (b)(3)(D).

Judge Donald reversed, beginning her analysis by saying that "equitable principles govern the exercise of bankruptcy jurisdiction." She largely based her decision on use of the word "including" before the list of administrative claims enumerated in subsection (b).

Given the use of "including," Judge Donald said Congress left the door open for courts to award administrative claims for expenses not specifically mentioned in Section 503(b)'s subsections.

The plain meaning of the subsection did not require denying the claim, Judge Donald said, because the statute nowhere says that expenses of the sort cannot be allowed in chapter 7. She also said the result was not compelled by the canon of construction known as "*expressio unis est exclusion alerius*," or the "expression of one thing excludes the other."

To Judge Donald's way of thinking, denying reimbursement "would disincentivize participation in the bankruptcy process" and "impugn the fundamental notion of bankruptcy's equitable relief."

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The opinion is *Mediofactoring v. McDermott* (*In re Connolly North America LLC*), 802 F.3d 810 (6th Cir. Sept. 21, 2015).

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A split is brewing on chapter 13 debt limits for couples filing jointly.

Georgia Judge Retains Individual Debt Limit for Joint Chapter 13s

A split is growing among the bankruptcy courts on the debt limit for a couple filing jointly in chapter 13.

Arguably referring to joint filers, the last half of Section 109(e) limits eligibility in chapter 13 to "an individual with regular income and such individual's spouse ... that owe, on the date of the filing of the petition, noncontingent, liquidated, unsecured debts that aggregate less than \$373,175...."

According to Bankruptcy Judge James R. Sacca of Atlanta, five courts interpret the section to mean that spouses who file jointly have twice the individual unsecured debt limit. He found one judge, from Illinois, who held that the \$373,175 limit also applies to a joint filing.

The case before Judge Sacca involved a couple who filed jointly, each with regular income. For each spouse separately, the individual and joint debts were less than the limit. Aggregated, however, their debts exceeded the limit.

Judge Sacca upheld the trustee's objection to confirmation of the plan, saying that Section 109(e) "expressly treats the unsecured debts of joint debtors in the aggregate." Courts holding to the contrary rely on policy arguments, not the language of the statute, according to Judge Sacca.

Judge Sacca rejected the argument that the last half of Section 109(e), quoted above, applies to cases where one spouse has regular income and the other does not.

Used in connection with the debt limit, the word "aggregate" was pivotal for Judge Sacca. It means, he said, that \$373,175 is the couple's aggregate debt limit.

Judge Sacca may have an overly narrow reading of the statute because each spouse can have debt up to the limit if they file separately. The text could be interpreted to make a couple eligible for chapter 13 if their aggregate debt is less than the limit when only one spouse has regular income.

Courts should keep in mind that the statute was written when women were less likely to be working mothers.

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The opinion is *In re Pete*, 541 B.R. 917 (N.D. Ga. Dec. 8, 2015).

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Arbitration

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Enforcing arbitration clause turns on core vs. non-core distinction.

Arbitration Clause Nixes Class Suit for an Automatic Stay Violation

Courts seem headed toward a rule allowing an individual bankrupt to sue for an alleged stay violation despite an arbitration clause, although an arbitration clause will be enforced if the same debtor initiates a class action.

A chapter 7 debtor filed a class action against a retailer for attempting to collect a discharged debt. She sought damages and attorneys' fees under Section 362(k) of the Bankruptcy Code.

After Bankruptcy Judge Randall L. Dunn of Portland, Ore., recommended withdrawing the reference, District Judge Michael H. Simon held a hearing, took evidence, and decided on Jan. 22 that the arbitration clause was enforceable outside of bankruptcy. He then held that the result was the same in bankruptcy because the debtor was pursuing a class action.

Attempting to defeat invocation of the Federal Arbitration Act and its policy of rigorous enforcement of arbitration clauses, the debtor argued that requiring individual enforcement of claims for stay violations would conflict "with the underlying purpose of the Bankruptcy Code" because "individual arbitration is not economically viable."

Judge Simon read the Ninth Circuit's *Schwartz-Tallard* decision in 2015 as meaning that Congress intended to permit suits by individual debtors for their own benefit. The appeals court, according to Judge Simon, perceived a difference between core and non-core proceedings. He said that courts do not have discretion to compel arbitration in core proceedings because it "would inherently conflict with the underlying purposes of the Bankruptcy Code."

Enforcing the arbitration clause and dismissing the class action, Judge Simon also found guidance from the Second's Circuit's 2006 decision in *MBNA Am. Bank v. Hill* and held that filing a class action is an admission that the claim was "not integral to her bankruptcy."

Judge Simon's opinion is similar in result to *Belton v. GE Capital Consumer Lending Inc.*, where District Judge Vincent L. Briccetti of White Plains, N.Y., enforced an arbitration clause and dismissed a class action alleging violation of a discharge injunction.

The opinion is *Campos v. Bluestem Brands Inc.*, 15-cv-629 (D. Or. Jan. 22, 2016).

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Bankrupts are left to the mercy of arbitrators to enforce discharge injunctions.

Creditors Can Compel Arbitration of Discharge Violations

A former bankrupt must arbitrate a claim that a creditor violated the discharge injunction by reporting that a debt was charged off rather than erased in bankruptcy, according to a district judge in White Plains, N.Y.

It is unclear from the decision whether the result would have been different had the debtor been seeking to enforce the discharge injunction only in his or her own case and not as a class action.

Two debtors reopened their chapter 7 cases to file class action suits against creditors that had told credit reporting agencies that their debts were charged off, not discharged. The debtors contended that the erroneous reports violated their discharge injunctions under Section 524(a)(2).

When Bankruptcy Judge Robert Drain denied the creditors' motions to enforce arbitration clauses in their credit agreements, the creditors appealed and won a reversal from District Judge Vincent L. Briccetti on Oct. 14.

Judge Briccetti relied in significant part on the Second Circuit's 2006 decision in *MBNA America Bank v. Hill*, which upheld an arbitration clause when the debtors filed class actions to enforce the automatic stay.

The result turned on the Federal Arbitration Act and its "liberal federal policy favoring arbitration," Judge Briccetti said. The question for him was whether Congress intended to preclude arbitration of a statutory federal right, as shown by an "inherent conflict" between arbitration and the Bankruptcy Code.

Judge Briccetti was persuaded by Section 1334(b) of the Judiciary Code, which does not give bankruptcy courts exclusive jurisdiction over claims arising under the Bankruptcy Code. In the creditors' favor, he cited the provision in Section 1334 giving bankruptcy courts exclusive jurisdiction over awards of compensation, thus cutting against the notion that Congress did not intended to exempt discharge enforcement from arbitration.

There was no "severe conflict" between the Bankruptcy Code and the Federal Arbitration Act that would "seriously" and "necessarily" jeopardize the "goal of centralized resolution of purely bankruptcy issues," Judge Briccetti said. Citing *MBNA America Bank*, he held that it is not enough to allege "a violation of an important, even fundamental, Bankruptcy Code provision."

The debtors are moving for leave to take an interlocutory appeal to the Second Circuit.

Judge Bricetti did not cite the *Lehman* case, decided two weeks earlier, in which another Southern District judge found a "severe conflict" and upheld a decision by the bankruptcy court barring arbitration over the subordination of claims. The *Lehman* decision, by District Judge Edgardo Ramos, is discussed above.

The opinion is *Belton v. GE Capital Consumer Lending Inc. (In re Belton)*, 15-cv-1934, 2015 WL 6163083 (S.D.N.Y. Oct. 14, 2015).

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Creditors bat 500 this fall when trying to compel arbitration in the Southern District of New York.

Subordination Clause Held Ineligible for Arbitration

With different results, arbitration clauses were the topic of two decisions handed down within two weeks of each other in Manhattan district courts.

The liquidation of Lehman Brothers Inc. teaches that an arbitration clause cannot be enforced when the issue concerns the subordination of hundreds of employees' claims.

In a case decided a fortnight later, individual debtors trying to mount class actions were unable to overcome an arbitration clause. That case, *Belton v. GE Capital Consumer Lending Inc.*, is discussed in the following item.

The case where creditors lost involved Lehman, the largest broker ever liquidated. Decades before it went bankrupt, the brokerage established a deferred compensation plan allowing senior employees to set aside some of their income in exchange for retirement benefits to be paid years or decades later. To comply with tax laws, the plan provided that the workers' claims would be subordinated to all other creditors' claims in the event of bankruptcy.

The compensation plan called for arbitration of disputes in the stock exchange. Hundreds of employees joined together and filed a motion calling on the bankruptcy judge to have an arbitrator decide whether the subordination clause was enforceable.

The bankruptcy judge made findings of fact at the conclusion of a hearing and denied the arbitration motion. Manhattan District Judge Edgardo Ramos upheld the bankruptcy judge in an opinion on Sept. 30. The employees are appealing to the Second Circuit; their brief currently is not due until Feb. 10.

Judge Ramos began with the proposition that the policy in the Federal Arbitration Act favoring arbitration must be "rigorously enforced," to use words penned by the Supreme Court. According to Second Circuit precedent, arbitration clauses will be overridden only when there is an "inherent conflict" between arbitration and another statute.

In the bankruptcy context, the Second Circuit has a two-part test, the first being an analysis of whether the dispute is core or non-core. Even if the question is core, the second part of the test provides that an arbitration clause will not be overridden unless litigation outside of bankruptcy court "would seriously jeopardize the objectives of the Bankruptcy Code," the Second Circuit proclaimed in *MBNA Bank NA v. Hill*.

Judge Ramos held that the bankruptcy court correctly decided that subordination issues are "quintessentially core bankruptcy proceedings." He also upheld the bankruptcy court's findings of a "severe conflict" between arbitration and the Code's objectives.

Given the lower court's findings, there was no abuse of discretion in refusing to compel arbitration, Judge Ramos held.

The opinion is *344 Individuals v. Giddens (In re Lehman Brothers Holdings Inc.)*, 14-civ-7643, 2015 WL 5729645 (S.D.N.Y. Sept. 30, 2015).

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Municipal Debt Adjustment

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The score is 2-1 in favor of equitable mootness in chapter 9 plan confirmation.

Franklin Funds Lost Again Challenging Stockton's Municipal Debt Plan

The Ninth Circuit Bankruptcy Appellate Panel sided with District Judge Bernard A. Friedman from Detroit by holding that the doctrine of equitable mootness applies to appeals from confirmation of chapter 9 municipal debt-adjustment plans, not only to corporate reorganizations in chapter 11.

In an appeal from the confirmation of Jefferson County, Ala.'s chapter 9 plan, District Judge Sharon Lovelace Blackburn of Birmingham held that equitable mootness was unavailable.

The appellate panel decision came down on Dec. 11 in the municipal bankruptcy of Stockton, Calif., which filed for chapter 9 protection in June 2012. Bankruptcy Judge Christopher M. Klein confirmed the plan in February, overruling objections from Franklin Resources Inc. high-yield bond funds. All other major bondholder, employee and creditor groups settled and accepted their treatment in Stockton's plan.

For the three-judge appellate panel, Bankruptcy Judge Randall L. Dunn of Portland, Ore., noted that his court in 2013 invoked equitable mootness in Vallejo, Calif.'s chapter 9 case. Equitable mootness is a judge-made rule of law that bars an appeal from a confirmation order in cases where overturning the bankruptcy court would pull the props out from under a consummated plan.

Judge Dunn was persuaded by the reasoning in the Detroit opinion, saying that equitable mootness has a "legitimate role to play" in chapter 9 just as it does in chapter 11. He also said Stockton's plan did not have potential constitutional defects like Jefferson County's. In the Alabama case, the district judge held that the objectors were entitled to have an Article III adjudication of their constitutional claims.

Invoking equitable mootness, Judge Dunn dismissed Franklin's appeal from confirmation as a whole because it would have a "potentially devastating impact on creditor constituencies" not participating in the appeal.

Franklin argued that confirmation was not entirely moot because an appellate court could simply require a larger payment on its claim. Judge Dunn recognized Ninth Circuit authority, which holds that it is not generally impossible to fashion a remedy seeking "only money."

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Consequently, Judge Dunn addressed and rejected Franklin's objections to the merits of the plan.

Franklin wanted Judge Klein to nix the plan unless the city cut workers' pensions, but Judge Klein said that Franklin was wrong in contending that the capital market creditors were recovering 1 percent on their claims while workers were unaffected by the bankruptcy.

Judge Klein pointed out how workers took pay cuts and lost benefits, stating that the "value of what employees and retirees lose under the plan is greater than what capital markets creditors lose."

Judge Klein calculated worker losses at $550 million, more than 10 times Franklin's loss. He said the employees were recovering 1 percent on their claims, the same as Franklin on the $32 million unsecured portion of its $36 million in bonds.

Based on Judge Klein's findings of fact, Judge Dunn rejected Franklin's argument that the plan unfairly discriminated and improperly classified its claims. He therefore dismissed the appeal generally as equitably moot while upholding the bankruptcy court's treatment of Franklin's unsecured claim.

The opinion is *Franklin High Yield Tax Free Income Fund v. City of Stockton, California (In re City of Stockton, California)*, 542 B.R. 261 (B.A.P. 9th Cir. Dec. 11, 2015).

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Detroit and Birmingham judges disagree on equitable mootness for municipalities.

Equitable Mootness Held Applicable to Chapter 9 Debt Adjustments

District courts in the Sixth and Eleventh Circuits disagree on applying equitable mootness to appeals from confirmation of chapter 9 municipal debt adjustment plans.

In September 2014, District Judge Sharon Lovelace Blackburn from Birmingham, Ala., ruled against Jefferson County and held that equitable mootness does not apply in chapter 9 cases. District Judge Bernard A. Friedman from Detroit wrote an opinion one year later in which he disagreed with Judge Blackburn, saying her distinctions between chapters 9 and 11 were "particularly problematic."

Judge Friedman was entertaining a motion by Detroit to dismiss appeals taken by dozens of pension recipients from confirmation of the city's chapter 9 plan. Detroit's is the largest municipal bankruptcy to date, with Jefferson County's in second place.

Equitable mootness is a judge-made doctrine calling for dismissal of an appeal from confirmation when modifying the plan would unravel a complex restructuring. The Third and Ninth Circuits in particular have been limiting instances in which the doctrine can be applied. The Third Circuit now applies the doctrine in only the largest reorganizations.

Judge Friedman said that the interests of 100,000 creditors and 700,000 Detroit residents "cannot be marginalized and dismissed in the broad brush manner adopted by the Jefferson County court." He believed that their "interests surely apply with greater force to the city's chapter 9 plan, which affects thousands of creditors and residents."

Judge Friedman invoked equitable mootness to dismiss the pensioners' appeal because reinstating their full claims would require a wholesale annihilation of the plan.

Judge Blackburn had denied dismissal of the Jefferson County appeal on a second theory. She held that as a life-tenured federal judge, she must hear the appeal because sewer customers contended the plan unconstitutionally locked in future rate increases to pay new bonds without enabling legislation or a vote by citizens.

Judge Blackburn held that a successful appeal by ratepayers would permit her to void "allegedly unconstitutional terms of the confirmation order" such as the "bankruptcy court's authority to set rates for sewer service." She nonetheless concluded that "some parts of the confirmation order may be impossible to reverse," such as the validity of newly issued bonds.

The Detroit opinion is *Ochadleus v. City of Detroit (In re City of Detroit)*, 14-cv-14872, 2015 WL 5697702 (E.D. Mich. Sept. 29, 2015).