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Case Updates: Business and Consumer Law Developments

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PLENARY SESSION

2018

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Introduction

It was difficult to identify a few key discussion cases for this panel with so many interesting developments in business and consumer law during the past year. As such, we have set forth below case summaries for those cases that the panel found not only interesting, but also important to the day-to-day dealings of a bankruptcy practitioner. In addition, for most of the cases cited below, we have included Bill Rochelle's analysis of the case in *Rochelle's Daily Wire* as part of our panel materials. Although the panel will not discuss each of these cases, we thought that we would at least highlight all of them in our materials.

The following case summaries (and the related excerpts from *Rochelle's Daily Wire*) are arranged by Circuit.

Case Summaries

United States Supreme Court

Czyzewski v. Jevic Holding Corp., 137 S. Ct. 973 (2017)
After an unsuccessful reorganization of Jevic Holding Corp., the official unsecured creditors' committee sued the secured lender over receipt of a fraudulent transfer. A settlement was negotiated, and the bankruptcy court approved that settlement over the objection of Jevic's former truckdrivers who held priority and general unsecured claims. The bankruptcy court also dismissed the case (i.e., a structured dismissal). The Supreme Court ruled that, without consent from affected parties, a court may not approve a structured dismissal that deviates from the bankruptcy priority scheme.

U.S. Bank, Nat'l Ass'n. v. Vill. at Lakeridge, LLC, 138 S. Ct. 960 (2018)
Lakeridge filed for chapter 11 bankruptcy with two substantial creditors. Lakeridge's plan impaired both creditors' claims, and Lakeridge sought to cram down the plan over U.S. Bank's objection. The other creditor was considered an "insider" of the debtor and therefore could not

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meet the statutory requirements for an impaired class consenting to the plan. This creditor transferred its claim to a non-insider, but U.S. Bank objected to the transfer on the basis that it was not an arm's length transaction. The bankruptcy court upheld the transfer, and the Ninth Circuit agreed with that ruling under a clear-error standard of review. The Supreme Court affirmed, holding that the Ninth Circuit invoked the correct standard of review.

Merit Mgmt. Grp., LP v. FTI Consulting, Inc., 138 S. Ct. 883 (2018)
Valley View Downs, LP was attempting to secure a harness racing license in Pennsylvania, and agreed to purchase all of Bedford Downs Management Corporation's stock if it was successful. Valley View secured the license and paid $55 million to Bedford shareholders, including Merit Management. Valley View filed for chapter 11 bankruptcy after being unable to open a racetrack casino, and FTI Consulting, as trustee, sought to avoid the transfer from Valley View to Merit ($16.5 million) as fraudulent under section 548(a)(1)(B). Merit in turn argued that the section 546(e) safe harbor barred FTI from avoiding the transfer. The Supreme Court ruled unanimously that the safe harbor applies only to the transfer that the trustee wants to avoid. Therefore, using a bank as an escrow agent does not stop a trustee from recovering fraudulent transfers if the trustee is seeking recovery from the ultimate recipient, not an intermediary bank.

Lamar, Archer & Cofrin, LLP v. Appling, __ S. Ct. __, 2018 WL 2465174 (June 4, 2018)
Lamar, Archer & Cofrin, LLP is a law firm located in Atlanta, Georgia, which was hired by Scott Appling to represent him in litigation against the former owners of a business that Appling had recently purchased. Appling agreed to pay hourly fees on a monthly basis, but ultimately fell behind. Appling told the law firm he would be filing an amended tax return entitling him to a refund that would cover the full amount of unpaid invoices. Ultimately, he received a smaller tax refund, spent that money elsewhere, and claimed to never receive it. The law firm sued Appling, and a judgment was entered against him. Appling then filed for chapter 7 bankruptcy seeking a discharge of debts, including the law firm's judgment. The law firm then sought a determination that its debt was nondischargeable under section 523(a)(2) of the Bankruptcy Code. The bankruptcy court held the debt nondischargeable, and the district court affirmed. The Eleventh Circuit (following the approach of the Fourth Circuit) reversed, holding that a statement about a single asset could be a "statement respecting a debtor's … financial condition" under section 523(a)(2). This conclusion also meant that the statement about the single asset (here, the tax refund) must be in writing to be nondischargeable under section 523(a)(2)(B). The Supreme Court affirmed the decision of the Eleventh Circuit, finding, among other things, that an appropriate interpretation of the word "respecting" as used in section 523(a)(2) supported that position. As such, a statement about a single asset may in fact be a "statement respecting a debtor's … financial condition" under section 523(a)(2).

Eleventh Circuit

Max v. Northington (In re Northington), 876 F.3d 1302 (11th Cir. 2017)
A debtor in Georgia entered into a pawn transaction exchanging title to his car for a cash advance. Under Georgia law, the debtor had a 30-day grace period after maturation to pay back the loan. The debtor failed to pay back the loan, and instead filed a chapter 13 case during the grace period, which extended the grace period for an additional 60 days. The bankruptcy court ultimately confirmed the debtor's plan, over the creditor's objection, allowing the debtor to keep the car and repay the creditor over the life of the plan. The Eleventh Circuit ruled that, upon the expiration of the redemption period, the car ceased to be property of the bankruptcy estate; therefore, section 1322(b)(2) did not apply.

Slater v. United States Steel Corp., 871 F.3d 1174 (11th Cir. 2017)
A plaintiff failed to disclose a civil lawsuit in a bankruptcy filing, and U.S. Steel, the defendant in the civil lawsuit, filed a summary judgment order in the civil suit based on the plaintiff/debtor's lack of disclosure and judicial estoppel. Slater claimed that any failure to disclose was not intentional, that she misunderstood the question on schedule B, and to correct the misunderstanding filed amended forms. Slater's case eventually converted to chapter 13, but was dismissed after confirmation for failure to make plan payments. U.S. Steel's summary judgment motion was granted based on judicial estoppel. After sitting *en banc* and reversing two prior decisions relating to judicial estoppel, the Eleventh Circuit determined that judicial estoppel was not warranted because the debtor was not intending to make a mockery of the judicial system.

Tenth Circuit

In re Bird, 577 B.R. 365 (B.A.P. 10th Cir. 2017)
In two similar chapter 7 bankruptcy cases, homes were listed on schedule A subject to mortgages and liens in excess of their scheduled values. In both cases, the debtors claimed homestead exemptions. The trustee objected to the homestead exemptions on the basis that no equity existed to exempt. The trustee found buyers willing to pay more than the encumbrances on both properties, and negotiated a stipulation with the IRS. If the sales were approved, the debtors would not receive any of the proceeds, lose their homes, and increase their nondischargeable tax debts. The debtors converted their cases to chapter 13. The chapter 7 trustee filed applications for compensation based on his work in the chapter 7 cases. The bankruptcy court denied the fee applications, finding the services were not necessary, and did not benefit the estate. The bankruptcy appellate panel reached the same result.

Fifth Circuit

In re Franchise Services of North America, *Inc*., 2018 WL 485959 (Bankr. S.D. Miss. Jan 17, 2018)
The debtor received a $15 million investment in return for a 49% share in the debtor's equity. The entity holding this investment was owned indirectly by one of the debtor's creditors. In the debtor's certificate of incorporation, the debtor included a provision prohibiting filing for bankruptcy without consent from the investor as a stockholder. After the debtor filed bankruptcy, the investor moved to dismiss because the investor did not authorize the filing. The bankruptcy court granted the motion to dismiss. Although a provision prohibiting filing bankruptcy is typically against public policy, the court stated that it is mostly against public policy if the provision mandated creditor consent to file. Such a provision may be enforced if a substantial equity owner's consent is required.

Fourth Circuit

Burkhart v. Grigsby, No. 16-1971, 65 Bankr. Ct. Dec. 113, 2018 U.S. App. LEXIS 7928 (4th Cir. Mar. 29, 2018)
The chapter 13 debtors had three junior liens on their home that were all unsecured due to a senior lien and the value of the home. Two of the junior liens were held by Tri-County Bank, and the third was held by PNC Bank. Although PNC and the senior lienholder filed a proof of claim, Tri-County did not. The debtors commenced an adversary proceeding to strip off the Tri-County and PNC liens. The court stripped off the PNC lien, but not the Tri-County lien, since Tri-County did not file a proof of claim. The district court upheld this ruling. The Fourth Circuit reversed, however, on the basis that the senior lienholder was only partially secured, and any and all junior lienholders were unsecured under section 1322(b). As a result, the junior liens may be stripped without the filing of a proof of claim.

Janvey v. Romero, 883 F.3d 406 (4th Cir. 2018)
Peter Romero filed a chapter 7 bankruptcy petition after he was found liable for $1.275 million to the victims of a Ponzi scheme. Janvey, the receiver in the litigation, moved to dismiss the petition for cause under section 707(a). The bankruptcy court denied the motion, and the district court affirmed. The Fourth Circuit agreed with the lower courts, finding that there was no abuse of the bankruptcy process. The Fourth Circuit determined that protecting exempt assets is not an abuse, and that the debtor had more debts than just the judgment in favor of Janvey.

Bate Land Co. v. Bate Land & Timber, LLC (In re Bate Land & Timber, LLC), 877 F.3d 188 (4th Cir. 2017)
Bate Land Co. sold 79 tracts of land to the debtor, Bate Land & Timber, LLC, for $65 million. The debtor paid $9 million in cash, and financed the rest. The debtor failed to repay its debt in full by the maturation date, and revised deadlines. The debtor filed chapter 11 bankruptcy. BLC filed a claim for $13 million. The debtor proposed a partial dirt-for-debt provision in their plan. Most of Bate's creditors accepted the provision, but BLC objected to it. A bankruptcy court can "cram down" over an objection, but must determine if the plan provides the creditor the "indubitable equivalent" of its claim. The Fourth Circuit evaluated the indubitable equivalent standard under a de novo review standard, and declined to find that a partial-dirt-for-debt plan can never provide indubitable equivalent of a claim.

Sheehan v. Ash, No. 17-1867, 2018 WL 2070556 (4th Cir. May 4, 2018)
The debtors, Keith and Phyllis Ash, filed for chapter 7 bankruptcy in the Northern District of West Virginia, in July 2015. The Ashes had just moved from Louisiana to West Virginia in March 2015. They owned property in both states. The West Virginia property was worth approximately $3,500, all of which the debtors exempted under Louisiana state exemptions. The trustee objected to the exemption scheme, because the property was in West Virginia, and the Supreme Court has a presumption against extraterritoriality. The bankruptcy court and district court allowed the exemptions. The Fourth Circuit also allowed the exemptions, based on the district court's finding that state exemption laws may be used by out-of-state debtors for out-of-state property to the extent the state exemption law permits it or does not explicitly limit the use of exemptions to in-state residents or in-state property.

Robbins v. Delafield (In re Williams), Adv. Pro. No. 16-07024, 2018 WL 832894 (Bankr. W.D. Va. Feb. 12, 2018) (ethics and professional compensation)
Law Solutions Chicago, LLC, is an Illinois limited liability company operating under various assumed names. Law Solutions Chicago, LLC is doing business as Upright Law, and would pop up in Internet ads when prospective clients would search for bankruptcy attorneys. A non-lawyer would take the call when a prospective client contacted the firm. The non-lawyers would use many tactics to get the prospective clients to sign up and pay fees. The non-lawyers sometimes gave legal advice, even though they were instructed not to give legal advice. Once a prospective client signed up, and became a client, a local lawyer was given the case, and treated as an associate of the firm. This would allow fee sharing between the firm and local lawyers. This specific proceeding focused on an arrangement between the firm and a company that took clients' surrendered autos and demanded payment of storage and towing fees from lenders. If lenders did not pay the fees, the company would keep the auction proceeds. The court found many ethical problems with this arrangement. The court also determined that the case was not constitutionally moot because the firm is still operating under the same business model.

Third Circuit

In re Millennium Lab Holdings II, LLC, 575 B.R. 252 (Bankr. D. Del. 2017)
Millennium Lab Holdings was a chapter 11 debtor that called for shareholders to contribute money to the plan in exchange for third-party releases, which were not subject to an opt-out provision. One lender filed suit before confirmation alleging fraud and RICO violations. The bankruptcy court confirmed the plan and third-party releases over the objection. On remand from the district court, the bankruptcy court found that it had the proper constitutional authority to approve the nonconsensual third party releases. The court also found that the lender forfeited its right by not raising it at the confirmation hearing, or any time prior to the confirmation order.

First Circuit

Mission Prod. Holding, Inc. v. Old Cold, LLC (In re Old Cold, LLC), 879 F.3d 376 (1st Cir. 2018)
The bankruptcy court did not err in finding that a successful bidder was a good faith purchaser under section 363(m). There was no evidence establishing any misconduct or collusion in the sale by the debtor or the bidder, even though the bidder was made up of some of the debtor's insiders. The First Circuit also approved the bankruptcy court's decision to waive the 14-day automatic stay, and that closing the sale immediately was also valid.

Case Analysis from Rochelle's Daily Wire

Jevic ***opinion continues to permit first-day wage and critical vendor orders, although its effect on gift plans is debatable.***

Supreme Court Reverses *Jevic*, Bars Structured Dismissals that Violate Priority Rules

Reversing the Third Circuit in *Czyzewski v. Jevic Holding Corp.*, the Supreme Court ruled 6/2 today in an opinion by Justice Stephen G. Breyer that the bankruptcy court, without consent from affected parties, cannot approve so-called structured dismissals that "deviate from the basic priority rules," not even in rare cases.

Justice Breyer was careful to narrow the Court's holding so the opinion would not be interpreted to preclude first-day wage or critical vendor orders.

Joined by Justice Samuel A. Alito, Jr., Justice Clarence Thomas dissented, saying that the writ of *certiorari* should have been dismissed as improvidently granted.

The Facts

In the unsuccessful reorganization of Jevic Holding Corp., the official unsecured creditors' committee had sued the secured lender for receipt of a fraudulent transfer. The committee and the lender negotiated a settlement calling for the lender to set aside some money for distribution to general unsecured creditors following dismissal in a scheme that did not follow the ordinary priority rules contained in Section 507.

Since it would give them nothing on their $8.3 million in wage priority claims, workers objected to the settlement because some settlement proceeds were to be held in a trust exclusively for lower-ranked general unsecured creditors.

The bankruptcy court in Delaware approved the settlement and structured dismissal and was upheld in district court. The Third Circuit, in a 2-1 opinion, upheld the structured dismissal, eliminating any chance of recovery by priority wage claimants through the bankruptcy. Although the dissenter in the Third Circuit concurred that structured dismissals could be approved on occasion, he did not believe *Jevic* was a proper case.

The Supreme Court granted *certiorari* in June 2016 to resolve a split of circuits. Before granting *certiorari*, the Supreme Court sought comment from the Solicitor General, who subsequently urged granting the petition and reversing the court of appeals.

Justice Breyer's Opinion

Justice Breyer cited the American Bankruptcy Institute Commission report's definition of structured dismissals. He went on to say that the ABI report referred to structured dismissals as "increasingly common."

Justice Breyer observed that the Bankruptcy Code "does not explicitly state what priority rules – if any – apply to a distribution" when a chapter 11 case is dismissed. He noted, however, that a chapter 11 plan cannot violate rules of priority over objection from an impaired creditor class.

Since Section 349(b) does not say when there is "cause" to depart from the ordinary rules governing the effects of dismissal, he said the propriety of structured dismissals was a "complicated question." Nonetheless, he said, the answer is "simple": Structured dismissals are not permissible.

The Bankruptcy Code's "priority system constitutes a basic underpinning of business bankruptcy law," the opinion says. Justice Breyer said the Court "would expect to see some affirmative indication of intent if Congress actually meant to make structured dismissals a backdoor means to achieve the exact kind of nonconsensual priority-violating final distributions that the [Bankruptcy] Code prohibits in chapter 7 liquidations and chapter 11 plans."

Justice Breyer was careful to ensure that the opinion is not read broadly to prohibit common practices in chapter 11 cases that depart from the rules and timing of distributions, such as first day orders allowing payment of pre-petition wages and claims of so-called critical vendors. Those practices, he said, are designed to enhance the chance for a successful reorganization.

On the other hand, Justice Breyer said, a "priority-violating" distribution in a structured dismissal "is attached to a final disposition; it does not preserve the debtor as a going concern."

He left the door open to other priority-defying practices if there is a "significant offsetting bankruptcy-related justification."

Justice Breyer ended his discussion of the merits by saying that a structured dismissal is not permissible even in a "rare case." He said that allowing them sometimes would result in "similar claims being made in many, not just a few, cases." He concluded that "Congress did not authorize a 'rare case' exception."

The Standing Question

Justice Breyer's majority opinion had a three-page discussion of standing that may be pertinent if the question avoided in *Spokeo Inc. v. Robbins*, 136 S. Ct. 1540, 194 L. Ed. 2d 635 (Sup. Ct. May 16, 2016), comes back to the Supreme Court.

The respondents contended that the workers had no standing because they suffered no injury. Although they got nothing under the settlement, the bankruptcy judge said they likewise would have received nothing if the settlement were disapproved.

The workers had standing, Justice Breyer said, because "a settlement that respects ordinary priorities remains a reasonable possibility." Furthermore, he said, the fraudulent transfer claim "could have litigation value" because the defendants were willing to pay $3.7 million in settlement. Consequently, "the structured settlement cost petitioners something. They lost a chance to obtain a settlement that respected their priorities. Or, if not that, they lost the power to bring their own lawsuit."

On an issue that may arise if a case like *Spokeo* comes back to the high court, Justice Breyer cited *McGowan v. Maryland*, 366 U.S. 420 (1961), and said that "a loss of even a small amount of money is ordinarily an 'injury'" that gives rise to standing.

'Gift' Plans

The majority opinion does not explicitly discuss the related question of so-called gift plans, where a lender allows some typically small portion of its collateral to be diverted to a low-ranking class, passing over a higher ranking class.

The holding in *Jevic* could be authority to bar gift plans to the extent they result from settlements negotiated by creditors' committees based on claims that belong to the estate.

On the other hand, gift plans arguably are permissible if they promote "significant Code-related objectives" that *Jevic* would allow.

The Dissent

Joined by Justice Alito, Justice Thomas dissented, saying the *certiorari* petition should have been denied as having been improvidently granted. He said the petitioners argued a different issue from the one for which the Court granted *certiorari* to resolve a circuit split.

On the question presented in the petitioners' brief, Justice Thomas said there is no circuit split.

The opinion in the Supreme Court is *Czyzewski v. Jevic Holding Corp.*, 15-649 (Sup. Ct.). 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).

Some justices are critical of the existing test for ruling on non-statutory insider status.

Supreme Court Says Insider Status Is Reviewed for Clear Error Under Existing Test

The Supreme Court used a bankruptcy case to elucidate the standard of review when an appellate court confronts a mixed question of law and fact. According to Justice Elena Kagan, who wrote the opinion today for the unanimous Court, clear error was the proper standard of review because the arm's-length nature of the transaction was primarily factual in nature.

In concurring opinions, four justices questioned whether the Ninth Circuit employed the proper legal test for non-statutory insider status. Implying that the dissenter in the Ninth Circuit was on the right track, they laid out a test for non-statutory insider status that would be more consonant with the statute and produce a different outcome.

At oral argument in the Supreme Court on October 31, it seemed possible that the justices might rule that review is *de novo* when the facts in the trial court were undisputed. However, the Court's opinion hewed to the traditional notion that inferences taken from undisputed facts are reviewed for clear error.

The Ninth Circuit Decision

In this chapter 11 reorganization, there were only two creditors. One was a bank with a $10 million secured claim. The other was the debtor's general partner, who had a $2.8 million unsecured claim.

The bank opposed the plan and could have defeated confirmation for lack of an accepting class, because the insider's vote could not be counted under Section 1129(a)(10) in cramming down the plan on the bank.

To create an accepting class and open the door to confirmation via cramdown, the insider sold her claim for $5,000 to a very close friend. The plan provided a $30,000 distribution on the unsecured claim.

The bankruptcy judge ruled that the buyer automatically became an insider by purchasing the insider's claim. The Bankruptcy Appellate Panel reversed and was upheld by the Ninth Circuit in a 2-1 opinion.

All three circuit judges agreed that the purchaser did not automatically become an insider by purchasing the insider's claim. The majority then said that status as an insider entails a "factual inquiry that must be conducted on a case-by-case basis." To be a non-statutory insider, the appeals court laid out a two-part test. A claim buyer "must have a close relationship with the debtor and negotiate the relevant transaction at less than arm's length."

The Ninth Circuit did not remand the case to the bankruptcy court because the bankruptcy judge had ruled that the buyer purchased the insider's claim in an arm's-length transaction. Since the purchaser bought the claim at arm's length, the second prong of the test had not been met, leading the majority on the Ninth Circuit to rule that the purchaser was not a non-statutory insider.

The majority on the circuit court therefore 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. It was "clear" to him 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 Petition for *Certiorari*

The bank filed a petition for *certiorari*, which was granted in March 2017. The Court limited its review to the appellate standard of review. The U.S. Solicitor General, who had opposed granting *certiorari*, submitted a merits brief on the side of the debtor and argued that the Ninth Circuit properly applied the clear-error standard of appellate review. The Solicitor General did not take a position on whether the bankruptcy judge committed clear error.

The Unanimous Opinion

In her 11-page opinion for the unanimous court, Justice Kagan said that courts have developed standards for non-statutory insiders that "are not entirely uniform." Many, she said, focus on whether the transaction was conducted at arm's length.

The buyer and seller were in a romantic relationship but lived apart and kept their finances separate. Despite the close relationship, the bankruptcy judge had found that the sale of the claim was negotiated at arm's length.

Justice Kagan said that the bankruptcy court had correctly applied the Ninth Circuit's two-part test. The Supreme Court, however, did not include a review of the test within the grant of *certiorari*. Instead, the Court only agreed to review the proper appellate standard for a ruling on non-statutory insider status.

Parsing the standards of appellate review, Justice Kagan said that findings of historical fact — such as "what, when or where, how or why" — are reviewable for clear error.

On the other hand, whether historical facts satisfy the test for non-statutory insider status is a mixed question of law and fact, Justice Kagan said. She then said that mixed questions "are not all alike."

Pinpointing the standard of review for mixed questions "all depends," she said, on whether the work of the appellate court is "primarily legal or factual."

Deciding whether the sale of the claim was "conducted as if the [buyer and seller] were strangers to each other" was "about as factual sounding as any mixed question gets," Justice Kagan said. Indeed, she said, applying the Ninth Circuit's two-part test amounts to what the Court "previously described as 'factual inferences[] from undisputed facts."

Justice Kagan said that the bankruptcy court had the "closest and the deepest understanding of the record" from hearing the witnesses and presiding over the presentation of evidence.

The appellate standard of review was therefore for clear error because the appellate court was called on to perform "[p]recious little" legal work in applying the Ninth Circuit's two-part test.

Approaching the issue from a different direction, Justice Kagan said that even a *de novo* review "will not much clarify legal principles or provide guidance to other courts resolving other disputes."

The Concurring Opinions

Justice Sonia Sotomayor wrote a seven-page concurring opinion joined by Justices Anthony M. Kennedy, Clarence Thomas, and Neil M. Gorsuch.

Justice Sotomayor said it "is not clear to me" that the two-prong test in the Ninth Circuit "is consistent with the plain meaning of the term 'insider' as it appears in [Section 101(31) of] the Code."

The enumerated statutory insiders in Section 101(31) do not lose that status, Justice Sotomayor said, by negotiating at arm's length. Therefore, she said, "it is not clear why the same should not be true of non-statutory insiders."

Finding shortcomings in the Ninth Circuit's test, Justice Sotomayor proceeded to offer two other tests.

First, the court could focus on "commonalities" between enumerated insiders and "characteristics of the alleged non-statutory insider." Second, the court might consider "other aspects of the parties' relationship" if the transaction was negotiated at arm's length.

Had the trial court applied one of her proposed tests, Justice Sotomayor said it "is conceivable" that the standard for review might have been different.

In the penultimate paragraph of her concurrence, Justice Sotomayor said that the facts of the case as applied to one of her two alternative tests may have resulted in a finding that the purchaser was an insider, even if the clear-error test were applied.

In a signal that she and her three colleagues were dissatisfied with the Ninth Circuit's existing test, Justice Sotomayor ended her opinion by imploring courts "to grapple with the role that an arm's-length inquiry should play in a determination of insider status."

Justice Kennedy wrote a separate two-page concurrence to emphasize that the Court's opinion should not be taken as an endorsement for the Ninth Circuit's existing two-part test. He also questioned whether the bankruptcy judge was correct in finding that the purchaser was not an insider, but said "*certiorari* was not granted on this question."

The opinion is *U.S. Bank NA v. The Village at Lakeridge LLC,* 15-1509 (Sup. Ct. March 5, 2018).

Intermediate transfers to financial institutions do not trigger the safe harbor.

Supreme Court Narrowly Interprets the Safe Harbor, Overrules the Majority of Circuits

Resolving a split of circuits, the Supreme Court ruled unanimously today in *Merit Management Group LP v. FTI Consulting Inc.* that the so-called safe harbor under Section 546(e) only applies to "the transfer that the trustee seeks to avoid." In other words, using a bank as an escrow agent does not preclude a trustee from recovering a constructively fraudulent transfer under Section 548(a)(1)(B), when the trustee is seeking to recover from the ultimate recipient of the transfer but not from an intermediary bank.

The Supreme Court had been asked to resolve a split of circuits and decide whether the safe harbor applies when a financial institution is only a "mere conduit." Instead, the unanimous opinion by Justice Sonia Sotomayor decided the case on a different and broader ground. The opinion may lead to a rethinking of safe harbor cases and might open the door to suits that previously were believed to rest comfortably within the safe harbor.

The Seventh Circuit Opinion

The case came to the Supreme Court from the Seventh Circuit, where a bankruptcy trustee had sued a selling shareholder in the leveraged buyout of a non-public company. The transaction was structured so that the purchase price for the stock initially came from an investment bank and was transferred to a commercial bank acting as escrow agent. As escrow agent, the bank paid a total of $16.5 million to the selling shareholder. The trustee sued the selling shareholder for receipt of a constructively fraudulent transfer.

The district court granted a motion to dismiss, reasoning that the safe harbor applied because the transfer included both a transfer from an investment bank and a transfer to a commercial bank, before the funds ended up in the hands of the selling shareholder.

On appeal, the Seventh Circuit reversed, in an opinion by Chief Circuit Judge Diane P. Wood. *FTI Consulting Inc. v. Merit Management Group LP*, 830 F.3d 690 (7th Cir. July 28, 2016).

The Seventh Circuit opinion stands for the proposition that routing consideration for an LBO of a non-public company through a financial institution cannot preclude a fraudulent transfer attack if it turns out that the seller was rendered insolvent.

Since the purchaser was buying stock, it was clear to the Seventh Circuit that the transfers were either a settlement payment or a payment in connection with a securities contract. The appeals court said it was therefore only necessary to decide whether the safe harbor protects transactions "simply [because they were] conducted through financial institutions."

The Seventh Circuit refused to "interpret the safe harbor so expansively that it covers any transaction involving securities that uses a financial institution or other named entity as a conduit for funds." Instead, the appeals court said "it is the economic substance of the transaction that matters."

The Chicago-based appeals court therefore reversed the district court, which had utilized the safe harbor to dismiss the trustee's suit.

The Seventh Circuit opinion deepened an existing circuit split because the Second, Third, Sixth, Eighth and Tenth Circuits have invoked the safe harbor when a financial institution is nothing more than a conduit. The Eleventh Circuit was aligned with the Seventh, requiring the financial institution to be more than a conduit.

The defendant-selling shareholder filed a petition for *certiorari*, which the Supreme Court granted in May 2017. Oral argument was held on Nov. 6.

The Unanimous Opinion

The seeds for Justice Sotomayor's opinion were sown in an exchange at oral argument between Justice Anthony M. Kennedy and former Solicitor General Paul D. Clement, counsel for the trustee. Justice Kennedy asked whether the opinion should be qualified to require that the financial institution have an "equity participation" before the safe harbor applies.

Clement said he had a "simpler way to write the opinion[: by just looking] to the transfer that the trustee seeks to avoid." And that's what Justice Sotomayor did.

Laying out the statute in full text in her opinion, Justice Sotomayor traced the many amendments to the safe harbor, saying Congress "each time expand[ed] the categories of covered transfers or entities."

In pertinent part, Section 546(e) provides that a trustee "may not avoid a transfer" that is a "settlement payment . . . made by or to (or for the benefit of) a . . . financial institution" or that "is a transfer made by or to (or for the benefit of) a . . . financial institution . . . in connection with a securities contract . . . ."

Justice Sotomayor framed the question as whether the safe harbor applied because the transfer was "'made by or to (or for the benefit of) a . . . financial institution.'" She said that

asking whether the bank had a beneficial interest in the transferred property "put the proverbial cart before the horse."

Before deciding whether the transfer was made to a covered entity, "the court must first identify the relevant transfer," she said.

Justice Sotomayor devoted the bulk of her opinion to explaining why the "language of Section 546(e)," the "specific context in which that language is used, and the broader statutory structure all support the conclusion that the relevant transfer for purposes of the Section 546(e) safe-harbor inquiry is the overarching transfer that the trustee seeks to avoid." She said the trustee properly identified the transfer as the sale of stock by the seller to the buyer, not intermediate transfers involving investment or commercial banks.

Uttering a phrase that will be cited countless times in the future, Justice Sotomayor cautioned that a trustee "is not free to define the transfer it seeks to avoid in any way it chooses."

Justice Sotomayor devoted the final third of her 19-page opinion to refuting the selling shareholder's arguments. The last part of her opinion arguably broadens the scope of the holding and makes the safe harbor more narrow than it is now generally understood to be.

She said that the addition of "(or for the benefit of)" in 2006 was only intended for the scope of the safe harbor to match the scope of the avoiding powers, where similar language is used. She rejected the selling shareholder's contention that the language was intended to bar avoidance if the financial institution was an intermediary without a financial interest in the transfer.

Next, the selling shareholder mounted an argument based on the inclusion of a securities clearing agency as one of the entities covered by the safe harbor.

If the relevant transfer is from the buyer to the seller, Justice Sotomayor said, "the question then becomes whether the transfer was 'made by or to (or for the benefit of)' a covered entity," such as a clearing agency.

Answering her own question, Justice Sotomayor said, "If the transfer that the trustee seeks to avoid was made 'by' or 'to' a securities clearing agency . . . , then Section 546(e) will bar avoidance, and it will do so without regard to whether the entity acted only as an intermediary."

On the next page, Justice Sotomayor acknowledged there was "good reason to believe that Congress was concerned about transfers '*by* an industry hub.'" [Emphasis in original.]

She went on to say that the safe harbor protects securities transactions "'made by or to (or for the benefit of)' covered entities. See Section 546(e). Transfers 'through' a covered entity, conversely, appear nowhere in the statute."

What exactly did the justice mean by her statements?

It was generally understood, at least before today's opinion, that a trustee could not recover a fraudulent transfer resulting from the sale of stock in a publicly held company, because the payoff to the selling shareholder would have been made through a "covered entity," like a clearing agent. Does today's opinion mean that a trustee for a public company can recover from selling shareholders but, of course, not from a clearing agent?

It had also been held that the LBO of a privately held company was protected by the safe harbor, if the sale of the stock utilized a bank somewhere in the stream of payments. It seems reasonably clear that an LBO of a privately held is no longer protected, unless the transferee is a financial institution.

However, what results if the transfer ends up in the coffers of a bank that held a lien on the stock being sold? May the trustee recover only from the beneficial owner of the stock but not from the bank where the money ended up?

The meaning of *Merit Management* will be debated in other contexts. For instance, the Second Circuit held in *Note Holders v. Large Private Beneficial Owners (In re Tribune Co.)*, 818 F.3d 98 (2d Cir. 2016), that the safe harbor bars suits by creditors under state law to recover payments made in securities transactions.

In *Tribune*, the Second Circuit concluded that Congress intended broad protection for securities markets, even to the extent of barring creditors from prosecuting claims that belong to them and not to bankruptcy trustees. Does *Merit Management* undercut the Second Circuit's notion that the safe harbor broadly immunizes any transaction involving securities whenever there has been a bankruptcy?

The opinion is *Merit Management Group LP v. FTI Consulting Inc.*, 16-784 (Sup. Ct.).

The high court seemed primed to rule that a debt will be discharged despite an oral misrepresentation about one asset.

Supreme Court Holds Argument in Lamar, Archer & Cofrin on Dischargeability

The Supreme Court heard oral argument yesterday in *Lamar, Archer & Cofrin, LLP v. Appling*, 16-1215 (Sup. Ct.). The justices seem primed to rule that a false statement about one asset must be in writing to provide grounds for ruling that a debt is nondischargeable under Section 523(a)(2).

The high court granted *certiorari* on Jan. 12 to resolve a split of circuits. The courts of appeals are evenly split, with the Eleventh and Fourth Circuits holding that a false oral statement about one asset is a "statement respecting the debtor's . . . financial condition" that must be in writing to result in denial of discharge of a debt under Section 523(a)(2). The Fifth and Tenth Circuits ruled to the contrary and held that misrepresenting one asset can result in nondischargeability of the debt owing to the creditor to whom the misrepresentation was made.

Among the lower courts, a majority follow the Eleventh and Fourth Circuits.

In a telling indication of how the Court may come out, the justices spent perhaps one-third of oral argument discussing the best rule they could devise to reach the same result as the Eleventh Circuit and hold that an oral misrepresentation about one asset cannot lead to the nondischargeability of a debt.

The Case Below

A client told his lawyers that he expected a large tax refund that would enable him to pay his legal bills. Based on that representation, the lawyers continued working.

Although the refund was smaller than represented, the client spent it on his business, falsely telling his lawyers that he had not received the refund. The lawyers continued working. Later, they obtained a judgment they could not collect when the client filed bankruptcy.

The bankruptcy judge held that the claim for legal fees was not discharged. The ruling in bankruptcy court was upheld in district court, but the Eleventh Circuit reversed in a Feb. 15, 2017, opinion authored by Circuit Judge William Pryor, *Appling v. Lamar, Archer & Cofrin LLP (In re Appling)*, 848 F.3d 953 (11th Cir. Feb. 15, 2017). To read ABI's discussion of the Eleventh Circuit opinion, click here.

The creditor filed a petition for *certiorari*. The U.S. Solicitor General recommended that the Court grant the petition, submitted an *amicus* brief, and participated in oral argument, contending that the Eleventh Circuit was correct and that an oral misstatement about one asset is a statement about "financial condition" that must be in writing before the debt can be declared nondischargeable.

The Issue and the Statute

The case centers around Sections 523(a)(2)(A) and 523(a)(2)(B). Under (a)(2)(B), a debt will not be discharged if it resulted from a materially false *written* statement "respecting the debtor's . . . financial condition."

Under (a)(2)(A), a debt will not be discharged if it resulted from "a false representation or actual fraud, other than a statement respecting the debtor's . . . financial condition."

The circuits are split about the result when a debtor prevaricates about one asset, rather than lies about his or her net worth or overall financial condition. Curiously, the Fifth and Tenth Circuits would discharge a debt if a debtor makes a big lie orally about his or her net worth, but would declare the debt nondischargeable if the debtor makes a smaller, oral lie about only one asset.

Oral Argument

The justices were uncharacteristically quiet, interrupting counsel on both sides less often than they do in most arguments. Perhaps the justices have already decided how they will rule. Or perhaps they were simply exhausted after the morning's prior argument in a very consequential case, *South Dakota v. Wayfair, Inc.*, to decide whether the Court will overrule its prior precedent and allow states to impose sales taxes on goods purchased through the Internet.

As the petitioner in the bankruptcy case, counsel for the creditor argued first. He asked the justices to rule "that a statement about a single asset or a single liability is not a statement respecting financial condition." He focused on the statutory word "respecting" to mean that a misrepresentation about "overall financial condition" is the only type of statement that must be in writing to result in nondischargeability. In "commercial practice," he said, "financial condition" refers "to one's overall financial status."

The creditor's counsel argued that the result might be different if the statute had used "about" rather than "respecting." But Justice Elena Kagan countered, "I honestly couldn't find one [example] where [the two words] meant something different."

Justice Stephen G. Breyer took a different approach. He focused on the word "statement" rather than "respecting" to broaden the meaning of "financial condition" to encompass one asset.

In the same vein, Justice Ruth Bader Ginsburg asked why a statement about a forthcoming tax refund "isn't . . . a statement respecting the financial condition."

Similarly, Justice Neil M. Gorsuch asked why a misrepresentation about a major asset "can't . . . be about your overall financial condition."

Justice Breyer used the example of a debtor who claimed to own an original painting by Vermeer. He asked, "What's that if it's not about overall financial [condition]?"

Later, counsel for the creditor addressed these questions by saying that a misstatement about one asset "goes to the ability to pay, not overall financial condition."

Counsel for the debtor and the Solicitor General drew even fewer questions.

Counsel for the debtor rested his case on the plain language of the statute, as did the creditor. Fleshing out his interpretation of the statute, he said "that any statement that has a direct impact on one's overall financial condition . . . is a statement respecting financial condition."

The debtor's counsel proposed the following test: "Does the statement describe what would be a line item on one's balance sheet or income statement?"

He described the government's proposed test as saying that a statement pertains to financial condition if it is "an affirmative representation about a single asset if that representation is offered as evidence of the debtor's ability to pay."

In response to questions from the bench, he could not think of a circumstance where the result would differ depending on which test was employed.

When the time came for the Solicitor General to speak, he agreed that "there is no practical difference in how it turns out" if the debtor's formulation were used rather than the government's. He grounded the government's position in history.

According to the Solicitor General, the phrase "financial condition" was not "plucked out of the ether in 1978" with the adoption of the Bankruptcy Code. He said it had existed in bankruptcy law "dating back to 1926 [and] had been interpreted by courts over the years to extend beyond statements about overall financial condition to include statements about particular assets."

The justices asked no questions of the creditor's counsel during rebuttal argument.

The creditor was represented in the Supreme Court by Gregory George Garre from Latham & Watkins LLP in Washington, D.C. The debtor's counsel was Paul Whitfield Hughes from Mayer

Brown LLP in Washington, D.C. Arguing for the government was Jeffrey E. Sandberg, Assistant to the Solicitor General.

To read the transcript of oral argument, click here.

The case is *Lamar, Archer & Cofrin, LLP v. Appling*, 16-1215 (Sup. Ct.).

Eleventh Circuit inveighs against harming innocent creditors by invoking judicial estoppel.

En Banc, Eleventh Circuit Narrows Applicability of Judicial Estoppel in Bankruptcy

At the urging of one of the judges on the original panel, the Eleventh Circuit sat *en banc* and reversed two of its prior decisions by holding that a court must consider all the facts and circumstances before invoking the doctrine of judicial estoppel. To prevent a defendant from reaping an "unjustified windfall," the intentional failure to list a claim belonging to a bankrupt no longer results in the automatic application of judicial estoppel.

Even after the Sept. 18 opinion by Circuit Judge Jill Pryor, the Eleventh Circuit still has not gone as far as the Fifth Circuit when the New Orleans-based court sat *en banc* and functionally held in *Reed v. City of Arlington*, 650 F.3d 571 (5th Cir. 2011), that a defendant in a lawsuit cannot assert judicial estoppel to inflict harm on a bankruptcy trustee and innocent creditors based on a debtor's shortcomings.

The Facts

A woman initiated an employment discrimination suit two years before filing a chapter 7 petition. The employer learned about the bankruptcy and filed a motion to dismiss based on judicial estoppel, because the debtor had not scheduled the lawsuit among her assets. The debtor modified her schedules to list the claim, and the chapter 7 trustee retained the debtor's litigation counsel as special counsel to pursue the suit on behalf of the estate.

The debtor then converted her case to chapter 13 and confirmed a plan, but the chapter 13 case was dismissed when the debtor failed to make plan payments.

Invoking judicial estoppel, the district court dismissed the discrimination suit. Recognizing that it was bound by Eleventh Circuit precedent, the appeals court's three-judge panel upheld dismissal in February 2016 in an unsigned, 32-page *per curiam* opinion.

One of the three judges on the panel, Circuit Judge Gerald B. Tjoflat, wrote a special concurrence that reads like a dissent. He urged the appeals court to rehear the case *en banc* and overrule two Eleventh Circuit precedents that he believed were "wrongly decided." Anyone confronted with an issue involving judicial estoppel should study Judge Tjoflat's 78-page concurrence from last year, because it reads like a treatise discussing everything there is to know on the subject.

The appeals court granted rehearing *en banc*, heard argument in February and reversed its own precedents in Judge Pryor's 33-page opinion.

'Mockery' No Longer Automatic

Judge Pryor began by reaffirming the circuit's general rule that judicial estoppel applies when a litigant takes inconsistent positions and intends "to make a mockery of the judicial system." Her opinion focused on the mockery element because the debtor unquestionably took inconsistent positions by originally omitting the suit from her schedules.

Under the circuit's *Barger* and *Burnes* decisions from 2003 and 2002, respectively, Judge Pryor said that the mockery element was conclusively established by a debtor's nondisclosure, "even if the plaintiff corrected his bankruptcy disclosures after the omission was called to his attention and the bankruptcy court allowed the correction without penalty."

Judge Pryor devoted her opinion to explaining why the court was reversing *Barger* and *Burnes* and holding that the court instead "should consider all the facts and circumstances," including the "plaintiff's level of sophistication, his explanation for the omission, whether he subsequently corrected the disclosure, and any action taken by the bankruptcy court concerning the nondisclosure." She said that "voluntariness alone does not necessarily establish a calculated attempt to undermine the judicial process."

In refusing to impose judicial estoppel reflexively, Judge Pryor seemed largely motivated to avoid giving "an unjustified windfall" to "an otherwise liable civil defendant," in the process harming "innocent creditors." She recognized that *pro se* debtors may not understand how the requirement for disclosing contingent and unliquidated claims also means claims that the debtor holds, not just claims against the debtor.

Judge Pryor explained why courts should not automatically apply judicial estoppel even in chapter 13 cases. Because the debtor must satisfy the best interests test to confirm a plan, creditors in chapter 13 would be harmed just like in chapter 7 if a claim by the debtor is treated as worthless.

Is a *Cert* Petition Next?

Judge Pryor said there is a split of circuits even after abandoning *Burnes* and *Barger*. Like her court now holds, the Sixth, Seventh and Ninth Circuits previously ruled that the "mockery" element requires showing more than an intention not to disclose.

The Fifth and Tenth Circuits, she said, take the opposite view by endorsing "the inference that a plaintiff who omitted a claim necessarily intended to manipulate the judicial system."

Judge Pryor may have overstated the circuit split.

The *en banc* opinion in *Reed*, written for the Fifth Circuit by Circuit Judge Carolyn King, laid down a "general rule that, absent unusual circumstances, an innocent trustee can pursue for the benefit of creditors a judgment or cause of action that the debtor fails to disclose." She also said that judicial estoppel must be applied "flexibly" to achieve "substantial justice," a principle that Judge Tjoflat advocated in his concurrence in the Eleventh Circuit's original decision last year.

In substance, the applicability of judicial estoppel is now virtually irrelevant in the Fifth Circuit when a trustee is prosecuting a previously undisclosed claim for the benefit of creditors. The Fifth Circuit also endorsed the idea of precluding a culpable debtor from benefitting from successful prosecution by directing any recovery exclusively toward creditors.

Therefore, the Fifth Circuit's pre-*Reed* automatic invocation of judicial estoppel may no longer be good law in that circuit. Even if it is, the principle has little relevance after *Reed*, which permits recoveries on undisclosed claims to benefit innocent creditors.

Consequently, the Tenth Circuit may be the only circuit functionally at odds with four other circuits. As such, there may not be a fully developed, entrenched split warranting a grant of *certiorari*. For lack of a final order, a *certiorari* petition also would be premature at this juncture because the circuit remanded for more than ministerial duties.

The *Amicus* in the Eleventh

Supporting the debtor, J. Erik Heath of San Francisco submitted an *amicus* brief in the Eleventh Circuit on behalf of the National Association of Consumer Bankruptcy Attorneys. In addition to explaining how Eleventh Circuit precedent had gone beyond the purpose of judicial estoppel, he recommended adopting the approach in *Reed* by granting a trustee standing to pursue a claim not available to a debtor in view of judicial estoppel.

Unfortunately, Judge Pryor did not cite *Reed* or consider how that case might inform the relief available on remand. Although the Eleventh Circuit "may not have explicitly gone the route of *Reed*," Heath told ABI in an email that he believes it's "part of the result." He also praised the appeals court for overruling *Barger* and thereby allowing "trustees to escape judicial estoppel."

Remand to the Panel

When a circuit court reverses, it ordinarily remands to the trial court. But not here.

Judge Pryor remanded the case to the original three-judge panel "to consider whether the district court abused its discretion in applying judicial estoppel *and to resolve any other remaining issues.*" [Emphasis added.]

The mandate to consider other issues should allow the three judges to opine on a result like *Reed*, where creditors can benefit but the debtor cannot.

To read ABI's discussion of the panel decision from February 2016, click here.

The opinion is *Slater v. U.S. Steel Corp.*, 12-15548 (11th Cir. Sept. 18, 2017).

Splitting with the Sixth Circuit, the Tenth Circuit BAP does not require equity to claim a homestead exemption.

Homestead Exemption Must Be Paid in Full Before a Sale Is Permitted, BAP Says

Laying the groundwork for a split of circuits, the Tenth Circuit Bankruptcy Appellate Panel built on *Czyzewski v. Jevic Holding Corp*., 137 S. Ct. 973 (2017), and *Law v. Siegel*, 134 S. Ct. 1188 (2014), by holding that a chapter 7 trustee cannot scheme with secured creditors to sell a home out from underneath a debtor without paying the homestead exemption in full, even when there is little or no equity in the property above secured debt.

If there is another appeal and the Tenth Circuit rules the same way, there will be a split with the Sixth Circuit on the question of whether a debtor can claim a homestead exemption without having any equity in the property. A split would also enable the Supreme Court to decide whether a trustee can sell a home without paying a homestead exemption in full.

Unless the Sixth Circuit reverses course or the Supreme Court takes up the issue, individuals who file chapter 7 petitions in four states are at risk of losing their homes even if the sale price will not pay their exemptions in full. Homeowners in six states are shielded from the same fate unless the Tenth Circuit reverses the BAP.

The Trustee's Scheme to Generate Fees at the Debtor's Expense

In two chapter 7 cases filed about the same time, the debtors each owned homes, which they scheduled as having values somewhat less than the sum of mortgages and tax liens on the properties. The debtors claimed homestead exemptions, however.

The trustee appointed in both cases found buyers who were offering to pay about $5,000 more than the encumbrances on both properties. The trustee also negotiated a stipulation with the Internal Revenue Service where the government consented to the sale of the properties and agreed to carve out $10,000 in each case for distribution to unsecured creditors. In addition, the IRS agreed to a further $60,000 reduction in the government's recovery on its tax liens in each case by allowing the trustee to pay his fees and the real estate broker's commissions from the sale proceeds.

If the sales had been approved, the debtors would have received nothing for their homestead exemptions, while the trustee and broker together would have taken home more than $60,000 for their services in each case. Unsecured creditors would have recovered only $10,000 in each case.

For the debtors, the proposed deal was worse than simply losing their homes without anything for their homestead exemptions. The government's agreement to carve out $10,000 for unsecured creditors and allow payment of the fees would have increased the debtors' nondischargeable tax debts and left them with no equity to apply toward the purchase of new residences.

The future looking bleak, the debtors both prevailed on the bankruptcy judge to convert their cases to chapter 13. Conversion mooted the trustee's incipient sale motions. In both cases, the bankruptcy judge upheld the debtors' homestead exemptions, over the trustee's objections. The conversion to chapter 13 mooted the trustee's appeals from the homestead exemption rulings.

Following conversion, the chapter 7 trustee filed applications for allowances of more than $30,000 in compensation in each case for himself and his counsel. In an encyclopedic opinion on Dec. 14, 2016, Chief Bankruptcy Judge R. Kimball Mosier of Salt Lake City ruled that a trustee cannot sell an individual debtor's home without paying the homestead exemption in full, in cash.

Citing Section 330(a)(4)(A), Judge Mosier denied the fee applications because the trustee's services were not necessary, did not benefit the estate, and "could work a substantial harm on the debtors if they were approved." In substance, he explained why he would not have approved the sales had the debtors not converted the cases to chapter 13. To read ABI's discussion of Judge Mosier's opinion, click here.

The trustee appealed to the Tenth Circuit BAP but lost again in a Nov. 30 opinion by Bankruptcy Judge Sarah A. Hall. The BAP reached the same result in barring a trustee from selling overencumbered property, albeit on somewhat narrower grounds than Judge Mosier.

Abandon, Don't Sell Without Equity

To determine whether the trustee was entitled to compensation, Judge Hall analyzed Section 330(a)(4)(A), which bars the allowance of compensation if the services "were not reasonably likely to benefit the debtor's estate [or] necessary to the administration of the case."

Regarding the necessity of the trustee's services, Judge Hall held that "abandonment of the homesteads would have better comported with a chapter 7 trustee's ultimate duties and responsibilities." The Bankruptcy Code, abundant caselaw, and the Handbook for Chapter 7 Trustees promulgated by the Office of the U.S. Trustee Program "emphatically" supported the bankruptcy court's decision, Judge Hall said.

Judge Hall cited the Handbook for the proposition that a trustee should abandon property when liquidation would not produce a "meaningful" distribution for unsecured creditors. Similarly, she cited caselaw holding that a sale of fully encumbered property is generally

prohibited, to prevent trustees from generating fees for themselves in a sale that produces nothing for unsecured creditors.

With regard to the Bankruptcy Code, Judge Hall said that equity for unsecured creditors "is what authorizes a trustee to exercise his powers of sale under Section 363 in the first place, because liquidation should not be for the benefit of the estate's secured creditors." Although a carve-out for unsecured creditors might be appropriate in some circumstances, she said that an agreement with a secured creditor to create equity "is suspect and presents opportunities for collusion."

Since the proposed sale would have benefitted primarily the trustee and secured creditors, Judge Hall concluded that the services were not necessary in the administration of the estates.

Again unsuccessfully, the trustee contended that his services were nonetheless reasonably likely to benefit the estate.

On that issue, Judge Hall said that the bankruptcy court's finding of lack of benefit to the estate was not reversible error, "regardless of whether its legal determinations were correct or incorrect."

The trustee argued that his services benefited the estate, based on the notion that the debtors lacked equity and were not entitled to homestead exemptions.

Under Utah and federal law, exemptions must be liberally construed in favor of debtors, Judge Hall said. Under Utah law, she said that debtors are entitled to homestead exemptions even if they have no equity in their homes. The exemption, she said, arises from title and possession, although the exemption is limited in dollar amount.

Therefore, the trustee was not entitled to compensation under Section 330(a)(4)(ii) because there was no benefit to the estate, since the trustee should have abandoned the properties.

The trustee also argued there could have been benefit to the estate because he could have sold the properties under Section 363(f).

There was no *bona fide* dispute, and therefore no ability to sell under Section 363(f)(4), because, Judge Hall said, the bankruptcy court had upheld the debtors' homestead exemptions, among other things.

Similarly, there was no right to sell under Section 363(f)(5), which would have applied were the debtors compelled to accept monetary satisfaction for their interests.

The Utah exemption statute does not permit a sale unless the price would pay the exemption in full. The trustee therefore could not have sold under Section 363(f)(5), thus shutting the door to the idea that the trustee could have conferred benefit on the estate.

Judge Hall upheld the denial of all the trustee's requested fees by saying it made "no sense whatsoever to sell the homesteads and incur administrative expenses [of about $60,000 in each case] in order to get only $10,000 to unsecured creditors and at the same time deny debtors their homesteads."

"All bankruptcy professionals," she said, "must exercise billing judgment."

Significant Circuit Splits in the Offing

If the trustee appeals again and if the Tenth Circuit affirms, there will be a split of circuits on two major issues.

In *Brown v. Ellmann (In re Brown)*, 851 F.3d 619 (6th Cir. March 20, 2017), the Sixth Circuit decided a strikingly similar case with a diametrically opposite result. In *Brown*, the debtor had owned an overencumbered home, but she did not initially claim a homestead exemption. Instead, she originally signaled her intention to surrender the house.

The trustee in *Brown* cobbled together a deal to sell the home for less than the first mortgage. The first mortgagee agreed to take a haircut on the senior mortgage, carve out $6,000 for the second mortgagee, and leave a small surplus for unsecured creditors. The debtor later claimed an exemption and opposed the sale, unsuccessfully.

The Sixth Circuit upheld the sale, holding that the debtor was not entitled to claim a homestead exemption under Michigan without equity in the property. Aside from the distinction that the two cases arose under the exemption laws of different states, the Tenth Circuit BAP split with the Sixth Circuit on the validity of a homestead exemption in the absence of equity in the property.

More fundamentally, the Sixth Circuit allowed selling a home out from underneath a debtor without paying the homestead exemption in full, whereas the Tenth Circuit BAP would not allow a sale under analogous circumstances.

Brown also widened a split in its own right by holding that a sale order is not automatically mooted by Section 363(m) if the appellate court can grant some relief without affecting the validity of the sale.

The Tenth Circuit BAP cited to *Brown* in passing, but without addressing in depth how the two cases reached fundamentally different results.

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

Jevic and *Siegel* Influence the BAP

The BAP buttressed its conclusions by referencing two recent Supreme Court decisions.

In a passing reference, the BAP said that "*Jevic* stands for the proposition that neither the parties, nor the courts, are free to circumvent the Bankruptcy Code's rules and policies regarding priorities and distributions through manipulation of substantive and procedural protections." The reference to *Jevic* in a footnote shows that the high court's decision on limiting structured dismissal informs the result in other contexts, such as exemptions.

The BAP also cited *Law v. Siegel* for the idea that homestead exemptions are "sacrosanct" and can be denied "only on statutory bases enumerated in the Bankruptcy Code."

Although the BAP case was not "strictly analogous" to *Law v. Siegel*, Judge Hall said the effect was the same: "to deprive debtors of their homestead exemptions on a basis other than one enumerated in the Code."

Moreover, she said, the debtors had not been accused of any fraudulent behavior, like the debtor in *Law v. Siegel*. The "scheme" to sell the homes by negotiating with the IRS was "nothing more than an attempt to do indirectly what the Bankruptcy Code and Utah exemption statutes prevent him from doing directly."

On behalf of the National Consumer Bankruptcy Rights Center and the National Association of Consumer Bankruptcy Attorneys, Tara A. Twomey submitted an *amicus* brief on behalf of the debtors.

The opinion is *Jubber v. Bird (In re Bird)*, 16-039 (B.A.P. 10th Cir. Nov. 30, 2017).

The Fifth Circuit is being asked to decide whether loan structuring can prevent a borrower from filing bankruptcy.

The Validity of a 'Golden Share' to Bar a Filing Goes to the Fifth Circuit

The Fifth Circuit is being asked to accept a direct appeal and decide whether a creditor can structure a loan agreement to prevent a borrower from filing bankruptcy, sidestepping the principle that public policy prohibits waiving the right to file bankruptcy.

Bankruptcy Judge Edward Ellington of Jackson, Miss., ruled in December that a creditor with a comparatively small claim who is also a minority equity holder can be given the right, wearing its shareholder hat, to preclude the borrower from filing bankruptcy. Consequently, Judge Ellington dismissed the debtor's chapter 11 petition for lack of proper corporate authorization.

The case raises the question of whether a creditor can utilize a so-called golden share to prevent a borrower from filing bankruptcy. On Jan. 17, Judge Ellington certified the case for direct appeal to the Fifth Circuit.

Judge Ellington said that a "blocking provision or golden share is a relatively new provision created by the credit community in an attempt to work around the prohibition against an entity contracting away the right to file bankruptcy."

The Golden Share Structure

The debtor owned a car rental company. To finance an acquisition, the debtor received a $15 million investment from a diversified financial group. In return, the investor was given 49% of the debtor's preferred equity.

An affiliate of the investor was a creditor with a $3 million claim. Judge Ellington said that the investor controlled the affiliate-creditor.

The debtor's Delaware certificate of incorporation included a golden share provision prohibiting the company from filing bankruptcy without consent from the investor wearing its hat as a preferred stockholder.

After the debtor filed a chapter 11 petition, the investor, in its status as the holder of the golden share, filed a motion to dismiss, contending the filing was accomplished without proper

corporate authorization. Judge Ellington granted the motion and dismissed the petition in December when the debtor was in the midst of selling the assets.

Caselaw on Golden Shares

Judge Ellington said there are six opinions from bankruptcy courts and one from a district court shedding light on the ability of a golden shareholder to block the filing of bankruptcy. All of the cases are new. The first was handed down in 2007. The six others date from 2014 or later. None reached a circuit court.

All of the seven cases, according to Judge Ellington, begin with the "general premise that the waiving or contracting away the right to file for relief under the Bankruptcy Code is contrary to public policy." All of the cases, he said, hold that a blocking power held by a creditor is "void as a matter of public policy."

On the other hand, Judge Ellington said it is "clear" from the cases dealing with "golden shares or blocking provisions" that "either provision will be upheld as valid if it is held by an equity holder."

Applying the caselaw to the facts at hand, Judge Ellington concluded that the blocking position held by the "substantial equity holder" was "valid and enforceable and . . . not contrary to public policy under federal law."

Judge Ellington conceded that the investor-creditor wears two hats, as a creditor owed $3 million and an equity holder with a $15 million investment. Quoting one of the seven cases, the judge said the equity investor had the "unquestioned right" to block a voluntary bankruptcy.

Judge Ellington also concluded that a golden share or blocking provision in articles of incorporation is not invalid under Delaware law.

Should the Fifth Circuit accept the direct appeal, Judge Ellington tasked the appeals court with deciding three issues: (1) Is a blocking provision or golden share, held by either a creditor or equity holder, invalid as a violation of public policy if it prevents a corporation from filing bankruptcy; (2) if the holder is both a creditor and shareholder, is barring bankruptcy invalid as a violation of public policy, and (3) under Delaware law, may a certificate of incorporation contain a blocking provision or golden share, and if permissible, does Delaware law impose fiduciary duties on the holder in exercising its power?

Enforcing the blocking provision may seem reasonable in a case like this where the equity investment was five times larger than the claim as a creditor. But what if the facts were reversed and the claim was five times larger than the equity investment? Where should the Fifth Circuit draw the line on the ratio between debt and equity? Does the creditor's control invalidate the

exercise of shareholder rights? Should the bankruptcy court make a finding of fact and decide whether the shareholder was using its blocking power to collect the debt or eliminate the bankruptcy court as a platform where other creditors might sue the shareholder-creditor?

The validity of a golden share in the hands of someone who is both a shareholder and creditor cries out for a bright-line rule, otherwise the outcome of every case will be uncertain and law could develop in different directions around the country, leading to inconsistent results and forum-shopping.

The December opinion and the certification of a direct appeal are both in *In re Franchise Services of North America Inc.*, 17-2361 (Bankr. S.D. Miss. Dec. 18, 2017 and Jan. 17, 2018).

A contrary result would have obviated the judicially recognized right to strip off underwater subordinate liens in chapter 13.

Chapter 13 Strip-Off Ok Even if Lienholder Does Not File a Claim, Fourth Circuit Holds

Despite having a reputation for being conservative, the Fourth Circuit is becoming uncommonly debtor-friendly. The appeals court held that a chapter 13 debtor can strip off an underwater subordinate mortgage even if the lienholder did not file a proof of claim.

The opinion on March 29 by Circuit Judge Albert Diaz is important, given the effect that a contrary holding would have. By not filing a claim, the holder of a subordinate mortgage waives the right to distributions under a chapter 13 plan but would realize a bigger payday by having the lien pass through bankruptcy unaffected, if Judge Diaz had ruled the opposite.

If failing to file a proof of claim would immunize a subordinate mortgage-holder from having the lien stripped off, subordinate mortgagees would never file claims, precluding chapter 13 debtors from stripping off underwater subordinate mortgages, even though every circuit to address the issue has held that chapter 13 debtors have the statutory right to strip off underwater subordinate liens.

The Simple Facts

The chapter 13 debtors had three mortgages on their home, which was worth less than the debt on the first mortgage. The holder of the second lien did not file a proof of claim, but the holder of the third mortgage did.

The debtors sued to strip off the second and third mortgages. Both subordinate mortgagees defaulted. The bankruptcy judge stripped off the third mortgage but refused to strip off the second mortgage because the lienholder had not filed a proof of claim. The bankruptcy judge theorized that Section 506(d)(2) prohibits lien avoidance when no proof of claim has been filed. The district court affirmed on the same ground.

The Fourth Circuit Opinion

Section 506(d) provides that a lien is void to the extent it "secures a claim against the debtor that is not an allowed secured claim." On appeal, the chapter 13 trustee argued that the claim on the second mortgage was not an allowed claim, because no proof of claim was filed. Therefore, according to the trustee, the debtor could not strip off the mortgage.

In short, Judge Diaz held that Section 506(d) plays no role in stripping off liens. He said the process is governed by Sections 506(a) and 1322(a). He also explained the statutory and caselaw basis for allowing or disallowing lien strip-off and lien strip-down.

In chapter 7, the Supreme Court decided in *Dewsnup v. Timm*, 502 U.S. 410 (1992), that a debtor cannot strip down a partially secured claim. In *Bank of America v. Caulkett*, 135 S. Ct. 1995 (2015), the high court extended *Dewsnup* to hold that a chapter 7 debtor cannot strip off a completely valueless subordinate lien.

In *Nobelman v. American Savings Bank*, 508 U.S. 324 (1993), the Supreme Court similarly prohibited strip-down in chapter 13 but has not granted *certiorari* to rule on strip-off in chapter 13. However, every court of appeals to consider the issue has held, like the Fourth Circuit, that strip-off is permissible in chapter 13. (Strip-off means eliminating a lien entirely. Strip-down means reducing the amount of a lien according to the value of the collateral securing the claim.)

Regarding the issue at bar, Judge Diaz said that a court "correctly" looks not to Section 506(d) but to Section 506(a) for valuation of the collateral to decide whether the debtor can modify the rights of the secured creditor under Section 1322(b)(2).

Judge Diaz said that the lower courts confused "the claim allowance and lien avoidance process." In addition, the lower courts turned "a blind eye to economic reality." He said that "the language and purpose of Section 1322(b) compels" reversal.

Judge Diaz noted that Section 1322(b) does not refer to modifying claims. Rather, the statute talks about modifying the "rights of holders of secured claims." He therefore held that "an entirely valueless lien may be stripped under Section 1322(b) whether or not a proof of claim has been filed."

Ruling otherwise, he said, "would require us to ignore the plain fact that . . . such a creditor has no incentive to file a proof of claim." Furthermore, the debtor could remedy any defect by filing a claim as permitted by Section 501(c), he said.

The opinion is *Burkhart v. Community Bank of Tri-County (In re Burkhart)*, 16-1971 (4th Cir. March 29, 2018).

The Fourth Circuit and a Delaware bankruptcy judge reach opposite conclusions on motions to dismiss petitions by solvent debtors.

Solvency May or May Not Result in Dismissal

Days apart, the Fourth Circuit and a bankruptcy court in Delaware reached opposite results on motions to dismiss a *solvent* debtor's petition as a bad faith filing. Whether the debtor was an individual or the filing was defensive (as opposed to offensive) may explain the difference.

The debtors' sincerity and ethics (or lack thereof) may also explain the opposite outcomes.

In Delaware, Bankruptcy Judge Laurie Selber Silverstein dismissed a corporate chapter 11 petition, basing her legal conclusions on *Integrated Telecom Express Inc.*, 384 F.3d 108 (3d Cir. 2004), where the Third Circuit theorized that a bankruptcy could be dismissed for bad faith if the filing did not serve a valid bankruptcy purpose and if the petition was filed to obtain a tactical advantage.

The debtor in Judge Silverstein's case was a car-rental franchisor that had spent $2.7 million in attorneys' fees attempting to cut off a franchisee in Los Angeles. The litigation was a near total failure, because the Fourth Circuit upheld rulings in the lower court to the effect that the franchisee had a royalty-free right to use the debtor's trademark, among other things. The judgment also precluded the debtor from establishing other franchises in Los Angeles.

Soon after filing the chapter 11 petition, the debtor moved to reject the executory contract with the Los Angeles franchisee. The franchisee countered with a motion to dismiss the petition, which Judge Silverstein granted in her Feb. 13 opinion, saying that the burden of showing a good faith filing by a preponderance of the evidence rests on the debtor.

At trial, the debtor conceded it was solvent. The extent of the debtor's net worth was unclear because the debtor had scheduled the value of its most important assets as "unknown."

Judge Silverstein went further into the balance sheet, noting that the $3 million in secured debt was owed to a non-bankrupt affiliate having common ownership with the debtor. While unsecured debt to affiliates was "significant," Judge Silverstein found that unsecured debt to third parties was "comparatively insignificant."

Rejecting the debtor's unsupported allegation that cash flow was negative, Judge Silverstein concluded that the debtor was not in "financial distress." She also found that non-financial evidence pointed to a bad faith filing.

Judge Silverstein said that the "primary purpose" of the chapter 11 case was to reject the Los Angeles franchise and thereby open the door to signing up a new franchisee who would pay royalties. She said that bankruptcy was "nothing more than a straightforward attempt to take value that belongs to [the franchisee] and give it to [the debtor's owner]."

Emphasizing her finding that the filing did not have a legitimate bankruptcy purpose, Judge Silverstein said she had "no doubt" that the attempted reorganization was "just another chapter in the attempt to terminate the [Los Angeles] franchise."

In contrast, the Fourth Circuit upheld a bankruptcy court's denial of the principal creditor's motion to dismiss a solvent individual's chapter 7 filing.

The debtor had the misfortune of having been an outside advisor for seven years to Ponzi schemer Allen Stanford. The receiver for Stanford sued the debtor and won a $1.275 million judgment.

Coincident with the receiver's domestication of the judgment in California, where the debtor owned property, the debtor filed a chapter 7 petition in Maryland. The bankruptcy judge denied the receiver's motion to dismiss the petition for "cause" as a bad faith filing under Section 707(a). The district court upheld the bankruptcy court, as did the Fourth Circuit in a Feb. 21 opinion by Circuit Judge J. Harvie Wilkinson, III.

Like Judge Silverstein, Judge Wilkinson said that dismissing a petition as a bad faith filing is based on the "totality of the circumstances." He could not find grounds for upsetting the bankruptcy court's exercise of discretion.

Like Judge Silverstein, Judge Wilkinson surveyed the facts in detail. The debtor in the Fourth Circuit was more sympathetic than the corporate debtor in Delaware.

Like Delaware, however, the Maryland debtor was solvent. According to the bankruptcy court, the Maryland debtor had assets of more than $5.3 million, but most were exempt. The debtor had turned his nonexempt assets, consisting of a boat and two cars, over to his trustee.

On the liability side, the judgment to the Stanford receiver represented 90% of the debtor's unsecured debt. Some $150,000 in unpaid legal fees formed the bulk of the third-party debt.

In terms of income and expenses, the debtor was living off a pension, rental income and Social Security because he had been unable to gain employment after his connection with Stanford become public information.

Of significance, the debtor had been spending $12,000 a month to care for his incapacitated wife. Otherwise, the debtor's expenses were modest.

The Stanford receiver argued for dismissal, saying the case was a two-party dispute where the debtor was attempting to shield his exempt assets. Indeed, the bankruptcy judge found that the "primary motivation" was to fend off the judgment.

Judge Wilkinson, however, ruled that the debtor had not "abused the bankruptcy process."

Like Judge Silverstein, Judge Wilkinson said that dismissal is proper if the debtor has "'abused the provisions, purpose, or spirit of bankruptcy law.'" He added, though, that dismissal is "reserved for cases of real misconduct."

Unlike the debtor in Delaware, the bankruptcy judge found the Maryland debtor to be "candid, forthcoming, timely, and cooperative." Judge Wilkinson said it was "simply not a case that [the debtor] filed for bankruptcy solely to avoid the judgment." The debtor, he said, had $150,000 in third-party debt.

Finally, and significantly, Judge Wilkinson said that protecting exempt assets is not an abuse, because forcing a debtor to use exempt assets to satisfy a debt "would also undercut the entire exemption scheme that Congress designed."

Although the ability to repay a debt "may be a relevant factor," Judge Wilkinson held that it is not a "per se bar to bankruptcy relief."

The Fourth Circuit opinion is *Janvey v. Romero*, 17-1197 (4th Cir. Feb. 21, 2018); the Delaware opinion is *In re Rent-A-Wreck of America Inc.*, 17-11592 (Bankr. Del. Feb. 13, 2018).

Equitable defenses can bar payment of interest on a fully secured claim, Fourth Circuit holds.

Circuits Split on Appellate Standard for Finding of 'Indubitable Equivalent'

The Fourth Circuit widened a circuit split by holding that a finding of "indubitable equivalent" in a cramdown opinion is reviewed for clear error, not *de novo*.

The Dec. 6 opinion by Circuit Judge Allyson Kay Duncan also held that an oversecured creditor's right to collect interest is subject to equitable defenses, even though Section 506(b) says that a claim for interest "shall be allowed."

The Valuation Trial in Bankruptcy Court

The case involved a chapter 11 reorganization that was little more than a two-party dispute. The primary secured creditor held a purchase money mortgage on all of the debtor's undeveloped real property. The debtor's so-called dirt-for-debt plan proposed transferring eight of the tract's 79 parcels plus $1 million to the lender in satisfaction of the fully secured claim. The principal amount of the lender's claim was about $13 million.

The lender objected to the plan, requiring the bankruptcy court to hold cramdown hearings and determine whether the plan represented the "indubitable equivalent" of the lender's claim under Section 1129(b)(2)(A)(iii).

The bankruptcy court conducted 10 valuation hearings and heard from multiple witnesses, including experts for both sides. Ultimately, the bankruptcy judge ruled that the eight parcels were worth $13.7 million.

The bankruptcy judge also calculated that the lender was entitled to about $1.4 million in post-petition interest. Principal and interest together, the lender had a secured claim of about $14.6 million.

Coupled with a $1 million cash payment under the plan, the bankruptcy judge confirmed the plan and ruled that the lender would receive the "indubitable equivalent" of its secured claim. Having unsuccessfully sought a stay pending appeal, the lender appealed, but the district court dismissed the appeal as equitably moot.

The Appeal Was Not Equitably Moot

On appeal to the Court of Appeals, Judge Duncan reversed on dismissal of the appeal as equitably moot but upheld confirmation and the finding of "indubitable equivalent."

Dismissal for equitable mootness is proper, Judge Duncan said, when effective judicial relief is no longer practically available. She concluded that the case was not moot because "the parties have offered no reason for us to conclude that this court would be unable to order the debtor to surrender additional cash or tracts of land" to the lender.

Modifying the plan by giving more land or cash to the debtor, she said, would neither impact other creditors nor affect their recoveries.

Partial 'Dirt for Debt' Is Ok

On the merits, the lender argued that a partial dirt-for-debt plan can never provide the "indubitable equivalent." The lender contended there can be no "indubitable equivalent" when "valuation involves some uncertainty."

Judge Duncan rejected this contention, saying there is "uncertainty in all disputed valuations." The lender's theory "would eviscerate the indubitable equivalence standard," she said.

The Appellate Review Standard

Judge Duncan then turned to the appellate standard for reviewing a finding of indubitable equivalence. She noted how the Ninth Circuit held in 1996 that valuation is reviewed for clear error, while the ultimate question of indubitable equivalence is a question of law reviewed *de novo*.

The Seventh Circuit, on the other hand, had held in 1992 that the deferential standard is proper because a finding of indubitable equivalence is a finding of fact.

Judge Duncan decided to follow the Seventh Circuit because the statutory standard in Section 1129(b)(2)(A)(iii) is "clear" and the "meticulous appraisal examination" entailed on indubitable equivalence "is inherently factual."

Detailed Findings Not Reversible

Applying the deferential clear error standard, Judge Duncan noted how the bankruptcy judge had a 4,000-page record, "made detailed findings," "weighed all of the expert testimony," and explained why the debtor's expert "was more credible." The bankruptcy court's analysis, she said, "was thorough and not arbitrary."

Upholding the finding of indubitable equivalence left the lender with one argument based on the bankruptcy court's decision to toll the post-petition accrual of interest for 266 days on account of the delay in ruling caused by the bankruptcy court's own workload and litigation initiated by the lender.

Equitable Denial of Interest

Although Section 506(b) says that an oversecured lender "shall be allowed" post-petition interest, Judge Duncan said that the word "shall" does not extinguish all defenses. The "statute's mandate," she said, "does not prevent consideration of equitable factors in calculating the post-petition interest owed."

She noted that the bankruptcy court did not deprive the lender of post-petition interest "altogether" because the lower court allowed almost $1.4 million in interest.

The decision to be handed down in a few weeks by the Supreme Court in *U.S. Bank NA v. The Village at Lakeridge LLC,* 15-1509 (Sup. Ct.), may indicate whether Judge Duncan employed the proper appellate standard of review when she held that a finding about indubitable equivalence is judged by the clear error rule.

In *Lakeridge*, the high court will decide whether a finding of non-statutory insider status is reviewed for clear error or *de novo*. *Lakeridge* is different, however, because it involved inferences taken from undisputed facts. In the Fourth Circuit case, the critical facts were disputed.

Nonetheless, the Supreme Court's *Lakeridge* opinion may include teachings about the appellate standard on mixed questions of law and fact. To read ABI's report on the *Lakeridge* oral argument, click here.

The opinion is *Bate Land Co. LP v. Bate Land & Timber LLC (In re Bate Land & Timber LLC)*, 16-2037 (4th Cir. Dec. 6, 2017).

Fourth Circuit avoids a result that would have left some debtors ineligible for any exemptions.

Three Circuits Approve Extraterritorial Application of a State's Exemptions

Joining the Eighth and Ninth Circuits and handing down another debtor-friendly opinion, the Fourth Circuit cleaned up some of the mess that Congress made in Section 522(b)(3)(A) regarding exemptions claimed by individuals who change their domicile before filing bankruptcy.

The May 4 opinion by Circuit Judge Robert B. King rejected plausible interpretations of the statute that could leave some debtors ineligible for any exemptions, state or federal.

The debtor moved to West Virginia from Louisiana four months before filing bankruptcy. Utilizing Louisiana's exemption statute, he claimed exemptions for about $3,500 of personal property located in West Virginia.

The trustee objected to the exemptions, contending that Louisiana exemptions could not be applied extraterritorially in view of the Supreme Court's presumption against extraterritoriality. The bankruptcy court allowed the exemptions and was upheld on appeal by District Judge Irene M. Keeley of Clarksburg, W.Va.

Again upholding the exemptions in the circuit court, Judge King characterized Judge Keeley's opinion as "well reasoned" and "comprehensive." To read ABI's discussion of Judge Keeley's opinion, click here.

The Statutory Mess

Attempting to prevent abuse, Congress made a hash out of Section 522(b)(3)(A) and compounded the problem by adding the so-called hanging paragraph, which, Judge King said, "has been the subject of some dispute in the bankruptcy courts."

Generally, a debtor is eligible for exemptions in the state where the debtor had been domiciled for 730 days before bankruptcy. To deter exemption shopping by people who would move within two years before bankruptcy to take advantage of another state's more generous exemptions, Section 522(b)(3)(A) provides that the debtor must take exemptions from the state where he or she resided for the largest part of the 180-day period before the 730-day period.

The statute had a problem, however, because Section 522(b)(3)(A) would leave some debtors eligible for no exemptions. To fill the gap, Congress added the hanging paragraph, which allows the debtor to claim federal exemptions specified in Section 522(d) if (b)(3)(A) makes a debtor ineligible for any state's exemptions.

The Case at Hand

The trustee conceded that the debtor could invoke Louisiana exemptions under Section 522(b)(3)(A) for property located in Louisiana. However, the trustee disputed the claim for exemptions covering the debtor's property in West Virginia, even though Louisiana does not limit the application of its exemptions to Louisiana residents or to property in Louisiana.

The trustee argued for the presumption against extraterritoriality, also known as the anti-extraterritoriality approach, under which a bankruptcy court may not give extraterritorial effect to any state's exemption laws. His theory would have precluded the debtor from using Louisiana law to exempt property in West Virginia.

The Fourth Circuit's Analysis

Judge King said that "almost all courts" have rejected the trustee's theory because it "would lead to nonsensical results." An example: Debtors who move would be ineligible for exemptions because they likely would have no property in their former domicile, the only state in which they could have exemptions under the anti-extraterritoriality approach. Judge King said that the only bankruptcy court to adopt this theory was "promptly overturned on appeal."

The second minority view, called the preemption approach, would permit a debtor to apply a state's exemption laws to nonresidents and out-of-state property, even if state law does not allow extraterritorial effect. Like Judge Keeley, Judge King rejected the idea. If "Congress had intended to override state laws limiting the use of exemption schemes to in-state residents or in-state property, it would not have placed the hanging paragraph in Section 522(b)(3)," he said.

The preemption approach, he said, would make the hanging paragraph applicable only to debtors who had resided in foreign countries.

Judge King adopted the so-called state-specific approach, which is followed by the Eighth and Ninth Circuits and a majority of courts. He said it best embodies congressional intent and the bedrock principle that "exemptions are entitled to the most liberal construction in favor of the debtor."

Judge King said there were no principles of Louisiana law that would bar out-of-state debtors from utilizing Louisiana's exemption statute. He also rejected the trustee's reliance on the Supreme Court's presumption against extraterritoriality.

Citing Fourth Circuit precedent, Judge King said that the presumption does not apply to conduct that occurs largely within the U.S. Therefore, he allowed the debtor to rely on Louisiana law and exempt property in West Virginia.

A Proposal to 'Fix' Section 522

In the circuit court, *pro bono* co-counsel for the debtor was Eugene Wedoff, the immediate past president of American Bankruptcy Institute and a former bankruptcy judge in Chicago.

In a message to ABI, Judge Wedoff said that "Section 522 is very much in need of a Congressional 'fix.'"

Judge Wedoff believes that Congress should "make the debtor immediately subject to the exemption law of the state to which a debtor has moved, but cap the homestead exemption and perhaps other very large exemptions for two years after the move at the level set by the debtor's former state of domicile."

Judge Wedoff said that his proposal would "eliminate the 'millionaire's loophole' that Congress was concerned about in BAPCPA without creating the confusion caused by applying a state's exemptions to debtors who are no longer domiciled in that state."

The "simplest fix," Judge Wedoff said, would be "a set of uniform federal exemptions, but that is very unlikely to be politically possible."

The opinion is *Sheehan v. Ash*, 17-1867 (4th Cir. May 4, 2018).

Local lawyers were also caught up in the maelstrom caused by a 'nationwide' firm that skirted bankruptcy law and rules.

Judge Revokes a 'Nationwide' Firm's Right to Practice in Virginia Bankruptcy Court

A so-called nationwide law firm serving consumer bankrupts and its local partners must ensure punctilious compliance with the Bankruptcy Code and Rules to avoid sanctions such as those imposed by Bankruptcy Judge Paul M. Black of Roanoke, Va.

In his 62-page opinion on February 12, Judge Black said that the "pursuit of the next dollar of compensation was the primary consideration" in the creation and structuring of the firm while the "integrity of the bankruptcy process was a distant thought in these cases." He said that the firm and its marketing program "preyed upon some of the most vulnerable in our society . . . while they were under great stress."

Based on "hard sell tactics" employed by non-lawyer intake workers, the lack of supervision, transcripts of recordings of phone calls with the firm's clients, "the focus on cash flow over professional responsibility," and participation in a questionable program to surrender automobiles, Judge Black concluded that the firm "acted in bad faith" and failed to comply with the fee disclosure requirements in Bankruptcy Rule 2016.

Given the findings of fact he made after a four-day trial, Judge Black sanctioned the nationwide firm and its principals by revoking their right to practice in the Western District of Virginia for five years. He also imposed $300,000 in fines on the nationwide firm and its principals.

The local "partners" did not emerge unscathed. Judge Black revoked their right to practice in the district for one year as to one lawyer and 18 months as to the other. He imposed $5,000 in sanctions on both.

The firm had already repaid the fees to the two clients whose bankruptcies constituted the test cases before Judge Black.

The Nationwide Firm

Judge Black said the case presented "yet another collision between traditional methods of providing . . . legal services to consumers for bankruptcy matters and attempts by attorneys and creative online marketers to tap into that market."

Without regurgitating Judge Black's detailed summary of the business model, suffice it to say that the firm advertised itself as operating nationwide by attracting clients through the internet. When a potential client contacted the firm, a non-lawyer would handle the call. According to the judge, the non-lawyers would employ "hard sell" tactics designed to have the clients agree to sign up and pay fees, either immediately or in installments. The fees evidently amounted to somewhat less than $2,000 in Virginia for a chapter 7 case.

Although the intake workers were told not to give legal advice, Judge Black found several instances where they did. The judge cited cases in which the advice given by non-lawyers was incorrect or might have resulted in the denial of discharge.

Judge Black said that the "Court is deeply disturbed by the lack of effective oversight of its sales people and methods used by [the nationwide firm] to sell its product."

Once a client signed up, the matter would be assigned to a local lawyer, referred to as a "partner." Judge Black ultimately concluded that the local partners were functionally "regular associates" or "counsel" to the nationwide firm, thus not barring fee-sharing between the nationwide firm and the local attorneys.

The Auto Repossession Program

In the adversary proceeding and ensuing trial, the U.S. Trustee focused on arrangements the firm made with at least 219 clients nationwide who pursued bankruptcy to surrender autos they could not afford. The firm allied itself with a company that would pick up the autos and haul them to the company's storage facility in either Indiana or two other states where the law allows possessory liens to have priority over financing liens.

The company would notify the lenders about having possession of the cars and demand payment of storage and towing fees that the lenders sometimes would not pay. After the time specified in state law, the company would sell the cars at auction if the lender did not pay the fees. In cases where the lenders did not pay the fees, the company evidently would pocket the auction proceeds, thus depriving the lenders of their collateral.

Why would the debtors sign up for the surrender program? Because the company would pay the debtors' attorneys' fees owing to the firm. Judge Black said that the firm received about $333,500 in fees from the program in two years before it was terminated.

Judge Black characterized the program as "a scam from the start."

Legal Issues

The vehicle-surrender program entailed an ethical problem, because the source of the fees was not properly disclosed as required by Section 329 and Rule 2016. In addition, Judge Black found that the clients did not sign retainer agreements within five days as required by Section 528(a)(1), thus rendering the agreements void. He also said the retention agreements "contained misrepresentations and were also unclear and inaccurate."

The opinion contains discussion of a legal issue of note. The firm argued that the suit was moot because the firm had already repaid the two clients' fees, the services were fully performed, and the debtors had received their discharges.

Judge Black decided that the case was not constitutionally moot under the "voluntary cessation doctrine," because the firm continues filing bankruptcies in the district "under the existing business model."

Judge Black cited the Fourth Circuit and the Supreme Court for saying that the "voluntary cessation of a challenged practice does not deprive a federal court of its power to determine the legality of the practice."

"To say that the Court cannot review their practices because in the two instances currently before the Court they paid the attorneys' fees back to the debtors before the Court had a chance to rule on the adequacy of their disclosures would gut the 'voluntary cessation' rule."

The opinion is *Robbins v. Delafield (In re Williams)*, 16-7024 (Bankr. W.D. Va. Feb. 12, 2018).

Delaware bankruptcy judge disagrees with district court on final adjudicatory power to include third-party releases in confirmation orders.

Bankruptcy Court Finds Constitutional Power to Grant Releases in Confirmation Orders

On remand from the district court in *Millennium Lab Holdings*, Bankruptcy Judge Laurie Selber Silverstein of Delaware decided that a bankruptcy court has constitutional power to enter a final order granting non-consensual, third-party releases of non-bankruptcy claims as part of a chapter 11 confirmation order.

Written with a passion suggesting it may be the most important decision of her career, Judge Silverstein's 69-page opinion on Oct. 3 concludes that the limitations on the constitutional power of a bankruptcy court under *Stern v. Marshall* are altogether inapplicable to granting third-party releases because a confirmation order exclusively implicates questions of federal bankruptcy law and raises no issues under state or common law.

Ordering remand in March, District Judge Leonard P. Stark of Delaware implied, without explicitly holding, that a bankruptcy court should only make proposed findings and conclusions when granting third-party releases as part of a chapter 11 confirmation order. Sending the case back to Judge Silverstein, he told her to consider the question of constitutional power and also decide whether the appellant had waived *Stern* objections.

In her Oct. 3 opinion, Judge Silverstein persuasively ruled that the appellant had waived *Stern* objections by never raising the issue during the confirmation process. If there is another appeal, Judge Stark and even the Third Circuit could uphold confirmation just on the issue of waiver and never reach the broader *Stern* questions given the principle that courts should not make constitutional rulings when a case can be decided on another ground.

Consequently, *Millennium Lab Holdings* may leave the constitutional issue undecided at the appellate level. Until the question is starkly raised and decided, parties will proceed at their peril if they consummate plans with releases based only on the bankruptcy court's confirmation order.

The Facts

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

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

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

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

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

District Judge Stark's Remand

Arguably for the first time, the objecting lender contended on appeal that the bankruptcy court lacked constitutional power to enter a final order granting third-party releases. Although the bankruptcy court had clearly found "related to" jurisdiction to impose the releases, District Judge Stark concluded that the bankruptcy court had not been called on to decide whether it had power under *Stern* to enter a final order including the releases.

To most readers, Judge Stark's decision in March implied, without holding, that granting the releases was beyond the bankruptcy court's constitutional power. Among other things, Judge Stark said that the objecting lender was entitled to an Article III adjudication because the releases were "tantamount to resolution of those claims on the merits against" the lender.

Rather than rule on a constitutional issue that had not been developed in the lower court, Judge Stark remanded the case for Judge Silverstein to decide whether she had final adjudicatory authority, either as a matter of constitutional law or as a consequence of the lender's waiver. If there were no power to make a final order, Judge Stark said that Judge Silverstein could submit proposed findings and conclusions or strike the releases from the confirmation order.

To read ABI's discussion of Judge Stark's opinion, click here.

Granting Releases Is a 'Core' Bankruptcy Power

Ruling after remand, Judge Silverstein didn't keep the reader in suspense. On the second page of her opinion, she said there is constitutional power to grant releases in a confirmation order. To rule otherwise, she said, would go "far beyond the holding of any court" and "dramatically change the division of labor between the bankruptcy and district courts."

Judge Silverstein found circuit court support for her conclusion. She cited post-*Marathon Pipeline* but pre-*Stern* decisions from the Seventh and District of Columbia Circuits finding constitutional power to grant third-party releases in a confirmation order.

Post-*Stern*, Judge Silverstein found support from two Third Circuit opinions for the proposition that a bankruptcy court can issue a final order on a core issue that has preclusive effect on a third party's lawsuit: *In re Lazy Days' RV Center Inc.*, 724 F.3d 418 (3d Cir. 2013), and *In re Linear Electric Co.*, 852 F.3d 313 (3d Cir. March 20, 2017). She emphasized a statement in *Lazy Days'* that *Stern* is "plainly inapposite" where the debtor sought relief "based on a federal bankruptcy law provision with no common law analogue."

More recently, Judge Silverstein cited bankruptcy court decisions from Boston and White Plains, N.Y., finding constitutional power to grant third-party releases in confirmation orders.

Adopting even the broadest interpretation of *Stern*, Judge Silverstein said that confirming a plan with releases "does not rule on the merits of the state law claims being released." Therefore, she said, "*Stern* is inapplicable as confirmation of a plan is not a state law claim of any type."

To the contrary, Judge Silverstein said, a bankruptcy court has final adjudicatory power because the court "is applying a federal standard" to ensure that the releases "comply with applicable provisions of the Bankruptcy Code."

In short, there is no contravention of *Stern* because the bankruptcy court is making a determination on confirmation based entirely on federal bankruptcy law, where there is statutory core power under 28 U.S.C. § 157(b)(2)(L). The fact that confirmation bars a creditor's state law claims against a third party is merely incidental.

Indeed, the incidental effect on third-party claims is the gist of the issue. Judge Silverstein pointed out the consequences of making *Stern* applicable to plans with third-party releases.

If there were no final adjudicatory power in the confirmation context, Judge Silverstein said that bankruptcy courts could no longer make Section 363 sale orders insulating buyers from successor liability. Similarly, bankruptcy courts would lack power, she said, to order substantive consolidation, bar annual shareholders' meetings, recharacterize debt as equity, or subordinate claims.

On the question of the waiver of *Stern* objections under *Wellness International*, Judge Silverstein thoroughly analyzed the record to conclude that the objecting lender never raised the constitutional question during or even after the confirmation process.

Her original ruling on confirmation did not deal with final adjudicatory power because any reference to *Stern* was so oblique that neither the court nor the parties understood that a constitutional issue was afoot. Citing the *Wellness International* prohibition of sandbagging, Judge Silverstein said that the lender could not lie in the weeds and raise constitutional infirmities for the first time on appeal.

On the ground of waiver alone, Judge Silverstein found that she was entitled to enter a final order.

The opinion is *In re Millennium Lab Holdings II LLC,* 15-12284 (Bankr. D. Del. Oct. 3, 2017).

Waiving the automatic stay and immediately closing a sale does not make Section 363(m) inapplicable.

Asset Sale Appeals Are Moot Even if There Is a *Jevic* Violation, First Circuit Says

The First Circuit held that a sale in possible violation of the Supreme Court's *Jevic* decision in 2017 does not allow an appellate court to examine the merits of a sale when the sale-approval order otherwise is statutorily moot under Section 363(m).

The appeal involved a typical bankruptcy sale where the purchaser who prevailed at auction was composed of some of the debtor's insiders. Utilizing Bankruptcy Rules 6004(h) and 6006(d), the bankruptcy court approved the sale to the insider and allowed the closing to occur immediately.

The competing bidder appealed without a stay, contending that Section 363(m) did not apply because the insider-purchaser was not in good faith. That section provides that the reversal or modification of an order approving a sale "does not affect the validity of a sale" to a purchaser "that purchased . . . such property in good faith, whether or not such [purchaser] knew of the pendency of the appeal, unless such authorization and such sale . . . were stayed pending appeal."

The First Circuit Bankruptcy Appellate Panel upheld the sale-approval order, holding that the appeal was moot under Section 363(m).

On a second appeal, First Circuit Judge William J. Kayatta, Jr. upheld the lower courts, likewise ruling in an opinion on Jan. 12 that the appeal was moot under Section 363(m).

The outcome of the appeal turned on the meaning of "good faith purchaser," a term not defined in the Bankruptcy Code. In the context of Section 363(m), the First Circuit has held that the term means someone "who buys property in good faith and for value, without knowledge of adverse claims."

In turn, Judge Kayatta said, "good faith" means someone who acts "without fraud, misconduct, or collusion, and must not take 'grossly unfair' advantage of other purchasers."

The competing bidder's appeal was based on a contention that the insider-purchaser was not in good faith because it knew the loser was challenging the sale. Judge Kayatta rejected the argument, saying that "a likely appellate challenge to the sale itself" is not an "adverse claim."

Citing the Fifth Circuit, he said there is a difference between knowing there are objections to the sale and having knowledge of an adverse claim.

Next, the disappointed bidder contended that Section 363(m) should not apply because the bankruptcy court waived the 14-day automatic stay under Bankruptcy Rule 7062 and allowed the sale to close immediately.

Since the debtor had repeatedly given notice that it would seek to waive the automatic stay, Judge Kayatta said there were no due process grounds to make Section 363(m) inapplicable.

Finally, and of perhaps the most significance, the appellant argued that the sale violated *Czyzewski v. Jevic Holding Corp*., 137 S. Ct. 973 (2017), because the insider-purchaser had agreed to assume some but not all claims against the debtor. The appellant contended that the sale thereby offended the priorities of distribution and gave better treatment to some creditors of the same rank.

Judge Kayatta refused to consider the *Jevic* allegations. Section 363(m) applies, he said, "even if the bankruptcy court's approval of the sale was not proper, so long as the bankruptcy court was acting under Section 363(b)."

He went on to say, "the fact that a sale is improper cannot mean *ipso facto* that there is no good faith purchaser. Otherwise, Section 363(m) would not preclude any challenge to the propriety of consummated sales."

The opinion is *Mission Product Holdings Inc. v. Old Cold LLC (In re Old Cold LLC)*, 16-9016 (1st Cir. Jan. 12, 2018).