AMERICAN BANKRUPTCY INSTITUTE

2022 Annual Spring Meeting

Circuit Splits and Hot Topics with Bill Rochelle and Friends

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American Bankruptcy Institute; Alexandria, Va.

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Hon. Brendan L. Shannon
U.S. Bankruptcy Court (D. Del.); Wilmington

LUNCHEON SESSION

2022

Circuit Splits and Hot Topics Headed for the Supreme Court

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Supreme Court

This Term

The Supreme Court granted certiorari to decide whether the 2018 increase in U.S. Trustee fees violated the Bankruptcy Clause because it was not immediately applicable in two states with Bankruptcy Administrators.

Supreme Court to Resolve Circuit Split on the 2018 Increase in U.S. Trustee Fees

The U.S. Supreme Court agreed to resolve a circuit split and decide whether the increase in fees payable to the U.S. Trustee system in 2018 violated the uniformity aspect of the Bankruptcy Clause of the Constitution because it was not immediately applicable in the two states that have Bankruptcy Administrators rather than U.S. Trustees. *See Siegel v. Fitzgerald*, 21-441 (Sup. Ct.) (*cert. granted* Jan. 10, 2022).

Oral argument is yet to be scheduled but will likely occur in April, allowing the justices to issue a decision before the term ends in late June.

The Split and the '*Cert* Grant'

The Court granted the petition for *certiorari* filed by the liquidating trustee of Circuit City Stores Inc. The Circuit City trustee will be asking the justices to overturn the decision by the Fourth Circuit that found no constitutional violation. *See Siegel v. Fitzgerald (In re Circuit City Stores Inc.)*, 996 F.3d 156 (4th Cir. April 29, 2021). To read ABI's report on the Fourth Circuit opinion, click here.

The chances of a grant of *certiorari* increased immeasurably in December when the U.S. Solicitor General urged the justices to resolve the circuit split. Needless to say, the government believes there was no constitutional infirmity.

In addition to the Fourth Circuit, the Fifth Circuit saw no lack of constitutional uniformity, even though chapter 11 debtors in two states were paying less for a time. *See Hobbs v. Buffets LLC (In re Buffets LLC)*, 979 F.3d 366 (5th Cir. Nov. 3, 2020). To read ABI's discussion of *Buffets*, click here.

On the three-judge panels in both the Fourth and Fifth Circuits, one judge in each circuit dissented, believing that the differing fees were unconstitutional.

Two other circuits that found violations of the Bankruptcy Clause. *See Clinton Nurseries Inc. v. Harrington (In re Clinton Nurseries Inc.)*, 998 F.3d 56 (2d Cir. May 24, 2021); and *John Q. Hammons Fall 2006 LLC v. U.S. Trustee (In re John Q. Hammons Fall 2006 LLC)*, 20-3203, 2021 BL 380406 (10th Cir. Oct. 5, 2021). To read ABI's reports on *Clinton Nurseries* and *Hammons Fall*, click here and here. Both decisions were unanimous.

Although the circuits are evenly spilt, five circuit judges saw a constitutional defect while four did not.

The decision by the Supreme Court in Circuit City will resolve a similar appeal now pending in the Federal Circuit. The Court of Federal Claims adopted the analysis of the Fifth Circuit, finding no constitutional violation and dismissing a class action seeking refunds for chapter 11 debtors who were paying more.

The debtor-plaintiff appealed and is asking the Federal Circuit to reinstate the class action, which could mean refunds for chapter 11 debtors nationwide whose cases were filed before the increase went into effect in Bankruptcy Administrator districts. *See Acadiana Management Group LLC v. U.S.*, 19-496, 151 Fed. Cl. 121 (Ct. Cl. Nov. 30, 2020). Oral argument in the Federal Circuit is scheduled for February 7. For ABI's report on *Acadiana*, click here.

The Underlying Facts

The Court will resolve the circuit split that arose from the increase in fees in U.S. Trustee districts that became effective as of January 1, 2018. The increase was significant. For the largest companies reorganizing in chapter 11, the maximum quarterly fee rose from $30,000 to $250,000.

Challenges arose throughout the country because the increase did not become effective until nine months later in Alabama and North Carolina, where there are Bankruptcy Administrators rather than U.S. Trustees.

The Legal Issues to Be Decided

The government contends that the Bankruptcy Clause does not apply because the fees are governed by 28 U.S.C. § 1930(a)(6), not the Bankruptcy Code. To the government's way of thinking, Section 1930 is not a "law of the subject of Bankruptcies." Rather, the Solicitor General has said it is a user fee.

The government's argument under Section 1930 was rejected even by the circuits that found the increase otherwise constitutionally valid.

When the justices rule, they may primarily focus on *Regional Rail Reorganization Act Cases*, 419 U.S. 102 (1974), where the Supreme Court upheld a railroad reorganization law that applied only to railroads in a specific region of the country where Congress saw financial problems.

Will the justices follow *Regional Rail* and say that the funding disparity responded to a regional problem without constitutional significance?

What the Decision Might Mean

Whenever the Supreme Court rules in a bankruptcy case, the decision always raises more questions than it answers.

The Court's opinion regarding fees may shed light on the lingering question about the constitutionality of the dual system of U.S. Trustees and Bankruptcy Administrators.

In 1995, the Ninth Circuit held that Congress' decision to impose quarterly fees in U.S. Trustee districts, but not in Bankruptcy Administrator districts, violated the Bankruptcy Clause of the Constitution. *St. Angelo v. Victoria Farms Inc.*, 38 F.3d 1525 (9th Cir. 1994), amended by 46 F.3d 969 (9th Cir. 1995).

Most recently, a district judge in California read *St. Angelo* to mean that the parallel systems in themselves are a violation of the Bankruptcy Clause. *See USA Sales Inc. v. Office of the U.S. Trustee*, 532 F. Supp. 3d 921 (C.D. Cal. April 1, 2021). To read ABI's report, click here.

The California judge is not alone. Dissenting in the Fifth Circuit's *Buffets* opinion, Circuit Judge Edith Brown Clement was persuaded by *St. Angelo* and said she "would hold that the permanent division of the country into [U.S. Trustee] districts and [Bankruptcy Administrator] districts violates the Bankruptcy Clause." *Buffets*, *supra*, 979 F.3d at 384.

If the Supreme Court finds no defect in the dual-fee system, the implications for bankruptcy may be few. If the high court finds a lack of constitutional uniformity, there may be ramifications in bankruptcy beyond the dual system itself. For instance, what about panel trustees and standing trustees? Are debtors entitled to have trustees who are employed and controlled directly by the government?

Historically, uniformity has not been an issue that arises frequently in bankruptcy. It has more often been an issue regarding taxation. Whatever the Supreme Court says about uniformity in the bankruptcy context may spawn disputes regarding uniformity in taxation.

The docket is *Siegel v. Fitzgerald*, 21-441 (Sup. Ct.) (*cert. granted* Jan. 10, 2022).

On an issue the Supreme Court will decide this spring, the Eleventh Circuit broke the tie among the circuits by finding no unconstitutional lack of uniformity when the 2018 increase in U.S. Trustee fees was not immediately applicable in two states with Bankruptcy Administrators.

Eleventh Circuit Takes Sides on the Split, Upholds the 2018 Increase in U.S. Trustee Fees

Although the U.S. Supreme Court will resolve the circuit split this spring, the Eleventh Circuit broke the tie among the circuits by upholding the constitutionality of the 2018 increase in fees paid to the U.S. Trustee system that was not immediately applicable in two states with Bankruptcy Administrators.

The Eleventh Circuit's January 14 opinion gives the Supreme Court a new theory for finding no constitutional offense: "Congress properly enacted a law in 2017 understanding it would increase fees for all districts."

There was a dissent in the Eleventh Circuit that was characterized as a concurrence. The dissenting judge believes that the uniformity aspect of the Bankruptcy Clause was offended, but he concurred with the result, reasoning that the debtor was not entitled to a remedy.

The Fee Increase

Effective on January 1, 2018, Congress increased the fees paid by chapter 11 debtors to the U.S. Trustee system. The increase was significant. For the largest companies reorganizing in chapter 11, the maximum quarterly fee rose from $30,000 to $250,000.

The fee increase in U.S. Trustee districts became effective on January 1, 2018, and was applicable to pending cases. The fee increase in the Bankruptcy Administrator districts did not come into effect for nine months and did not apply to pending cases, only to newly filed cases.

In the appeal to the Eleventh Circuit, the chapter 11 debtor had confirmed a plan before the increase came into effect. The assets had been turned over to a liquidating trust to pay creditors and administer the remaining estate.

The increase paid by the liquidating trust was $125,000, or 3.5 times more than the fees would have been under the "old" fee schedule. The liquidating trustee sued to recover the increase,

contending that the increase violated the Bankruptcy Clause because the increase did not become effective until nine months later in the two states with Bankruptcy Administrators rather than U.S. Trustees.

The bankruptcy court decided that the increase was constitutional, generally speaking, but was unconstitutionally nonuniform as to the 2% of the fees that Congress appropriated for "national purposes."

Both sides appealed, and the Eleventh Circuit granted a direct appeal, overstepping an interim appeal to the district court.

The '*Cert*' Grant

The Supreme Court granted *certiorari* to the Fourth Circuit on January 10 to resolve the circuit split on the constitutionality of the 2018 increase. *See Siegel v. Fitzgerald*, 21-441 (Sup. Ct.) (*cert. granted* Jan. 10, 2022). To read ABI's report on the grant of *certiorari*, click here.

Like the Fourth Circuit, whose decision will be reviewed in *Siegel*, the Fifth Circuit found no constitutional infirmity. *See Siegel v. Fitzgerald (In re Circuit City Stores Inc.)*, 996 F.3d 156 (4th Cir. April 29, 2021); and *Hobbs v. Buffets LLC (In re Buffets LLC)*, 979 F.3d 366 (5th Cir. Nov. 3, 2020). To read ABI's reports, click here and here.

Two other circuits found violations of the Bankruptcy Clause. *See Clinton Nurseries Inc. v. Harrington (In re Clinton Nurseries Inc.)*, 998 F.3d 56 (2d Cir. May 24, 2021); and *John Q. Hammons Fall 2006 LLC v. U.S. Trustee (In re John Q. Hammons Fall 2006 LLC)*, 20-3203, 2021 BL 380406 (10th Cir. Oct. 5, 2021). To read ABI's reports on *Clinton Nurseries* and *Hammons Fall*, click here and here.

Oral argument in the Supreme Court has not yet been scheduled, but the case will likely be heard in April, allowing the justices to issue a decision before the end of the term in late June.

The Eleventh Circuit's New Theory

It was not immediately apparent to this writer why the Eleventh Circuit chose to take sides on a split to be resolved by the Supreme Court within a few months. As we will discuss below, the Atlanta-based appeals court offered a different rationale for upholding the constitutionality of the increase.

However, the 76-page opinion of the court by Circuit Judge R. Lanier Anderson, III began on the usual trajectory. First, he held that the increase did not offend substantive due process. He reasoned that vested rights were not impaired, constitutionally speaking.

Next, Judge Anderson knocked down the idea that the increase was impermissibly retroactive. Like other courts, he said that the increase applied only to disbursements made after enactment of the increase. He then ruled that the increase pertained to "user fees," not taxes, thus obviating any argument that the increase was a nonuniform tax.

Like every other circuit court, Judge Anderson held that the increase was a bankruptcy law, subject to the strictures of the Bankruptcy Clause.

Before he examined the uniformity aspect of the increase, Judge Anderson was careful to say that the debtor had not argued that the dual system of U.S. Trustees and Bankruptcy Administrators was unconstitutional in itself. He thus left open the argument that the fee increase was unconstitutional because the dual system is unconstitutional.

Judge Anderson held "that the 2017 Amendment is uniform and fully complies with the requirements of the Bankruptcy Clause because the flexibility inherent in the Clause cautions us against a strict inquiry that would make dispositive Congress' use of two different statutory vehicles to impose quarterly fees."

Judge Anderson noted that the Supreme Court had found only one law to violate the Bankruptcy Clause. The clause, he said, "is thus understood to prohibit private bankruptcy bills, as [*Ry. Lab. Execs.' Ass'n v. Gibbons*, 455 U.S. 457 (1982)] makes clear, as well as restrictions based on regionalism that do not address a geographically isolated problem." Again citing *Gibbons*, he said "that the Bankruptcy Clause imposes its limited constraint on congressional power."

Consequently, Judge Anderson said that "the flexibility of the Bankruptcy Clause permits Congress to choose how to provide for the implementation of a uniform law."

Judge Anderson therefore held "that the uniformity requirement does not require that Congress increase fees by mandating them in all districts in the country." The delayed increase in Bankruptcy Administrator districts did not violate the Bankruptcy Clause because "Congress enacted the 2017 Amendment with the understanding that the quarterly fees would be increased uniformly across all bankruptcy districts" once the Judicial Conference got around to raising the fees in Bankruptcy Administrator districts.

Judge Anderson buttressed his conclusion by referencing the disparity in state exemptions, which the Supreme Court has held to entail no violation of the Bankruptcy Clause. He said that the "disparity [in exemptions] was not only expressly and knowingly authorized by Congress, the disparity is ongoing and permanent."

By analogy to exemptions, Judger Anderson said, "it follows, *a fortiori*, that there is no violation of the uniformity requirement in the instant context."

Having found that the disparate increase was permissible given the flexibility in the Bankruptcy Clause, Judge Anderson saw no reason to decide whether the increase was a permissible response to "the geographically isolated problem exception."

Affirming the bankruptcy court by ruling that the increase itself was constitutional, Judge Anderson held that the bankruptcy court erred in deciding that the disparate fee was unconstitutional to the extent of the 2% earmarked for "national purposes."

Concurrence by Judge Jordan

Circuit Judge Adalberto Jordan wrote a two-page concurrence, noting there was no constitutional challenge to the dual system of Bankruptcy Administrators and U.S. Trustees. He speculated that the Second and Tenth Circuits "may have relied in part on their suspicions about the constitutionality of the dual bankruptcy system."

Judge Jordan joined in Judge Anderson's opinion "in full" because there was "no challenge here to the existence of the two different bankruptcy systems in the United States."

Concurrence (Dissent) by Judge Brasher

Circuit Judge Andrew L. Brasher wrote a six-page concurrence in the judgment that reads like a dissent.

"I believe that the substantial variance in fees as between the Trustee and Bankruptcy Administrator districts amounts to an unconstitutional lack of uniformity," Judge Brasher said. In his opinion, "the flexibility principle is not so broad that it covers meaningfully reducing payments to creditors based purely on the location of the pending bankruptcy case . . . . I believe that the substantial variance in fees as between the Trustee and Bankruptcy Administrator districts amounts to an unconstitutional lack of uniformity."

Judge Brasher nonetheless concurred in the result given his belief that the debtor was not entitled to the remedy it sought: a refund of the overpayment. In his view, the "proposed remedy contravenes the intent of Congress."

That is to say, Congress intended to raise the fees throughout the country, but giving the debtor a refund would be contrary to the intent of Congress.

Judge Brasher said that the debtor should have joined the Judicial Conference as a defendant, because the Judicial Conference was responsible for setting the fee in Bankruptcy Administrator districts. Because the Judicial Conference was not a defendant, Judge Brasher said that the debtor was "left without a remedy."

The opinion is *U.S. Trustee Region 21 v. Bast Amron LLP (In re Mosaic Management Group Inc.)*, 20-12547 (11th Cir. Jan. 14, 2022).

An arbitration case to be argued in November may inform bankruptcy courts whether they must enforce arbitration agreements.

Supreme Court Update: Equitable Mootness Not Ready for Prime Time

With two petitions for *certiorari* denied this month and a third withdrawn last month, there are no "pure" bankruptcy cases already on the Supreme Court's calendar for the term that began on October 4.

One *certiorari* petition still pending is an odds-on favorite for a "grant": The justices are being asked to resolve a circuit split on the constitutionality of the 2018 increase in fees for the U.S. Trustee system.

There is an arbitration case to be argued in November in the Supreme Court. Depending on what the decision says, the outcome might affect how lower courts treat arbitration agreements arising in bankruptcy cases.

No High Court Ruling Yet on Equitable Mootness

In the justices' first two conferences this term, they denied *certiorari* petitions from the Second and Third Circuits asking the Court to decide the validity of the judge-made doctrine of equitable mootness. *See GLM DWF Inc. v. Windstream Holdings Inc.*, 21-78 (Sup. Ct. *cert. den*. Oct. 4, 2021); and *Hargreaves v. Nuverra Environmental Solutions Inc.*, 21-17 (Sup. Ct. *cert. den.* Oct. 12, 2021). To read ABI's latest report on the *certiorari* petitions, click here.

As is customary, the Court gave no reason for declining to rule on the validity of a doctrine that allows federal appellate courts to refuse to review the merits of orders confirming chapter 11 plans. On occasion, the doctrine has been invoked to dismiss appeals from other bankruptcy court orders.

Equitable mootness is arguably impermissible in view of appellate courts' mandatory jurisdiction. The doctrine is also questionable when appeals are dismissed even though there is constitutional jurisdiction under Article III, given the continued existence of a case or controversy.

The attempted appeals coming from the Second and Third Circuits were both attractive candidates for high court review.

In the *Windstream* nonprecedential, *per curiam* opinion, the Second Circuit used equitable mootness to make a critical vendor order virtually unreviewable after confirmation of a chapter 11 plan. For ABI's report on *GLM DWF Inc. v. Windstream Holdings Inc. (In re Windstream Holdings Inc.)*, 838 Fed. Appx. 634 (2d Cir. Feb. 18, 2021), click here.

Over dissent in a case involving so-called horizontal gifting, the Third Circuit held that an appeal from confirmation of a chapter 11 plan is equitably moot even if the appellant was only asking the appellate court to pay one relatively small claim and no others. For ABI's report on *Hargreaves v. Nuverra Environmental Solutions Inc. (In re Nuverra Environmental Solutions Inc.)*, 834 Fed. Appx. 729 (3d Cir. Jan. 6, 2021), click here.

The Court's disinclination to tackle the issue does not bode well for a "grant" when equitable mootness comes up again in new cases. Notably, the Eighth Circuit came near to banning equitable mootness altogether. *See FishDish LLP v. VeroBlue Farms USA Inc. (In re VeroBlue Farms USA Inc.)*, 6 F.4th 880 (8th Cir. Aug. 5, 2021). To read ABI's report, click here.

A Likely 'Grant'

Frankly, the Supreme Court would be remiss if it does not grant *certiorari* and decide this term whether the 2018 increase in fees paid by chapter 11 debtors to the U.S. Trustee Program violated the Bankruptcy Clause of the U.S. Constitution. There is a stark, 2/2 circuit split.

A petition for *certiorari* hit the Supreme Court on September 20.

The Second and Tenth Circuits found violations of the Bankruptcy Clause because the increase did not apply immediately to chapter 11 debtors in two states with bankruptcy administrators rather than U.S. Trustees. *See Clinton Nurseries Inc. v. Harrington (In re Clinton Nurseries Inc.)*, 998 F.3d 56 (2d Cir. May 24, 2021), and *John Q. Hammons Fall 2006 LLC v. U.S. Trustee (In re John Q. Hammons Fall 2006 LLC)*, 20-3203, 2021 BL 380406 (10th Cir. Oct. 5, 2021). To read ABI's reports on *Clinton Nurseries* and *Hammons Fall*, click here and here.

On the other side of the fence, the Fourth and Fifth Circuits found no constitutional infirmity. *See Siegel v. Fitzgerald (In re Circuit City Stores Inc.)*, 996 F.3d 156 (4th Cir. April 29, 2021), and *Hobbs v. Buffets LLC (In re Buffets LLC)*, 979 F.3d 366 (5th Cir. Nov. 3, 2020). To read ABI's discussions of *Circuit City* and *Buffets*, click here and here.

The Fourth Circuit debtor filed a *certiorari* petition on September 20. *See Siegel v. Fitzgerald*, 21-441 (Sup. Ct.). On behalf of the government, the U.S. Solicitor General filed a request this week for an extension of time to respond to the petition until November 22.

Assuming no further delays, the justices should be holding a conference to consider the *certiorari* petition early in the New Year, still giving time for argument and a decision late this term.

An Important Case Settled

The New York Court of Appeals held in a 4/3 decision that there is no federal preemption of a nondebtor third party's tortious interference claims against other nondebtor third parties. At least in New York, the decision could mean that lawyers or financial advisors who help a client file bankruptcy could be liable to the lender if the loan agreement says that filing bankruptcy is a breach of contract. *See Sutton 58 Associates LLC v. Pilevsky*, 36 N.Y.3d 297, 140 N.Y.S.3d 897, 164 N.E.3d 984 (N.Y. Nov. 24, 2020). To read ABI's report, click here.

A group of retired bankruptcy judges and law professors filed an *amicus* brief urging the Supreme Court to grant *certiorari* and reverse. Perhaps because the parties settled, the petition was withdrawn on September 24. *See Pilevsky v. Sutton 58 Associates LLC*, 20-1483 (Sup. Ct. pet. withdrawn Sept. 24, 2021).

Another Arbitration Case

In recent terms, the Supreme Court has been adamant about enforcing arbitration agreements. *See, e.g.*, *Epic Systems Corp. v. Lewis*, 200 L. Ed. 2d 889 (Sup. Ct. May 21, 2018).

Of late, the Supreme Court has taken up no case to decide whether or not arbitration agreements are generally enforceable in bankruptcy cases. For instance, must a debtor arbitrate the allowance of a claim? Is the result different if the debtor is suing to make a recovery from a creditor armed with an arbitration agreement?

If arbitration is generally enforceable in bankruptcy, the effect will be dramatic. The process will slow, costs will increase for the debtor, and many critical decisions will be taken out of the hands of bankruptcy judges.

Historically speaking, the leading authority in the Supreme Court on the enforceability of arbitration agreements is or has been *Shearson/American Express Inc. v. McMahon*, 482 U.S. 220 (1987). Years later in *Epic*, the Supreme Court compelled employees to arbitrate wages and hours claims governed by the Fair Labor Standards Act. The Court said that a statute like the FLSA did not manifest a clear intention to override the Federal Arbitration Act.

Some circuits still interpret *McMahon* liberally by overriding arbitration agreements in bankruptcy cases, even though the Bankruptcy Code contains no express language barring enforcement of the FAA. *See, e.g.*, *Credit One Bank NA v. Anderson (In re Anderson)*, 884 F.3d 382 (2d Cir. March 7, 2018), *cert. denied*, 139 S. Ct. 144 (2018). To read ABI's report, click here.

Epic raised the question of whether *McMahon* is still good law. Does the Bankruptcy Code manifest a clear intention to override arbitration agreements, or is bankruptcy for some reason an exception to *Epic*'s exacting standard?

That's why we watch any arbitration case in the Supreme Court. On November 2, the Court will hear argument in *Badgerow v. Walters*, 20-1143 (Sup. Ct.). The case presents the question of whether a federal court has subject matter jurisdiction to confirm an arbitration award when the only basis for federal jurisdiction is that the underlying dispute involved a federal question.

The question before the Court does not seem to bear on bankruptcy, but the opinion may contain language that informs lower courts about arbitration in the bankruptcy context.

The circuit opinion on review in the Supreme Court regarding U.S. Trustee fees is *Siegel v. Fitzgerald (In re Circuit City Stores Inc.)*, 996 F.3d 156 (4th Cir. April 29, 2021).

Decided Last Term

Supreme Court narrows Spokeo by holding that violation of a statute won't always give rise to standing and the right to sue for damages.

Supreme Court Majority Deals a Blow to Enforcement of Consumer Protection Laws

Trimming back the already narrow definition of standing laid down in *Spokeo Inc. v. Robins*, 578 U.S. 330 (2016), the Supreme Court held 5/4 on June 25 that "an injury in law is not an injury in fact." In other words, a violation of federal law doesn't necessarily confer Article III standing to mount a lawsuit for the recovery of damages provided by statute.

A credit reporting agency maintained a list of individuals who were terrorists, drug traffickers and serious criminals. The majority held that those erroneously on the list had no standing to sue for statutory damages unless the false and defamatory report had been given to a third party.

The opinion is important in bankruptcy because the decision questions whether a debtor or trustee has standing to seek damages for violation of the automatic stay if the debtor can identify no concrete damages apart from violation of the statute. Arguably, the June 25 opinion means that a debtor or trustee is only entitled to an injunction barring further violations of the automatic stay, if the estate suffered no concrete damages from the original stay violation.

Five conservative justices were in the majority. The vigorous dissent by Justice Clarence Thomas indicates that the decision would have gone the other way were Justice Ruth Bader Ginsburg still on the bench.

As pointed out by Justice Thomas's dissent, the majority arguably intruded on the separation of powers by depriving Congress of the ability to define individuals' rights and create remedies to be enforced in federal court. Significantly, however, Justice Thomas explained in his dissent how plaintiffs in the future could bring the same claims in state courts.

Justice Brett M. Kavanaugh wrote the opinion of the Court, joined by Chief Justice Roberts and Justices Samuel A. Alito, Jr., Neil M. Gorsuch and Amy Coney Barrett. Justice Thomas wrote a dissent joined by Justices Stephen G. Breyer, Sonia Sotomayor and Elena Kagan. Justice Kagan wrote a separate dissent, joined by Justices Breyer and Sotomayor.

To read ABI's report on *Spokeo*, click here.

The Terrorist List

The government maintains lists of terrorists, drug traffickers and other serious criminals. For an extra fee, the credit reporting agency would tell its customers if someone's name appeared on the list.

The credit agency listed people with the same or similar names. It did not compare birth dates, Social Security numbers or other available identifiers. Consequently, innocent people could appear on the credit agency's list of terrorists and criminals.

The plaintiff negotiated to buy a car. The dealer refused to sell the car because the prospective buyer's name appeared on the credit agency's list of terrorists and criminals. Of course, the buyer was not a terrorist or criminal. He only shared a name with someone on the government's list.

After being denied the ability to buy a car, the plaintiff requested a copy of his credit report from the credit agency. The agency sent him a copy of the report purporting to be complete, but the report did not show him as being on the list of criminals and terrorists.

Later, the agency sent him a letter telling him that he was a potential match with someone on the government list, but it again did not tell him that the information appeared on his credit report. The letter also did not tell the plaintiff about his rights to remove incorrect information from the credit report, as required by the Fair Credit Reporting Act.

The plaintiff filed a class action in federal district court in California under the FCRA. The class of about 8,000 individuals included everyone who was erroneously on the credit agency's list during a specified time, whether or not their reports had been given to third parties. Among the class, erroneous reports for some 1,900 individuals had been given by the credit agency to third parties.

The class of 8,000 was certified. After trial, the jury awarded each of the 8,000 class members almost $1,000 in statutory damages and some $6,400 in punitive damages, for a total of more than $60 million. The Ninth Circuit affirmed 2/1 but reduced the total award to some $40 million.

The dissenter in the Ninth Circuit believed that class members had no standing if their erroneous reports had not been given to a third party, even though the FCRA gave them the right to damages.

The credit agency filed a petition for *certiorari*, which the Supreme Court granted in December 2020. It is not clear whether there was a circuit split. Oral argument was held on March 30.

The Majority Opinion

After laying out the facts, Justice Kavanaugh recounted the history of Article III standing, which requires that a plaintiff have a "personal stake" in the case. To meet the test, the plaintiff must show that (1) she or he suffered an injury that was concrete, particularized and actual or imminent; (2) the injury was likely caused by the defendant; and (3) the injury would likely be redressed by judicial relief.

In the case before the Court, Justice Kavanaugh said that the question under *Spokeo* was whether "the plaintiff's injury was 'concrete' — that is, 'real, and not abstract.'" *Spokeo*, he said, allowed for various intangible harms to be concrete, such as "reputational harms, disclosure of private information, and intrusion upon seclusion" or abridgement of free speech.

Justice Kavanaugh said that the views of Congress may be "instructive." Legislation, he said, can elevate the status of concrete, *de facto* injuries that previously were inadequate in law.

Quoting the Sixth Circuit, Justice Kavanaugh said that Congress's lawmaking power may not transform something that is not harmful into something that is. Citing *Spokeo*, he said that Article III standing requires a concrete injury even when there has been a statutory violation.

Justice Kavanaugh therefore held that "an injury in law is not an injury in fact. Only those plaintiffs who have been *concretely harmed* by a defendant's statutory violation may sue that private defendant over that violation in federal court." [Emphasis in original.] If the rules of Article III standing were different, he said, "Congress could authorize virtually any citizen to bring a statutory damages suit against virtually any defendant who violated virtually any federal law."

Applying the law to the facts, Justice Kavanaugh had "no trouble" in concluding that the 1,900 class members had suffered "concrete harm" because their erroneous reports had been given to third parties. For the remainder, "the mere presence of an inaccuracy in an internal credit file, if it is not disclosed to a third party, causes no concrete harm."

The plaintiffs cited *Spokeo* for the proposition that the risk of real harm can sometimes satisfy the requirement of concreteness. Justice Kavanaugh countered by saying that someone "exposed to a risk of future harm may pursue forward-looking, injunctive relief to prevent the harm from occurring, at least so long as the risk of harm is sufficiently imminent and substantial."

In other words, a plaintiff must show standing separately for each type of relief. "Therefore," Justice Kavanaugh said, "a plaintiff's standing to seek injunctive relief does not necessarily mean that the plaintiff has standing to seek retrospective damages."

For the majority, Justice Kavanaugh reversed and remanded to the Ninth Circuit. The 1,900 class members whose reports were disseminated to third parties "suffered a concrete harm," but the remainder did not and had no standing.

The Dissent by Justice Thomas

In his dissent joined by three liberal justices, Justice Thomas began by emphasizing the facts. The credit reports "flagged many law-abiding people as potential terrorists and drug traffickers" and in doing so violated several provisions in the FCRA. He continued:

> Yet despite Congress' judgment that such misdeeds deserve redress, the majority decides that [the credit agency's] actions are so insignificant that the Constitution prohibits consumers from vindicating their rights in federal court. The Constitution does no such thing.

Justice Thomas noted how the notion of injury in fact only emerged in 1970, 180 years after ratification of Article III. To the contrary, he said that "courts for centuries held that injury in law to a private right was enough to create a case or controversy." To his way of thinking, the entire class of 8,000 had "a sufficient injury to sue in federal court" given that the jury had found that the credit agency "violated each member's individual rights."

By way of contrast, Justice Thomas characterized the majority as holding that "the mere violation of a personal legal right is *not* — and never can be — an injury sufficient to establish standing." [Emphasis in original.] In that regard, he insinuated that the Court was cutting back on *Spokeo* because the majority had said five years ago that "Congress is well positioned to identify intangible harms that meet minimum Article III requirements" and that "the violation of a procedural right granted by statute can be sufficient in some circumstances to constitute injury in fact." *Spokeo*, *id.*, 578 U.S. at 341, 342.

Justice Thomas characterized the import of the majority's opinion as meaning that "legislatures are constitutionally unable to offer the protection of the federal courts for anything other than money, bodily integrity, and anything else that this Court thinks looks close enough to rights existing at common law . . . . Never before has this Court declared that legal injury is *inherently* insufficient to support standing." [Emphasis in original.]

Consequently, Justice Thomas said, "this Court has relieved the legislature of its power to create and define rights." If characterizing someone as a drug trafficker or terrorist was not enough, he wondered what could rise to the level of sufficient injury. What if someone were falsely labeled as a child molester or a racist? "Or what about openly reducing a person's credit score by several points because of his race?"

"If none of these constitutes an injury in fact, how can that possibly square with our past cases . . . ? Weighing the harms caused by specific facts and choosing remedies seems to me like a much better fit for legislatures and juries than for this Court," Justice Thomas said.

In a footnote near the end of his dissent, Justice Thomas observed that the majority's decision "might actually be a pyrrhic victory" for the credit agency. The Court only held that some of the class lacked standing in federal court.

Justice Thomas said that state courts would become "the sole forum for such cases" because they are not bound by Article III's requirement of a case or controversy. Moreover, defendants could not remove the suits to federal court, because federal courts would have no jurisdiction for lack of an Article III case or controversy.

"By declaring that federal courts lack jurisdiction," Justice Thomas concluded his footnote by saying that "the Court has thus ensured that state courts will exercise exclusive jurisdiction over these sorts of class actions."

Justice Kagan's Dissent

Joined by Justices Breyer and Sotomayor, Justice Kagan further developed the majority's intrusion into the separation of powers. She said that the "Court here transforms standing law from a doctrine of judicial modesty into a tool of judicial aggrandizement. It holds, for the first time, that a specific class of plaintiffs whom Congress allowed to bring a lawsuit cannot do so under Article III."

Justice Kagan said that the reporting agency had "willfully violated" the statute by preparing credit files falsely reporting class members as potential terrorists and by obscuring the mistake when class members requested copies of their files. She said that finding no injury in the real world "is to inhabit a world I don't know. [citation omitted] And to make that claim in the face of Congress's contrary judgment is to exceed the judiciary's 'proper — and properly limited — role,'" quoting *Warth v. Seldin*, 422 U.S. 490, 498 (1975).

Justice Kagan ended her dissent by saying that "Congress is better suited than courts to determine when something causes a harm or risk of harm in the real world. For that reason, courts should give deference to those congressional judgments."

Observations

Assume that a creditor willfully violates the Section 362 automatic stay but causes no injury. After last week's decision, is the debtor or trustee entitled to damages such as attorneys' fees, or is injunctive relief the only remedy?

In this writer's opinion, the majority has reincarnated substantive due process, this time under Article III. If a remedy for an injustice was not known at common law, the majority are saying that relief other than an injunction is beyond the reach of Congress.

The opinion is *TransUnion LLC v. Ramirez*, 20-297 (Sup. Ct. June 25, 2021).

'Cert' Denied

Despite several errors about the safe harbor, the government recommends that the Supreme Court deny certiorari in Tribune.

Solicitor General Says the Second Circuit 'Erred' in *Tribune* Safe Harbor Decision

The U.S. Solicitor General told the Supreme Court that the Second Circuit "erred in finding that creditors' state-law avoidance actions are preempted by [the safe harbor in] Section 546(e)."

On March 12, the government's advocate in the Supreme Court also said that the Second Circuit's ruling in *In re Tribune Co. Fraudulent Transfer Litigation*, 946 F.3d 66 (2d Cir. Dec. 19, 2019), "would render [*Merit Management Group LP v. FTI Consulting Inc.*, 138 S. Ct. 883 (Feb. 27, 2018)] a virtual nullity."

Nonetheless, the Solicitor General recommended that the justices not grant *certiorari* to correct the errors in *Tribune*, largely because there is no circuit split as yet. To read ABI's reports on *Tribune* and *Merit Management*, click here and here.

Merit Management

The Supreme Court held in *Merit Management* that the presence of a financial institution as a conduit in the chain of payments in a leveraged buyout will not invoke the safe harbor in Section 546(e).

Section 546(e) provides that "the trustee may not" sue for recovery of a "settlement payment" that was made "by or to (or for the benefit of) a . . . financial institution" unless the suit was brought under Section 548(a)(1)(A) for recovery of a fraudulent transfer within two years of bankruptcy made with actual intent to hinder, delay or defraud creditors.

The Supreme Court held that the safe harbor is for "financial institutions," not for transactions. More specifically, the Court ruled that Section 546(e) only applies to "the transfer that the trustee seeks to avoid." *Merit Management*, *id.*, at 888. In other words, sticking a bank or broker in the middle of a chain of payments from the transferor to the defendant does not invoke the safe harbor.

The Second Circuit's *Tribune* Decisions

The Second Circuit's opinions arose from the chapter 11 reorganization of newspaper publisher Tribune Co.

Two years before *Merit Management*, the Second Circuit reversed the district court and dismissed the fraudulent transfer suit, holding that Section 546(e) impliedly preempted a lawsuit by creditors under state fraudulent transfer law. The appeals court held that having a financial institution somewhere in the chain of payments was sufficient to invoke the safe harbor.

The Second Circuit believed that allowing creditors' fraudulent transfer suits under state law to unwind "settled securities transactions" would "seriously undermine" the markets. *In re Tribune Co. Fraudulent Transfer Litigation*, 818 F.3d 98, 119 (2d Cir. 2016).

The creditors in *Tribune* had filed a petition for *certiorari* before the Supreme Court handed down *Merit Management*. At the suggestion of a pair of justices on the Supreme Court after *Merit Management*, the Second Circuit withdrew the mandate in May 2018 to revisit the issues.

Merit Management had overruled one of the grounds for the Second Circuit's belief that having a bank in the chain of payments is enough to invoke the safe harbor.

The Second Circuit handed down its new decision in December 2019. The result was the same: dismissal. The Second Circuit found a loophole in *Merit Management*.

The appeals court adhered to its original holding that the safe harbor in the Bankruptcy Code preempts state law. Upholding dismissal a second time, the panel also held that the safe harbor was applicable because a bank was acting as Tribune's depositary. The newspaper publisher was therefore a "financial institution" as defined in Section 101(22)(A).

How's that possible?

A "financial institution" in Section 101(22)(A) is defined to be a bank or "trust company, . . . and when any such . . . entity is acting as agent or a custodian for a customer . . . in connection with a securities contract . . . such customer." In plain English, a customer of a financial institution itself becomes a "financial institution" if the financial institution is acting as the customer's agent or custodian.

In July 2020, the creditors filed a second petition for *certiorari*. *Deutsche Bank Trust Co. v. Robert R. McCormick Foundation*, 20-8 (Sup. Ct.). Several *amicus* briefs were filed. In October, the Supreme Court invited the Solicitor General to file a brief expressing the views of the government.

SG Says the New *Tribune* Decision Is Wrong

The Solicitor General didn't beat around the bush. In the first sentence of the "Discussion" in the its *amicus* brief, the government said that the Second Circuit "erred in finding that creditors'

state-law avoidance actions are preempted by [the safe harbor in] Section 546(e)." To read the government's brief, click here.

"The text of Section 546(e)," the government said, "does not express an intent to preempt state-law avoidance claims brought by creditors." The Solicitor General said that "nothing in the statutory text indicates that Congress intended permanently to divest creditors of their own state-law causes of action."

According to the Solicitor General, the Second Circuit "also erred" in holding that suits by creditors under state law would create an "irreconcilable conflict" with the purposes of the safe harbor.

The Supreme Court "in *Merit Management* rejected a similar effort to override Section 546(e)'s text based on assumptions about congressional purpose. 138 S. Ct. at 897," the Solicitor General said. The government went on to say that "that Congress did not intend to preclude every avoidance action that might introduce uncertainty into securities markets."

Similarly, the Solicitor General concluded that the Second Circuit erred in calling Tribune a "financial institution" just because a bank acted as its depositary in the leveraged buyout transaction. In the government's opinion, that "understanding of Section 101(22)(A) would render *Merit Management* a virtual nullity."

The Solicitor General went on to say that the Second Circuit's interpretation will make "the safe harbor . . . apply to virtually every transfer made in connection with a securities contract, since some party to almost every such transfer will" have a financial institution embedded somewhere in the chain of payments.

The Solicitor General criticized the Second Circuit for failing to consider whether the financial institution was acting as an "agent for significant aspects of the overall transaction" or was only providing "ministerial assistance."

No Split — No '*Cert*' Grant

Despite having found several errors by the Second Circuit, the Solicitor General concluded that the Supreme Court's "review is not warranted at this time [in the] absence of a circuit conflict" on the issue of federal preemption. The government believes that the Supreme Court's "eventual review . . . would benefit from further analysis by other courts of appeals."

On the question of whether a whether a minor role by a financial institution is sufficient to invoke the safe harbor, the Solicitor General again said there is no circuit split. The government believes that the high court "would likely benefit from prior consideration of the issues by additional courts of appeals."

The certiorari petition was *Deutsche Bank Trust Co. v. Robert R. McCormick Foundation*, 20-8, 209 L. Ed. 2d 568 (*cert. den.* April 19, 2021).

Reorganization

Fraudulent Transfers

Reversing in favor of the Madoff trustee, the Second Circuit rules that inquiry notice, not willful blindness, governs the good faith defense by recipients of fraudulent transfers.

Second Circuit Revives $3.75 Billion in *Madoff* Lawsuits Against Financial Institutions

In a major victory for the trustee and victims of the Bernard Madoff Ponzi scheme, the Second Circuit again reversed District Judge Jed Rakoff, this time by holding that so-called inquiry notice is sufficient to show a lack of good faith by a transferee of a fraudulent transfer avoided under the Securities Investor Protection Act. Judge Rakoff had required the Madoff trustee to meet the higher standard of "willful blindness."

The appeals court reversed Judge Rakoff on a second issue: Good faith is an affirmative defense to be pleaded by the defendant. In the complaint, the trustee is not required to plead facts showing the transferee's lack of good faith.

Together, the rulings revive about 90 lawsuits against global financial institutions, hedge funds and other participants in the global financial markets. The decision allows Irving Picard, the Madoff trustee, to pursue the recovery of an additional $3.75 billion in stolen customer property, the trustee said in a statement.

The resurrected lawsuits will bring defrauded customers "as close as possible to recovering 100% of their losses," the trustee said. A full recovery would be remarkable given that customers' cash losses aggregate almost $19.5 billion.

The Madoff liquidation is being conducted in bankruptcy court under SIPA, which incorporates large swaths of the Bankruptcy Code, including Sections 548 and 550. The trustee filed hundreds of fraudulent transfer suits in the two years following the commencement of the liquidation in 2008.

The 'Bad Faith' Defendants

Most of the suits by the Madoff trustee were lodged against so-called "net winners," meaning Madoff customers who took out fictitious profits. In reality, they were not receiving profits from investments. Rather, Madoff gave them money stolen from other investors because he never bought any securities with customers' deposits.

The Madoff trustee benefited from the so-called Ponzi scheme presumption, where a transfer in a Ponzi scheme is presumed to be made with actual intent to defraud creditors under Section 548(a)(1)(A). The presumption is based on Bernie Madoff's fraudulent intent, not the intent of the recipients of the fraudulent transfers.

Earlier in the Madoff liquidation, the Second Circuit held that net winners did not give value for receipt of fictitious profits and are therefore liable to pay back however much cash they took out within two years of bankruptcy in excess of the cash they invested. Because the return of a customer's principal investments constitutes "value," customers who took out less than they invested (so-called "net losers") were not liable for receipt of fraudulent transfers.

In test cases decided by the Second Circuit on August 30, the Madoff trustee had reason to believe that the defendants either knew there was fraud or ignored enough red flags to be on inquiry notice. For lack of good faith, the Madoff trustee contended in his suits that the defendants were liable even for principal they took out.

The Decisions Below

There were three defendants-appellees in the Second Circuit. One was an initial transferee from Madoff who was being sued for $213 million. The other two were subsequent transferees being sued for $343 million and $6.6 million, respectively.

Early in the litigation, District Judge Rakoff withdrew the reference, reasoning that the suits involved securities law, of which SIPA arguably is part. In a decision in 2014, Judge Rakoff established two principles. *SIPC v. BLMIS (In re Madoff Sec.)*, 516 B.R. 18 (S.D.N.Y. 2014).

First, District Judge Rakoff reasoned that a SIPA trustee must plead lack of good faith in the complaint with particularity. Otherwise, he said, placing the burden on the defendant would undercut SIPA's goal of encouraging investor confidence.

Second, District Judge Rakoff required the trustee to plead the higher standard of "willful blindness" in proving lack of good faith because a securities investor has no inherent duty to inquire about his stockbroker.

Remanded to bankruptcy court, the bankruptcy judge dismissed the complaints under the pleading standards laid down by District Judge Rakoff. The bankruptcy court did not permit the trustee to amend the complaints, saying that the trustee could not plausibly show willful blindness.

The Second Circuit accepted a direct appeal.

Good Faith in the Statutes

Good faith appears in two sections of the Bankruptcy Code pertinent to the appeal.

Under Section 548(c), an initial transferee who "takes for value and in good faith has a lien on or may retain any interest transferred . . . to the extent that such transferee . . . gave value to the debtor in exchange for such transfer." In a Ponzi scheme case like *Madoff*, the initial transferee's lack of good faith requires giving back all transfers within two years of bankruptcy, not just net winnings.

Under Section 550(b)(1), a subsequent transferee is entitled to retain the transferred property if the subsequent transferee took "for value, . . . in good faith, and without knowledge of the voidability of the transfer avoided." Section 550(b)(1) is applicable only to subsequent transferees.

In his complaint, the Madoff trustee alleged facts aiming to show that the three defendants all undertook investigations leading them to suspect that Madoff was conducting a fraud. For District Judge Rakoff, however, the allegations did not rise to the level of willful blindness.

The Reversal on Willful Blindness

Circuit Judge Richard C. Wesley reversed on willful blindness.

He defined inquiry notice as arising when "the facts the transferee knew would have led a reasonable person in the transferee's position to conduct further inquiry into a debtor-transferor's possible fraud."

In comparison, District Judge Rakoff required willful blindness, which he defined as "a showing that the defendant acted with willful blindness to the truth, that is, he intentionally chose to blind himself to the red flags that suggest a high probability of fraud."

Judge Wesley explained that the two standards differ in "degree and intent." Someone who is willfully blind takes deliberate action to avoid confirming a high probability of wrongdoing. Inquiry notice, on the other hand, requires "knowledge of suspicious facts" that would induce "a reasonable person to investigate."

District Judge Rakoff had invoked willful blindness because it is the standard for some securities law claims, and SIPA is part of securities law.

The Bankruptcy Code does not define "good faith," so Judge Wesley looked to the "commonly understood meaning." Before the Bankruptcy Code, he said that "good faith" meant "inquiry notice," citing Circuit Judge Learned Hand for using that standard in 1914.

Judge Wesley concluded that "the plain meaning of good faith in Sections 548 and 550 of the Bankruptcy Code embraces an inquiry notice standard." Other circuits, he said, "unanimously accept the inquiry notice standard."

"The historical usage of the phrase 'good faith' (particularly as used in the context of fraudulent conveyance law), this Court's prior case law, and the legislative history of the Bankruptcy Code all lead us to reject the heightened willful blindness standard," Judge Wesley said.

The Same Standard in SIPA Cases

The defendants contended that willful blindness obtains in SIPA cases because inquiry notice is inconsistent with the standard in federal securities law.

Judge Wesley rejected the argument, observing that it had not been adopted by any other circuit court. He noted, among other things, that a Section 10(b) suit "for securities fraud is meaningfully different from a SIPA liquidation."

The Burden of Pleading

Although good faith is an affirmative defense that the defendant must plead in an answer under Rule 8(c), District Judge Rakoff had placed the burden on the Madoff trustee in view of the "policy goals" of a SIPA liquidation.

Judge Wesley held that "the trustee is not required to plead a transferee's lack of good faith" because "good faith is an affirmative defense under Sections 548 and 550 and . . . SIPA does not compel departing from the well-established burden-of-pleading rules."

Other circuits, Judge Wesley said, "uniformly agree," along with the *Collier* treatise. He found no "policy-based justifications for departing from Rule 8(c)(1) because placing the burden on the defendant "does not contradict the goals of SIPA."

Judge Wesley vacated the judgments of the bankruptcy court and remanded for further proceedings.

The Concurrence

Circuit Judge Steven J. Menashi wrote separately.

He said that using "fraudulent transfer law rather than the law relating to preferences to promote an equal distribution among creditors . . . is questionable." Because none of the defendants had challenged the Ponzi scheme presumption, he concurred in Judge Wesley's opinion.

This writer finds the concurrence difficult to follow. Judge Menashi may have been saying that the defendants' liability should have been judged by whether or not the transfers were preferences, had the defendants made the argument. To read the concurrence, click here.

Observations

The Second Circuit had reversed District Judge Rakoff two years ago by holding that Sections 548 and 550 can be applied extraterritorially to recover fraudulent transfers even if subsequent transfers occurred abroad. *In re Picard, Trustee for the Liquidation of Bernard L. Madoff Investment Securities LLC*, 917 F.3d 85 (2d Cir. Feb. 25, 2019). To read ABI's report, click here.

The rulings by District Judge Rakoff on good faith set back the Madoff trustee even more in his efforts to recover on behalf of defrauded investors. More than five years into the liquidation, the decision by Judge Rakoff seemingly killed off about 90 lawsuits aiming to recover about $3.75 billion.

Rather than settle for little or nothing in the face of unfavorable decisions by District Judge Rakoff, the Securities Investor Protection Corp. supported the trustee's decision to undertake seven years of further litigation to set up the test cases in the Second Circuit.

Already, the Madoff trustee has recovered almost $14.5 billion and has distributed more than $13.5 billion. He holds more than $900 million. The distributions so far represent almost 70% of investors' cash losses.

The opinion is *Picard v. Citibank NA (In re Bernard L. Madoff Investment Securities LLC)*, 20-1333, 2021 BL 326779, 2021 Us App Lexis 26100 (2d Cir. Aug. 30, 2021).

Properly structuring a leveraged refinancing in the Second Circuit can avoid attack as a fraudulent transfer despite the Supreme Court's effort at narrowing the 'safe harbor.'

Affirmance Shows that *Merit Management* Has Been Gutted in the Second Circuit

Affirming the bankruptcy court, a district judge in New York handed down a decision seeming to mean that a leveraged transaction cannot be set aside in the Second Circuit as a fraudulent transfer if the professionals properly structure the transaction to invoke the so-called safe harbor in Section 546(e).

If followed elsewhere, the September 13 decision by District Judge George B. Daniels allows the structuring of a transaction to avoid the consequences of *Merit Management Group LP v. FTI Consulting Inc.*, 138 S. Ct. 883 (Sup. Ct. Feb. 27, 2018). There, the Court held that the presence of a financial institution as a conduit in the chain of payments in a leveraged buyout was insufficient to invoke the safe harbor in Section 546(e). That section provides that a trustee may not avoid a "settlement payment . . . made by or to (or for the benefit of) . . . a financial institution."

Merit Management held that Section 546(e) only applies to "the transfer that the trustee seeks to avoid." More particularly, Justice Sonia Sotomayor said that "the relevant transfer for purposes of the Section 546(e) safe-harbor inquiry is the overarching transfer that the trustee seeks to avoid." *Id.* at 888, 893.

The Leveraged Recapitalization

At the risk of oversimplification, the highly complex leveraged recapitalization worked like this:

The operating company borrowed about $1 billion by taking down new credit facilities secured by its assets. The operating company transferred the loan proceeds to a bank account of its parent holding company. The holding company had no assets other than ownership of the operating company.

The holding company then transferred the loan proceeds to a second bank, which distributed the funds to equity holders in redemption of their warrants and equity interests and to pay a dividend.

More than three years later, the operating company was in chapter 11. The plan paid only the first-lien lender. Subordinate lenders, owed hundreds of millions of dollars, received nothing more than the right to distributions from whatever the liquidating trustee could recover in lawsuits.

The liquidating trustee filed a fraudulent transfer suit under state law, alleging that the operating company was insolvent at the time of the leveraged restructuring. Bankruptcy Judge Robert E. Grossman of Central Islip, N.Y., granted the defendants' motion for summary judgment. *Holliday v. K Road Power Management LLC (In re Boston Generating LLC)*, 617 B.R. 442 (Bankr. S.D.N.Y. June 18, 2020). To read ABI's report, click here.

Where Judge Grossman needed 82 pages to dismiss, Judge Daniels affirmed in only 20 pages.

The Relevant Transaction

On appeal, the trustee argued that the relevant transfer under *Merit Management* was the initial transfer from the operating company to the holding company's first bank account. Under the trustee's theory, the safe harbor would not come into play because the first transfer was not in connection with a settlement payment for securities.

Judge Daniels disagreed. In substance, he compressed the first two transfers into one. In other words, the relevant transfer put the loan proceeds into the hands of a financial institution that made the distributions to equity holders. The transfer was a settlement payment that invoked the safe harbor.

Furthermore, Judge Daniels said, the parent holding company was a financial institution itself protected by the safe harbor. Why, you say?

In Section 101(22), a non-financial institution becomes a financial institution if a financial institution is acting as its agent. In the case on appeal, Judge Daniels decided as a matter of common law that a bank was serving as the holding company's agent, thus making the holding company a financial institution itself protected by the safe harbor.

Bound by Second Circuit authority from *Note Holders v. Large Private Beneficial Owners (In re Tribune Co. Fraudulent Conveyance Litigation)*, 818 F.3d 98 (2d Cir. 2016), Judge Daniels also upheld the ruling by Judge Grossman that the safe harbor in Section 546(e) preempted the trustee's fraudulent transfer claims under state law.

The opinion is *Holliday v. Credit Suisse Securities (USA) LLC*, 20-5404, 2021 BL 344979 (S.D.N.Y. Sept. 13, 2021).

Judge in New Jersey explains why chapter 11 is the best alternative for a large company to deal with mass torts.

Johnson & Johnson Survives a Motion to Dismiss that Alleged a Bad Faith Filing

The Johnson & Johnson entity named LTL Management LLC survived a motion to dismiss its chapter 11 case originally filed in North Carolina, in an opinion on February 25 by Chief Bankruptcy Judge Michael B. Kaplan of Trenton, N.J.

Judge Kaplan's 54-page opinion is a ringing endorsement of chapter 11 as the best alternative in the state and federal legal systems for dealing with mass torts. He found no fault with J&J's use of the so-called Texas Two-Step to avoid putting the entire enterprise in chapter 11.

Judge Kaplan said he had "little trouble finding that the chapter 11 filing serves to maximize the property available to satisfy creditors by employing the tools available under the Bankruptcy Code to ensure that all present and future tort claimants will share distributions through the court-administered claims assessment process."

Compared to the tort system, Judge Kaplan said that chapter 11 represents "a more beneficial and equitable path toward resolving Debtor's ongoing talc-related liabilities." For the reasons expressed in his opinion, Judge Kaplan developed "a strong conviction that the bankruptcy court is the optimal venue for redressing the harms of both present and future talc claimants in this case — ensuring a meaningful, timely, and equitable recovery."

In reaching his decision, Judge Kaplan was not blind to recent criticism of the bankruptcy system. He said,

> There is no question that, over time, our bankruptcy courts have witnessed serious abuses and inefficiencies, striking at the heart of the integrity of our bankruptcy courts. For instance, the approval of overly broad nonconsensual third-party releases, and the propriety/necessity for twenty-four hour accelerated bankruptcy cases have drawn deserved scrutiny. Likewise, the selection of case venue, as in the matter at hand, has warranted critical attention and debate.

Refusing to dismiss the case after a five-day trial, Judge Kaplan said that the chapter 11 filing "is unquestionably a proper purpose under the Bankruptcy Code." Still, he had "no expectation that this decision will be the final word on the matters."

Corporate Restructuring & Venue

Just before the chapter 11 filing, Johnson & Johnson created two new subsidiaries. LTL was created to be the debtor, and the other took over J&J's operating businesses.

The debtor was first created as a limited liability company in Texas and converted to a North Carolina limited liability company. On October 14, two days later, the debtor filed a chapter 11 petition in Charlotte.

The debtor was given no business operations of its own but assumed liability for all talc-related claims. The debtor was given some non-operating assets and insurance receivables, plus $6 million in cash. The debtor was also the beneficiary of a so-called funding agreement where the other J&J businesses agreed to supply the funds necessary for emerging from chapter 11, up to about $60 billion, representing the value of the businesses at the time of the restructuring.

In an opinion on November 16, Bankruptcy Judge J. Craig Whitley transferred venue to New Jersey, where the case was assigned to Judge Kaplan. To read ABI's report on the venue opinion, click here.

The official committee representing talc claimants filed a motion to dismiss the chapter 11 case under Section 1112(b), contending that the filing was in bad faith. The U.S. Trustee supported either dismissal or appointment of a chapter 11 trustee.

J&J's Financial Distress

Judge Kaplan laid out J&J's financial problems resulting from the 38,000 talc-related lawsuits that have been filed so far, not to mention tens of thousands more that would be filed in the future as cancers manifest themselves.

Judge Kaplan mentioned one case where the jury awarded an individual claimant $4.69 billion that was affirmed on appeal but reduced to $2.25 billion. Based on awards stemming so far from litigation, he roughly calculated liability as exceeding $15 billion, "not including the tens of thousands of ovarian cancer claims and all future cancer claims."

In sum, Judge Kaplan said that the tort system outside of bankruptcy would result in judgments in favor of a few claimants exhausting all of the value in J&J, leaving nothing for the vast majority of claimants.

The debtor itself said that the corporate restructuring before bankruptcy and the chapter 11 filing together were designed to "globally resolve talc-related claims through a chapter 11 reorganization without subjecting the entire [J&J business] to a bankruptcy proceeding."

Applying the Facts to the Law

Arguing for dismissal, talc claimants noted that the debtor had no creditors (aside from talc claimants), no lenders, no customers and no suppliers. They said the bankruptcy had no business purpose but was designed to shed tort liability without subjecting the J&J business to the rigors and inconveniences of chapter 11.

The talc claimants, according to Judge Kaplan, argued that the bankruptcy strategy was "intended to force talc claimants to face delay and to secure a 'bankruptcy discount'; in Movants' words, 'an obvious legal maneuver to impose an unfavorable settlement dynamic on talc victims.'"

To decide whether the bankruptcy strategy justified dismissal for cause under Section 1112(b), Judge Kaplan said that the good faith inquiry examines "the totality of the circumstances." The general focus, he said, is whether the petition serves a valid bankruptcy purpose or was filed "merely to obtain a tactical litigation advantage."

Valid Reorganization Purpose

Judge Kaplan found a valid reorganization purpose because bankruptcy is the only method to "ensure that all present and future tort claimants will share distributions through the court-administered claims assessment process."

In the Third Circuit, Judge Kaplan said, there must be "some" degree of financial distress to underpin a valid business purpose. In that respect, he said,

> No public or private company can sustain operations and remain viable in the long term with juries poised to render nine and ten figure judgments, and with such litigation anticipated to last decades going forward.

Judge Kaplan said that J&J "need not have waited until its viable business operations were threatened past the breaking point."

In reaching his conclusion on valid business purpose, Judge Kaplan examined what he called "a far more difficult issue": whether there was "a more beneficial and equitable path toward resolving Debtor's ongoing talc-related liabilities." In that regard, he said he "simply cannot accept the premise that continued litigation in state and federal courts serves best the interest of [the tort lawyers'] constituency."

Class actions, Judge Kaplan said, are usually not suitable for mass tort cases. Likewise, multidistrict litigation would produce a few bellwether trials, "at best." Thereafter, 40,000 tort cases would be sent to district courts for trials throughout the country, where the same issues would be relitigated over and over.

By contrast, Judge Kaplan said that chapter 11 invokes Section 524(g) to "ensure[] that present claimants do not exhaust the debtor's assets before future claimants have even manifested injuries." The tort system, on the other hand, "produces an uneven, slow-paced race to the courthouse, with winners and losers." It was "folly," he said, to say that "the tort system offers the only fair and just pathway of redress."

Unfair Tactical Advantage

With regard to the claim that J&J invoked bankruptcy to obtain an unfair tactical advantage, Judge Kaplan found "no improprieties or failures to comply with the Texas statute's requirements." He added, "the interests of present and future talc litigation creditors have not been prejudiced." He found "nothing inherently unlawful or improper with application of the Texas divisional merger scheme."

Judge Kaplan was "not prepared to rule that use of the statute as undertaken in this case, standing alone, evidences bad faith."

With regard to other aspects of good faith, Judge Kaplan said that the funding agreement "will be available upon confirmation of a plan — whether or not the plan is acceptable to [the debtor or J&J], and whether or not the plan offers payors protections under § 524(g)."

Had there been no reorganization to exclude the operating business from chapter 11, Judge Kaplan said,

> [S]uch filings would pose massive disruptions to operations, supply chains, vendor and employee relationships, ongoing scientific research, and banking and retail relationships — just to name a few impacted areas. The administrative and professional fees and costs associated with such filings would likely dwarf the hundreds of millions of dollars paid in mega cases previously filed — and for what end?

It was not, Judge Kaplan said, "a case of too big to fail . . . rather, this is a case of too much value to be wasted, which value could be better used to achieve some semblance of justice for existing and future talc victims."

"The potential loss in market value, the disruptions to operations, and the excessive administrative costs associated with independent chapter 11 filings," Judge Kaplan said, "justify the business decision to employ the divisional merger statute as a means of entering the bankruptcy system." Bankruptcy, he said, "may indeed accelerate payment to cancer victims and their families."

In sum, it would be fair to say that Judge Kaplan found that bankruptcy confers benefits on the bulk of existing and future claimants and was not designed to gain an unfair litigation advantage.

The Remedy

Judge Kaplan denied the motion to dismiss and said that the record did not support the appointment of a chapter 11 trustee. He nonetheless agreed "that there is a need for independent scrutiny of possible claims while the case progresses through the appointment of a Future Talc Claims Representative, mediation and towards the plan formulation process."

Judge Kaplan said he would take up questions about a future claimants' committee and mediation at the omnibus hearing on March 8.

The opinion is *In re LTL Management LLC*, 21-30589 (Bankr. D.N.J. Feb. 25, 2022).

Executory Contracts & Leases

The bankruptcy community needs a better definition of what's an executory contract, and Prof. Jay Westbrook has it.

Puerto Rico Case and the Efficacy of Prof. Westbrook's Definition of 'Executoriness'

A decision by the district court in restructuring Puerto Rico's debt demonstrates the gyrations a court must sometimes undertake to conclude that a contract is capable of assumption under the "Countryman" definition of an executory contract.

Rather than decide whether a contract is executory under the dueling "Countryman" and "functional" definitions of executoriness, this writer instead recommends adoption of the "Modern Contract Analysis" proposed by Prof. Jay L. Westbrook and Kelsi S. White in "The Demystification of Contracts in Bankruptcy," 91 Am. Bankr. L.J. 481 (Summer 2017). Prof. Westbrook occupies the Benno C. Schmidt Chair of Business Law at the University of Texas School of Law.

The Class Action Insurance Settlements

When auto owners in Puerto Rico register their vehicles, they pay auto insurance premiums to the commonwealth government. If an owner has private insurance, the owner is entitled to a refund of the premium paid to the government.

Two class actions were filed seeking refunds for auto owners who had private insurance but paid for duplicate insurance between 1998 and 2010. One suit was in a commonwealth court, and the other was in federal district court in Puerto Rico.

The suits were settled at least in principle before Puerto Rico and its instrumentalities initiated their debt adjustments in district court in Puerto Rico in 2017 under the Puerto Rico Oversight, Management, and Economic Stability Act, or PROMESA (48 U.S.C. §§ 2161 *et. seq.*). PROMESA incorporates large parts of the Bankruptcy Code, including Section 365 and law on assuming executory contracts.

Acting as the representative of the commonwealth in the debt-adjustment cases, the Financial Oversight and Management Board for Puerto Rico filed a motion to assume the settlements as executory contracts under Section 365. The official creditors' committee objected, contending that the settlements were not executory, and if they were, that assumption did not satisfy the business judgment standard.

District Judge Laura Taylor Swain overruled the objections in an opinion on June 29. She concluded that the settlements were executory and that the Oversight Board exercised sound business judgment in deciding to assume the settlements as executory contracts. Judge Swain ordinarily sits in the Southern District of New York but was tapped by the Chief Justice to preside over the PROMESA proceedings.

The Two Definitions of 'Executory'

Under Section 365(a), a trustee may assume or reject a contract if it is "executory." The term is not defined in the Bankruptcy Code.

Judge Swain laid out two competing definitions of executory contracts:

> (1) The so-called Countryman definition, where Prof. Vern Countryman of Harvard Law School proposed that a contract is executory if it is "a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing performance of the other." *Executory Contracts in Bankruptcy: Part I*, 57 Minn. L. Rev. 439, 460 (1973); and
>
> (2) The so-called functional approach, which, as explained by Judge Swain, works backward from the purposes to be accomplished by rejection. The contract is no longer executory if the purposes have been accomplished already.

Judge Swain said that "some courts" have moved away from the Countryman definition to the functional approach, believing that courts should not be bound by a static definition not appearing in the language of the statute.

Judge Swain first applied the Countryman test and found one narrow (if not contorted) basis for concluding that the contract remained executory because the plaintiffs had remaining obligations that would amount to breach if not performed.

Without much in the way of explanation, Judge Swain also decided that the contract was executory under the functional approach.

Having decided that the contract was available for assumption, Judge Swain asked whether the Oversight Board had properly exercised its business judgment.

Settlement would resolve a lawsuit kicking around for 20 years and end the commonwealth's expenditures on counsel fees. The settlement would also avoid paying interest on the monies withheld from auto owners for so long.

Judge Swain authorized assumption of the settlements.

The Westbrook Approach

Prof. Westbrook told ABI that the result reached by Judge Swain was correct, but he went on to say that "the so-called 'functional' cases are a dead end, with the name taken from my first executoriness article but ignoring its analysis."

In that regard, we have written several times in recent months about the sometimes baffling analysis and results that courts reach in applying the Countryman analysis or avoiding it. To read ABI discussions of recent cases on the Countryman definition, click here, here, here, and here.

To provide a more solid foundation for analysis, this writer recommends that courts embrace Prof. Westbrook's Modern Contract Analysis.

Prof. Westbrook told ABI that he provides a "simple analysis and relates it to all the major lines of modern cases to show how it can light the way out of the labyrinth."

The approach in the professor's 2017 article "ensures that pre-bankruptcy bargains and entitlements will be changed in Chapter 11 only insofar as bankruptcy policies, like equality of treatment and rehabilitation of debtors, require alteration. Properly understood, the very process of acceptance or rejection is simply the trustee's exercise of the opportunity every contract party has to perform or breach with whatever consequences non-bankruptcy law proscribes." Westbrook, *supra*, 91 Am. Bankr. L.J. at 535.

The opinion is *In re Financial Oversight and Management Board for Puerto Rico*, 17- 3283, 2021 BL 242214 (D. P.R. June 29, 2021).

Officers are presumptively disqualified from KERPs, "absent a strong showing that they do not perform any significant role in management," a district judge in New York says.

Being an 'Officer' Disqualifies Someone from a KERP, New York District Judge Says

Reversing a bankruptcy court in New York, District Judge J. Paul Oetken held that someone with the title of a corporate officer is not entitled to participate in a key employee retention program, or KERP, "absent a particularly strong showing that they do not perform a significant role in management."

In his July 9 opinion, Judge Oetken also held that the appeal was not equitably moot, even though the KERP payments had been made to six officers and the U.S. Trustee had not sought a stay pending appeal.

On the subject of who is or is not an "officer" for the purpose of Section 503(c), Judge Oetken referred to the "messy state of the law on this topic." The section prohibits retention payments to an "insider" absent evidence that the payment is "essential" to retain someone who has a *bona fide* offer from another business. In turn, an "insider" is defined in Section 101(31)(B)(ii) to include an "officer."

The Six Corporate Officers and the KERP

The chapter 11 debtor established an $8 million KERP for 190 employees. The group included six officers slated for retention bonuses aggregating $1.8 million.

Among the six, one was the deputy general counsel, three were senior vice presidents, and two were vice presidents. The debtor conceded that all six were deemed to be officers under Delaware law.

The U.S. Trustee objected to approval of the KERP as to the six officers. The bankruptcy judge overruled the objection and approved the KERP across the board, adopting the debtor's argument that the six were officers in name only and had no broad decision-making authority.

The U.S. Trustee appealed but did not seek a stay pending appeal. The KERP payments were made to everyone. The chapter 11 plan was confirmed and consummated.

Equitable Mootness

The debtor contended that the appeal was equitably moot because the U.S. Trustee had not sought a stay pending appeal and requiring repayment would be inequitable.

To determine whether the appeal was moot, Judge Oetken applied the five-part *Chateaugay* test. *See In re Chateaugay Corp.*, 10 F.3d 944, 952 (2d Cir. 1993).

Among the tests relevant to the case on appeal, Judge Oetken saw no reason he could not provide relief by compelling disgorgement. Further, the six officers knew about the appeal and had been represented by the debtor, effectively speaking.

It was "regrettable," Judge Oetken said, that the U.S. Trustee had not sought a stay, but clawing back the payments would not be "inequitable" if the payments were illegal in the first place.

Judge Oetken decided that the appeal was not equitably moot, noting that the lack of a stay "is much more dire" on appeal from a confirmation order.

The Significance of Being an 'Officer'

In approving the KERP, the bankruptcy court applied a functional test to determine whether the six officers had "sufficient authority" to be seen as officers under Section 503(c). The debtor argued that being an officer under Delaware law was neither controlling nor dispositive.

"From a policy standpoint," Judge Oetken said, "giving more weight to an objective criterion — whether an employee was appointed by the board — provides better guidance to parties than a functional, non-exhaustive test."

Although a "functional approach" may be appropriate "in many cases," Judge Oetken agreed "with the [U.S.] Trustee that with respect to officers *appointed or elected by the Board*, such individuals are 'officers' under the Bankruptcy Code, at least absent a particularly strong showing that they do not perform a significant role in management." [Emphasis in original.]

Judge Oetken concluded that the bankruptcy court "erred by inquiring beyond the fact that the six employees were appointed by [the] board." Even had he made a "more expansive analysis" beyond the fact that the six were appointed by the board and were officers under Delaware law, Judge Oetken said their designation as officers would be "dispositive, at least absent a strong showing that they do not perform any significant role in management."

In the case at hand, Judge Oetken said that the debtor "failed to overcome the strong presumption that, as board-appointed employees, the six employees are officers." He therefore reversed the order approving the KERP as to the six officers.

The Standards on Appeal

In a footnote at the conclusion of his decision, Judge Oetken said that the case presented mixed questions of law and fact, where the issues were "primarily legal." On that basis, he reversed on *de novo* review.

If the questions were "primarily factual," Judge Oetken said, then the bankruptcy court's conclusion that the six were not officers was "clearly erroneous."

The opinion is *Harrington v. LSC Communications Inc. (In re LSC Communications Inc.)*, 20-5006 (S.D.N.Y. July 9, 2021).

The 'Countryman' definition of an executory contract allows a debtor sell a contract without curing a default if the non-debtor counterparty has no further material, unperformed obligations.

Curing Defaults Isn't Always Required Before Selling a Contract, Third Circuit Says

Third Circuit Judge Thomas L. Ambro found an exception to the general rule that a debtor must cure defaults before selling a contract.

If the non-debtor counterparty has no remaining material obligations, the debtor may sell or assign the contract without curing monetary defaults owing to the counterparty, and the non-debtor cannot require the buyer to cure pre-petition monetary defaults.

The counterparty only has a pre-petition unsecured claim against the debtor, according to Judge Ambro.

In his May 21 opinion, Judge Ambro has identified an aspect of the so-called Countryman definition of executory contracts that undercuts the general notion that debtors must cure defaults before selling or assigning contracts.

As Judge Ambro said, "This pill is bitter to swallow, but bankruptcy inevitably creates harsh results for some players." However, Judge Ambro explained how parties can draft their contracts to avoid the result.

The Movie Producer's Contract

An individual, whom we shall call the producer, had a contract to produce a movie for a movie company. In the movie business, it's called a work-made-for-hire contract where the producer produces the movie, but the movie company owns all of the intellectual property.

In this case, the producer was paid $250,000 for producing the movie, plus contingent future payments equal to some 5% of the movie's net profits. The movie was a success. A cast member won the Academy Award for Best Actress.

By the time the movie company filed a chapter 11 petition years later, the movie company owed the producer an additional $400,000.

In chapter 11, a purchaser bought the movie company's assets along with the right to designate executory contracts for assumption and assignment. The buyer filed a declaratory judgment action asking Bankruptcy Judge Mary F. Walrath in Delaware to rule that the contract was not executory and had already been sold.

Bankruptcy Judge Walrath granted summary judgment in favor of the purchaser. The district court affirmed, prompting an appeal to the Third Circuit.

The Countryman Definition

The outcome turned on an extrapolation from the definition of "executory contracts" proposed by Harvard Law Professor Vern Countryman. *See Executory Contracts in Bankruptcy: Part I*, 57 Minn. L. Rev. 439 (1973). The Third Circuit adopted the Countryman definition.

Prof. Countryman defined an executory contract as "a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing performance of the other." *Id*. at 460.

In turn, Judge Ambro said that a "material unperformed obligation" is determined by state law, in this case New York law chosen by the parties to govern the contract. Combining the Countryman definition with state law, Judge Ambro said there is an executory contract if "each side has at least one material unperformed obligation as of the bankruptcy petition date."

Judge Ambro described an executory contract as a bundle of assets and liabilities. From the point of view of the debtor, the performance owed by the debtor is a liability, while the performance due from the contract party is an asset. When the contract party has fully performed but the debtor has not, he said that the contract is "not executory because it is only a liability for the estate."

If the contract is not executory, Judge Ambro said that it can be sold without curing defaults under Section 363 just "like any other liability or asset." On the other hand, the "buyer must typically fulfill obligations under the contract it bought after the sale closes, just as it would with any other asset or liability."

Should there be no buyer, the counterparty would be left with only an unsecured claim, Judge Ambro said.

Judge Ambro saw "no fairness concerns" when the counterparty has fully performed and retains only an unsecured claim, even when the contract is sold without cure. He said that the counterparty "should simply be grateful that someone agreed to buy its contract and assume obligations after the sale's closing."

Did the Non-Debtor Fully Perform?

Having laid out the law, Judge Ambro applied the law to the facts, first to determine whether there were material unperformed obligations making the contract executory.

The debtor's obligations to make contingent payments were "clearly material," Judge Ambro said. The same could not be said for the obligations of the producer.

The contract called for the producer "to produce the Picture in exchange for money. Thus, he contributed almost all his value when he produced the movie," Judge Ambro said. In the movie industry, Judge Ambro cited the Ninth Circuit for the notion that "the employee in a work-made-for-hire contract usually does not have material obligations after the work is completed despite ancillary negative covenants or indemnification obligations."

In the case on appeal, Judge Ambro said that the producer's remaining obligations were not material because they were "all ancillary after-thoughts in a production agreement."

Because the producer had no remaining material unperformed obligations, the contract was not executory, and the debtor could sell the contract without curing the $400,000 default.

Parties May Change the Outcome by Contract

Judge Ambro said that the parties "can contract around" the substantial performance rule and thereby "override the Bankruptcy Code's intended protections for the debtor."

The producer argued that the contract indeed altered the substantial performance rule by declaring that the unperformed obligations by the producer were material. Judge Ambro rejected the argument, because the contract "did not clearly and unambiguously avoid the substantial performance rule for evaluating executory contracts."

Observations

In the view of Prof. Stephen J. Lubben, it's "a nicely written opinion, although it does not take up the suggestion of *Tempnology* that we might analyze contracts and leases in a more straightforward way, with a bit less emphasis on the late Professor Countryman's notion of executoryness. Indeed, Judge Ambro even suggests that the parties might be able to control, by contract, whether or not their agreement is subject to Section 365, which itself suggests to me that we are asking the concept of executoryness to do too much work."

Prof. Lubben is the Harvey Washington Wiley Chair in Corporate Governance & Business Ethics at Seton Hall University School of Law.

The professor is on the right track. For example, consider the implications of the opinion with regard to sales of intellectual property.

Assume that a writer sold a book and all its intellectual property to a publisher in return for a small payment up front and a percentage of sales thereafter. Applying the Third Circuit's analysis, the publisher could file bankruptcy and either retain or sell the intellectual property without curing defaults.

Presumably, the publisher or the buyer must pay royalties on later sales, but the most lucrative royalties might have been produced before bankruptcy. Under general notions of contract law, why doesn't the publisher's default and breach of contract mean that the intellectual property reverted to the writer?

Assuming Prof. Countryman pronounced the correct definition for executory contracts to apply in *all circumstances*, and also assuming that Judge Ambro reached the proper conclusion that the producer's remaining obligations were not material, the result seems correct. But what about the effect of the debtor's breach of contract? Why didn't ownership of the intellectual property revert to the producer following the debtor's breach?

Because the Countryman definition has been adopted as a matter of judge-made law, courts have the power to make exceptions to the definition if the outcome seems at odds with the general notions about intellectual property and curing defaults before selling contracts in bankruptcy.

The opinion leaves open an interesting question. The movie company debtor had a right of first refusal covering sequels. Can the buyer enforce the first-refusal right without curing the pre-bankruptcy defaults, or were those claims cut off by the sale "free and clear"?

If the producer can never require the purchaser to pay $400,000 to enforce the right of first refusal, it seems as though the right of first refusal was a material, unperformed, bilateral provision in the contract.

In that regard, Judge Ambro said that the "buyer must typically fulfill obligations under the contract it bought after the sale closes, just as it would with any other asset or liability." Does that language imply that the producer can or cannot enforce the right of first refusal (or perhaps other rights under the contract) without paying $400,000?

The opinion is *Cohen v. Spyglass Media Group LLC (In re Weinstein Company Holdings LLC)*, 20-1750 (3d Cir. May 21, 2021).

Unsuccessfully attempting to punch homes in Mirant, FERC emerged from the Fifth Circuit with no power to stop bankruptcy courts from rejecting contracts otherwise within FERC's jurisdiction.

Invoking *Mirant*, Fifth Circuit Permits Rejection of a Gas Pipeline Contract

The Fifth Circuit reaffirmed its *Mirant* decision from 2004 by holding that the bankruptcy court has power to reject a filed-rate contract with a natural gas pipeline without authorization from FERC, the Federal Energy Regulatory Commission.

Bound by *Mirant*, Circuit Judge Carolyn Dineen King said in her March 14 opinion that the "pitched battle" mounted by FERC was actually "a settled truce." *Mirant*, she said, "holds that a bankruptcy court can authorize rejection of a filed-rate contract, and that, post-rejection, FERC cannot require continued performance on the rejected contract."

The Gas Pipeline Contract

The debtor was a producer of oil and natural gas. The debtor had a seven-year contract to transport the gas it produced through a particular pipeline. The contract called for the debtor to pay the pipeline owner $169 million over the life of the contract, whether or not the debtor shipped any natural gas.

In chapter 11, the debtor moved to reject the pipeline contract, having stopped producing natural gas. FERC objected, contending that its approval was required before the bankruptcy court could reject. Even if the contract were rejected, FERC argued that the debtor was obligated to pay rejection damages in full, not with the discount afforded by the plan. FERC also objected to confirmation of the debtor's chapter 11 plan.

Bankruptcy Judge Marvin Isgur authorized rejection of the pipeline contract and confirmed the plan. FERC appealed, and the Fifth Circuit accepted a direct appeal, overstepping an intermediate appeal to the district court.

Mirant and the Dueling Regulatory Schemes

Judge King characterized the appeal as "a clash of two congressionally constructed titans, FERC and the bankruptcy courts." FERC, she said, has exclusive jurisdiction over

the interstate transportation of natural gas. Rates approved by FERC cannot be modified or abrogated without the commission's consent.

Judge King made the following points about *In re Mirant Corp.*, 378 F.3d 511 (5th Cir. 2004):

- The case dealt with an electricity-purchase agreement. The bankruptcy court allowed rejection, but the district court reversed, believing that FERC's approval was required. The circuit reversed the district court.
- Although FERC has jurisdiction over the modification of rates, *Mirant* said that rejection was a breach, not a change in a filed rate.
- The rejection power, *Mirant* said, does not contain an exception for power contracts like it does for union contracts.
- *Mirant* rejected the idea that the debtor must pay the full amount of rejection damages and not with the bankruptcy discount afforded by the plan.
- Rejection can be accompanied by an injunction aimed at FERC, but is limited to prohibiting FERC from compelling performance under the rejected contract.
- Akin to the rejection of a union contract, the bankruptcy court must apply a more rigorous standard considering public interest and the disruption of energy supplies.
- Rejection is not a collateral attack on the filed rate because the filed rate forms the basis for fixing rejection damages.

Mirant Controls

Bound by *Mirant*, Judge King said that "a bankruptcy court can authorize rejection of a filed-rate contract, and that, post-rejection, FERC cannot require continued performance on the rejected contract." She dismissed FERC's argument that many of the statements in *Mirant* were *dicta*, not holding. Everything in *Mirant* pertinent to the case on appeal was necessary to the decision in *Mirant*.

Judge King noted that the Sixth Circuit concurred with *Mirant* in *In re FirstEnergy Solutions Corp.*, 945 F.3d 431 (6th Cir. 2019). To read ABI's report on *FirstEnergy*, click here. [Note: *FirstEnergy* was a 2/1 decision in the Sixth Circuit.]

Applying Mirant to the case on appeal, Judge King said,

> Given that it is clear that the challenged language in *Mirant* is binding, the result of this case is straightforward. A district court (and, by extension, a bankruptcy court) has the 'power . . . to authorize rejection of' a filed-rate contract . . . .

Judge King added that rejection was not a collateral attack on the filed rate, because the filed rate would be the basis for fixing the pipeline's rejection damages. Furthermore, she said, the debtor was "not just seeking to secure a lower rate, but instead wants out of the contract altogether, given the suspension of its drilling program."

The bankruptcy court, Judge King said, had not allowed rejection under the business-judgment standard but had "explicitly considered the public interest."

Judge King said that the bankruptcy court had properly invited FERC to participate in the rejection proceedings as a party-in-interest. She declined "to expand beyond our dictates in *Mirant* by requiring a bankruptcy court to halt its progress and allow FERC to hold a hearing on the public-interest ramifications of the rejection of a filed-rate contract."

Judge King ended her decision by saying there was no violation of Section 1129(a)(6), which requires governmental regulatory approval of rate changes. She said there was no rate change because rejection damages would be based on the filed rate.

The opinion is *FERC v. Ultra Resources Inc. (In re Ultra Resources Corp.)*, 20-20623 (5th Cir. March 14, 2022).

An irrevocable surety bond isn't executory because it gives the bonding company no further obligations to the debtor.

Surety Bonds Aren't Executory Contract and Can't Be Assumed, District Judge Says

Affirming Bankruptcy Judge Douglas D. Dodd of Baton Rouge, La., the district court held that a surety bond is not an executory contract that a debtor can assume.

The surety may have been lulled into complacency during the chapter 11 case by the debtor's having said it would continue paying the bonds. Just like Judge Dodd, District Judge Brian A. Jackson held that a surety bond is not an executory contract capable of assumption under the so-called Countryman definition of executory contracts.

The E&P Bonds

The debtor was engaged in oil and gas exploration and production. Before bankruptcy, the debtor had acquired four irrevocable performance bonds securing the debtor's obligations to the state for environmental liabilities and for plugging and abandoning wells. The bonds were accompanied by an indemnity agreement where the debtor agreed to indemnify the bonding company if it were called on the bonds.

The insurer was liable for a maximum of about $10.6 million on the bonds, Bankruptcy Judge Dodd said in his opinion on Sept. 22, 2020. At filing, the insurer held some $3.2 million in cash to secure the bonding company's obligations were claims to be made on the bonds. *See In re Falcon V LLC*, 620 B.R. 256 (Bankr. M.D. La. Sept. 22, 2020). To read ABI's report, click here.

The bonding company filed a secured claim for $3.2 million and an unsecured claim for the difference, $7.4 million. In the claim, the insurer said that the bonds were financial accommodations that the debtor could not assume or assign.

The Confirmed Plan

On motion of the debtor near the outset of reorganization, the bankruptcy court authorized the debtor to "continue and maintain" the surety bonds and to pay obligations under the bonds as they came due. Later, the disclosure statement said the debtor would "maintain" the bonds after confirmation. The plan said that executory contracts were deemed assumed unless they were listed for rejection, but the bonds were not on the list of rejected executory contracts.

After confirmation, the debtor failed to pay a premium on the bonds. The bonding company responded by demanding more collateral. The debtor refused, accusing the bonding company of violating the discharge injunction.

To resolve the dispute, the bonding company filed a motion for a declaration that the bonds were among executory contracts assumed automatically on confirmation.

Bankruptcy Judge Dodd agreed with the debtor. He held that the bonds were not executory contracts capable of assumption. And if they were executory, he said they were financial accommodations incapable of assumption.

The bonding company appealed, to no avail.

Countryman Ends the Discussion

The outcome turned on Section 365(a), which permits the assumption of an executory contract with the court's permission. "Curiously," Judge Jackson said, the statute does not define "executory contract."

Judge Jackson prefaced his analysis of the law by recognizing that the Fifth Circuit has adopted the definition of executory contracts proposed by Prof. Vern Countryman of Harvard Law School. The professor called a contract executory if it is "a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing performance of the other." *Executory Contracts in Bankruptcy: Part I*, 57 Minn. L. Rev. 439, 460 (1973).

The key to the outcome was contained on the second page of Judge Jackson's opinion. He said that the indemnity imposed continuing obligations on the debtor but none on the bonding company.

"Under any stretch" in applying the Countryman definition, Judge Jackson said that the bonding company "owes *no* additional performance to the Reorganized Debtors after posting the surety bonds." The bonding company's "only remaining duty is a contingent obligation" to the beneficiaries of the bonds.

Even "more problematic," Judge Jackson said, the bonds are "irrevocable."

"Thus," he said, "the Reorganized Debtors failure to perform does *not* create a material breach that excuses [the bond company's] performance, as required by the second prong of the Countryman test."

Governed by the Fifth Circuit's adoption of the Countryman test, Judge Jackson said he would rule, as he "must," that the bonds were not executory contracts and thus were incapable of assumption.

Judge Jackson upheld the ruling by Judge Dodd and, in the process, said that surety bonds cannot pass unaffected through bankruptcy because the ride-through doctrine applies only to executory contracts that were neither assumed nor rejected.

The opinion is *Argonaut Ins. Co. v. Falcon V LLC*, 20-00702 (M.D. La. Sept. 30, 2021).

Courts disagree on whether a repudiated contract remains executory.

Once Repudiated, a Contract Is No Longer Executory

Once repudiated, a contract is no longer executory, according to Bankruptcy Judge Marvin Isgur of Houston.

Repudiation has two significant implications: (1) There is nothing for the debtor to assume, and (2), as Judge Isgur ruled, repudiation requires the creditor to file a proof of claim by the general bar date, not by the rejection bar date, if it's later.

The debtor was under contract to purchase component parts from the creditor. Claiming that a shipment of parts was defective, the debtor wrote to the creditor six months before bankruptcy and said it was considering open purchase orders to be "cancelled." The creditor objected, contending that the shipment was not defective and calling on the debtor to perform the remainder of the contract.

The creditor did not file a proof of claim by the general bar date before confirmation of the debtor's chapter 11 plan. The bar date for claims arising from the rejection of executory contracts was after confirmation.

The creditor filed a proof of claim after confirmation and after the general bar date but before the bar date for rejected contracts.

The plan said that claims filed after the bar dates would be deemed disallowed. When the creditor did not receive a dividend as an unsecured creditor with a rejected contract, the creditor filed a motion to compel payment of the claim.

Judge Isgur denied the motion in an opinion on April 27.

Judge Isgur defined an executory contract as one with material, unperformed obligations. He cited the Seventh Circuit for holding that "the non-repudiating party is no longer under an obligation to perform" when there has been "clear evidence of an intent to repudiate." *In re C&S Grain Co.*, 47 F.3d 233, 237 (7th Cir. 1995).

Although some courts disagree with *C&S*, Judge Isgur said they "typically have done so out of a concern that pre-petition repudiations should not limit a debtor's ability to assume executory contracts." The case at hand, he said, "presents the opposite scenario."

Judge Isgur made fact findings that were central to his legal conclusion. For instance, he said that the "debtor made clear, long before bankruptcy, that it no longer intended to perform and that it did not seek reciprocal performance." Similarly, he said that the creditor "had no reasonable basis to believe that [the debtor] still sought performance of the contract" or that the debtor would pay outstanding invoices.

Judge Isgur said he was not deciding who was at fault for breaching the contract. Rather, he held that the "contract was not executory on the petition date."

Judge Isgur denied the motion to compel payment of the claim because the creditor "was not justified in its belief that it only needed to file by the rejection bar date."

The opinion is *In re Cornerstone Valve LLC*, 19-30869, 2021 BL 154997, 2021 Bankr Lexis 1120 (Bankr. S.D. Tex. April 27, 2021).

Venue, Jurisdiction & Power

The U.S. Trustee is not the better or the only party to uphold the integrity of the bankruptcy court, the Second Circuit holds.

Second Circuit Expands Standing to Ensure Integrity of the Bankruptcy Court

Although written in the context of a RICO suit, language in a Second Circuit opinion seems to mean that a creditor who otherwise might not have standing would have standing to pursue litigation "to ensure the integrity of the Bankruptcy Court."

The Second Circuit handed down its opinion on January 19 reversing the district court, which had dismissed a lawsuit brought by Jay Alix against consulting firm McKinsey & Co. Inc. under the Racketeer Influenced and Corrupt Organizations Act, or RICO.

The Allegations

Jay Alix was the founder of AlixPartners LLP, a bankruptcy consulting firm. As the assignee of the firm, Alix sued McKinsey and some of its officers in federal district court in New York under RICO. Alix alleged that his firm and three others along with McKinsey were retained as consultants in most of the country's so-called mega chapter 11 cases.

Alix alleged that his firm and three others had been retained in 75% of the cases in which McKinsey was not the court-retained bankruptcy consultant. Among the assignments that did not go to McKinsey, Alix alleged that his firm captured 24%.

The complaint alleged that McKinsey failed to disclose connections under Sections 327(a) and 101(14) that would have made the firm not disinterested and would have disqualified the firm from being retained in 13 cases. Alix alleged that his firm would been retained in some of those 13 cases had McKinsey been disqualified.

Alix also alleged that McKinsey had been engaged in a so-called pay-to-play scheme.

The district court granted McKinsey's motion to dismiss under Rule 12(b)(6). The district court reasoned that the allegations in the complaint were insufficient to satisfy RICO's proximate cause requirement.

The Second Circuit reversed the dismissal in a 31-page opinion by Circuit Judge Barrington D. Parker.

Special Standing Rules for Bankruptcy Integrity

To prove a RICO claim, the complaint must show a violation of RICO, an injury to the plaintiff's business and that the injury was caused by the RICO violation. "This appeal implicates the causation requirement," Judge Parker said.

The district judge believed that the injury to Alix had been caused by the debtors' decisions not to hire AlixPartners and not by McKinsey's alleged misconduct. The district judge also believed that the U.S. Trustee would have been the better plaintiff to remedy the alleged misconduct.

Disagreeing, Judge Parker said that the district court had "conflated proof of causation and proof of damages and that it did not draw all reasonable inferences in Alix's favor."

Here's the important bankruptcy angle:

"More importantly," Judge Parker said, "the district court gave insufficient consideration to the fact that McKinsey's alleged misconduct targeted the federal judiciary."

Judge Parker expanded on the idea, suggesting that litigants who can't show direct harm to afford standing may nonetheless pursue litigation when the integrity of the process is at stake. He said:

> [T]his case requires us to focus on the responsibilities that Article III courts must shoulder to ensure the integrity of the Bankruptcy Court and its processes. Litigants in all of our courts are entitled to expect that the rules will be followed, the required disclosures will be made, and that the court's decisions will be based on a record that contains all the information applicable law and regulations require. If McKinsey's conduct has corrupted the process of engaging bankruptcy advisors, as Alix plausibly alleges, then the unsuccessful participants in that process are directly harmed.

Later, Judge Parker said that "fraud on the Bankruptcy Court committed in the manner alleged by Alix causes direct harm to litigants who are entitled to a level playing field and calls into play our unique supervisory responsibilities."

Judge Parker went on to explain why Alix had "plausibly alleged proximate cause with respect to all thirteen engagements." He said there was "also a reasonable inference that, in making another selection [of a consultant had McKinsey been disqualified, the chapter 11 debtors] would likely have awarded assignments to eligible firms in approximately the same ratio they had been using in the past."

To the idea that the U.S. Trustee would have been a better plaintiff, Judge Parker said he was "not persuaded that the Bankruptcy Court or the U.S. Trustee, which McKinsey argues would be a more appropriate alternative plaintiff, would be in a position to gather information about McKinsey's conduct were Alix not in the picture."

Likewise, he was "not persuaded that, under the circumstances presented here, either the Bankruptcy Court or the U.S. Trustee would be in a superior position to find out what McKinsey did (or did not do)."

Judge Parker also reversed dismissal of Alix's pay-to-play claim under 18 U.S.C § 152(6), which proscribes fraudulently offering money to act or forbear from acting in a bankruptcy case. He said it was "implausible — indeed inconceivable — that any Bankruptcy Court would have approved McKinsey's retention if Alix's allegations were substantiated."

Because Judge Parker was reversing a motion to dismiss, he said that "McKinsey might well prevail on summary judgment or at trial, and to be sure, uncertainties at those stages might exist."

In the same vein, D.J. Carella, a spokesperson for McKinsey, said in a statement that the "decision solely addresses technical pleading standards and not whether Mr. Alix's claims are true. To date, Mr. Alix has lost all six of his lawsuits against McKinsey, and we are confident the evidence will ultimately show that this lawsuit is similarly meritless."

Although not in lawsuits with Alix, the U.S. Trustee Program issued a press release in February 2019 about a settlement where McKinsey agreed to pay $15 million for inadequate disclosure in three chapter 11 cases. In December 2020, the U.S. Trustee Program issued a press release about a separate settlement made in connection with a case in Texas where McKinsey agreed to withdraw its application for retention and waive the recovery of fees for work it had performed. The press release said that the fees and expenses "likely" would have been "millions of dollars."

The Circuit Split

To establish appellate standing, courts require the appellant to be a "person aggrieved." The Second Circuit's opinion reignites a circuit split.

Alix previously argued in a petition for *certiorari* that the Second, Third, Sixth and Eleventh Circuits recognize an exception to the pecuniary interest requirement. They hold, he argued, that the public interest may also create a sufficient stake in the outcome to confer appellate standing.

On the other hand, Alix argued to the Supreme Court that the Fourth, Fifth and Seventh Circuits do not recognize the public interest exception to the pecuniary interest test. The Supreme Court denied *certiorari* in *Mar-Bow Value Partners LLC v. McKinsey Recovery & Transformation Services US LLC*, 139 S. Ct. 1601, 203 L. Ed. 2d 755 (Sup. Ct.) (*cert. den.* April 22, 2019).

Alix was in the Supreme Court because the Fourth Circuit had upheld dismissal of another lawsuit against McKinsey where the district court concluded that Alix would not have benefitted monetarily. To read ABI's stories on the petition for *certiorari*, click here and here.

The opinion is *Alix v. McKinsey & Co. Inc.*, 20-2548 (2d Cir. Jan. 19, 2022).

The Ninth Circuit answered a question left open by the Supreme Court in Ritzen.

Denial of Stay Modification *Without* Prejudice Can Be Final, Ninth Circuit Says

Reaching an issue the Supreme Court left undecided in *Ritzen*, the Ninth Circuit held that denial of a stay-relief motion *without* prejudice can still be a final, appealable order.

The appeals court looked beyond the "without prejudice" label placed on the order by the bankruptcy court to decide whether denial of the motion meant that the creditor would not have stay relief for the purpose sought by the creditor.

Reversing the district court, which had believed that the order was not appealable, the panel majority reached the merits and upheld the bankruptcy court's denial of stay relief.

Stay-Relief Motion Denied

The debtor and a creditor had been embroiled in litigation in Massachusetts state court for seven years, trading claims and counterclaims about breach of fiduciary duty and fraudulent misrepresentation. One week before a jury trial was to begin in Massachusetts, the debtor-defendant filed a chapter 7 petition in California.

The creditor filed a $2 million claim in bankruptcy court, a complaint in bankruptcy court to bar discharge of the debt and a companion motion to modify the automatic stay. The creditor reasoned in the lift-stay motion that the Massachusetts court was familiar with the case and could resolve all questions about the validity of the claim and facts indicating whether the claim was dischargeable.

Originally inclined to modify the stay, the bankruptcy court ultimately denied the motion without prejudice.

The district court denied the creditor's motion for leave to appeal an interlocutory order. The creditor appealed to the circuit.

The Ninth Circuit panel handed down two decisions on March 8. One decision unanimously reversed the district court by holding that lift-stay denial was a final, appealable order. In the second opinion, all three judges found reason to rule on the merits. Over a dissent, two judges in the second opinion upheld denial of the lift-stay motion.

Lift-Stay Denial Was Appealable

In his precedential opinion on finality, Circuit Judge A. Wallace Tashima began by citing *Ritzen Group, Inc. v. Jackson Masonry, LLC*, 140 S. Ct. 582 (2020), where the Supreme Court held that an order denying a stay-relief motion is final and appealable when it "conclusively resolve[s] the movant's entitlement to the requested relief." *Id.* at 591. Citing *Bullard v. Blue Hills Bank*, 575 U.S. 496, 501 (2015), the Supreme Court went on to say that "[o]rders in bankruptcy cases qualify as 'final' when they definitively dispose of discrete disputes within the overarching bankruptcy case." *Id.* 586.

In *Ritzen*, Judge Tashima said that the Supreme Court "did 'not decide whether finality would attach to an order denying stay relief if the bankruptcy court enters it "without prejudice" because further developments might change the stay calculus.'" *Id.* at 592, n.4. To read ABI's report on *Ritzen*, click here.

Confronting the question left undecided in *Ritzen*, Judge Tashima said, "We address the finality of an order denying stay relief without prejudice."

In the case on appeal, Judge Tashima said that "the record makes clear that the [bankruptcy] court 'unreservedly denied relief'" even though "the bankruptcy court stated that the denial was without prejudice."

Judge Tashima gave several reasons for his conclusion about finality. Principally, the bankruptcy judge made it clear that the issues in the creditor's proof of claim and adversary proceeding would be tried in bankruptcy court, not before a jury in state court. The bankruptcy court said it would hold trial in short order and gave no indication of an inclination to revisit stay relief.

In saying that stay denial was without prejudice, Judge Tashima said that the bankruptcy court meant that it was "willing to consider stay relief if sought for a different purpose, but not for the purpose of resolving [the creditor's] state claims against [the debtor]."

The Merits of Stay Relief

In a separate but nonprecedential opinion, the panel dealt with the merits: Did the bankruptcy court abuse its discretion in denying stay relief? On the merits, the panel was divided. Oddly enough, Judge Tashima would have reversed and modified the stay.

The affirmance on the merits was an unsigned memorandum principally by the other two judges on the panel, Circuit Judges Milan D. Smith, Jr. and Paul J. Watford.

Generally, the two judges said, the appeals court would remand to the district court after reversing on appealability. In the case before them, they said that the record presented the issues, and the circuit court was in as good a position as the district court to address the merits.

The two judges saw no abuse of discretion and upheld denial of the stay-relief motion. Among other things, they said that the bankruptcy court "properly considered the interests of judicial economy."

The Dissent

Judge Tashima agreed that the panel should reach the merits of stay relief. However, he "respectfully" dissented. He identified several reasons why the stay should have been modified.

State law issues predominated, he said. There would have been no basis for federal jurisdiction on many of the issues had there been no bankruptcy, and the creditor had a right to a jury trial.

Judge Tashima believed that denial of stay modification was an abuse of discretion.

The opinions are *Harrington v. Mayer (In re Mayer)*, 20-56340 (9th Cir. March 8, 2022), and *Harrington v. Mayer (In re Mayer)*, 20-56340 (9th Cir. March 8, 2022).

To satisfy Article III, an appellee need only have 'concrete adverseness' and an ongoing interest in the dispute.

Someone Defending an Appeal Isn't Required to Show 'Standing,' Fifth Circuit Says

Even after a liquidating trust has expired by its terms, the Fifth Circuit tells us that the trustee retains the right to protect the trust estate and defend appeals.

The corporate chapter 11 debtor sold most of the assets and confirmed a plan. The plan created a liquidating trust to prosecute claims belonging to the estate. The confirmation order continued the automatic stay to protect assets of the trust.

The plan called for the trust to terminate at the end of 2018, about two years after the plan was confirmed.

Six months after the trust's termination date, owners of the debtor sued third parties in bankruptcy court, asserting claims belonging to the estate. The owners reasoned that they could sue because the trust had terminated, and the trustee of the trust no longer had authority to prosecute claims of the estate.

The trustee of the liquidating trust sought sanctions in bankruptcy court and dismissal of the owners' suit for interference with trust property. The bankruptcy court dismissed the owners' suit and awarded sanctions representing the trustee's legal expenses.

Later, the bankruptcy court ruled that the trustee continued in possession of trust property even though the trust had terminated.

The district court affirmed the dismissal and sanctions, and so did the Fifth Circuit in an opinion on February 11 by Circuit Judge Jerry E. Smith.

The owners argued in the circuit that the appeals court had no appellate jurisdiction because the trustee had no standing once the trust had terminated. The owners also wanted the circuit court to vacate the sanctions on the theory that the trustee had no standing to seek sanctions after the trust terminated.

Judge Smith observed that the bankruptcy judge had imposed sanctions under the court's inherent power under Section 105(a) because the owners were interfering with trust property. He

held that the bankruptcy court had jurisdiction to impose sanctions given that the bankruptcy court had jurisdiction over the debtor's case.

Next, the owners argued that the trustee had no standing to defend the appeal. Judge Smith said that "standing isn't the right doctrine."

Citing the Supreme Court, Judge Smith explained that a litigant must have standing to "initiate" a proceeding. Because the trustee was defending the appeal, he said that the trustee "doesn't need to show he would have standing."

Again citing the Supreme Court, Judge Smith said that Article III only requires that the opposing party demonstrate "concrete adverseness" and have an ongoing interest in the dispute.

To conclude the analysis, Judge Smith referred to Texas law regarding the powers and responsibilities of a trustee after a trust has terminated. Although the trustee no longer had "legal ownership" of the trust assets, the trustee had continuing possession of the assets and a duty to return the trust property to the beneficiaries of the trust.

Consequently, Judge Smith said that the trustee had "an interest in defending his continued possession of the trust assets so he can fulfill his fiduciary duties and return the property to the trust beneficiaries. That's enough to give him a meaningful interest in this case, so we have jurisdiction."

Having established the circuit's jurisdiction, Judge Smith proceeded to uphold the dismissal and sanctions on the merits.

The opinion is *Kreit v. Quinn (In re Cleveland Imaging & Surgical Hospital LLC)*, 21-20067 (5th Cir. Feb. 11, 2022).

Filing bankruptcy to gain a 'litigation advantage' in the N.Y. Attorney General's dissolution action meant the chapter 11 petition was not filed in good faith and must be dismissed, Judge Harlan Hale rules.

NRA's Bankruptcy Dismissed as Being Filed for an Improper Purpose

Following a 12-day trial with 23 witnesses, Bankruptcy Judge Harlan D. Hale dismissed the chapter 11 petition filed by the National Rifle Association, finding that the filing was "not filed in good faith but instead was filed as an effort to gain an unfair litigation advantage in the [action by the New York Attorney General to dissolve the NRA] and as an effort to avoid a regulatory scheme."

Judge Hale found that the NRA was "in its strongest financial condition in years" and that its "primary legal problem [was the] state regulatory action." As a "solvent and growing organization," he said that "using this bankruptcy as a tool to win the dissolution lawsuit" was "not an appropriate use of bankruptcy."

Judge Hale dismissed the case "without prejudice," meaning that the NRA can attempt chapter 11 reorganization once more.

However, Judge Hale ended his 37-page opinion on May 11 by warning the NRA that he may appoint a trustee if the organization files again, given the "cringeworthy facts" that came out during trial. He also alluded to the "surreptitious manner" in which the petition was filed, saying it was "nothing less than shocking."

The Leadup to the Chapter 11 Filing

The New York Attorney General had conducted a 15-month investigation of the NRA, culminating in August 2020 with the filing of a complaint seeking dissolution of the NRA, among other relief. The Attorney General did not seek appointment of a receiver.

At a meeting in January 2020, the NRA board adopted a resolution giving Wayne LaPierre, the organization's executive vice president, authority "to reorganize or restructure the affairs of the Association for the purpose of cost-minimization, regulatory compliance *or otherwise*." [Emphasis added.]

Eight days later, the NRA filed a chapter 11 petition in Dallas, where the case was assigned to Judge Hale. In his opinion, Judge Hale said that the board "was not informed that the NRA was considering filing bankruptcy at all."

About three weeks into the chapter 11 case, an NRA board member filed a motion seeking appointment of an examiner. Two days later, the NRA's former advertising firm filed a motion to dismiss or, alternatively, appoint a chapter 11 trustee. Soon thereafter, the New York Attorney General filed her own motion to dismiss.

The official creditors' committee wanted management to remain in place and not be replaced by a chapter 11 trustee, or one with only limited powers if the court wanted a trustee. The committee saw no reason for an examiner.

The State of Texas and 15 other states filed *amici* briefs supporting the NRA.

The Reason for Filing

The movants wanted three forms of relief: dismissal, a chapter 11 trustee or an examiner.

Judge Hale first addressed the dismissal motions and the reasons for the NRA's filing. At different times, he said that the NRA had given "slightly different" reasons for the filing.

Because LaPierre made the "ultimate decision," Judge Hale said that his testimony was "the most compelling evidence." Based on LaPierre's testimony, he concluded that "the real driving force" behind the filing "was not related to the NRA's financial condition," because the NRA could pay its debts in full if the bankruptcy were dismissed.

Rather, Judge Hale quoted LaPierre as saying, in substance, that the filing was designed to head off dissolution by the New York Attorney General.

Judge Hale found that the "evidence does not support a finding that the purpose of the NRA's bankruptcy filing was to reduce operating costs, to address burdensome executory contracts and unexpired leases, to modernize the NRA's charter and organization structure, or to obtain a breathing spell." Likewise, he concluded that a desire "to leave New York and reincorporate in Texas . . . was not the real purpose for filing."

"Based on the statements of counsel and the evidence in the record," Judge Hale summed up by finding "that the primary purpose of the bankruptcy filing was to avoid potential dissolution in the NYAG Enforcement Action."

Filing for an Improper Purpose

Judge Hale then turned to deciding whether avoiding dissolution by the state "was a valid purpose for bankruptcy."

To dissolve the NRA, the New York Attorney General had told Judge Hale that she must prove there was looting or waste of corporate assets or that the persons in control "otherwise acted in an illegal, oppressive or fraudulent manner."

Quickly, Judge Hale said that "dissolution that requires this showing is not the type of dissolution that the Bankruptcy Code is meant to protect against." He said that the NRA's purpose in filing was "less like a traditional bankruptcy case in which a debtor is faced with financial difficulties or a judgment that it cannot satisfy and more like cases in which courts have found bankruptcy was filed to gain an unfair advantage in litigation or to avoid a regulatory scheme."

Citing cases, Judge Hale said that courts "have consistently held that a bankruptcy case filed for the purpose of obtaining an unfair litigation advantage is not filed in good faith and should be dismissed."

Dismissing other explanations for filing, Judge Hale found that "the NRA is financially healthy" and that adverse results in litigation "are too attenuated to justify a good faith bankruptcy filing."

Based on the "totality of the circumstances," Judge Hale found cause for dismissal under Section 1112(b)(1) because the petition was "not filed in good faith but instead was filed as an effort to gain an unfair litigation advantage [over the New York Attorney General] and as an effort to avoid a regulatory scheme."

No Trustee or Examiner

Judge Hale addressed the question of whether a trustee or an examiner would be in the best interests of the creditors and the estate under Section 1104.

Outside bankruptcy, Judge Hale said that the NRA could pay its creditors in full more quickly than through a chapter 11 plan. Also outside bankruptcy, the NRA could fight the New York Attorney General and pursue reincorporation in Texas. Those facts, he said, weigh against having a trustee or examiner, because neither would be in the best interests of creditors and the estate.

Judge Hale's Conclusion

In the last section of his opinion, Judge Hale said there were "several aspects of this case that still trouble the Court, including the manner and secrecy in which authority to file the case was obtained in the first place, the related lack of express disclosure of the intended Chapter 11 case to

the board of directors and most of the elected officers, the ability of the debtor to pay its debts, and the primary legal problem of the debtor being a state regulatory action."

Because the moving parties had not sought dismissal with prejudice in their original motions, Judge Hale dismissed the case without prejudice. But "should the NRA file a new bankruptcy case," Judge Hale said he "would immediately take up some of [his] concerns . . . , which could cause the appointment of a trustee out of a concern that the NRA could not fulfill the fiduciary duty required by the Bankruptcy Code for a debtor in possession."

The opinion is *In re National Rifle Association of America*, 21-30085 (Bankr. N.D. Tex. May 11, 2021).

Deciding to transfer venue, a North Carolina bankruptcy judge said that the debtor underwent a corporate restructuring 'purely for the purpose of filing bankruptcy.'

Johnson & Johnson Venue Transferred from North Carolina to New Jersey

Johnson & Johnson incorporated a newly formed subsidiary in North Carolina and filed a chapter 11 petition for that company in Charlotte two days later. According to Bankruptcy Judge J. Craig Whitley, J&J undertook the restructuring "to fully resolve talc-related claims through chapter 11 reorganization without subjecting the entire J&J enterprise to a bankruptcy proceeding."

On motion by the bankruptcy administrator, Judge Whitley transferred venue to New Jersey, where J&J is headquartered and where 35,000 multidistrict talc cases have been pending against J&J for five years.

In his opinion on November 16, Judge Whitley said that J&J was "trying to manufacture venue and is attempting to outsmart the purpose of the [venue] statute." Although he considered the "purposeful creation of venue," Judge Whitley sent the case to New Jersey as the "more appropriate venue for the administration of the estate."

The Facts

Just before filing, J&J created two new subsidiaries. One was to be the debtor. In substance, the other took over J&J's businesses.

The debtor was first created in Texas as a limited liability company and converted to a North Carolina limited liability company. On October 14, two days later, the debtor filed a chapter 11 petition in Charlotte.

The debtor was given all talc-related claims and insurance receivables, plus $6 million cash in a North Carolina bank account. The debtor was also given an interest in a newly created affiliate. [Note: This analysis does not deal with fraudulent transfer or similar theories. The description of the corporate structure has been abbreviated to highlight factors of significance regarding venue.]

The debtor's principal place of business is New Jersey, and its employees all work in New Jersey. The debtor has no operations in North Carolina, Judge Whitley said.

Of 38,000 talc-related tort suits against J&J, 35,000 have been in a multidistrict litigation in New Jersey district court for five years. Insurance companies are prosecuting declaratory judgment suits against J&J in a New Jersey state court pertaining to their obligations under insurance policies.

Given "the apparent lack of a connection to this judicial district as well as its own judicial resources," Judge Whitley entered an order to show cause on October 25 to consider the bankruptcy administrator's motion to transfer venue. Other parties then filed motions of their own to transfer venue to New Jersey or Delaware. At the hearing on November 10, the debtor opposed transferring venue. [Note: North Carolina is one of two states with bankruptcy administrators rather than U.S. Trustees.]

The Venue Statute

Under 28 U.S.C. §1408(1), venue is proper where the debtor has its "domicile, residence, principal place of business . . . or principal assets." Judge Whitley said that venue was proper in North Carolina because the debtor was "a North Carolina entity on the filing date, if only for two days."

Under 28 U.S.C. §1412, the court may transfer venue "in the interest of justice or for the convenience of the parties."

Judge Whitley said that the debtor's choice of venue is given "substantial weight" and that transferring venue is "highly unusual." However, he said, "this case is highly unusual." He spent the bulk of his opinion explaining why "the convenience of the parties and the interests of justice [both] warrant transfer of this case to the District of New Jersey."

Convenience of the Parties

Regarding the convenience of the parties, Judge Whitley listed five factors and concluded that all counseled for venue transfer. There was substantial litigation in another district. At the request of J&J, the multidistrict panel had selected New Jersey as the venue for the 35,000-case multidistrict litigation. The multidistrict panel, he said, chose New Jersey "because it was convenient and accessible for all the parties involved."

Although the multidistrict suit is currently stayed by Section 362, Judge Whitley said:

> [I]t could even be joined with the bankruptcy case to help efficiently resolve thousands of talc related claims and aid in any future estimation proceeding. Therefore, the administration of this estate is best served by transferring this case to the District of New Jersey.

Other factors weighing in favor of transferring venue were: (1) the debtor's headquarters in New Jersey; (2) the location of the debtor's employees and witnesses in New Jersey; (3) the location of the parent's headquarters in New Jersey; and (4) the lack of the debtor's connections to North Carolina, aside from the $6 million bank account.

Judge Whitley distinguished two seemingly similar mass tort cases pending in North Carolina where the bankruptcy courts declined to change venue. In one, there was no other "inherently more favorable" venue, and in the second case, the venue motion was not decided until two years after filing.

Judge Whitley mentioned the three other mass-tort cases in his district but said there had been no motions to transfer venue.

The Interests of Justice

While the interests-of-justice standard is "broad and flexible," Judge Whitley said that "forum shopping is also a consideration."

Judge Whitley said that the debtor underwent a corporate restructuring "purely for the purpose of filing bankruptcy." Quoting *In re Patriot Coal Corp.*, 482 B.R. 718, 745 (Bankr. S.D.N.Y. 2012), he said, "Setting up a company with the sole intent of filing bankruptcy in a certain district cannot be 'the thing which the [venue] statute intended.'"

Judge Whitley said that the debtor was "attempting to outsmart the venue statute." He cited the debtor for arguing that creditors wanted another venue "with a more friendly dismissal standard."

Judge Whitley cited four other mass-tort cases where the debtors employed the so-called Texas Two Step and filed "for bankruptcy in this district shortly after its creation." He said that "every debtor using the Texas Two Step filed for bankruptcy in this district. As a result, any superior experience and purported expertise this Court may possess as to divisional mergers exists only because it is the only court that has ever seen these issues."

Judge Whitley saw "no reason this Court should be the only bankruptcy court to have the opportunity to weigh in on these novel legal issues, especially considering that the 'Texas Two Step' tactic is being employed by national corporations and impacts tens of thousands of present and future claimants across the country."

Judge Whitley transferred venue to New Jersey, "potentially to be referenced to the Bankruptcy Court, should that Court deem it appropriate."

Epilogue

The case has been transferred to the district of New Jersey, to be heard in Trenton before Chief Bankruptcy Judge Michael B. Kaplan. In New Jersey, the case number is 21-30589.

The opinion is *In re LTL Management LLC*, 21-30589 (Bankr. W.D.N.C. Nov. 16, 2021).

If the district court is adjudicating a suit with "related to" jurisdiction under 28 U.S.C. § 1334(b), the district court applies the Bankruptcy Rules, not the Federal Rules, the First Circuit says.

In 'Related To' Jurisdiction, District Court Applies the Bankruptcy Rules, Circuit Says

Joining three other circuits, the First Circuit held that the Bankruptcy Rules, not the Federal Rules of Civil Procedure, apply to lawsuits adjudicated in federal district court when the district court has "related to" jurisdiction under 28 U.S.C. § 1334(b).

Unable to tease a definitive answer from the language of the statutes and the rules, the Boston-based appeals court based the outcome on "the practicalities attendant to the efficient operation of a modern bankruptcy system."

The Personal Injury Lawsuits

In 2013, a train derailed in a small Canadian town, spilling crude oil, causing a massive fire and killing 47 residents. The railroad transporting the crude ended up in bankruptcy in Maine.

On behalf of those killed or injured, scores of plaintiffs commenced 39 personal injury suits in several states against numerous defendants. Later, the plaintiffs joined a Canadian railroad as a defendant. The Canadian railroad was a connecting carrier, not the railroad whose train derailed to cause the disaster.

The scattered lawsuits were consolidated in the federal district court in Maine under 28 U.S.C. § 157(b)(5). Although the lawsuits were non-core, the district court had subject matter jurisdiction under 28 U.S.C. § 1334(b), because the personal injury suits were "related to" the bankruptcy in Maine.

Later, the plaintiffs settled with all of the defendants aside from the Canadian railroad. The other defendants were dismissed from the suit, leaving the Canadian railroad as the sole remaining defendant.

The district court entered judgment dismissing the suit after granting the Canadian railroad's motion to dismiss for lack of personal jurisdiction. The plaintiffs filed a motion for reconsideration 28 days after entry of judgment.

The district court summarily denied reconsideration, ruling that the deadline for a reconsideration motion was 14 days under Bankruptcy Rule 9023.

The plaintiffs appealed to the First Circuit, making a variety of arguments for the proposition that the time limit for reconsideration was 28 days under Federal Rule 59(b).

In an opinion on June 2, Circuit Judge Bruce M. Selya dismissed the appeal for want of appellate jurisdiction. Because the reconsideration motion in district court was untimely, the time for appealing dismissal to the circuit had not been tolled. In the absence of tolling, Judge Selya explained that "the plaintiffs' ensuing notice of appeal was untimely and, therefore, their appeal must be dismissed for want of appellate jurisdiction."

Which Rules Apply?

Judge Selya framed the question like this: "Do the Bankruptcy Rules or the Civil Rules govern the procedures in a case over which a federal court exercises section 1334(b) jurisdiction as one 'related to' a pending bankruptcy proceeding?"

Judge Selya traced the history of bankruptcy jurisdiction following the adoption of the Bankruptcy Reform Act in 1978 but found no explicit answer in either title 28, the Bankruptcy Rules or the Federal Rules. He nevertheless said that title 28 and the rules "point strongly" to the idea that the Bankruptcy Rules apply to non-core, "related to" cases in district court.

For Judge Selya, "the sockdolager is found in the practicalities attendant to the efficient operation of the modern bankruptcy system." If the Federal Rules applied to non-core issues, a district court would be simultaneously applying the Federal Rules and the Bankruptcy Rules in a suit where the claims were both core and non-core.

Judge Selya offered another example of the practical need for applying one set of rules. If the district court were ruling *de novo* on the bankruptcy court's proposed findings and conclusions, the district court would be applying the Federal Rules when the bankruptcy court had been following the Bankruptcy Rules.

Judge Selya rejected several "fallback" arguments by the plaintiffs. First, he found no basis in the rules giving a district court the ability to select between the two sets of rules.

Next, the plaintiffs argued that they should have been given notice that the Bankruptcy Rules were controlling. Judge Selya dismissed the idea, saying there is "no room for an equitable exception to the quintessentially legal determination of which set of rules applies to a particular case."

Judge Selya was not alone in his conclusion. He cited the *Collier* treatise alongside the Third, Fourth and Seventh Circuits for holding that the Bankruptcy Rules govern when adjudication in district court is founded on "related to" jurisdiction under Section 1334. Two of those circuits explicitly warned against a procedural hybrid, the judge said.

Judge Selya held as follows: "The Bankruptcy Rules apply to non-core, related to cases adjudicated in federal district courts under section 1334(b)'s 'related to jurisdiction.'"

The opinion is *Roy v. Canadian Pacific Railway Co. (In re Lac-Megantic Train Derailment Litigation)*, 17-1108 (1st Cir. June 2, 2021).

Recent Supreme Court authority supports the conclusion by Delaware's Judge Sontchi that law from the jurisdiction of incorporation, not federal common law, determines what is or isn't a business trust eligible for chapter 11.

Federal Common Law Doesn't Define a Business Trust Eligible for Chapter 11

Disagreeing with the Sixth Circuit, the First Circuit Bankruptcy Appellate Panel and several lower courts, Bankruptcy Judge Christopher S. Sontchi of Delaware applied the law of Singapore — not federal common law — to decide whether an offshore real estate investment trust was a "business trust" eligible for chapter 11.

In his June 1 opinion, Judge Sontchi based his conclusion on "the bedrock principle of *Butner v. U.S.* that bankruptcy judges should not unsettle non-bankruptcy rights in the absence of a clear directive from Congress."

Judge Sontchi's decision to reject federal common law is consistent with — if not mandated by — an opinion last year from the U.S. Supreme Court.

The Singapore REITs

Three real estate investment trusts organized under the laws of Singapore filed chapter 11 petitions in Delaware. One was the ultimate parent, and the other two were intermediate holding companies. Downstream, the REITs owned hotels in the U.S.

The highly complex corporate structure was designed so the ultimate non-U.S. equity holders would not be subject to U.S. withholding taxes. As a result, the REITs themselves had no employees and no operations of their own. Indeed, non-debtor managers made decisions for the REITs. However, the REITs were liable for substantial debts related to the hotels.

The largest creditor filed a motion asking Judge Sontchi to dismiss the petitions, alleging that the REITs were not business trusts and were thus ineligible to be chapter 11 debtors. Judge Sontchi applied the law of Singapore and concluded that the REITs were business trusts. Finding that the REITs were eligible to be debtors, he denied the motion to dismiss.

Butner Governs

Under Section 109(d), only a "person" may be a chapter 11 debtor. A "person" is defined in Section 101(41) to include a "corporation" which, in turn, is defined in Section 101(9)(A)(v) to include a "business trust."

Does federal common law or the law of the state of incorporation determine whether an entity is a business trust? Judge Sontchi said there is "a split of authority as to whether the law of the jurisdiction in which the trust resides or federal common law governs."

Recently, the First Circuit BAP cited the Sixth Circuit approvingly and invoked federal common law. *See In re Catholic School Employees Pension Trust*, 599 B.R. 634 (B.A.P. 1st Cir. 2019); and *Brady-Morris v. Schilling (In re Kenneth Allen Knight Trust)*, 303 F.3d 671 (6th Cir. 2002).

Judge Sontchi explained that those courts based their conclusions on the uniformity aspect of the Bankruptcy Clause of the Constitution, to foster results that would be uniform throughout the U.S. Those courts created federal common law because, as Judge Sontchi said, "There is no federal [statutory] law that creates business entities."

Judge Sontchi said he disagreed with "the weight of authority." The argument about uniformity, he said, "is the exact argument that was rejected by the Supreme Court in" *Butner v. U.S.*, 440 U.S. 48 (1979).

Butner dealt with the ownership of rents following default. Did the rents belong to the lender or to the debtor? State laws differed. In some states, rent would be estate property, and in others, it wouldn't. The courts that adopted federal common law sought uniformity.

The Supreme Court rejected the quest for uniformity, holding that "[p]roperty interests are created and defined by state law." *Id.* at 55. The high court said that employing state law reduces uncertainty.

Similarly, Judge Sontchi said that following the law of the state of incorporation would foster uniformity. Even though results may be different in different states, the definition of a business trust will be uniform "based on the law of the jurisdiction under which the trust exists." For instance, people "will know when they form a trust in Delaware . . . that Delaware law will uniformly govern whether it is a business trust even if the trust files bankruptcy in California," he said.

Furthermore, no uniform definition of a business trust has been developed under federal common law. The First Circuit BAP, for example, said there is "no uniform standard . . . to define what constitutes a 'business trust.'" *Catholic School*, *id.*, 599 B.R. at 653.

Judge Sontchi added his own take when he said there is "a striking inconsistency between bankruptcy courts on this issue with at least three different legal tests having been developed."

Judge Sontchi held that "federal common law should not determine whether a trust is a 'business trust' under the Bankruptcy Code. Rather, the law of the jurisdiction in which the trust is organized, in this case the Republic of Singapore, shall govern."

Hearing from experts on Singapore law, Judge Sontchi decided that the REITs were business trusts eligible to be chapter 11 debtors. He also denied the creditor's motion to dismiss based on arguments that the petitions were bad faith filings. The petitions, he said, were filed in good faith and for a legitimate bankruptcy purpose.

Observations

Judge Sontchi's conclusion finds support in recent Supreme Court authority, *Rodriguez v. F.D.I.C.*, 140 S. Ct. 713, 206 L. Ed. 2d 62 (Feb. 25, 2020).

In *Rodriguez*, the high court used a bankruptcy case to limit the use of federal common law. More particularly, the Supreme Court held that federal courts may not employ federal common law to decide who owns a tax refund when a parent holding company files the tax return but a subsidiary generated the losses giving rise to the refund. Rather, state law governs.

The unanimous opinion said that "cases in which federal courts may engage in common lawmaking are few and far between." *Id.*, 140 S. Ct. at 716.

Almost on point, the Supreme Court said that state law — such as "rules for interpreting contracts, creating equitable trusts, avoiding unjust enrichment" — are "readymade" for deciding an ownership dispute. *Id*. The opinion went on to say that "only limited areas exist in which federal judges may appropriately craft the rule of decision." Appropriate areas, the Court said, are in admiralty law and disputes among states. *Id*. at 717.

To read ABI's report on *Rodriguez*, click here.

The opinion is *In re EHT US1 Inc.*, 21-10036 (Bankr. D. Del. June 1, 2021).

Eleventh Circuit splits with four other circuits by holding that the Barton doctrine doesn't protect trustees once the bankruptcy is over.

Barton Protection Ends When the Bankruptcy Case Closes, Eleventh Circuit Says

Going beyond the appeals court's own decision eight months ago, the Eleventh Circuit has now created a stark split of circuits by holding that the *Barton* doctrine does not protect a bankruptcy trustee from suit after the bankruptcy case is closed.

In contrast to what the result would be in four other circuits, a bankruptcy trustee or receiver in the Eleventh Circuit now can be sued outside of the appointing court if the receivership or bankruptcy has been closed and there are no more estate or receivership assets that could be affected.

Consequently, a bankruptcy trustee, a receiver and other retained professionals must bear the cost and defend themselves in the Eleventh Circuit if they are sued outside of the bankruptcy court or the receivership court. The Atlanta-based appeals court found no policy concerns resulting from the lack of protection by the *Barton* doctrine because a receiver or trustee still will be protected by judicial immunity.

Receiver Sued in District Court

As an adjunct to the criminal prosecution of a doctor for homicide and violation of state narcotics laws, the state court appointed a receiver to liquidate the doctor's assets in a civil forfeiture action.

The doctor was convicted of murder, but he filed a *habeas* petition that resulted in a settlement where the doctor was released from prison in return for accepting a conviction for involuntary manslaughter. The doctor also agreed to forfeit his claims for the assets seized in the receivership.

After the assets were gone, the receivership was terminated. Later, the doctor sued the receiver for monetary damages in federal district court, alleging that the receiver was part of a conspiracy to deprive him of his civil rights under 42 U.S.C. § 1985.

Invoking the *Barton* doctrine, the district judge dismissed the suit for lack of subject matter jurisdiction, even though the receivership had terminated. The doctor appealed.

In an opinion on June 15, Circuit Judge William Prior reversed on the *Barton* issue but upheld dismissal because the receiver was entitled to judicial immunity.

The Prior Decision

The starting point for Judge Prior's opinion was the circuit's decision in October 2020 written by Circuit Judge Beverly B. Martin. *Tufts v. Hay*, 977 F.3d 1204 (11th Cir. Oct. 20, 2020). To read ABI's report, click here.

Judge Martin dealt with *Barton v. Barbour*, 104 U.S. 126 (1881), the genesis of the idea that receivers cannot be sued without permission from the appointing court.

After adoption of the Bankruptcy Act of 1898, the doctrine was extended to cover bankruptcy trustees. *Barton* was subsequently broadened to protect court-appointed officials and fiduciaries, such as trustees' and debtors' counsel, real estate brokers, accountants, and counsel for creditors' committees.

Like *Tufts*, the new opinion by Judge Prior explained that the *Barton* doctrine was based on the idea that the court lacked subject matter jurisdiction, because the receivership or bankruptcy had exclusive *in rem* jurisdiction over the estate.

By suing a court-retained professional outside of the bankruptcy court or receivership, the creditor would be interfering with the bankruptcy court's or the receivership's exclusive jurisdiction, since the suit could have a "conceivable effect" on the estate.

When Bankruptcy Ends, *Barton* Ends

Judge Prior cited the First, Seventh, Ninth and Tenth Circuits for holding that *Barton* continues to confer protection for policy reasons even after bankruptcy has ended. Those courts, Judge Prior said, believe that courts will have difficulty finding competent people to serve if receivers or trustees can be sued outside of the appointing court for actions taken in their official capacities.

Despite policy concerns, Judge Prior said that the jurisdictional foundation for *Barton* protection ends when the bankruptcy or receivership ends. "It follows," he said, "that when there is no longer a *res* controlled by a single court, there is no longer a potential conflict in the exercise of jurisdiction over it. And the court that first exercised jurisdiction over the *res* may no longer exclude other courts from exercising jurisdiction."

Judge Prior enlarged on the jurisdictional foundation, saying:

> We disagree with our sister circuits that the need to protect court-appointed receivers and bankruptcy trustees is relevant to the *Barton* doctrine. Their opinions

> fail to grapple with the fact that the *Barton* doctrine is grounded in the exclusive nature of *in rem* jurisdiction.

There "might be a legitimate policy concern," Judge Prior said, "but it has nothing to do with subject matter jurisdiction."

Judge Prior said that *Tufts* "credited this policy concern," but in *dicta*. He went on to say that the
"policy concern is unfounded because court-appointed receivers enjoy judicial immunity for acts taken within the scope of their authority. Receivers do not need the *Barton* doctrine to provide an additional layer of protection for the performance of their duties."

Because there was no longer any property in the receivership, Judge Prior held that "there is no longer a disputed property over which [the receivership court] may exercise jurisdiction," and thus no jurisdictional conflict between the district court and the receivership.

Judge Prior therefore held that *Barton* did not apply and that the district court had subject matter jurisdiction.

Next, Judge Prior examined the doctor's complaint in district court. He found that the receiver was entitled to judicial immunity and upheld dismissal on the merits.

Observations

This writer respectfully disagrees with the idea that trustees or retained professionals do not need the "additional layer of protection" afforded by *Barton* or some other theory.

In case after case, there are obstreperous parties who oppose everything and take groundless appeals. Lift *Barton's* protection, and they will begin suing in state courts or districts courts.

Yes, professionals have qualified judicial immunity, but they will be obliged to mount their defense in courts unfamiliar with the bankruptcy. In bankruptcy courts, claims against trustees and retained professionals can be disposed of more economically than in courts unfamiliar with the underlying proceedings.

The loss of *Barton* protection will fall disproportionately on the shoulders of chapter 7 or chapter 13 trustees. Why? Because chapter 11 confirmation orders inevitably contain releases and indemnifications in favor of retained professionals and other parties central to the conduct of the case. Trustees lack similar protections.

Judge Prior has a point to the extent that *Barton* must be based on the idea of exclusive subject matter jurisdiction. Under 28 U.S.C. § 1334, the bankruptcy court only has exclusive jurisdiction over the "case." If *Barton* has any continuing validity, the rationale must be found somewhere else.

Perhaps protection similar to *Barton* can be based on another strategy: Having been sued, a trustee could reopen the bankruptcy case and remove the suit to federal district court for referral to the bankruptcy court. Plaintiffs will likely back off when faced with the same bankruptcy judge. Removal, venue transfer and referral are less costly and less complicated than litigating on the merits in a court unfamiliar with the bankruptcy.

The opinion is *Chua v. Ekonomou*, 20-12576 (11th Cir. June 15, 2021).

The Eleventh Circuit has subjected its trustees to the risk of expensive litigation in a faraway court unfamiliar with what happened in the bankruptcy case.

Opinion Shows the Fault in Barring *Barton* Protection When a Case Is Closed

Now that the Eleventh Circuit has seemingly abolished the *Barton* doctrine as protection for estate professionals after bankruptcy cases have closed, an opinion by Bankruptcy Judge Erik P. Kimball shows how bankruptcy courts may no longer be available to protect trustees from the predation of possibly vexatious litigants.

As we shall discuss at the foot of this story, there still may be notions of jurisdiction that would allow the bankruptcy court to ride to the rescue.

The Obstreperous Debtor

The individual debtor filed a chapter 11 petition that was converted to chapter 7. In his January 28 opinion, Judge Kimball, from West Palm Beach, Fla., said that the case involved "an unusual amount of contentious litigation."

Due a "great extent . . . to [the debtor's] obstruction of the trustee and extreme litigiousness," Judge Kimball said, the estate was insolvent; there was no distribution to unsecured creditors, and administrative creditors received "only a tiny portion of" their claims. He alluded to the debtor's "shocking behavior."

Judge Kimball said he had "twice held [the debtor] in contempt, including for previously filing suit against the trustee and trustee's counsel without the Court's authority during the pendency of his chapter 7 case." He added that the debtor had been "permanently disbarred by the Florida Supreme Court, . . . [i]n part because of his actions in this case."

More than one year after the chapter 7 case was closed, the debtor sued the chapter 7 trustee, the trustee's counsel and others in federal district court in New York. Judge Kimball said that the lawsuit in New York was "a continuation of [the debtor's] inappropriate actions in this Court, for which he was twice held in contempt."

In addition to the trustee and the trustee's counsel, defendants in the $30 million civil RICO suit included 13 law firms, seven lawyers and numerous individuals. The complaint raised a plethora of allegations of fraud in connection with legal proceedings involving the debtor.

The U.S. Trustee responded by filing a motion asking Judge Kimball to reopen the case and reappoint a chapter 7 trustee. Were he to reopen the case, Judge Kimball said, the U.S. Trustee would contend under the *Barton* doctrine that the debtor should have sought permission from the bankruptcy court before suing the chapter 7 trustee and his counsel.

The chapter 7 trustee joined in the motion by the U.S. Trustee.

The Doctrine and Its Limitations

The modern doctrine arose from *Barton v. Barbour*, 104 U.S. 126 (1881), where the Supreme Court held that receivers cannot be sued without permission from the appointing court. After adoption of the Bankruptcy Act of 1898, the doctrine was extended to cover bankruptcy trustees. *Barton* was subsequently broadened by many circuits to protect court-appointed officials and fiduciaries, such as trustees' and debtors' counsel, real estate brokers, accountants, and counsel for creditors' committees.

Judge Kimball traced the adoption of the *Barton* doctrine in the Eleventh Circuit. First, the Eleventh Circuit held in 2000 that *Barton* protected trustees and other court-appointed officers for actions taken in their official capacity. In 2009, the Atlanta-based appeals court ruled that *Barton* protected a receiver's court-approved counsel and other court-sanctioned professionals.

In both, Judge Kimball said that the underlying cases were still pending when *Barton* protection was invoked.

Then came *Tufts v. Hay*, 977 F.3d 1204 (11th Cir. Oct. 20, 2020), and *Chua v. Ekonomou*, 1 F.4th 948 (11th Cir. 2021), where the Eleventh Circuit created a split of circuits by holding that the *Barton* doctrine does not protect a bankruptcy trustee from suit after the bankruptcy case is closed and there are no more estate assets. To read ABI's reports, click here and here.

The New, Limited *Barton* Doctrine Applied

Judge Kimball said that *Chua* wrought "a significant change in Eleventh Circuit precedent." After the 2021 decision, he said it is "not appropriate to apply the *Barton* doctrine primarily as a prophylactic measure to protect bankruptcy trustees and other representatives of the bankruptcy estate."

After *Chua*, "the sole question," Judge Kimball said, "is whether the bankruptcy court has subject matter jurisdiction over the matter presented in the suit. The *Barton* doctrine applies only where the suit would have a conceivable effect on the administration of the bankruptcy estate."

Applying the facts to the law, Judge Kimball said that the estate was closed and fully administered. There were no longer any assets to distribute, so the lawsuit in New York "cannot impact distributions in this case as there are no longer any assets to distribute."

Finding that "the *Barton* doctrine does not apply," Judge Kimball denied the motion to reopen the case. He said there was no "subject matter jurisdiction over the claims brought against" the trustee and the trustee's counsel.

As consolation for the trustee and his counsel, Judge Kimball said that judicial immunity still afforded "a remedy."

Observations

By reopening the case, an estate would arise from the dead. Respectfully, jurisdiction in the bankruptcy court does not depend entirely on the existence of estate assets. Jurisdiction can exist if there is a conceivable effect on the estate.

Section 541(a) creates an estate alongside the filing of a petition. Nothing in the Bankruptcy Code requires the existence of assets in the U.S. before there is an estate or before a debtor can file a petition under title 11. In fact, Section 109(a) says that a person may be a debtor who has "a domicile, place of business, ***or*** property in the United States." [Emphasis added.]

Although previously existing estate property may have disappeared, the ability of the chapter 7 trustee to sue the debtor for later misdeeds conceivably gave life to new estate assets that previously did not exist.

There would at least be a "conceivable" effect on the estate, given the right of the trustee to seek compensation for fending off the new lawsuit. The fact that the estate has no remaining cash assets would not obviate the right of the trustee to assert an administrative claim to be paid if assets were found to exist.

Given the debtor's prior obstreperous behavior, it's conceivable that the estate would have claims of some sort against the debtor, perhaps under Rule 11, for fomenting frivolous litigation or for violating prior bankruptcy court orders.

The trustee and counsel would have other defenses lending themselves to bankruptcy jurisdiction.

The trustee and his counsel received final allowances of compensation, which will bar claims by the debtor alleging misdeeds by the trustee and counsel. The final allowances arguably gave *res judicata* defenses available to the trustee and counsel that in turn may lead to sanctions against the debtor.

The bankruptcy court had discharged the trustee in closing the case, arguably absolving the trustee for misdeeds.

Although jurisdiction in the bankruptcy court would not be exclusive, the bankruptcy court arguably had concurrent jurisdiction to enforce and interpret its own prior orders.

All things considered, this writer respectfully submits there should be sufficient "related to" or "arising in" jurisdiction to permit the reopening of the case, to hear the defenses of the trustee and counsel, and to hear claims against anyone who may have offended the good order of the bankruptcy proceedings.

The trustee might have employed another strategy even if there were no bankruptcy jurisdiction.

The debtor brought suit in federal court in New York based on diversity jurisdiction. The trustee could have filed a venue motion, seeking to transfer the suit to a Florida district court.

Once in Florida, a district judge could refer the suit to the bankruptcy court as being "related to" the bankruptcy court. There would be no jurisdiction problem because the debtor was claiming diversity jurisdiction.

The opinion is *In re Keitel*, 15-21654 (Bankr. S.D. Fla. Jan. 28, 2022).

Someone seeking to issue a subpoena to a trustee is the proper party to seek leave under the Barton doctrine, Judge Clarkson says.

California Judge Splits with his BAP; Subpoenas Require Court Approval Under *Barton*

Someone issuing a subpoena to a bankruptcy trustee in a criminal case or a lawsuit outside of bankruptcy court must first ask the bankruptcy court for permission to issue the subpoena in view of the *Barton* doctrine, for reasons explained by Bankruptcy Judge Scott C. Clarkson of Santa Ana, Calif.

Without prior bankruptcy court approval, expenses incurred by a trustee to comply with a subpoena issued outside of bankruptcy court would be an unauthorized use of estate property not in the ordinary course of business under Section 363(b), Judge Clarkson said in his March 3 opinion. The opinion suggests that a third party intending to issue a subpoena to a bankruptcy trustee for a case outside of bankruptcy court should offer to reimburse the estate for the expense of complying with the subpoena.

The Criminal Subpoena

The case involved Michael Avenatti, whose law firm is in chapter 7 liquidation in Judge Clarkson's court. Individually, Mr. Avenatti is a defendant in a criminal case in California, with a trial scheduled to begin on May 10. He is now appealing a criminal judgment entered against him in February in New York.

Mr. Avenatti went to trial in a separate criminal case in New York beginning on January 24. The jury found him guilty of wire fraud and aggravated identity theft in a verdict on February 4.

In the criminal case that went to trial in January, both the prosecution and the defense had issued subpoenas on the California trustee demanding that the trustee appear personally and produce four terabytes of data held by the trustee.

On January 24, when the trial was beginning in New York, the California trustee filed an emergency motion asking Judge Clarkson to authorize expenses to be incurred in complying with the two subpoenas. The motion did not challenge the validity of the subpoenas, although the trustee's motion did mention the *Barton* doctrine.

The doctrine arose from *Barton v. Barbour*, 104 U.S. 126 (1881), where the Supreme Court held that receivers cannot be sued without permission from the appointing court. After adoption of the Bankruptcy Act of 1898, the doctrine was extended to cover bankruptcy trustees. *Barton* was subsequently broadened by many circuits to protect court-appointed officials and fiduciaries, such as trustees' and debtors' counsel, real estate brokers, accountants, and counsel for creditors' committees.

Barton Applied

Although the trustee was not asking for a declaration that the subpoenas were invalid under *Barton*, Judge Clarkson said that "the Court must address issues that pertain to the Motion's essence; namely, those principles that make up the *Barton* Doctrine."

Judge Clarkson said that *Barton* was based on the notion that the bankruptcy court has exclusive jurisdiction of the estate. As the Ninth Circuit held in 2005, a party must first obtain leave from the bankruptcy court before "it initiates an action in another forum against a bankruptcy trustee or other officer appointed by the bankruptcy court for acts done in the officer's official capacity."
In re Crown Vantage, Inc., 421 F.3d 963, 970 (9th Cir. 2005).

Judge Clarkson relied heavily on *In re Circuit City Stores, Inc.*, 557 B.R. 443 (Bankr. E.D. Va. 2016), where the bankruptcy court applied *Barton* to subpoenas served on trustees or other officers or their agents "owing their positions to bankruptcy court orders."

On the other side of the fence, Judge Clarkson cited *In re Media Group, Inc.*, 2006 WL 6810963 (B.A.P. 9th Cir. 2006), where he said that the BAP "declined to extend the application of the *Barton* Doctrine to a subpoena issued on a trustee's lawyer."

Judge Clarkson described the BAP as believing that *Barton* only applies to lawsuits against trustees, not subpoenas.

As an opinion from the BAP, even in his own circuit, Judge Clarkson said that *Media Group* was "not binding precedent." He also said that the BAP "did not correctly apply the rule of law developed either in the Supreme Court's 1881 decision in *Barton* or the Ninth Circuit's 2005 *Crown Vantage* decision." In his opinion, the BAP "engaged in a too narrow, textual analysis of the Supreme Court's decision in *Barton*."

Judge Clarkson quoted *Crown Vantage* for applying *Barton* to "all legal proceedings." Under "any common-sense interpretation," commanding a trustee to appear 3,000 miles away "involves a legal proceeding," he said.

Although the Ninth Circuit has not addressed the question, Judge Clarkson said that he was "persuaded that the application of the *Barton* Doctrine respecting subpoenas, as so thoughtfully discussed in the more recent (2016) *Circuit City* case, is appropriate."

Without permission from the bankruptcy court, Judge Clarkson said that the trustee could not comply with the subpoena because the trustee would have been using estate property outside of the ordinary course of business in violation of Section 363(b).

By asking him for permission to comply with the subpoena, Judge Clarkson said that the trustee was seeking permission to use estate property "without first allowing this Court to engage in a *Barton* analysis . . . . This was improper."

"The proponent[s] of the subpoenas are the proper parties to seek permission to submit these subpoenas," Judge Clarkson said. "In the absence of this Court's prior approval, the subpoenas commanding the Trustee to use Estate resources usurp the power and authority of this Court."

Judge Clarkson denied the trustee's motion with prejudice, saying that *Barton* "considerations should be raised in the first instance by the issuers of the proposed subpoenas."

The opinion is *In re Egan Avenatti LLP*, 19-13560 (Bankr. C.D. Cal. March 3, 2022).

Plans & Confirmation

Manhattan district judge vacated confirmation of Purdue Pharma's chapter 11 plan because the court had no statutory power to impose non-consensual releases of creditors' direct claims against non-debtors.

Third-Party, Non-Consensual Releases Nixed in the Purdue 'Opioid' Reorganization

Non-consensual releases of creditors' direct claims against non-debtors are not permitted by the Bankruptcy Code, according to District Judge Colleen McMahon of Manhattan, who vacated the bankruptcy court's confirmation of the controversial Purdue Pharma LP chapter 11 plan.

Had the reorganization plan been upheld (or if it is upheld after appeal to the Second Circuit), the controlling Sackler family's $4.325 billion contribution to the reorganization plan would have absolved them from all liability stemming from the opioid crisis, even if creditors with direct claims did not consent.

Judge McMahon's 142-page decision on December 16 is perhaps the most outstanding and remarkable bankruptcy opinion of the decade. Unless reversed on appeal, she will have barred debtors from confirming chapter 11 plans in the Second Circuit with non-consensual releases of creditors' direct claims against non-debtor third parties.

Prof. Ralph Brubaker agrees. He told ABI:

> This is one of the most consequential decisions for the chapter 11 system that's ever been handed down. Judge McMahon's decision goes even further than the previous decisions of the Fifth, Ninth, and Tenth Circuits prohibiting nonconsensual non-debtor releases. Judge McMahon has forcefully declared that bankruptcy judges have no inherent common-law discharge power. That power resides exclusively with Congress, and outside of asbestos cases, nothing in the Bankruptcy Code authorizes bankruptcy judges to discharge the obligations of a nondebtor."

Prof. Brubaker is the James H.M. Sprayregen Professor of Law at the University of Illinois College of Law.

The Decision Is Limited

Contrary to what may have been reported in the press, Judge McMahon did not prohibit all non-debtor releases, nor did she bar members of the Sackler family from obtaining releases from perhaps the majority of opioid claims.

Judge McMahon's opinion is narrow. She only barred non-consensual releases where creditors have direct claims against the Sacklers that are not derivative of claims that the company has against family members.

Judge McMahon's opinion is consistent with the Second Circuit's approval of more limited releases given to non-debtors in the liquidation of the Bernard Madoff Ponzi scheme. There, the Manhattan-based appeals court ratified non-consensual releases given to non-debtor defendants who knew that Bernard Madoff was conducting a Ponzi scheme and who made settlements with the trustee on the understanding that they could not be sued by Madoff's defrauded customers. The releases only applied when defrauded customers were suing on the same claims held by the Madoff trustee.

U.S. Attorney General Merrick B. Garland applauded the opinion. Immediately after it came down, he issued a statement saying that the "bankruptcy court did not have the authority to deprive victims of the opioid crisis of their right to sue the Sackler family." The statement is an overbroad characterization of the opinion, but it signals that the government is on the side of limiting third-party releases in bankruptcy cases if the case eventually goes to the Supreme Court.

The opinion has ominous implications for other mass-tort bankruptcies, like the Boy Scouts' chapter 11 case in Delaware. Judge McMahon's opinion is not binding on the bankruptcy judge in Delaware. However, the plan proposed by the Boy Scouts would bar thousands of claims by allegedly abused men who have direct claims against scout leaders and organizations not in bankruptcy. It remains to be seen if the Delaware courts follows the *Purdue* decision from New York.

The Executive Summary

Judge McMahon in substance wrote an executive summary about her legal conclusions on pages 6 and 7 of her typescript opinion. She said that the bankruptcy court had subject matter jurisdiction to enter non-consensual releases, even though the bankruptcy court "may have lacked constitutional authority" to give final approval.

The "great unsettled question," Judge McMahon said, is whether "any court . . . is statutorily authorized to grant such releases." The circuits are split, but the Second Circuit "has not yet analyzed the issue," despite having "identified the question" in 2005.

"This will no longer do," Judge McMahon said. "Either statutory authority exists or it does not. . . . Moreover, the lower courts are desperately in need of an answer."

In her summary, Judge McMahon summed up her holding:

> [T]he Bankruptcy Code does not authorize such non-consensual non-debtor releases; not in its express text (which is conceded); not in its silence (which is disputed); and not in any section or sections of the Bankruptcy Code that, read singly or together, purport to confer generalized or "residual" powers on a court sitting in bankruptcy.

Judge McMahon found it unnecessary to reach constitutional questions. Likewise, she did not decide whether the settlement with the Sacklers was permissible if the Second Circuit were to decide that she was wrong about releases.

"This is a real 'the emperor has no clothes' moment for the chapter 11 system," Prof. Brubaker told ABI. He added:

> The legal legitimacy of nonconsensual non-debtor releases has always been dubious, at best. The parties, though, have engaged bankruptcy and appellate judges in an ultra-high-stakes game of chicken, daring them to blow up complex deals they have spent years and many millions (and in the *Purdue* case, hundreds of millions) of dollars negotiating. Judge McMahon is pressing the Second Circuit (and perhaps ultimately the Supreme Court) to put an end to that practice by definitively resolving the legal permissibility of nonconsensual non-debtor releases, once and for all.

The Facts

In minute detail, Judge McMahon laid out the facts and procedural history in the first 70 pages of her opinion, allowing the Second Circuit to focus on the law in the inevitable next appeal.

Purdue is a privately-held company owned by members of the Sackler family and controlled by them until not long before bankruptcy. Between 1996 and 2019, Purdue had revenue of $34 billion, with 91% emanating from the company's opioid called OxyContin.

Judge McMahon explained how Purdue pled guilty to one felony count in 2007 for falsely marketing the opioid. Four company officers pled guilty to misdemeanor charges of misbranding. The company paid $600 million in fines.

After the plea, Judge McMahon said that the company's profits "were driven almost exclusively" by aggressively marketing the opioid.

By 2014, lawsuits were mounting, and Sackler family members were being named as defendants. Discovery led to allegations that some of the Sacklers set sales targets for the opioid that were higher than those recommended by company executives.

Citing the bankruptcy judge's findings, Judge McMahon said that the Sacklers "distributed significant sums of Purdue money to themselves" from 2008 to 2016, when they were "aware of the opioid crisis and the litigation risk."

The distributions from 2008 to 2016 were a "sharp departure" from the practice in 1996 to 2007. In the prior years, the distributions to the family amounted to about 9% of company revenue, enough to cover taxes. In the later years, the distributions were an average of 53% of revenue, Judge McMahon said.

The distributions in the later years aggregated about $10.4 billion. Of the total, some $4.6 billion paid pass-through taxes. The family's own expert said that the withdrawals substantially reduced the company's "solvency cushion."

Judge McMahon cited the bankruptcy judge for saying that the distributions would allow the company to assert more than $11 billion in avoidable transfers.

Facing a "veritable tsunami of litigation," the company filed a chapter 11 petition in September 2019. Immediately, the bankruptcy court approved a temporary injunction barring suits against the Sackler family, their trusts and other officers, directors or employees.

The injunction stopped more than 2,900 suits against the company and 400 against the Sacklers. Upheld in district court, the injunction was extended 18 times, until plan confirmation this year.

In the chapter 11 case, 614,000 creditors filed claims asserting damages for more than the world's domestic product, Judge McMahon said. Nonetheless, the so-called bar date occurred before potential creditors with direct claims against the Sacklers were to learn that that the plan would extinguish their claims.

The company took another plea in 2020 while in bankruptcy, conceding extensive violations of the 2007 plea agreement. Judge McMahon said the violations "began almost from the time the ink was dry" on the 2007 plea deal.

The Chapter 11 Plan

With the help of mediators, the Sacklers agreed to contribute $4.325 billion toward Purdue's chapter 11 plan, on the condition that their payments over nine years would end lawsuits against the family for all time.

Demanded by the bankruptcy judge, Purdue amended its plan to provide that the non-consensual releases in favor of the Sacklers barring future litigation would apply only where the company's conduct was "a legal cause or a legally relevant factor to the cause of action against" a family member.

Judge McMahon said that the non-consensual releases in the plan in favor of the Sacklers would cover "[a]ll present and potential claims connected with OxyContin and other opioids." She said that the releases included "third-party claims that could not be asserted by the Debtors against" the Sacklers "but were particularized to others."

"Chief among those claims," Judge McMahon said, "are claims asserted by the states — both consenting states and the objecting states — arising under various unfair trade practices and consumer protection laws that make officers, directors and managers who are responsible for corporate misconduct personally liable for their actions."

Judge McMahon characterized the plan as providing "broad releases" to members of the Sackler family, "not just of derivative, but of particularized or direct claims."

The U.S. Trustee, eight states and others objected to confirmation. The U.S. Attorney from New York filed a statement of interest supporting objections to the breadth of the releases.

Summarizing the bankruptcy judge's confirmation opinion in detail, Judge McMahon called it "a judicial *tour de force*." The bankruptcy judge found no other reasonably conceivable means to achieve the result reached by the plan and said that failure to confirm the plan would lead to Purdue's liquidation and no recovery for unsecured creditors, including personal injury plaintiffs.

The bankruptcy judge confirmed the plan on September 17, 2021, "with obvious reluctance," Judge McMahon said. The plan had been approved overwhelming by creditors.

The U.S. Trustee, eight states, the District of Columbia, several cities in Canada, several Native American tribes and a number of *pro se* creditors filed appeals from the confirmation order. The U.S. Attorney in New York filed an *amicus* brief supporting the appellants.

To preclude invocation of equitable mootness, Judge McMahon accelerated the appeal and issued her decision on December 16, before the plan was due to be consummated.

Stern v. Marshall

On the merits, Judge McMahon first addressed the standard of review and the implications of *Stern v. Marshall*, 564 U.S. 462 (2011). She said that the bankruptcy judge "improperly elided"

his authority to confirm the plan, "an indubitably core function," with authority to dispose of claims finally where the bankruptcy court only had "related to" jurisdiction.

Judge McMahon disagreed with a recent Third Circuit opinion where the Philadelphia-based appeals court read *Stern* as allowing the bankruptcy court to confirm a plan with similar releases because the injunctions were "integral" to restructuring the debtor-creditor relationship. *See Millennium Lab Holdings LLC*, 945 F.3d 126 (3d Cir. 2019), *cert. den.* 140 S.Ct. 2805 (2020). To read ABI's report on *Millennium*, click here.

Applying *Stern*, Judge McMahon said that the proper analysis requires deciding whether the releases "would necessarily be resolved in the claims allowance process — not whether the release and injunction are 'integral to the restructuring of the debtor-creditor relationship.'" She said that the debtor "cannot manufacture constitutional authority to resolve a non-core claim by the artifice of including a release of that claim in a plan of reorganization."

Because the nonconsensual releases were "the equivalent of a final judgment for *Stern* purposes," Judge McMahon held that the bankruptcy judge did not have power to enter a final order and "should have tendered" proposed findings and conclusions of law.

Prof. Brubaker agrees that *Stern* does not allow the bankruptcy court to enter a final confirmation order with releases of the sort. *See* Ralph Brubaker, *A Case Study in Federal Bankruptcy Jurisdiction: Core Jurisdiction (or Not) to Approve Non-Debtor 'Releases' and Permanent Injunctions in Chapter 11*, 38 Bankr. L. Letter No. 2, at 7-8 (Feb. 2018). To read, click here.

N.B.: Should Judge McMahon's analysis be adopted universally, equitable mootness will not be an issue in cases where the district judge alone can enter a final order of confirmation. To the argument that the delay resulting from district court review would be the death of chapter 11 cases, the answer is this: The district and bankruptcy judges could sit together at the confirmation hearing.

Subject Matter Jurisdiction

Objectors argued that the bankruptcy court lacked subject matter jurisdiction to underpin releases. Judge McMahon recognized that third parties' claims against non-debtors "touches the outer limits of the Bankruptcy Court's jurisdiction."

In the Second Circuit, Judge McMahon said there is subject matter jurisdiction if the outcome might have "any conceivable effect" on the estate.

Judge McMahon said there was "absolutely no question" about the existence of subject matter jurisdiction under the rubric of "related to" because the releases might have a conceivable effect on the estate.

Statutory Authority for Non-Debtor Releases

Throughout, when we refer to releases, we mean non-consensual releases of creditors' direct claims against non-debtors. Releases will not refer to derivative claims, which Judge McMahon defined as meaning claims that would make the Sacklers liable based on the company's actions.

Releases refers to injunctions barring claims based on non-debtors' own conduct, "predicated on their own alleged misconduct and the breach of duties owed to claimants other than Purdue," Judge McMahon said.

Judge McMahon did not leave the reader in suspense for long. She quickly said that the Bankruptcy Code "does not confer on any court the power to approve the release of non-derivative third-party claims against non-debtors, including specifically" some of the releases in the Purdue plan.

The Primacy of Section 524(g)

Judge McMahon found only one provision in the Bankruptcy Code, Section 524(g), which authorizes injunctions barring third-party claims, and then "exclusively in cases involving . . . injuries arising from the . . . sale of asbestos." In confirming the Johns-Manville plan years ago, she noted that the Second Circuit "did not cite to a single section of the Bankruptcy Code as authorizing the entry of the injunction." *See MacArthur Co. v. Johns-Manville Corp. (In re Johns-Manville Corp.)*, 837 F.2d 89 (2d Cir. 1988).

After *Manville*, Congress adopted Section 524(g), codifying the result in *Manville* for asbestos cases. Judge McMahon interpreted the statute to mean that Congress retained "the task of determining whether and how to extend a rule permitting non-debtor releases . . . into other areas."

In other words, Judge McMahon believes that *Manville* was not binding on her and did not compel her to approve the Purdue plan because the decision was overruled *sub silentio* when Congress later adopted Section 524(g).

The Split Among the Circuits

Judge McMahon surveyed the circuits, where she found "a long-standing conflict among the Circuits" and no "definitive guidance" from the Second Circuit. After *Manville*, she said in substance that no Second Circuit decision had actually approved non-debtor releases. She cited *Madoff* for the notion that Section 105(a) supplied power to enjoin derivative claims. *See In re Bernard L. Madoff Inv. Securities LLC*, 740 F.3d 81 (2d Cir. 2014).

Summarizing, Judge McMahon said that Second Circuit law is "unsettled, except in asbestos cases where statutory authority is clear. . . . [I]ts only clear statement is that Section 105(a), standing alone, does not confer such authority . . . outside the asbestos context."

The other circuits are in conflict, Judge McMahon said. The Fifth, Ninth and Tenth Circuits "reject entirely the notion that a court can authorize non-debtor releases outside the asbestos context."

In approving releases of the type, Judge McMahon said that the Third Circuit "has not identified any section of the Bankruptcy Code that authorizes such non-debtor releases." The Fourth and Eleventh Circuit "have concluded that Section 105(a), without more, authorizes such releases."

Judge McMahon read the Sixth and Seventh Circuits as holding that Sections 105(a) and 1123(b)(6), "read together, codify something that they call a bankruptcy court's 'residual authority'" to impose releases.

The Purdue bankruptcy judge found statutory authority from a combination of Sections 105(a), 1123(a)(5), (b)(6) and 1129. Judge McMahon said that those sections only confer power "to enter orders that carry out other, substantive provisions of the Bankruptcy Code." Since the Code nowhere authorizes releases of the type, she held that none of them conferred the necessary statutory power.

Judge McMahon noted that some of the governments' claims for civil penalties would not be dischargeable even if the individuals were to file their own bankruptcies.

The Debtor's Other Arguments

The debtor argued that the absence of a statutory prohibition permitted the releases.

Judge McMahon said that Congress has not been silent. It "has in fact spoken" in "Sections 524(g) and (h) to preempt the field where non-debtor releases are concerned. . . . Congress in its wisdom elected to limit Code-based [releases] to asbestos litigation."

Finally, Judge McMahon found no "residual authority." If residual power were to exist, it would be "exercised in contravention of specific provisions of the Bankruptcy Code." She declined "to insert a right that does not appear in the Bankruptcy Code to achieve a bankruptcy objective."

Because "the Bankruptcy Code confers no such authority" to grant releases, Judge McMahon ruled that "the order confirming the Plan must be vacated."

Scholarly Commentary

Prof. Brubaker identifies a path for reaching the same result without stretching a bankruptcy court's statutory powers beyond the breaking point. In a forthcoming article in the *Yale Law Journal Forum*, he says that "efficient (and fair) joint settlements of both debtors' and nondebtors' mass tort liability will still be possible, even (and particularly) if nonconsensual nondebtor releases are prohibited." Ralph Brubaker, *Mandatory Aggregation of Mass Tort Litigation in Bankruptcy*, 131 Yale L.J.F. (forthcoming 2022).

He goes on to say that the "essential architecture for facilitating powerful aggregation and corresponding settlement of tort victims' claims against nondebtors already exists in the bankruptcy jurisdiction, removal, and venue provisions of" 28 U.S.C. § 157(b)(5). The section, he said, "provides for single-district consolidation of all creditors' related personal injury claims against a nondebtor, in a manner similar to an MDL consolidation. . . . In fact, section 157(b)(5) consolidations would be an immensely more powerful and fairer centralization process than MDL consolidations."

To read the forthcoming article, click here.

The opinion is *In re Purdue Pharma LP*, 21-07532 (S.D.N.Y. Dec. 16, 2021).

A district judge in Virginia holds that third-party, non-debtor releases must be approved by district judge under Stern and must comply with the strictures of Federal Rule 23.

Another District Judge Emphatically Rejects a Plan with Non-Debtor Third-Party Releases

In a scorching opinion, a district judge in Richmond, Va., set aside confirmation of a chapter 11 plan that contained "extremely broad third-party (non-debtor) releases."

District Judge David J. Novak said that the releases in the appeal before him "represent the worst of this all-too-common practice, as they have no bounds." He described the releases as barring the claims

> of *at least* hundreds of thousands of potential plaintiffs not involved in the bankruptcy . . . , shielding an incalculable number of individuals associated with the Debtors . . . for an unspecified time period stretching back to time immemorial . . . ." [Emphasis in original.]

Judge Novak said that the bankruptcy court "exceeded the constitutional limits of its authority . . . , ignored the mandates of the Fourth Circuit . . . , and offended the most fundamental precepts of due process."

Referring to what he called the "ubiquity of third-party releases" approved by a bankruptcy judge in Richmond who "regularly approves third-party releases," Judge Novak said that "[t]his recurrent practice contributes to major companies like [the debtor] using the permissive venue provisions of the Bankruptcy Code to file for bankruptcy here."

Citing the U.S. Trustee, Judge Novak said that "the Richmond Division (just the division, not the entire Eastern District of Virginia) joins the District of Delaware, the Southern District of New York, and the Houston Division of the Southern District of Texas as the venue choice for 91% of the 'mega' bankruptcy cases."

On the penultimate page of his 88-page opinion reversing and remanding, Judge Novak directed the chief bankruptcy judge to reassign the chapter 11 case to another bankruptcy judge outside of the Richmond division. If there is another appeal after remand, Judge Novak said that the new appeal would be assigned to him.

Takeaways

On December 16, District Judge Colleen McMahon in New York vacated confirmation of the Purdue Pharma LLP chapter 11 plan, holding that the court had no statutory power to impose non-consensual releases of creditors' direct claims against non-debtor third parties. *In re Purdue Pharma LP*, 21-07532, 2021 BL 482465, 2021 WL 5979108 (S.D.N.Y. Dec. 16, 2021). To read ABI's report, click here.

The January 13 opinion by Judge Novak goes beyond Judge McMahon's more narrow preservation of creditors' direct claims against non-debtors. Readers may draw some of the following conclusions from Judge Novak's opinion.

- Third-party releases are virtually impermissible when the releasing parties are receiving no consideration under the chapter 11 plan and the creditors do not manifest actual consent, under high standards for what constitutes actual consent.

- Just providing creditors with an ability to opt out does not make the release consensual as a matter of fact and law.

- The limited power of a bankruptcy judge under Article I of the Constitution requires that third-party releases be approved by district judges, and confirmation orders with third-party releases should be reports and recommendations.

- The procedure for approval of third-party releases in a chapter 11 plan must comply with Federal Rule 23, which deals with class actions. Among other things, creditors who are losing the right to sue must be involved in negotiations on the plan and must be adequately represented.

- Like the Eighth Circuit, which limited the doctrine of equitable mootness almost to the vanishing point, equitable mootness will not protect third-party releases from appellate review.

- A creditor who opts out has no standing to appeal.

Judge Novak's opinion is required reading for anyone involved in chapter 11 practice. He gathers together authorities that are either hostile to or limit third-party releases.

However, Judge Novak does not proscribe third-party releases altogether. Indeed, he could not in view of *Behrmann v. Natl. Heritage Found. Inc.*, 663 F.3d 704 (4th Cir. 2011), where the Fourth Circuit adopted the Sixth Circuit's approach to approval of third-party releases and rejected the idea that Section 524(e) bars them outright.

The Facts

The debtors were Mahwah Bergen Retail Group, Inc. and affiliates. Together, they operated 2,800 retail stores with names like Ann Taylor, LOFT and Lane Bryant. The debtors had about $1.6 billion in secured debt and perhaps $800 million in unsecured debt.

In chapter 11, they sold the business in three sales for more than $650 million. The chapter 11 plan paid some secured creditors and set aside $7.25 million in cash for unsecured creditors.

Before bankruptcy, plaintiffs filed a securities class action suit in New Jersey against the debtors and several individuals, including the debtors' former chief executive and former chief financial officer. The district court had not certified the class before the chapter 11 filing brought the suit to a halt.

As confirmed by the bankruptcy court, the plan included "extremely broad" releases that "cover any type of claim that existed or could have been brought against anyone associated with the Debtors as of the effective date of the plan," Judge Novak said.

At the confirmation hearing, Judge Novak said that the bankruptcy court focused on the claims that would be released against the former CEO and CFO in the class action. The bankruptcy court, he said, "ignored all of the other potential claims (both federal and state claims) released against others covered by the releases."

The plan allowed creditors and shareholders to opt out of the releases. Shareholders were not receiving any consideration under the plan, although they would be released from any claims that the debtors might hold against those who did not opt out.

The debtors sent notices and opt-out forms to some 300,000 parties believed to be in the putative class. Almost 600 opted out, representing 0.2% of the class. Notice was published in two newspapers with nationwide publication.

Other than shareholders, the bankruptcy court did not require that notice and opt-out forms be sent to anyone else who would be giving releases, including employees, consultants, accountants, attorneys for the debtors or any of their affiliates, lenders, owners or shareholders.

The named plaintiffs in the class action opted out for themselves and attempted to opt out for the class. The bankruptcy court declined to allow the plaintiffs to opt out for the class.

The plan also contained exculpation clauses in favor of the debtors, the creditors' committee, committee members, shareholders who did not opt out, the term loan agent and anyone related to them.

The class plaintiffs and the U.S. Trustee unsuccessfully objected to confirmation and filed appeals. They also unsuccessfully sought stays pending appeal from both the bankruptcy court and the district court.

Standing to Appeal

The debtors agreed that the U.S. Trustee had standing to appeal but challenged the appellate standing of the class plaintiffs.

Citing the Second Circuit and other appellate authority, Judge Novak said that the class plaintiffs could not establish individualized harm because they opted out and preserved their claims. Thus, the U.S. Trustee had standing to appeal but not the class plaintiffs.

The Constitution and Third-Party Releases

Judge Novak framed the question as whether the bankruptcy court had constitutional authority to impose third-party releases. He said that the releases covered "an extraordinarily vast range of claims held by an immeasurable number of individuals against a broad range of potential defendants." Other than the claims against the former CEO and CFO, Judge Novak said that the bankruptcy court "ignored all of the other potential claims that it terminated in approving the releases."

Delving into the statutory and constitutional power underlying the releases, Judge Novak said that the "bankruptcy court lacks any authority to act on it" if "the claim has no relation to a case under title 11." In that regard, he said that the bankruptcy court "engaged in none of the content-based analysis demanded by" *Stern v. Marshall*, 564 U.S. 1058 (2011).

Judge Novak did not pause to determine whether the released claims were "core" or "noncore." He said "it takes only a cursory review . . . to find released claims that the Bankruptcy Court lacked authority to adjudicate." The first example he gave was the class suit against the former CEO and CFO, because the former officers had no involvement in the chapter 11 case.

Releasing claims, Judge Novak said, "amounts to adjudication of the claims for *Stern* purposes," citing Judge McMahon's *Purdue* opinion. He went on to say that the bankruptcy court had no *in rem* jurisdiction over third-party claims not against the estate or property of the estate."

Referring to Section 105(a) and the plenary power of a bankruptcy court to confirm a plan, Judge Novak said that "Article III simply does not allow third-party non-debtors to bootstrap any and all of their disputes into a bankruptcy case to obtain relief."

Next, Judge Novak dealt with the argument that the bankruptcy court had authority to issue the releases because the failure to opt out amounted to consent. He said that Supreme Court authorities

"do not permit a finding of consent based on *inaction*." [Emphasis in original.] He could not "discern any actions undertaken by the Releasing Parties to support a finding that they knowingly and voluntarily consented to Article I adjudication of the claims that they released."

Judge Novak held that the bankruptcy court "erred in adjudicating the *Stern* claims without the knowing and voluntary consent of the Releasing Parties."

Consequences of a *Stern* Violation

Because the bankruptcy court exceeded its power under *Stern*, Judge Novak vacated the confirmation order and treated the bankruptcy court's decision as a report and recommendation. Saying that the bankruptcy court's opinion "lacks any meaningful factfinding," Judge Novak made his own factual findings based on the record from the confirmation hearing.

In the future, Judge Novak said it would "preferable" for a bankruptcy court to issue a report and recommendation, identifying "with specificity the claims and individuals released and provid[ing] detailed findings . . . to ensure that the released claims are truly integral to the reorganization."

Judge Novak rejected the bankruptcy court's findings and made five single-spaced pages of findings of his own. He said that the third-party releases were "nonconsensual both as a matter of fact and a matter of law." He also found that the former CEO and CFO were not integral to the reorganization.

The Circuit Split on Third-Party Releases

Judge Novak cited the Fifth, Ninth and Tenth Circuits for prohibiting third-party releases under Section 524(e). He cited other circuits, like the Second and Third, that permit releases in rare cases.

In *Behrmann*, *supra*, the Fourth Circuit followed the test laid down by the Sixth Circuit for third-party releases. He ruled that the failure to opt out did not amount to the level of consent required by *Behrmann*.

Judge Novak said that the bankruptcy court "failed to conduct any *Behrmann* analysis." He said that the released parties gave no substantial contribution as required by *Berhmann*. In addition, the releases were not essential to the reorganization and were not "overwhelmingly" approved by the affected class.

"Because the Plan extinguishes these claims entirely without giving any value in return, this weights strongly against granting the Releases," Judge Novak said.

Beyond *Behrmann*, Judge Novak said that "no court" would have found the instant settlement "fair, reasonable and adequate under Rule 23." No one represented the interests of those who were giving releases, and the releases did not result from negotiations with those on whom releases were imposed. Instead, he said, the negotiations only occurred between those who would benefit from the releases. Furthermore, he found that the releases given by the debtor to shareholders "lacked any value and [were] purely fictional."

Judge Novak went on to hold that the third-party releases failed three of the four elements required to afford due process under Rule 23. "Accordingly," he said, allowing releases only based on the failure to opt out "does not comport with due process." He voided the third-party releases and held them unenforceable.

Severability

After confirmation, the plan said in substance that the releases were not severable from the remainder of the plan. Before confirmation, however, the releases were severable, Judge Novak said.

Again treating the confirmation order as a report and recommendation, Judge Novak examined the record and found that they did not "form an integral part of the Plan." Stepping into the shoes of the bankruptcy court, he severed the releases.

Equitable Mootness

The debtors argued for dismissal of the appeal as equitably moot, but Judge Novak found four reasons why the appeal was not equitably moot.

"First and foremost," he said, the confirmation order was no longer a final order, and equitable mootness does not apply when the confirmation order has been converted to a report and recommendation.

Second, equitable mootness does not apply when the government, via the U.S. Trustee, is representing absent individuals.

"Not only did the parties craft a release that would extinguish the rights of countless individuals, they did so in a way that would insulate the release from judicial review," Judge Novak said. He refused to "apply the doctrine of equitable mootness against the Trustee when the Trustee seeks to protect the rights of absent individuals."

Third, the "seriousness" of the bankruptcy court's "errors counsels against a finding of equitable mootness."

Fourth, effective relief was available. Judge Novak said he could sever the releases without altering any creditor's recovery "or affect[ing] the bankruptcy estate in any way."

Applying the factors to the appeal at hand, Judge Novak observed that equitable mootness "is all too often invoked to avoid judicial review, as Debtors seek to do here," citing the recent Eighth Circuit opinion that limited equitable mootness dramatically. *FishDish LLP v. VeroBlue Farms USA Inc. (In re VeroBlue Farms USA Inc.)*, 6 F.4th 880 (8th Cir. Aug. 5, 2021). To read ABI's report, click here.

Judge Novak refused to allow nonseverability or equitable mootness "to preclude appellate review of plainly erroneous release provisions."

The Exculpation Provisions

Contrasted to the releases, Judge Novak said that the plan's exculpation provisions provided protection to "court professionals who acted reasonably while carrying out their responsibilities."

Judge Novak remanded for the bankruptcy court to narrow the exculpation clause to cover "fiduciaries who have performed necessary and valuable duties."

Remand

Judge Novak's order vacated the confirmation order, voided the third-party releases, severed the third-party releases from the plan, and voided the exculpation clause.

Judge Novak remanded the case to another bankruptcy judge with instructions to redraft the exculpation clause and "then to proceed with confirmation of the Plan without the voided Third-Party Releases."

Another Appeal?

It is unclear whether Judge Novak's ruling is a final order appealable to the Fourth Circuit. Does the remand call for merely ministerial actions by the bankruptcy court that would allow an appeal?

The parties may not appeal again if they decide they can live without the broad releases that Judge Novak voided.

Judge-Shopping Curtailed in the E.D. of Va.

Like the Southern District of New York, the Eastern District of Virginia has adopted a local order that goes into effect on February 15: For chapter 11 debtors with more than $100 million in

liabilities, the cases will be assigned randomly to a bankruptcy judge in the district without regard to the division in which the petition was filed.

The opinion is *Patterson v. Mahwah Bergen Retail Group Inc.*, 21-167 (E.D. Va. Jan. 13, 2022).

At the risk of committing error, a district judge in New York reads a third-party release to cover only derivative claims, not direct claims that a creditor may have against a nondebtor.

Another New York District Judge Is Hostile to Nondebtor, Third-Party Releases

An opinion by another district judge in New York underscores the growing hostility of Article III courts to nondebtor, third-party releases in chapter 11 plans, even plans that have been confirmed and consummated.

The reader may conclude from reading the March 8 opinion that District Judge Denise Cote was stretching the rubber band to hold that the corporate parent's guarantee of a lease was not released by a broadly worded third-party release in the lessee's chapter 11 plan.

The Plan and the Release

The debtor signed a three-year commercial lease. The debtor's corporate parent issued an unconditional guarantee in favor of the landlord.

The pandemic intervened, and the debtor was never able to open a store in the leased premises. Eventually, the debtor filed a chapter 11 petition, rejected the lease and confirmed a plan.

The plan contained a release reading in pertinent part as follows:

> [A]ll Persons who . . . hold Claims . . . that are subject to . . . the Plan . . . are deemed to have released the Debtor, Reorganized Debtor, the Estate and each of their affiliates, current and former officers, directors, principals, members, professionals, advisors, accountants, attorneys, investment bankers, consultants, employees, agents, and other representatives (collectively, the "Released Parties"), from any and all claims . . . , *including any direct claims held by any such Person against each Released Party* . . . whether known or unknown, . . . that each such Person would have been legally entitled to assert, . . . based on or relating to . . . the Debtor or its affiliates. [Emphasis added.]

After the plan was confirmed and consummated, the landlord sued the parent on the guarantee in district court in New York. The landlord and the parent filed cross motions for summary judgment.

The parent wins, right? The parent was an affiliate of the debtor, and the guarantee was related to the debtor. It's open and shut, isn't it? There was no suggestion in the opinion that the landlord was unaware of the bankruptcy or the plan. So, didn't the plan release the landlord's claim on the guarantee against the parent?

Answer: No. Not by a long shot.

Narrow Reading of the Plan

Tellingly, Judge Cote began her legal analysis by quoting *Metromedia* where the Second Circuit said that plans may contain third-party releases in "rare cases." *In re Metromedia Fiber Network*, 416 F.3d 136, 141 (2d Cir. 2005). Later in the opinion, she would remark how the parent never explained "why this is one of the 'rare cases' in which a nondebtor release would be essential to the reorganization plan."

Focusing on the plan, Judge Cote said that releases in favor of officers, directors and other entities had to do their potential liability on derivative claims. The landlord's claim, she said, was not derivative. It was direct and primary.

However, the plan explicitly released creditors' direct claims. In other words, without saying so directly, Judge Cote was at least suggesting that a nondebtor release may only pertain to derivative claims.

Next, Judge Cote focused on the word "affiliate," because the plan broadly released claims against the debtor's affiliates.

The parent alluded to the definition of "affiliate" in Section101(2)(A), which includes an entity controlling at least 20% of a debtor's voting securities. Wouldn't "affiliate" cover the parent?

No, Judge Cote said. The definition in Section 101(2)(A) was "irrelevant" because the plan said that capitalized terms would have the meaning given in the Bankruptcy Code. In the plan, "affiliate" bore a lower case "a."

Judge Cote cited an authority that distinguishes between affiliates and parents.

In addition, the plan several times referred to "Parent." Judge Cote said that the drafters of the plan knew how to refer to the parent but didn't when it came to the releases.

Next, Judge Cote said that adoption of the parent's interpretation of the plan "would lead to extreme results." She said that the broad language in the plan would release any claim that any

creditor had against the parent, "regardless of whether that claim had anything to do with [the debtor]."

We heard the same refrain in the district court's opinion overturing confirmation of the chapter 11 plan of Mahwah Bergen Retail Group Inc. and affiliates. *See Patterson v. Mahwah Bergen Retail Group Inc.*, 21-167, 2022 BL 13068, 2022 US Dist. Lexis 7431 (E.D. Va. Jan. 13, 2022). To read ABI's report, click here.

[Note: This writer reads the release quoted above as only releasing a claim that a creditor had against the parent if that claim was related to the debtor.]

Because it was not a "rare" case, Judge Cote ruled that the landlord was entitled to enforce the guarantee against the parent.

Before entering summary judgment against the parent for more than $2 million, Judge Cote dismissed the parent's other affirmative defenses, including failure of consideration and impossibility of performance.

Observations

Looking only at the language of the release in view of the finality of the plan, Judge Cote's ruling might be upset on appeal.

However, an appellate court might find other reasons to affirm.

Notably, the plan released the landlord's direct claim against the parent seemingly without additional consideration. Releases of that sort stuck in the craw of District Judge Colleen McMahon of Manhattan when she overturned confirmation in *In re Purdue Pharma LP*, 635 B.R. 26 (S.D.N.Y. Dec. 16, 2021). However, there was a timely appeal in *Purdue,* and the plan had not been consummated. To read ABI's report on *Purdue*, click here.

Perhaps the bankruptcy court lacked subject matter jurisdiction or constitutional power on its own to release direct claims. Perhaps a circuit court would say that a plan provision is unenforceable if the bankruptcy court lacked constitutional power under *Stern*.

What we are seeing is Article III courts' animosity toward third-party releases. This writer recommends that bankruptcy courts sense which way the wind blows and trim third-party releases back to the bone before circuit courts or Congress toss them out altogether.

The opinion is *605 Fifth Property Owners LLC v. Abasic S.A.*, 21-811 (S.D.N.Y. March 8, 2022).

Mallinckrodt's nondebtor releases didn't have the defects that infected Purdue and Patterson.

Horizontal 'Gifting' Approved in Mallinckrodt's Confirmed Chapter 11 Plan

On top of crippling opioid liability, drug-producer and distributor Mallinckrodt was saddled with securities class actions and lawsuits by governmental units regarding a different drug called Acthar. The chapter 11 petition filed in October 2020 was the only hope for avoiding slow corporate death and liquidation from insufferable litigation costing $1 million a week.

Before and after filing, the debtor hashed out settlements and a chapter 11 plan that garnered approval from every fiduciary, almost every organized creditor group and 88% of voting creditors. The plan has $1.725 billion in cash, new secured notes, warrants and other consideration parceled out among the creditor classes.

Of course, there were dissenters, including the U.S. Trustee, the Securities and Exchange Commission and classes deemed to reject the plan. With a minor modification of exculpations that were overly broad, Bankruptcy Judge John T. Dorsey of Delaware confirmed the plan in a 98-page opinion on February 3.

The confirmed plan had nondebtor, third-party releases. However, the alleged shortcomings in Mallinckrodt's plan did not rise to the level that recently resulted in reversals of confirmation in New York and Virginia. *See In re Purdue Pharma LP*, 21-07532, 2021 BL 482465, 2021 WL 5979108, 2022 US Dist Lexis 8160 (S.D.N.Y. Dec. 16, 2021); and *Patterson v. Mahwah Bergen Retail Group Inc.*, 21-167, 2022 BL 13068, 2022 US Dist Lexis 7431 (E.D. Va. Jan. 13, 2022). To read ABI's reports, click here and here.

Although some may disagree, Mallinckrodt's plan would not have been offensive to the district judge in *Purdue*, because it did not release creditors' nonderivative, direct claims against nondebtors. Although subject more to doubt, Mallinckrodt's plan might not have offended the district judge in *Patterson*, because the creditor groups giving nondebtor releases negotiated the plan and are receiving substantial recoveries.

However, the district judge in *Patterson* might believe that Judge Dorsey erred in ruling that the bankruptcy court had constitutional power to issue releases in favor of third parties.

Mallinckrodt's plan is notable in several respects, according to Prof. Bruce A. Markell. He told ABI:

> The opinion accomplishes everything I would want, but very little I would grant. It tackles all the current hot-buttons of mass tort reorganization — third party releases, consents obtained through the use of opt-outs, and validation of gifting that freezes out identifiable classes to the benefit of those favored by the donor — and resolves each of them in favor of the debtor's reorganization. Unfortunately, I disagree that the reorganization achieved is one anticipated or authorized by the Code. The result may be the best one possible on utilitarian grounds, but those grounds are not written into the Code nor have they been embraced or enacted by Congress.

Prof. Markell is the Professor of Bankruptcy Law and Practice at the Northwestern Univ. Pritzker School of Law.

Chapter 11 practitioners should set aside several hours to read the opinion in full text.

Nondebtor Releases

The plan releases claims against nondebtors, such as officers and directors. Unlike *Millennium Lab Holdings II, LLC*, 945 F.3d 126 (3d Cir. 2019), where shareholder defendants paid $325 million for their releases, the U.S. Trustee opposed the releases because the released third parties are paying nothing for theirs. For ABI's report on *Millennium*, click here.

Judge Dorsey noted that the third-party releases were negotiated, to a large extent, with fiduciaries for claimants giving the releases. Were there no releases, he said that the debtor would be dragged back into litigation in view of indemnification rights. If there were continued litigation and no settlements and releases, Judge Dorsey concluded that claimants would have lower recoveries because the debtor would end up in liquidation.

With regard to releases that might be nonconsensual for some classes, Judge Dorsey said it was "exactly the type of extraordinary case the Third Circuit alluded to in *Continental*, where nonconsensual releases might be appropriate." For the classes that negotiate the settlements and releases, he said they were "both necessary and fair" and "overwhelmingly supported by the creditor body."

To the argument that the bankruptcy court lacked statutory or constitutional power, "the fact is," Judge Dorsey said, "that only one single creditor out of hundreds of thousands actually objected to these releases. To apply a blanket prohibition on non-consensual releases in this case would simply not make sense."

Opting Out

The Securities and Exchange Commission and the U.S. Trustee objected to releases on the part of shareholders, arguing that the releases were impermissibly nonconsensual because the class was deemed to reject the plan. They contended that the ability to opt out did not make the releases consensual and subjected the releases to the *Continental* test.

Despite the debtor's extensive trolling for opt-outs, Judge Dorsey said there had only been 2,200. Conceding that not all courts agree, he decided "that they are appropriate." He noted that the plan was "supported by every estate fiduciary, almost every organized creditor group, and 88% of voting creditors."

Unfair Discrimination, Horizontal Gifting

The so-called waterfall proffered by the debtor indicated that some subgroups of unsecured creditors would receive no recovery if distributions were made solely in accordance with bankruptcy priorities. Significantly, unsecured noteholders held guarantees from all of the myriad debtor entities. Other unsecured creditor groups might have recourse against only one debtor entity with little value.

The waterfall revealed that unsecured noteholders would be entitled to $1.4 billion. Under the same scenario, other general unsecured creditors receive $22.5 million, but only three of the seven subclasses would receive anything at all.

"To avoid litigation with constituents in the other unsecured classes and facilitate settlements," Judge Dorsey said that the noteholders "agreed to reallocate or 'gift' $228.5 million of their Entitled Recovery" to other classes of unsecured creditors.

As a result, Judge Dorsey said one subclass of unsecured creditors with $41 million in claims would have its recovery rise from 1% to 100%. Another subclass would go from nothing to 4%.

To analyze the propriety of gifting in the case before him, Judge Dorsey adopted the test proffered by Prof. Markell and decided there was a rebuttable presumption of gifting that would amount to unfair discrimination prohibited by Section 1129(b)(1).

On the question of unfair discrimination, Judge Dorsey found none, because the debtor had rebutted the presumption. He cited Third Circuit authority and said it is "irrelevant" when one "out of the money unsecured creditor class is doing better" than another out-of-the-money creditor.

Observations

Prof. Markell is the leading scholarly authority among those who believe that gifting is not permitted by the Bankruptcy Code. His commentaries are to be found in Bruce A. Markell, "A New Perspective on Unfair Discrimination in Chapter 11," 72 *Am. Bankr. L.J.* 227 (1998); and

Bruce A. Markell, "The Clock Strikes Thirteen: The Blight of Horizontal Gifting," 38 *Bankr. L. Ltr.* 12 (Dec. 2018). To read his more recent discussion, click here.

In his later work on horizontal gifting, like that afoot in Mallinckrodt's plan, Prof. Markell contends there is no gift. Rather, he says, the gift-giver is obtaining releases and injunctions and a shorter path to confirmation. He said, "Creditors ought not to be able to change results Congress picked by bribes to out-of-the-money classes."

The opinion is *In re Mallinckrodt PLC*, 20-12522 (Bankr. D. Del. Feb. 3, 2022).

The first court of appeals to reach the issue decides that the SBA properly interpreted the CARES Act to bar chapter 11 debtors from receiving PPP 'loans.'

Second Circuit Holds that Debtors Are Properly Barred from Receiving PPP Loans

On an issue where the lower courts are divided, the Second Circuit became the first court of appeals to rule that a "loan" under the Paycheck Protection Program, "as a matter of law, . . . is a loan guaranty program and not an 'other similar grant,' and thus is not covered by [the antidiscrimination provision in] Section 525(a)" of the Bankruptcy Code.

In other words, the Small Business Administration properly barred companies in chapter 11 from receiving PPP "loans," according to a March 16 opinion by Circuit Judge Joseph F. Bianco.

The Debtor Wins in Bankruptcy Court

The Paycheck Protection Program, or PPP, was part of the $2.2 trillion Coronavirus Aid, Relief and Economic Security Act (CARES Act), which became law in March 2020. Although denominated as a loan, it will be forgiven if the proceeds are spent on eligible expenses like payroll and rent.

A hospital in Vermont was in chapter 11 and applied for a PPP loan. The Small Business Administration denied the loan solely because the debtor answered "yes" to a question on the loan application asking whether the borrower was in bankruptcy.

The debtor sued the SBA in bankruptcy court, where the judge decided that a PPP "loan" was a "grant" protected by the antidiscrimination provision in Section 525(a). The bankruptcy court granted summary judgment in favor of the debtor and entered a permanent injunction requiring the SBA to make the loan. *Springfield Hospital Inc. v. Carranza (In re Springfield Hospital Inc.)*, 618 B.R. 70 (Bankr. D. Vt. June 22, 2020). To read ABI's report, click here.

The bankruptcy court authorized a direct appeal, which the Second Circuit accepted.

The Circuit Sides with the Majority

In his 53-page opinion, Judge Bianco said that 18 courts to date have ruled that the PPP is not protected by Section 525(a), while six courts have decided that the section requires the SBA to grant loans to businesses in chapter 11.

Principally, Judge Bianco found the answer in the plain language of Section 525(a), which provides:

> [A] governmental unit may not deny . . . a license, permit, charter, franchise, or other similar grant to . . . a person that is or has been a debtor under this title . . . .

A PPP loan was not a license, permit, charter or franchise. Judge Bianco therefore focused on whether it was a "grant," a word not defined in the statute.

Two Second Circuit decisions were controlling: *In re Goldrich*, 771 F.2d 28 (2d Cir. 1985), and *Stoltz v. Brattleboro Hous. Auth. (In re Stoltz)*, 315 F.3d 80, 90 (2d Cir. 2002). In *Goldrich*, the circuit held that Section 525, as it was then written, did not cover a guaranteed student-loan program.

Almost a decade after *Goldrich*, Judge Bianco said that "Congress amended Section 525 to include a subsection prohibiting discrimination against debtor-borrowers by any 'governmental unit that operates a student grant or loan program.' 11 U.S.C. § 525(c)."

In *Stoltz*, the Second Circuit held that a lease for a public housing unit was a "grant" protected by Section 525(a).

Taken together, Judge Bianco said that the two opinions mean that a "grant" is something that is "'unobtainable from the private sector' [and] 'essential to a debtor's fresh start.' *Stoltz v. Brattleboro Hous. Auth. (In re Stoltz)*, 315 F.3d 80, 90 (2d Cir. 2002)."

Judge Bianco said that *Goldrich*, which precluded loans from coverage in Section 525(a), remained good law after *Stoltz.* He said that the amendment to Section 525 "narrowly abrogated *Goldrich*'s specific holding as to *student* loans but had not abrogated its broader holding that Section 525(a) did not cover loans in general." [Emphasis in original.]

"[W]e reaffirm here," Judge Bianco said, "that the plain text of Section 525(a) does not cover loan programs."

PPP 'Loans' Aren't Grants

Even if loans are not protected by Section 525(a), the debtor contended that PPP loans are actually grants.

Judge Bianco disagreed. He said that the CARES Act refers to PPP loans as "loans" 75 times. Furthermore, he said, the forgiveness of PPP loans is "neither automatic nor guaranteed."

Judge Bianco again referred to the dual standards in *Goldrich/Stoltz*. Unlike the refusal to grant a license that would put a company out of business, he said that the refusal of the SBA to grant a loan does not exclude a debtor "from receiving capital from other sources," nor is an SBA loan "essential to a debtor's fresh start."

Subsequent Legislation

Although Judge Bianco found the answer in the plain language of the statute, he said that "the additional PPP legislation enacted after the Cares Act provides further support for our interpretation of Section 525(a)."

In the Consolidated Appropriations Act of 2021, he said,

> Congress amended Section 525 to expressly bar discrimination based on bankruptcy status in the provisioning of certain Cares Act benefits — such as foreclosure moratoriums, 15 U.S.C. § 9056, forbearance of certain residential mortgages, *id.* § 9057, and eviction moratoriums, *id.* § 9058 — but notably did *not* include PPP loans in this amendment. [Emphasis in original.]

Judge Bianco drew a "clear negative inference from this amendment . . . that other provisions of the Cares Act are *not* covered by Section 525(a)." [Emphasis in original.]

Judge Bianco vacated the permanent injunction and remanded with instructions that the SBA was entitled to summary judgment in its favor. However, he did not rule on whether the SBA was "immune from injunctive relief" under Section 634(b)(1) of the Small Business Act.

The opinion is *Guzman v. Springfield Hospital Inc.*, 20-3902 (2d Cir. March 16, 2022).

Circuit Judge Loken predicts the Supreme Court will abolish equitable mootness if the lower courts don't cut back and start reviewing the merits of confirmed chapter 11 plans.

Eighth Circuit Comes Near to Abolishing Equitable Mootness

The Eighth Circuit has come one step short of altogether abolishing the judge-made doctrine of equitable mootness.

Strictly speaking, the appeals court barred dismissal of an appeal from confirmation of a chapter 11 plan without

> at least a preliminary review of the merits of [the appellant's] appeal to determine the strength of [the appellant's] claims, the amount of time that would likely be required to resolve the merits of those claims on an expedited basis, and the equitable remedies available — including possible dismissal — to avoid undermining the plan and thereby harming *third parties*. [Emphasis in original.]

The St. Louis-based court of appeals did ban further use of the term "equitable mootness" in the Eighth Circuit, telling courts instead to say "equitable dismissal."

The Complex, Hard-Fought Chapter 11 Case

The case was a typical blood-and-guts reorganization of a large company. The original start-up capital was $63 million in debt and equity, with further investments down the road. At filing, the first-lien debt was $54 million, more than the assets were worth. The debt was secured by all the assets.

The chapter 11 case began with a $2 million "DIP" loan made by the largest equity holder. It was a so-called priming lien ahead of all other debt. In return for being primed, the first-lien secured lender was given an adequate protection lien.

In addition, the financing order included a so-called challenge deadline requiring the official creditors' committee to raise an objection to the prebankruptcy secured debt before a specified date. In the absence of a timely objection by the *creditors' committee*, the secured debt would be an allowed claim subject to no further challenge or objection.

The official creditors' committee lodged a timely objection, demanding that the debtor initiate an adversary proceeding against the secured lender and the dominant equity holder. The next day, an unofficial, *ad hoc* group of equity holders joined in the creditors' objection.

The creditors' committee reached a settlement on a chapter 11 plan. In return for a dollop of consideration for unsecured creditors, the committee dropped its objection to the secured claim. The bankruptcy court soon after ruled that secured debt was sacrosanct because there had been no timely objection.

Then, one of the smaller equity holders objected to the disclosure statement and to allowance of the secured claim. The bankruptcy court confirmed the plan and denied the objection to the secured claim.

You know what happened next, and quickly. The plan was consummated. Among other things, the dominant equity holder funded the plan with $13.5 million, existing stock was cancelled, cash distributions were made to creditors, and the secured lender received $6 million.

Having objected unsuccessfully to the secured claim, the smaller equity holder appealed the confirmation order, claiming unfair discrimination between creditors of the same class, violation of the absolute priority rule, bad faith, and failure to meet the best interests test.

The district court dismissed the appeal as equitably moot, but the equity holder appealed to the circuit.

Predicting the Demise of Equitable Mootness

In his 16-page opinion on August 5, Circuit Judge James B. Loken reversed and remanded for reconsideration of the merits, at least to a limited extent. His opinion is a "must read" for anyone involved in chapter 11 practice. He wrote a compendium of the best objections to the survival of equitable mootness.

If the doctrine becomes embedded in appellate jurisdiction, "rather than an exception to the Article III-based rule that jurisdiction should be exercised," he "predict[ed] [that] the Supreme Court, having up to now denied petitions for *certiorari* to review the doctrine, will step in and severely curtail – perhaps even abolish – its use, just as the Court curtailed lower courts' excessive use of the '*Rooker-Feldman* doctrine' to avoid difficult claim and issue preclusion analysis."

Insiders Aren't Protected by Equitable Mootness

Judge Loken began his analysis by saying that equitable mootness "is misleading." Consequently, "we banish 'equitable mootness' from the (local) lexicon," he said.

Judge Loken explained that an appeal is "moot, that is, beyond a federal court's Article III jurisdiction, only if 'it is impossible for a court to grant any effectual relief whatsoever,'" quoting *Mission Prod. Holdings Inc. v. Tempnology LLC*, 139 S. Ct. 1652, 1660 (2019).

As for equitable mootness, he said the doctrine has been "adopted by our sister circuits (though not uniformly)." The Eighth Circuit had not taken a position except in a nonprecedential opinion upholding the doctrine without discussion.

Equitable mootness, Judge Loken said, "has been thoughtfully criticized by many judges." He heaped praise on the concurrence by Circuit Judge Cheryl Krause in *In re One2One Communications LLC*, 805 F.3d 428 (3d Cir. 2015), where the Third Circuit reversed an equitable mootness dismissal and remanded for reconsideration of the merits.

Judge Loken quoted Judge Krause as follows:

> [A] motion to dismiss an appeal as equitably moot has become "part of the Plan." Proponents of reorganization plans now rush to implement them so they may avail themselves of an equitable mootness defense, much like Appellees did here. Rather than litigate the merits of an appeal, parties then litigate equitable mootness. And even if an appeal is dismissed as equitably moot by a district court, that dismissal is appealed to our Court, often resulting, in turn, in a remand and further proceedings . . . . Without the equitable mootness doctrine, on the other hand, the District Court would have ruled on the merits long ago. *Id*. at 446-7.

In the case before him, Judge Loken said that half of the cash distribution went to the secured lender whose lien was being challenged by the minority shareholder. The lender and the plan sponsor, he said, "are not third parties that the equitable mootness doctrine is intended to protect."

Again quoting Judge Krause, Judge Loken said that the case on appeal dealt with complex questions like compliance with cramdown provisions and claims of conflict of interest or preferential treatment "that go to the very integrity of the bankruptcy process." *Id*. at 454. The appeal before him, Judge Loken said, "takes on the look of the type of Chapter 11 plan that Judge Krause defined as one needing review on the merits by an Article III appellate court."

Judge Loken reversed on equitable mootness and remanded. He did not tell the district court how to rule on the merits of the plan, saying that we only "decide that the inquiry must be made."

However, Judge Loken did say that "if the confirmed plan must be set aside on the merits, the district court may be able to fashion effective relief for those whose rights were impaired by the

plan even if the business assets have been sold to a third party purchaser relying on the confirmed plan, such as disgorgement of the proceeds."

Observations

Judge Loken seems to require that appellate courts take four steps on appeal from confirmation of a chapter 11 plan: The appellate court must (1) accelerate the appeal; (2) undertake a preliminary review of the objections to confirmation; (3) decide how long it would take to resolve the merits of the appeal on an expedited basis; and (4) evaluate available remedies that would not harm third parties.

The opinion could mean that parties central to the reorganization, including plan sponsors and major secured creditors, are not entitled to protection by equitable dismissal. The doctrine in the Eighth Circuit seems to protect only true third parties not involved in maneuvering to confirm the plan.

The opinion will have its effects. Sad to say, the Eighth Circuit may take on a stigma worse than those (increasingly fewer) circuits proscribing non-debtor, third-party releases.

The divergence among the circuits on equitable mootness is good reason for the Supreme Court to grant *certiorari* in the next term and resolve the issue once and for all. As it stands now, many of the most consequential questions about chapter 11 plans defy appellate review on authority of equitable mootness.

The two petitions now before the Court on equitable mootness are *GLM DWF Inc. v. Windstream Holdings Inc.*, 21-78 (Sup. Ct.); and *Hargreaves v. Nuverra Environmental Solutions Inc.*, 21-17 (Sup. Ct.). Click here to read yesterday's Rochelle's Daily Wire regarding the *certiorari* petitions.

The opinion is *FishDish LLP v. VeroBlue Farms USA Inc. (In re VeroBlue Farms USA Inc.)*, 19-3413, 2021 BL 294741, 2021 Us App Lexis 23164 (8th Cir. Aug. 5, 2021).

Although Section 1141(d)(1) sets a default rule only discharging claims that arose before confirmation, Circuit Judge Ambro says that a plan may alter the default rule and allow discharge of administrative claims arising after confirmation.

Chapter 11 Plans May Discharge Post-Confirmation 'Admin' Claims, Third Circuit Says

The first among the courts of appeals to rule on the issue, the Third Circuit held that an administrative claim arising between confirmation and the effective date of a chapter 11 plan must be filed before the administrative bar date to avoid being discharged.

In his August 30 opinion, Circuit Judge Thomas L. Ambro said that "holders of post-confirmation, pre-effective date administrative expense claims are bound by a bar date like other holders of claims against the estate, and thus they cannot choose to bypass the bankruptcy process altogether."

The result, Judge Ambro said, is "supported by [the] principal purpose of granting the debtor a fresh start." A debtor "still needs comfort [that] administrative expense claims will not come out of the woods later to assert them against the reorganized debtor."

The Plan and the 'Admin' Claim

The corporate debtor confirmed a chapter 11 plan. The plan said that administrative expense claims must be filed before a specified date, which we shall refer to as the "admin bar date." Naturally, the plan also said that all claims would be discharged on the effective date of the plan.

One of the debtor's executives was fired two months after confirmation. The firing took place two months before the plan became effective and about three months before the admin bar date.

The effective date of the plan had been delayed given the need for governmental regulatory approvals. The debtor said it had given the executive notice of the admin bar date. The executive had also received notices about the general bar date and the deadlines for voting and objecting to confirmation.

After being fired, the 67-year-old executive immediately hired a lawyer, believing that his firing was the result of age discrimination. He filed a complaint with the Equal Employment

Opportunity Commission before the admin bar date. He filed suit in federal district court about two months after the admin bar date. The plan's effective date occurred about two months after the executive was fired. He did not file an administrative claim before or after the admin bar date.

The debtor filed a motion for summary judgment in district court, contending that the claim was discharged because the executive had not filed a claim in bankruptcy court before the admin bar date. The district court denied the debtor's motion but granted the executive's motion for summary judgment, holding that Section 503 does not authorize a bar date to discharge post-confirmation administrative claims.

The district court also held that Section 1141(d) prohibits the discharge of post-confirmation claims.

The district court authorized an interlocutory appeal, which the Third Circuit accepted.

Plans May Alter the Default Rule in Section 1141(d)(1)

Methodically, Judge Ambro dissected the issues leading to his conclusion that the plan discharged post-confirmation-but-pre-effective-date administrative claims. First, he addressed the question of whether a post-confirmation claim is an administrative expense of the chapter 11 case.

The district court had held that the claim was an administrative expense but was not discharged. Judge Ambro found no textual support for the holding. He said that a "claim is either an administrative expense claim or it is not; it cannot be a chameleon."

Judge Ambro went on to say:

> [T]he District Court's position that the claim is entitled to administrative priority, but not subject to discharge, is untenable, as that would allow creditors to cherry-pick whether they want to recover from the estate or the reorganized debtor.

Recognizing that the chapter 11 estate was still in existence when the claim arose, Judge Ambro held that the "claim is thus an administrative expense claim under § 503 and subject to the Administrative Claims Bar Date."

Citing the *Collier* treatise, Judge Ambro next held that Section 503 authorizes bankruptcy courts to set and enforce bar dates for administrative expense claims. He said that bar dates for administrative claims "help the debtors know their liabilities and implement a viable plan to obtain a fresh start."

Judge Ambro turned to the question of whether Section 503 permits courts to discharge post-confirmation administrative claims. In that regard, the district court had held that a bankruptcy court cannot set a bar date for post-confirmation administrative claims.

Judge Ambro said that "Section 503 recognizes no such limitation, and we generally refrain from adding words to a statute." He said that Section 503 works in tandem with Section 1141(d) by allowing bankruptcy courts "to set and enforce bar dates," while Section 1141(d) allows the plan and a confirmation order "to govern the discharge of claims (with a few exceptions)."

Last, Judge Ambro held that Section 1141(d) does not prohibit the discharge of post-confirmation claims." Rather, it sets a default rule "that can be overridden by the plan and confirmation order."

The district court had held that Section 1141(d)(1) precludes the discharge of post-confirmation claims. The section says:

> Except as otherwise provided in this subsection, in the plan, or in the order confirming the plan, the confirmation of a plan —
>
> (A) discharges the debtor from any debt that arose before the date of such confirmation, and any debt of a kind specified in section 502(g),502(h), or 502(i) of this title . . . ; and
>
> (B) terminates all rights and interests of equity security holders and general partners provided for by the plan.

Disagreeing with the district court, Judge Ambro read the section as creating

> a default rule for discharging pre-confirmation debts, meaning it applies only when the plan and confirmation order are silent on the issue. Here the Plan provided for the discharge of postconfirmation claims not timely filed by the Administrative Claims Bar Date. This overrides the default rule in § 1141(d)(1).

Judge Ambro reversed the district court but said that the decision would not prevent the executive from asking the bankruptcy court to accept a late-filed claim for cause under Section 503(a).

The opinion is *Westinghouse Electric Co. LLC v. Ellis*, 20-2867, 2021 BL 326588, 2021 Us App Lexis 26092 (3d Cir. Aug. 30, 2021).

The Third Circuit made more rules to decide whether an insurance company can be insulated from failure-to-warn claims by the channeling injunction in a chapter 11 'asbestos' plan.

Third Circuit Makes More Rules on the Proper Scope of Asbestos Channeling Injunctions

For a second time in three years, the Third Circuit declined to rule on whether an insurance company is protected by the so-called channeling injunction in the "asbestos" plan confirmed by W.R. Grace & Co. 10 years ago, in a chapter 11 reorganization begun 20 years ago.

Simplified, the September 15 opinion by Circuit Judge Julio M. Fuentes remanded the case for the bankruptcy judge to decide as a fact-finding matter whether providing workplace inspections was an obligation imposed on the insurance company by the insurance policies. If the services weren't required by the policies, the insurance company was not protected by Grace's chapter 11 plan and must face lawsuits lodged by workers at the company's asbestos mine.

Warning: Only asbestos mavens should read this story. For anyone else, it'll induce a fatal attack of narcolepsy.

The Prior Appeal

The Grace plan created a trust to pay asbestos claims and contained a channeling injunction protecting both the debtor and its insurers under Section 524(g).

In a decision three years ago, Third Circuit Judge Thomas L. Ambro described a channeling injunction as one "that channels [asbestos] liability to a trust set up to compensate persons injured by the debtor's asbestos." He said it "can also protect the interests of non-debtors, such as insurers." *In re W.R. Grace & Co.*, 900 F.3d 126, 129 (3d Cir. 2018). To read ABI's report on the prior decision, click here.

Giving rise to the prior appeal and the new one, asbestos claimants had sued an insurance company that provided Grace with workers' compensation and employers' liability coverage, based on the insurer's right but not obligation to inspect the company's facilities.

After the plaintiffs sued in Montana state court, the insurance company sought a declaratory judgment in bankruptcy court in Delaware. The bankruptcy court granted the insurer's motion for

summary judgment and ruled that the channeling injunction enjoined the plaintiffs from suing the insurance company.

On the prior appeal, Judge Ambro upheld the bankruptcy court's conclusion that the insurance company's policies were covered by the channeling injunction. However, that wasn't the end of the story, because a channeling injunction can go no further than Section 524(g) allows in protecting non-debtor third parties.

Judge Ambro remanded the case to the bankruptcy court to decide whether the injunction exceeded the limits laid down by Section 524(g).

Citing Section 524(g)(4)(A)(ii) and providing guidance for the bankruptcy court on remand, Judge Ambro said that the claims must arise "'by reason of' one of four statutory relationships between the third party and the debtor" before a channeling injunction can protect a third party. *Id*. at 135. Judge Ambro examined two of the four.

First, Judge Ambro examined whether the Montana claimants were seeking to hold the insurance company "directly or indirectly liable for the conduct of, claims against, or demands on" Grace, as specified in Section 524(g)(4)(A)(ii). He said that the statute limits the permissible scope of the injunction to claims based on derivative liability, meaning that the insurance company's liability must "arise by reason of" the provision of insurance to Grace.

Judge Ambro remanded the case to the bankruptcy court, saying that the "proper inquiry is to review the law applicable to the claim being raised against the third party (and when necessary to interpret state law) to determine whether the third-party's liability is wholly separate from the debtor's liability or instead depends on it." *Id*. at 137.

Next, Judge Ambro analyzed the so-called statutory relationship requirement, also in Section 524(g)(4)(A)(ii). He remanded the case for the bankruptcy judge to review "the applicable law to determine the relationship's legal relevance to the third-party's alleged liability." *Id*. at 138. He said that the bankruptcy court should "examine the elements necessary to make [a claim under Montana law] and determine whether [the] provision of insurance to Grace is relevant legally to these elements." *Id*.

The Decision Remand

On remand, the plaintiffs contended that the insurers were negligent and failed to warn about the dangers of exposure to asbestos. In substance, the bankruptcy judge concluded that the negligence and failure-to-warn claims were not derivative in nature and were therefore not subject to the channeling injunction.

The bankruptcy judge authorized the plaintiffs to continue litigation against the insurers in Montana state court. *Continental Casualty Co. v. Carr (In re W.R. Grace & Co.)*, 607 B.R. 419 (Bankr. D. Del. Sept 23, 2019). To read ABI's report, click here.

Naturally, the insurance company appealed. The case was heard by a different panel.

Ruling on the new appeal, Judge Fuentes said that the bankruptcy court had "misapplied our guidance." Like the bankruptcy court, he held that the plaintiffs' claims meet the "derivative liability requirement," but the record did not permit the circuit court to decide whether the claims "meet the statutory relationship requirement."

He was careful to say that the bankruptcy court is not required to decide the state-law claims on the merits.

Derivative Liability Requirement

The outcome of the appeal turned on Montana law, which, in turn, follows Section 324A of the Restatement (Second) of Torts, dealing with liability to third persons other than the intended beneficiary of the contractual undertaking. In short, the insurance company's liability under the Restatement turns on whether its liability is dependent on Grace's liability or wholly separate from it.

It was "indisputable," Judge Fuentes said, that the injuries were caused by Grace's conduct. Therefore, the insurance company's liability was not "wholly independent" of Grace's.

Judge Fuentes therefore agreed with the bankruptcy court that the circumstances met the derivative liability requirement.

But there's more.

Statutory Relationship

With regard to Section 324(g)'s requirement of a statutory relationship, the bankruptcy court decided that the requirement was not satisfied because providing insurance to Grace had no relevance to the insurance company's liability under the Restatement or state law.

Judge Fuentes disagreed. He said:

> [T]he appropriate question is whether the Montana Plaintiffs have made a prima facie case that [the] provision of insurance was legally relevant to [the insurance company's] allegedly negligent undertaking of industrial hygiene and medical monitoring services. Or, put another way, whether they have shown that the

> services allegedly provided by [the insurance company] were incidental to its provision of insurance.

Judge Fuentes had a narrower understanding of Montana law than the insurance company. State law, he said, only requires that the insurance company affirmatively undertook to render services to a third party and that it should have recognized that the services were necessary for the protection of others.

"In other words," Judge Fuentes said, the Restatement "is unconcerned with why [the insurance company] undertook to render services; only that it did so."

The record, Judge Fuentes said, did not show whether the services provided by the insurance company were "within the scope of its provision of services to Grace." There was no evidence, he said, as to whether inspections or loss-control recommendations are generally central to insurance underwriting and risk management. Likewise, the appeals court did not know whether "industrial-hygiene services of the type" were standard insurance-related services.

Even if the circuit court knew the industry standard, Judge Fuentes said that the record did not show whether the services were within the scope of the Grace policies. In that regard, the appeals court only had the policy that said that the insurance company was permitted, but not obligated, to inspect the facilities.

Judge Fuentes remanded for the bankruptcy court to make factual findings "as to what services were included in [the] provision of insurance to Grace, and whether the Montana Plaintiffs have made a prima facie showing under Montana law that [the insurance company] provided services beyond these."

If the insurance company provided services beyond the policy, Judge Fuentes said that "the Montana Claims do not meet the statutory relationship requirement; if not, however, then the claims at issue meet all of the requirements of § 524(g) and are barred by the channeling injunction."

After remand, Judge Fuentes said that the panel "will retain jurisdiction over any future appeals."

The opinion is *Continental Casualty Co. v. Carr (In re W.R. Grace & Co.)*, 20-2171 (3d Cir. Sept. 15, 2021).

Maryland district judge predicts that the Fourth Circuit would adopt a debtor-friendly rule more broadly discharging environmental claims when the acts occurred before chapter 11.

Fourth Circuit Would Discharge CERCLA Claims if Pollution Occurred Before Filing

Predicting how the Fourth Circuit would rule at the intersection of environmental and bankruptcy law, District Judge Stephanie A. Gallagher of Baltimore held that claims for environmental pollution are discharged if the pollution occurred before the chapter 11 filing.

In her October 12 opinion, Judge Gallagher said that environmental claims are discharged even if response costs were not incurred until after bankruptcy and even if the debtor was not identified as a potentially responsible party until after bankruptcy.

The opinion is notable for Judge Gallagher's succinct summary of the three approaches courts have taken to decide whether environmental liabilities are discharged in bankruptcy. Under at least one of the theories, the debt would not have been discharged.

CERCLA Response Costs Incurred After Discharge

The facts were straightforward and typical of many environmental claims arising in bankruptcy under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980, or CERCLA.

Between the 1950s and the early 1970s, the corporate debtor deposited hazardous chemicals in a landfill. The debtor filed a chapter 11 petition in 1992 and confirmed a chapter 11 plan the same year.

The U.S. Environmental Protection Agency gave notice in 1999 to potentially responsible parties, or PRPs. The debtor had not been identified as a PRP before bankruptcy.

In 2017, the EPA entered into a consent decree with some of the PRPs, whom we shall refer to as the settling defendants. The settling defendants did not begin incurring response costs until 2006.

In Judge Gallagher's court, the settling defendants sued the debtor in 2000 for its share of the response costs incurred under the consent decree. The debtor filed a motion for summary

judgment, contending that the 1992 chapter 11 discharge cut off liability. The settling defendants argued that the debt was not discharged because they had not begun incurring response costs until 14 years after discharge.

Judge Gallagher agreed with the debtor, granted the motion and dismissed.

'Conduct' Test Discharges CERCLA Claims

Because the claim against the debtor was for contribution, Judge Gallagher said that the debtor's liability would depend on when both the debtor and the settling defendants became liable to the government. In turn, the discharge of the CERCLA claims would depend on when the claims "arose."

Two policies were at odds, Judge Gallagher said. Bankruptcy aims to give the debtor a "fresh start," while CERCLA "casts a broad net" of liability to clean up hazardous waste.

Circuits have taken different approaches in deciding whether bankruptcy discharges a CERCLA claim.

Sporting a narrow interpretation of a "claim," the "right to payment" approach "prioritizes" CERCLA, Judge Gallagher said, and is "the least deferential" to bankruptcy law.

In the Third Circuit, the right-to-payment approach discharges environmental liability only if all four CERCLA elements existed before bankruptcy. One of the elements had not been met because the debtor had not been identified as a PRP before bankruptcy.

The debtor's liability would not have been discharged if the right-to-payment standard applied. However, Judge Gallagher said that the "right to payment approach has come under criticism for subjugating bankruptcy law and, thus, undermining the goals of bankruptcy."

Although not in CERCLA cases, Judge Gallagher said that the Fourth Circuit employs the "underlying acts" or "conduct" approach, which says that a claim exists if the underlying acts occurred before bankruptcy, citing *Grady v. A.H. Robins Co., Inc.*, 839 F.2d 198 (4th Cir. 1988), and *Holcombe v. US Airways, Inc.*, 369 F. Appx. 424 (4th Cir. 2010).

Judge Gallagher said that the "underlying acts" standard "respects the intent of the Bankruptcy Code," which defines "claim" more broadly than the traditional cause of action, no matter how distant or contingent. She acknowledged that the test "has been criticized for undermining CERCLA's goal of polluter accountability, which would be rendered ineffectual if polluters could evade response costs and action obligations by filing for bankruptcy before EPA became aware of their polluting."

Judge Gallagher saw herself bound by Fourth Circuit precedent to apply the "more debtor-friendly 'underlying acts' or 'conduct' approach." She granted the motion for summary judgment and dismissed the suit because the debts had been discharged since the underlying acts took place before bankruptcy.

A Third Approach

In a footnote at the end of the opinion, Judge Gallagher mentioned that some courts "in recent years" employed a third approach known as the "fair contemplation" test. She said it "attempts to strike a middle ground between the competing objectives of CERCLA and the Bankruptcy Code by" having claims arise when all future response costs resulting from prepetition conduct can be fairly contemplated.

Whatever the merits of the third standard, Judge Gallagher said it "contravenes existing Fourth Circuit precedent in the bankruptcy context."

The opinion is *68th Street Site Work Group v. Airgas Inc.*, 20-3385 (D. Md. Oct. 12, 2021).

The appeals court barred the holder of a personal guarantee from launching a collateral attack on a confirmed chapter 11 plan.

Reducing a Personal Guarantee Under a Plan Isn't a Discharge, Fifth Circuit Says

Although the Fifth Circuit is among the most restrictive courts of appeals when it comes to non-debtor, third-party releases, the New Orleans-based court once again held that a chapter 11 plan can reduce the amount of a non-debtor guarantor's liability to a creditor.

A couple owned a corporation that operated a grocery store. The couple owned the real estate occupied by the grocery store. The store borrowed $325,000. The couple personally guaranteed the debt and secured the debt with a mortgage on the store and a mortgage on their home.

The grocery store filed a chapter 11 petition and confirmed a plan that called for surrendering the store and its contents to the lender in return for a $225,000 reduction in the couple's debt on their personal guarantee. The lender had an unsecured claim for the $100,000 deficiency.

After confirmation, the lender evidently decided that the store was not worth $225,000. The lender apparently believed it would have a larger recovery by asserting a claim against the couple for the entire $325,000.

So, the lender began foreclosure proceedings against the couple's home. The couple filed their own chapter 11 petition in response.

Overruling the lender's objection, the bankruptcy court confirmed the couple's chapter 11 plan and held that their debt to the lender had been reduced to $100,000. The district court affirmed, ruling that the lender could not relitigate the debt that had been reduced to $100,000 in the grocery store's confirmed chapter 11 plan.

Circuit Judge Gregg Costa affirmed once again in an opinion on November 12.

According to Judge Costa, the grocery store's plan lifted the automatic stay by allowing the lender to foreclose. He found no provision in the plan conditioning the reduction in the guarantee on the lender's taking title to the store, either by foreclosure or voluntary transfer.

Judge Costa said that the lender could not "upend the arrangement by ignoring the [store's] obligation and going after the [couple] for the entire debt."

Even so, the lender argued in the circuit court that Section 524(e) barred the couple from using the grocery store's plan to reduce their obligations on the guarantee. The section provides that the "discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt."

Citing two earlier decisions by the Fifth Circuit, Judge Costa responded by saying:

> But discharge is not the issue here. The [grocery store's] bankruptcy plan does not discharge the [debt to the lender] or the [the couple's] obligations under it . . . . [A] partial release of liability for the secured portion of the debt is not a discharge.

To understand the principle, Judge Costa said, "imagine that the bankruptcy court had ordered the [grocery store] to turn over cash instead of real estate." If the lender had received cash, he said, "No one would view an order requiring the [the grocery store's] estate to pay [the lender] $250,000 in cash as eliminating a guaranty."

Judge Costa held that a "bankruptcy plan, then, can limit a creditor's claim against third-party guarantors — not by discharging the guaranty but by determining the source and value of payments satisfying the guaranteed debt."

Judge Costa buttressed his conclusion by alluding to the preclusive effect of the grocery store's chapter 11 plan under Section 1141(a), which says that "the provisions of a confirmed plan bind the debtor . . . and any creditor . . . whether or not . . . such creditor . . . has accepted the plan."

Judge Costa quoted the *Collier* treatise, which says Section 1141(a), like *res judicata*, "precludes parties from raising claims or issues that they could have or should have raised before confirmation." 8 *Collier on Bankruptcy* § 1141.02 (16th ed. 2021).

Had there been a post-confirmation default by the grocery store under its plan, Judge Costa said that the default "would not void the credit but would instead give rise to a new and separate claim against the [the grocery store] for noncompliance with the plan."

Judge Costa upheld the judgment, calling the lender's theory "a collateral attack on the [grocery store's] bankruptcy plan's disposition of the secured debt."

The opinion is *New Falls Corp. v. LaHaye (In re LaHaye)*, 19-30795 (5th Cir. Nov. 12, 2021).

The Eleventh Circuit has two standards for non-debtor releases: One for free-standing settlements and another for releases engrafted into chapter 11 reorganization plans.

Eleventh Circuit Differentiates the Two Standards for Approval of Non-Debtor Releases

The Eleventh Circuit has two standards for approval of non-debtor, third-party releases. In a nonprecedential opinion on November 5, the appeals court explained why one applies to chapter 11 reorganizations and the other to settlements.

One company acquired another. After the acquisition, the buyer discovered that officers of the seller had misappropriated about $2 million. Both companies later ended up in chapter 11 with a creditors' committee.

The two companies, the committee and the defendants worked out a settlement, which included a bar order, as the appeals court called it. The bar order prevented anyone from suing the defendants.

The buyer's dominant shareholder unsuccessfully objected to the settlement and appealed. The district court affirmed. In the Eleventh Circuit, the shareholder contended that the bankruptcy court had applied the wrong standard for imposing a bar order.

Twenty years apart, the Eleventh Circuit wrote two opinions laying out standards for approval of bar orders. *See In re Munford*, 97 F.3d 449 (11th Cir. 1996); and *In re Seaside Engineering & Surveying, Inc.*, 780 F.3d 1070 (11th Cir. 2015). In both cases, the corporate debtors were in chapter 11.

In *Munford*, the bankruptcy court approved a bar order included in settlement of an adversary proceeding. The November 5 *per curiam* opinion explained how the panel in *Munford* approved the bar order as "necessary because at least one of the [defendants] 'would not have entered into the settlement agreement' without it, and as such, it was 'integral' to the settlement." *Munford, supra*, 97 F.3d at 455.

In *Seaside*, the debtor proposed a chapter 11 plan to reorganize and continue operating. The plan included a bar order precluding lawsuits against company officers "related to or arising out of the bankruptcy."

The panel in the November 5 opinion said that *Seaside* approved the bar order "because it was deemed necessary for the reorganized entity to succeed." *Seaside, supra*, 780 F.3d. at 1077. The panel in 2015 said that failing to prevent "claims against non-debtors . . . would undermine the operations of, and doom the possibility of success for, the reorganized entity." *Id*.

The November 5 opinion said that *Munford* and *Seaside* presented "non-comparable bar orders." The fact that they both arose in chapter 11 cases was "non-determinative." To decide which precedent to apply, the court must review the "context and facts underlying the bar order."

Munford, the circuit said, applies "to bar orders assessed in the settlement context." They are "appropriate where the parties would not have entered into a settlement agreement without it, and thus it is 'integral' to the settlement."

Seaside is applicable "to bar orders that are specifically within the reorganization context" and are proper in "unusual cases in which such an order is necessary for the success of the reorganization." *Seaside, supra*, 780 F.3d at 1078–1079.

The panel decided that the case on appeal was "more like *Munford*" because "the Bar Order under review was integral to settlement." The appeals court said that the bar order was not intended "to ensure success for a reorganized entity by eliminating liability," because neither corporate debtor "sought to reorganize and continue operations."

Instead, the bar order was adopted "to facilitate a settlement agreement."

The circuit affirmed because the bankruptcy court had not abused its discretion in applying the *Munford* factors.

The opinion is *Markland v. Davis (In re Centro Group LLC)*, 21-11364 (11th Cir. Nov. 5, 2021).

Although averse to third-party releases in chapter 11 plans, the Fifth Circuit will allow bankruptcy courts to enforce releases given by one third party to another.

Consent Orders Strictly Enforced in the Fifth Circuit, Even if the Result Is Unreasonable

The Fifth Circuit teaches us to beware of negotiated consent orders. Without regard to the intent of the parties, a consent order will be interpreted strictly according to its terms, just like a contract, even if it produces an arguably "unreasonable result."

The appeals court's February 9 opinion also attests to the power of a bankruptcy court over noncore matters when the parties consented.

The Broadly Worded Consent Order

A creditor was a party to a contract with the debtor. Before bankruptcy, the creditor and the debtor were asserting claims against one another in state court. The debtor filed a chapter 11 petition, halting the suit in state court.

In bankruptcy, the debtor sold its assets to the secured lender, including the debtor's claims against the creditor in state court. To some extent, both the lender and the creditor wanted the suit to proceed in state court. Entered by the bankruptcy court, a consent order negotiated among the parties modified the automatic stay and provided the following:

- In state court, the creditor could liquidate its claims against the debtor for the purpose of exercising its rights of setoff and recoupment;
- If the creditor were to obtain a judgment in excess of the debtor's claims, the excess could only be enforced by a proof of claim in the bankruptcy case; and
- The creditor could recover "*no money damages*" *from the lender* "*under any circumstances* on account of any claims that have been or could have been asserted in" state court. [Emphasis added.]

With the benefit of hindsight, the creditor came to realize that the italicized language in the agreed order was too broad. Here's why:

In discovery in state court, the creditor learned that the lender allegedly directed the debtor to breach the contract with the creditor. The creditor then sought leave from the state court to assert new claims against both the debtor and the lender.

Trumpeting the agreed order, the lender moved in bankruptcy court to bar the creditor from asserting any direct claims against the lender. Bankruptcy Judge Harlan D. Hale of Dallas sided with the lender and interpreted the agreed order as barring the creditor from asserting any claims in state court against the lender.

Later, the creditor filed a motion in bankruptcy court under Rules 60(b)(4) and (b)(6), contending that the bankruptcy court lacked jurisdiction to enter an order barring one nondebtor (the creditor) from suing another nondebtor (the lender). Bankruptcy Judge Hale found that he had jurisdiction and denied the motion for reconsideration because the language in the lift-stay order had been negotiated among the parties.

The district court affirmed, prompting the creditor to appeal unsuccessfully to the circuit court.

The Bankruptcy Court's Jurisdiction

In his February 9 opinion, Circuit Judge Patrick E. Higginbotham first addressed the jurisdiction and power of the bankruptcy court to enjoin one nondebtor from suing another nondebtor. Odds would have seemed to favor reversal, because the Fifth Circuit is one of three circuits commonly understood as prohibiting nonconsensual, third-party releases in chapter 11 plans. *See Bank of N.Y. Trust Co. v. Official Unsecured Creditors' Comm. (In re Pacific Lumber Co.),* 584 F.3d 229 (5th Cir. 2009).

Making no analogy to chapter 11, Judge Higginbotham did not depart from established law closer to home. He quickly concluded that a claim by the creditor against the lender could "conceivably" affect the bankruptcy estate, thus conferring "related to" jurisdiction.

Even given jurisdiction, the constitutional power of the bankruptcy court was another question, because the claims by one nondebtor against another were noncore.

Without hesitation, Judge Higginbotham concluded that the lender and the creditor had "knowingly and voluntarily consented to the bankruptcy court's jurisdiction over the claims in the California Action." He said,

> The parties agreed to the language of the [consent order] and presented it to the bankruptcy court, which then entered the proposed order. The parties having thus consented, the bankruptcy court had jurisdiction to hear and enter appropriate orders related to the proceedings surrounding the entry of the Lift Stay Order.

With jurisdiction and constitutional power to enter the consent order, Judge Higginbotham said that the bankruptcy court "retained jurisdiction to interpret and enforce its orders."

Interpreting a Consent Order

Referring to the motion for rehearing that the bankruptcy court denied, the creditor argued that the court ignored the parties' intent and "surrounding circumstances" to "produce an unreasonable result."

Given that the consent order was negotiated and drafted by the parties, Judge Higginbotham approached interpretation as matter of contract law. He said,

> Where a contract's terms are unambiguous, it must be enforced irrespective of the parties' subjective intent; the same applies to an unambiguous court order such as the [consent order].

Judge Higginbotham said that the consent order "unambiguously conditioned" stay modification by ordering that the creditor could obtain "no money damages . . . of any kind" from the lender. Reliance on "subjective intent" was "unavailing," and references to the circumstances were "also irrelevant when interpreting an unambiguous consent order."

The lesson to be learned: Be careful when negotiating consent orders. They will be interpreted strictly in accordance with the plain language.

The opinion is *VSP Labs Inc. v. Hillair Capital Investments LP (In re PFO Global Inc.)*, 20-10885 (5th Cir. Feb. 9, 2022).

Reversing the bankruptcy court, a district judge in New York held that a civil penalty wasn't discharged even though the fraud wasn't committed against the government.

Civil Penalties for Defrauding Consumers Weren't Discharged

Reversing the bankruptcy court while expounding and expanding on the Supreme Court's *Cohen* decision, District Judge Paul A. Engelmayer of New York ruled that a civil penalty imposed by the Federal Communications Commission for defrauding consumers is not discharged in a corporate debtor's chapter 11 case under Section 1141(d)(6)(A).

In *Cohen v. de la Cruz*, 523 U.S. 213 (1998), the Supreme Court held that treble damages and attorneys' fees imposed against a bankrupt landlord in favor of tenants under state law for actual fraud in charging excess rent were not dischargeable under Section 523(a)(2)(A), even though the treble damages were in excess of the actual damages sustained by the tenants.

The case before Judge Engelmayer was different from *Cohen* in that the government had not been defrauded, whereas the tenants in *Cohen* had been.

The Defrauded Customers and the Government Fine

The debtor was a telecommunications provider that entered into a consent decree with the Federal Communications Commission before bankruptcy. The debtor had made misrepresentations to consumers in marketing calls and placed unauthorized charges on customers' bills.

The consent decree called for the debtor to issue $1.9 million in refunds to customers and pay a $4.2 million civil penalty to the FCC over five years. By the time the debtor filed in chapter 11, the debtor had paid its customers, but not $2.1 million of the fine to the FCC.

The government filed an adversary proceeding to declare that the $2.1 million remaining to be paid on the civil fine was not dischargeable under Section 1141(d)(6)(A). The bankruptcy judge ruled that the remaining fine was dischargeable. *U.S. v. Fusion Connect Inc. (In re Fusion Connect Inc.)*, 617 B.R. 36 (Bankr. S.D.N.Y. June 9, 2020). To read ABI's report, click here.

The government appealed and won in a September 2 opinion by Judge Engelmayer.

The Controlling Statutes

Two statutes were controlling: Sections 523(a)(2)(A) and 1141(d)(6)(A).

Section 523(a)(2)(A) bars discharge of a debt "obtained by . . . false pretenses, a false representation, or actual fraud," but it applies only to individual debtors.

To prevent corporate debtors from filing in chapter 11 to discharge debts owing to the government for fraud, the so-called BAPCPA amendments in 2005 added Section 1141(d)(6)(A). Now, confirmation in chapter 11 does not discharge a corporate debtor from "any debt . . . of a kind specified in paragraph (2)(A) or (2)(B) of section 523(a) that is owed to a domestic governmental unit . . . ."

The debtor had several arguments to say that the fine was dischargeable: No fraud was committed against the government; the debtor made no misrepresentations to the government; the victims of the fraud had been made whole; and the fine would not fall under the definition of a common law fraud.

Judge Engelmayer knocked down the arguments in his 27-page opinion.

Cohen Controls

Like the bankruptcy court, Judge Engelmayer began with *Cohen*, but unlike the bankruptcy court, he didn't go much further.

He addressed two questions: Was the fine a "debt," and was it "obtained by" fraud?

Judge Engelmayer said that "*Cohen* underscored the breadth of the debts that Section 523(a)(2)(A) exempts from discharge." Regarding whether the treble damages were a "debt," he quoted the Supreme Court for saying that treble damages and attorneys' fees "fell within the scope of 'any debt'" for money or property that was fraudulently obtained. *Cohen*, *supra*, 523 U.S. at 218.

Cohen also held that the treble damages and attorneys' fees were "obtained by" fraud.

To define the broad scope of Section 523(a)(2)(A), Judge Engelmayer quoted the Supreme Court for saying that the section "prevents the discharge of all liability arising from fraud." *Id*. at 215.

To plug a hole, Congress adopted Section 1141(d)(6)(A) seven years after *Cohen*. He said that Cohen's "broad" construction of Section 523(a)(2)(A) "necessarily governs the construction of Section 1141(d)(6)(A)."

Focusing on Section 1141(d)(6)(A), Judge Engelmayer noted that *Cohen* involved non-compensatory treble damages and attorneys' fees, while the appeal before him entailed non-compensatory civil penalties imposed by a governmental unit that was not a victim of fraud.

Following the direction shown by *Cohen*, Judge Engelmayer easily concluded that the civil fine was a debt resulting from money "obtained by fraud." In that regard, he cited *Cohen* for saying that the debt itself need not be obtained by fraud, so long as it was traceable to fraud. *Id*. at 218-221.

Non-Statutory Arguments Fail

The debtor contended that the fine should be dischargeable because it did not contain the common law elements of fraud.

Judge Engelmayer countered by saying that the customers suffered from "actual fraud."

Next, the debtor argued that the fraud was not directed against the government.

"Neither the statutory text nor the case law construing Section 523(a)(2)(A), however, requires that the common law elements of fraud must be met both as to the fraud and as to the creditor holding a debt arising from the fraud," Judge Engelmayer said. He cited two bankruptcy courts for holding that judgments in favor of the government were nondischargeable when the common law elements of fraud were shown in fraud foisted on consumers.

To buttress his conclusion, Judge Engelmayer cited the Third and Eleventh Circuits for holding that disgorgement judgments obtained by the Securities and Exchange Commission were not discharged, although the fraud had not been directed against the SEC.

The debtor argued that dischargeability should be judged by Section 523(a)(7), which bars an individual from discharging fines and penalties assessed by the government that are not compensation for actual pecuniary loss. Since it was not an individual, the debtor contended that the debt should be discharged.

Judge Engelmayer disagreed. Some overlap happens in statutes, he said

Finally, Judge Engelmayer said that the debtor's policy arguments were "unusually unpersuasive." Allowing a corporate debtor "to shed a regulatory fraud penalty in this manner could invite mischief." He reversed and remanded.

The opinion is *U.S. v. Fusion Connect Inc. (In re Fusion Connect Inc.)*, 20-5798, 2021 BL 333387 (S.D.N.Y. Sept. 2, 2021).

Subordination agreement did not transfer voting rights, but prudential standing nevertheless barred the subordinated creditor from participating in confirmation, Judge Somers says.

Deeply Subordinated Creditor Barred from Voting or Objecting to Plan Confirmation

A deeply subordinated creditor may neither vote on a chapter 11 plan nor object to confirmation if the creditor has no chance of receiving a distribution in either chapter 11 or chapter 7, according to Chief Bankruptcy Judge Dale L. Somers of Topeka, Kan.

The opinion could be read broadly to mean that an underwater creditor is barred by the doctrine of prudential standing from voting on a plan. Other courts may view the holding as applicable only to creditors who are deeply subordinated by contract.

The Debtor's Capital Structure

The corporate debtor's principal creditor was a bank with a secured claim of $7.7 million. The subordinated creditor had a $5.3 million unsecured claim. Both the bank and the subordinated creditor filed claims for the $5.3 million.

In addition to providing that any recovery on the subordinated creditor's claim would go to the bank, the subordination agreement allowed the bank to file and vote the subordinated creditor's claim.

The chapter 11 plan evidently bifurcated the secured creditor's claim into a $2.5 million secured claim and a $5.2 million unsecured claim. General unsecured creditors, including the bank, were to be paid 15% of their claims.

The subordinated creditor was in a separate class to be paid $120,000, but the payments would go to the bank.

The equity holders were to retain ownership after confirmation.

The subordinated creditor conceded that it would receive no distribution in either chapter 11 or chapter 7.

The debtor and the bank filed a motion to disallow the claim filed by the subordinated creditor and to declare that the bank could vote the subordinate claim.

In his March 31 opinion, Judge Somers ruled in favor of the subordinated creditor until the very end, but he then gave the prize to the bank and the debtor.

The Right to Vote and File a Claim

The bank argued that the subordination agreement allowed the bank to vote the subordinated claim in favor of the plan.

Judge Somers analyzed lower court cases coming down both ways. He adopted the analysis by former Bankruptcy Judge Eugene R. Wedoff of Chicago in *Bank of America, Nat'l Ass'n v. N. LaSalle St. Ltd. P'ship (In re 203 N. LaSalle Street P'ship)*, 246 B.R. 325 (Bankr. N.D. Ill. 2000).

Judge Wedoff gave several reasons why a subordination agreement cannot divest the subordinated creditor of voting rights. Among other things, Judge Wedoff said that the right to vote is controlled by the Bankruptcy Code, not by an intercreditor agreement. He also said that Section 510(a), permitting the enforcement of subordination agreements, does not allow a waiver of voting rights because subordination affects the priority in payment of claims, not voting rights.

Like the caselaw, Judge Somers cited commentators who come down both ways. Ultimately, he quoted the ABI Commission to Study the Reform of Chapter 11 by saying that a subordination agreement should not be enforced to preclude a subordinated creditor from voting. *American Bankruptcy Institute Commission to Study the Reform of Chapter 11: 2012-2014 Final Report and Recommendations*, 23 Am. Bankr. Inst. L. Rev. 1, 284 (2015).

Judge Somers held "that the attempted modification of voting rights stated in the Subordination Agreements is not enforceable."

Judge Somers also overruled the objection to the proof of claim filed by the subordinated creditor. He said that "subordination merely reorders priorities among creditors. Unlike the circumstance where a claim is assigned to another party, subordination does not involve transfer of the subordinated creditor's legal interest."

Prudential Standing

Judge Somers addressed three "distinct" standing doctrines: constitutional standing, statutory standing and prudential standing. Pertinent factually, he said there was "no circumstance under which the [subordinated creditor] has any financial stake in the outcome of the confirmation process."

The subordinated creditor had statutory standing under Section 1109(b), which provides that a "party in interest, including . . . a creditor, . . . may raise and may appear and be heard on any issue in a case under this chapter."

Constitutional standing under Article III deals with the required existence of a case or controversy. Judge Somers said he found no caselaw dealing with Article III standing principles applied to the right of subordinated creditors to participate in the confirmation process.

Because he was ruling next on prudential standing, Judge Somers found it unnecessary to rule on constitutional standing.

Prudential Standing

Prudential standing is a court-made doctrine. Judge Somers quoted the Supreme Court for saying that prudential standing encompasses "the general prohibition on a litigant's raising of another person's legal rights." *Lexmark Int'l, Inc. v. Static Control Components, Inc.*, 572 U.S. 118, 126 (2014).

Judge Somers said that the subordinated creditor "would be litigating issues affecting the rights of third parties, not itself," because "there is no scenario under which the [subordinated creditor] will receive any direct financial benefit."

Were there a plan amendment to improve the recovery for the subordinated creditor, Judge Somers predicted that "other unsecured creditors would likely receive less."

Judge Somers surmised that the subordinated creditor aimed to vote against the plan and thereby invoke the absolute priority test under Section 1129(b). He said that other creditors had the "financial interest" in asserting the absolute priority rule and other cramdown requirements.

Absolute priority could have been an issue in cramdown were there an objecting class, because the plan allowed existing equity to retain ownership. If all creditor classes voted "yes," absolute priority would not be an issue.

Judge Somers decided that "prudential standing principles preclude the [subordinated creditor] from participating in the disclosure statement and Plan confirmation process."

Observations

The opinion confirms the subordinated creditor's statutory standing under Section 1109(b), the right to file a claim, and the statutory right to vote on the plan, yet prudential standing deprived the creditor of rights granted by Congress. Other courts may limit the persuasive value of the opinion to cases involving creditors who are deeply subordinated by contract.

If it were followed by other courts, the opinion would have important implications for chapter 11 plan confirmation. By preventing underwater classes of creditors from voting, a debtor might confirm a plan without addressing the requirements of cramdown in Section 1129(b). Or, as Prof. Stephen J. Lubben told ABI, "By ignoring the vote of an out of the money creditor, equity does not even have to show it is paying 'new value.'"

Prof. Lubben added, "Nobody but the lenders could object in many cases where everything is all liened up." He is the Harvey Washington Wiley Chair in Corporate Governance & Business Ethics at the Seton Hall University School of Law.

Prof. Bruce A. Markell went the next step. He said that "the holders of equity interests in an insolvent company would not have standing." He saw the opinion as confusing "the financial facts with the bankruptcy process: it is the plan that allocates rights, not the financial situation of creditors."

On a practical level, Prof. Markell observed that "owners and out-of-the-money creditors participate all the time — usually to get a different plan which will allocate value differently." Prof. Markell is the Professor of Bankruptcy Law and Practice at the Northwestern Univ. Pritzker School of Law.

Prof. Lubben believes that the "discussion about raising 'other people's rights' is really off point, given that the creditor at issue was really just forcing compliance with Section 1129 — not somebody else's rights."

Prof. Markell said he agreed with the ruling about the transfer of voting rights.

A final note: If one subscribes to the idea that the subordination agreement validly transferred voting rights, then the outcome is correct in terms of voting on the plan, and perhaps also with regard to barring the subordinated creditor from objecting to confirmation.

The opinion is *In re Fencepost Productions Inc.*, 19-41545 (Bankr. D. Kan. March 31, 2021).

Stays & Injunctions

Even for egregious, repeated violations of Bankruptcy Rule 3002.1, the bankruptcy court may only award recovery of economic losses, never punitive damages.

Second Circuit Makes *Taggart* Applicable to All Contempt Citations in Bankruptcy Court

Over a vigorous dissent, the Second Circuit overruled the bankruptcy court and in the process made two landmark rulings: (1) The *Taggart* standard for the imposition of contempt applies to all proceedings in bankruptcy court, not only for violating the discharge injunction; and (2) bankruptcy courts may not impose contempt sanctions for violations of Bankruptcy Rule 3002.1, which requires lenders to give notice within 180 days of fees or expenses being charged against a debtor.

According to the majority, sanctions even for repeated violations of Rule 3002.1 are limited to economic damages, which may be minimal.

The dissent concurred with the broad imposition of the *Taggart* standard but argued that contempt sanctions should be available under Rule 3002.1 or the bankruptcy court's inherent powers.

Perhaps accurately, the dissenter said that the majority rendered "a bankruptcy court powerless to levy any sanction under the Rule [3002.1] against a serial violator of the Rule's provisions over a substantial period of time where those violations . . . did not result in any actual economic harm to the multiple debtors who were the victims of the Rule violations."

The Repeated, Flagrant Violations of Rule 3002.1

Bankruptcy Rule 3002.1 was added in 2011 to avoid situations where chapter 13 debtors would have received a discharge but face foreclosure on account of undisclosed post-petition charges from mortgage lenders.

In his majority opinion on August 2, Circuit Judge Dennis Jacobs said the rule was also designed to aid mortgage servicers in fear of allegedly violating the automatic stay by notifying chapter 13 debtors about defaults on mortgages.

Rule 3002.1(c) requires mortgage lenders to file notices of post-petition fees and charges within 180 days of when the charges were incurred.

For failure to file a notice, Rule 3002.1(i) allows the bankruptcy court to disallow the charges and "award *other appropriate relief, including* reasonable expenses and attorneys' fees caused by the failure." [Emphasis added.]

The opinion by the bankruptcy judge involved three debtors and a company advertising itself as one of the country's 10 largest mortgage originators and servicers.

The servicer had been in trouble before for violating Rule 3002.1. The bankruptcy judge said that the servicer had been "chastised" by a bankruptcy judge in North Carolina for violating the rule. In one of the three cases in her court, the bankruptcy judge said that the servicer previously agreed to pay a $9,000 sanction for sending erroneous mortgage statements for three years.

In two of the three cases, the bankruptcy court had previously entered an order declaring that the debtors were current on all pre- and post-filing payments, fees and charges. Within a month after the so-called Debtor Current Orders, the servicer began billing the debtors for about $250 in fees allegedly incurred during the periods encompassed by the Debtor Current Orders. In those two cases, the servicer had not filed notices required by Rule 3002.1(c).

In the third case, there was no Debtor Current Order, but the servicer billed for expenses without filing the Rule 3002.1(c) notice.

For violating the rule, the bankruptcy judge imposed a total of $75,000 in sanctions under Rule 3002.1(i), representing $1,000 for each of the 25 months in which the servicer billed the three debtors without filing a notice.

In one of the cases where there was a Debtor Current Order, the bankruptcy judge imposed $100,000 in sanctions under Section 105. In the case with a Debtor Current Order where the lender had previously paid a $9,000 sanction for improper billing, she assessed a $200,000 sanction.

The bankruptcy court imposed Section 105 sanctions because she said that the record "categorically demonstrates" that the $9,000 sanction two years earlier had failed to achieve its intended remedial effect of deterring the servicer from sending out "inaccurate account statements." Since she had given the servicer "an opportunity to bring its practices in line with the mandates of Rule 3002.1," the bankruptcy judge felt that "the time has come for 'the imposition of severe sanctions.'"

The bankruptcy judge admitted that the sanctions were not in the nature of coercive civil contempt sanctions because the servicer already had waived the post-filing fees. She based her action on the court's "inherent authority" under Section 105 to impose punitive, non-contempt sanctions even when there had been belated compliance.

The sanctions totaled $375,000 and were to be paid to the state's largest *pro bono* provider of legal services in bankruptcy cases. *In re Gravel*, 556 B.R. 561 (Bankr. D. Vt. Sept. 12, 2016). To read ABI's report on the first bankruptcy court opinion, click here.

The servicer appealed. The district court reversed, ruling that $375,000 in sanctions exceeded the bankruptcy court's statutory and inherent powers. Remanding, the district court said that the bankruptcy court could enforce its orders short of punitive sanctions.

After remand, the bankruptcy court adopted its previous findings and imposed the same $75,000 in sanctions for violating Rule 3001.2. The bankruptcy court reduced the other $300,000 in sanctions to $225,000. *In re Gravel*, 601 B.R. 873 (Bankr. D. Vt. June 27, 2019).

The servicer appealed. The Second Circuit accepted a direct appeal, overstepping an intermediate appeal to the district court.

Sanctions for the Debtor Current Orders

In his 33-page opinion, Judge Jacobs first reviewed the $225,000 in contempt sanctions for violation of the Debtor Current Orders.

Those orders declared that the debtors were current on their mortgages, including all monthly payments and any other charges. The orders prohibited the servicer "from disputing that the debtors are current (as set forth herein) in any other proceeding."

Simply put, Judge Jacobs said that the servicer "did not, as a matter of law, violate" the Debtor Current Orders. The orders, he said, "did not enjoin the recording of expired fees on the statements" sent to the debtors.

Judge Jacobs applied the contempt standard established in *Taggart v. Lorenzen*, 139 S. Ct. 1795 (2019), where the Supreme Court held that there can be no sanctions for civil contempt of the discharge injunction if there was an "objectively reasonable basis for concluding that the creditor's conduct might be lawful under the discharge order." *Id*. at 1801. To read ABI's discussion of *Taggart*, click here.

Under *Taggart*, Judge Jacobs said there can be contempt for violating an "injunction only 'if there is *no fair ground of doubt* as to whether the order barred the creditor's conduct.'" *Id*. at 1799. [Emphasis in original.]

"Without an express injunction" barring the servicer from sending out statements contrary to the Debtor Current Order, Judge Jacobs said there was a "fair ground of doubt as to whether the listed fees can form the basis for contempt." He said that the bankruptcy court "could have crafted an order that would have forbidden the conduct."

No Contempt for Violating Rule 3002.1

Judge Jacobs turned to the $75,000 in sanctions for violating Bankruptcy Rule 3002.1 by failing to file required notices.

Judge Jacobs began by noting how the sanctions were based on the number of incorrect mortgage statements, not the amount of incorrect charges that totaled $716. The bankruptcy court found authority for the sanction in Rule 3002.1's authorization to "award other appropriate relief, including reasonable expenses and attorneys' fees caused by the failure."

Evidently minimizing the word "including" but focusing on "expenses and attorneys' fees," Judge Jacobs held that "other appropriate relief is limited to "nonpunitive sanctions." He said that other provisions in the Bankruptcy Code, such as Section 362(k)(1), explicitly authorize punitive sanctions. Similarly, he said that Rule 3002.1 lacks a reference to "just orders," like analogous Rule 37 of the Federal Rules of Civil procedure.

Given that the sanctions were not permitted by Rule 3002.1, Judge Jacobs deflected the argument that the $75,000 in sanctions were permissible under the court's inherent powers. The circuit court, he said, could not consider the question because, in his view, the bankruptcy court had not adequately assessed whether the sanctions were authorized under inherent powers.

Judge Jacobs said it was "dubious" whether the bankruptcy court exercise its inherent powers because "there is no finding of bad faith." In short, he held,

> The sanction was imposed under Rule 3002.1(i), and our holding is that the sanction went beyond the relief authorized by that rule.

Despite the holding, Judge Jacobs left the door open for sanctions in future cases when the bankruptcy court uses a few magic words. He said that his opinion "does not limit a bankruptcy court's inherent power to sanction offenders who act in bad faith. That is just not what the bankruptcy court did here; others might be free to do so if they were to make sufficient findings."

Judge Jacobs reversed and vacated the bankruptcy court's order. The majority did not remand and allow the bankruptcy judge to explain whether she had issued sanctions under the court's inherent powers.

The Dissent

Circuit Judge Joseph F. Bianco wrote a 36-page dissent, three pages longer than the majority's opinion. However, he agreed with the majority's holding that the Debtor Current Orders "did not clearly and unambiguously prohibit" the servicer's conduct. In other words, he appears to agree

that *Taggart* applies to all potential contempt findings in bankruptcy court, including violations of the automatic stay.

Although he "respectfully" dissented, Judge Bianco vigorously disagreed with vacating the $75,000 in sanctions for violating Rule 3002.1. He believes that the "'other appropriate relief' language in [Rule 3002.1(i)(2)] conferred upon bankruptcy courts . . . a proper basis to impose the $75,000 punitive sanction against [the servicer] based upon its flagrant and repeated violations of the Rule."

Judge Bianco saw his understanding of the Rule as being "not only consistent with the plain text of the Rule itself but is further supported by the purpose of the Rule and the fact that the Rule was modeled after Rule 37 of the Federal Rules of Civil Procedure, which allows for similar punitive sanctions."

Even if Rule 3002.1 in itself did not permit the imposition of sanctions, Judge Bianco believes that the bankruptcy court has "independent authority under its inherent powers to impose this $75,000 sanction against [the servicer] for its egregious conduct in violation of the Rule." The record, he said, was "more than sufficient" for upholding $75,000 in sanctions under a court's inherent powers.

Judge Bianco went further. He read the "the plain text of Rule 3002.1 [as allowing] punitive, non-compensatory sanctions . . . consistent with the Rule's purpose."

On a practical level, Judge Bianco saw reason for punitive sanctions. He said that the "reimbursement of costs to a debtor for a Rule violation . . . does little to prevent future violations and therefore falls far short of safeguarding the Chapter 13 'fresh start' process for all such debtors."

Judge Bianco also disagreed with the majority failure to remand. He would have allowed the bankruptcy court on remand to expound on its "reasoning for the imposition of sanctions under its inherent powers."

Observations

When *Taggart* came down, the question arose, "Does the same standard apply to contempt for violation of the automatic stay?"

The Second Circuit has now answered the question. In the Second Circuit, *Taggart* seems to apply not only to automatic stay violations but also to any circumstance when the bankruptcy court is inclined to impose contempt sanctions.

In this writer's view, applying *Taggart* to automatic stay violations means there can be no contempt if the creditor has a non-frivolous argument aimed at explaining why there was no violation of Section 362.

The majority's opinion also means that bankruptcy courts (and the lawyers who draft proposed orders) must now lay out in detail the types of actions that are prohibited. Otherwise, contempt will be unavailable.

On Rule 3002.1, the lower courts are split about the availability of contempt. The Second Circuit is the first appeals court to reach the issue. There may be a circuit split eventually.

Fortunately, the Rule could be amended without Congressional action to permit contempt sanctions for violations of Rule 3002.1.

This writer predicts there will be a petition for rehearing *en banc*, but the Second Circuit rarely agrees to sit *en banc*. The vigorous dissent makes a strong case for sitting *en banc*.

The opinion will have wide-ranging effect on bankruptcy. For example, the panel made blanket statements without reflecting on how applying *Taggart* will affect enforcement of the automatic stay.

The circuit should grant rehearing *en banc*, allowing scholars and the wider community to appear as *amici* and comment on what may be the most significant circuit court decision this year on bankruptcy law.

The opinion is *PHH Mortgage Corp. v. Sensenich (In re Gravel)*, 6 F.4th 503 (2d Cir. Aug. 2, 2021), rehearing and rehearing en banc *den*. Nov. 1, 2021.

Lack of authority on point is no defense to a willful violation of the automatic stay, according to the Third Circuit.

Good Faith Is No Defense to an Allegedly Willful Stay Violation, Third Circuit Says

The Third Circuit handed down an opinion containing several holdings that close the door on defenses a creditor could make after being charged with a willful violation of the automatic stay:

- The Third Circuit's *University Medical* decision in 1992 did not create a general good faith defense to an automatic stay violation;
- Willfulness and good faith are separate and distinct issues when it comes to automatic stay violations;
- The lack of authority on the precise facts of an alleged stay violation does not create a defense in itself; and
- The appeals court cast doubt on lower courts' decisions in the Third Circuit finding no stay violation from an educational institution's refusal to turn over a transcript if the underlying debt to the school is nondischargeable.

Contempt for Withholding a Transcript

When the debtor filed her chapter 13 petition, she owed about $6,000 to a college. After filing, she requested that the college send her a transcript. The college sent a transcript, but it did not show that she had graduated.

When challenged about the accuracy of the transcript, the college said it had put a "financial hold" on a complete transcript because she owed the school $6,000.

The college filed an adversary proceeding seeking a declaration that the debt was a nondischargeable student loan. Counterclaiming, the debtor alleged that withholding an accurate transcript was a willful violation of the automatic stay under Section 362(k).

Later, the college withdrew the nondischargeability claim with prejudice, establishing that the debt was dischargeable.

The bankruptcy court held a trial and ruled that the school had violated the automatic stay by withholding a complete transcript. Finding the violation to be willful, the bankruptcy judge entered judgment in favor of the debtor, awarding about $200 in actual damages plus attorneys' fees to be

determined later. The bankruptcy court denied a request for punitive and emotional distress damages.

The district court affirmed, and so did the Third Circuit in a September 9 opinion by Circuit Judge Julio M. Fuentes.

The Amendment to Section 362(k)

The college conceded that it violated the automatic stay but argued that the violation was not willful. Section 362(k)(1) provides that "an individual injured by any willful violation of a stay provided by this section [362] shall recover actual damages, including costs and attorneys' fees, and, in appropriate circumstances, may recover punitive damages."

In large part, the college argued that its actions were not willful under *In re University Medical Center*, 973 F.2d 1065 (3d Cir. 1992). Much of Judge Fuentes' opinion was spent in explaining what *University Medical* did or did not hold and why it was not legislatively overruled by the amendment of Section 362(k) in 2005.

Before the so-called BAPCPA amendments in 2005, Section 362(k) said nothing about good faith. The amendment added subsection (2), which says:

> If such violation is based on an action taken by an entity in the good faith belief that [the stay automatically terminated for the debtor's failure to file a statement of intention], the recovery under paragraph (1) of this subsection against such entity shall be limited to actual damages.

University Medical Wasn't Legislatively Overruled

The defendant in *University Medical* argued that its actions were not willful, thus providing insulation from damages and attorneys' fees. At the time the opinion was written in 1992, Section 362(k) did not say whether good faith was a defense. Then, the statute only addressed a "willful violation" of the stay.

However, the Third Circuit had ruled two years before *University Medical* that a defendant's good faith belief that its actions did not violate the stay did not, by itself, "establish a defense to willfulness," Judge Fuentes said. *See In re Atlantic Business & Community Corp.*, 901 F.2d 325, 329 (3d Cir. 1990). The appeals court said there was ample evidence that the defendant acted intentionally and with knowledge of the stay, despite the defendant's claim that its actions were in good faith.

In *University Medical*, Judge Fuentes said, the defendant did more than claim good faith. The defendant presented "persuasive authority" to show that a stay violation was "uncertain."

According to Judge Fuentes, the Third Circuit held in *University Medical* that good faith by itself was "insufficient" but that "persuasive authority negated any finding of willfulness" and obviated liability for damages.

Several bankruptcy courts concluded that *University Medical* was legislatively overruled because the amendment to Section 362(k) installed a good faith defense that was narrower than the 1992 decision. Judge Fuentes disagreed.

Judge Fuentes agreed with recently retired Bankruptcy Judge S. Martin Teel, Jr., who read *University Medical* to mean that good faith is not a defense to willfulness. Rather, willfulness is separate and distinct from good faith.

Judge Teel explained:

> [W]hen the law is sufficiently unsettled, willful violation of the statutory command is absent, and damages are not recoverable, because the offending party has not acted in violation of a command of which it had fair notice.

In re Stancil, 487 B.R. 331, 343-44 (Bankr. D.D.C. 2013).

Judge Fuentes cited the First Circuit for also interpreting *University Medical* to mean that a good faith belief that one's actions do not violate the stay is not determinative of willfulness. *IRS v. Murphy*, 892 F.3d 29, 37-38 (1st Cir. 2018).

Judge Fuentes read *University Medical* as not creating a good faith defense, like the limited good faith defense created in 2005 for situations where there was an automatic termination of the stay for failure to file a statement of intention.

On the bottom line, Judge Fuentes concluded that *University Medical* remains good law. The 1992 opinion, he said, makes a willfulness defense "separate and distinct from one of good faith alone."

The College Had No Authority on Its Side

Unlike the defendant in *University Medical*, the college-appellant had no "persuasive authority" to support the notion that withholding a transcript did not violate the stay, Judge Fuentes said. The college, he said, "predominantly relies on the absence of case law addressing these precise facts."

Judge Fuentes held:

> [A] lack of case law to the contrary does not render the law sufficiently unsettled under *University Medical*. Rather, the defendant must point to authority that reasonably supports its belief that its actions were in accordance with the stay.

The college cited two bankruptcy court decisions in the Third Circuit for the idea that withholding a transcript is no stay violation. Judge Fuentes distinguished both.

In both cases, the bankruptcy courts found no stay violation for withholding a transcript when the underlying debt to the school was nondischargeable. In the case on appeal, the college had withdrawn its complaint and conceded that the debt was dischargeable.

Judge Fuentes cited three other circuits and "many other federal courts" for holding that withholding a transcript is a stay violation, even when the debt is nondischargeable.

Because the college failed to show that the law was "sufficiently unsettled within the meaning of *University Medical*," Judge Fuentes upheld the district court for finding a willful stay violation.

There Was Sufficient Injury

The college claimed there was not a sufficiently meaningful injury to justify a stay violation.

The bankruptcy court had awarded the debtor about $200 in lost wages for time spent in court to attend trial. The college, Judge Fuentes said, cited "no authority for its position that a debtor's lost wages from attending trial, even if a modest amount, is not a legitimate financial harm." Likewise, he saw no "compelling explanation" for the idea that "attorneys' fees do not constitute a financial injury on their own."

Judge Fuentes found other "cognizable injury" under Section 362 arising from the debtor's failure to receive a complete transcript.

Judge Fuentes affirmed the district court.

Observations

In *Taggart v. Lorenzen*, 139 S. Ct. 1795 (2019), the Supreme Court rejected a strict liability standard for violation of the discharge injunction. Instead, the Court held that there can be no sanctions for civil contempt of the discharge injunction if there was an "objectively reasonable basis for concluding that the creditor's conduct might be lawful under the discharge order." *Id*. at 1801. To read ABI's discussion of *Taggart*, click here.

In a footnote, Judge Fuentes seemed to say there was no reason to discuss *Taggart* because the court was not imposing a strict liability standard.

Increasingly, courts are saying that *Taggart* also applies to alleged violations of the automatic stay.

This writer submits that *Taggart* was worthy of discussion to determine whether the college in the Third Circuit case had an "objectively reasonable basis" for believing that withholding a transcript was no stay violation.

Did Judge Fuentes satisfy the *Taggart* standard by finding no "persuasive authority" to support the college's argument? Is no "persuasive authority" equivalent to no "objectively reasonable basis?" Were two distinguishable cases in bankruptcy court sufficient to give the college a defense under *Taggart*?

The opinion is *California Coast University v. Aleckna (In re Aleckna)*, 20-1309 (3d Cir. Sept. 9, 2021).

The BAP decision may have a hint that failure to stop proceedings after bankruptcy can be an automatic stay violation, even after Fulton.

No Duty to Release an Attachment After *Fulton*, Ninth Circuit BAP Says

Concluding that the Supreme Court's *Fulton* decision overruled prior Ninth Circuit authority, the Ninth Circuit Bankruptcy Appellate Panel held that a creditor no longer violates any provision of the automatic stay in Section 362(a) by maintaining the *status quo* and declining to vacate a prepetition attachment.

While the decision under Section 362(a)(3) is no surprise given that *Fulton* addressed the same subsection, the November 10 BAP opinion is noteworthy for finding no stay violations under any other subsection in Section 362(a).

The Prepetition Attachment

A municipality in Arizona obtained a $30,000 judgment against an individual and served a writ of garnishment on a bank that held about $9,000 belonging to the judgment debtor in three accounts.

The judgment debtor moved in state court to quash the garnishment, contending that the accounts were community property. The state court allowed the city to take discovery, but the debtor filed a chapter 13 petition before the city took further action in state court.

Once in bankruptcy, the debtor's counsel sent messages to both the city and bank demanding the release of the attachment. The city's attorney responded by filing a motion to stay the litigation in state court.

The debtor moved the state court to vacate the garnishment. The city's attorney responded by saying that the city would abide by whatever decision was made under the Bankruptcy Code and did not oppose releasing the funds.

More specifically, the city told the debtor that Section 362(a) only required staying the proceedings, not dismissing the garnishment.

The state court vacated the garnishment, and the bank released the funds. The debtor then filed a motion in bankruptcy court seeking $30,000 in damages for a willful violation of the stay under Section 362(k).

The Pre-*Fulton* Finding of a Stay Violation

At the ensuing hearing held before the Supreme Court handed down *Fulton*, the bankruptcy court cited Ninth Circuit authority from 2017, faulted the city for not vacating the garnishment, and entered an order finding a stay violation. The bankruptcy court told the debtor to proceed with a hearing to fix damages.

After *Fulton* came down, the city filed a motion for rehearing under Bankruptcy Rule 9024 and Federal Rule 60(b). The bankruptcy court granted rehearing.

The Ruling After *Fulton*

Ruling under *Fulton*, the bankruptcy court said that its prior ruling was wrong and that the automatic stay does not require a creditor to take affirmative action under any of the subsections in Section 362(a).

The debtor appealed to the BAP, but Bankruptcy Judge Robert J. Faris affirmed for the BAP in an opinion on November 10.

First, Judge Faris dealt with the question of whether the city properly moved for rehearing under Bankruptcy Rule 9024. He said that the finding of a stay violation was not a final order in the absence of a decision fixing damages.

Because there was no final order, Judge Faris said that Rule 9024 did not apply and that the "bankruptcy court was free to review and change its own interlocutory order whether or not Rule 9024 permitted it to do so."

Judge Faris therefore reviewed the reconsideration order *de novo*.

Fulton Means No Stay Violation

Citing *City of Chicago v. Fulton*, 141 S. Ct. 585, 208 L. Ed. 2d 384 (Sup. Ct. Jan. 14, 2021), Judge Faris saw no error when the city "failed to move to quash the writ of garnishment or cause [the bank] to unfreeze the bank accounts." To read ABI's report on *Fulton*, click here.

Before *Fulton*, Judge Faris cited the Ninth Circuit for having held that the knowing retention of estate property violates Section 362(a)(3). *Fulton*, he said, overruled those decisions.

Judge Faris quoted *Fulton* for saying that Section 362(a)(3) contains no affirmative turnover obligation and that mere retention of estate property does not violate the stay. He affirmed the bankruptcy court's ruling on subsection (a)(3) by saying that the city "had no affirmative duty to ensure the return of estate property to [the debtor]."

Judge Faris cited *Margavitch v. Southlake Holdings LLC (In re Margavitch)*, 20-00014, 021 BL 383922, 2021 Bankr. Lexis 2784, 2021 WL 4597760 (Bankr. M.D. Pa. Oct. 6, 2021), as being directly on point. In *Margavitch*, he described Bankruptcy Judge Mark J. Conway of Wilkes-Barre, Pa., as finding "no affirmative obligation to release the funds and [said that the creditor] need only maintain the *status quo*." To read ABI's report on *Margavitch*, click here.

Having found no violation of Section 362(a)(3), Judge Faris saw no violation of any other subsection in Section 362(a).

By promptly taking steps to stay the litigation in state court, Judge Faris said there was no violation of subsection (a)(1), which bars the continuation of a suit against a debtor. Because the city had done nothing to enforce the judgment or the writ, he saw no violation of subsection (a)(2).

Likewise, there was no act to recover a claim against the debtor and no violation of subsection (a)(6), because the city only maintained the *status quo*.

A Possible Qualification

Judge Faris concluded his opinion by saying there was no stay violation because the city "did nothing to change the *status quo*" and "immediately asked the state court to stay the case."

Is there significance in Judge Faris's use of the word "immediately"?

Assume that the motion was *sub judice* in state court to convey estate property to a creditor. Would the creditor violate the automatic stay if the creditor does not ask the state court to withhold a decision conveying property to the creditor?

The opinion is *Stuart v. City of Scottsdale (In re Stuart)*, 21-1063 (B.A.P. 9th Cir. Nov. 10, 2021).

A minority of courts hold that a suit in bankruptcy court can violate the automatic stay if based on a claim that could have been brought before bankruptcy and did not arise under the Bankruptcy Code.

Courts Split on Whether Suits in Bankruptcy Court Can Violate the Automatic Stay

Adopting the minority view, a bankruptcy judge in New Mexico decided that the automatic stay bars a creditor from suing the debtor *in bankruptcy court* if the claim is one that the creditor could have brought before bankruptcy and does not arise under the Bankruptcy Code.

The May 13 opinion by Bankruptcy Judge David T. Thuma of Albuquerque, N.M., could be one of those cases where facts buried in the record may have affected the outcome.

The Allegations of Improper Conduct

The Archdiocese of Santa Fe, N.M., filed a chapter 11 petition in December 2018 to deal with sexual abuse claims. Before bankruptcy in September 2017, the archdiocese published a list of priests and other "religious" persons who were credibly accused of sexual abuse. One of the men on the list, whom we shall call the accused, was shown as having been a member of the Benedictine Order.

The archdiocese published the list again after bankruptcy.

Before bankruptcy, the accused told the archdiocese that he was wrongly included in the list and that he had never been "religious" as that term is used within the church, had never been a seminarian working within the archdiocese who was "found guilty" of abuse, and was not a member of the Benedictine Order. Explaining the inaccuracy of the accusations in detail, the accused wrote to the archbishop, but the church did not remove him from the list, the accused said in court papers.

In court papers in bankruptcy court, the accused said that the archdiocese "summarily ordered him to cease and desist having any contact with the [cathedral in Santa Fe where he was a volunteer coordinator for wedding preparation] . . . and summarily ordered him to cease and desist any other contact with any other parish volunteer organization."

Also before the chapter 11 filing, the accused commenced a defamation action in state court, seeking compensatory and punitive damages. The complaint did not seek equitable relief, such as

a mandatory injunction to delete the accused from the list. After bankruptcy, the accused filed a $200,000 proof of claim.

In bankruptcy court, the accused filed a motion asking Judge Thuma to enjoin the archdiocese by directing the removal of his name from the list. With refinements described below, Judge Thuma denied the motion without reaching the merits.

The accused made many denials in his prebankruptcy letter to the archdiocese and in his motion to be deleted from the list, but the papers could be understood to mean that he did not deny having inappropriate relations with a minor.

The Stay Applies to Some Suits in Bankruptcy Court

First, Judge Thuma asked whether the motion was filed in violation of the automatic stay.

Judge Thuma said there "is conflicting case law on whether it violates the automatic stay for a creditor to sue the debtor in bankruptcy court on a prepetition claim." The majority, he said, believe that "creditors may bring such proceedings in bankruptcy court without violating the stay."

Judge Thuma said that the majority justify the result by saying that a lawsuit in bankruptcy court is equivalent to filing a proof of claim.

The minority, according to Judge Thuma, believe the stay applies based on the "plain language" of Section 362(a)(1), which stops the commencement or continuation of an action on a claim that arose before bankruptcy.

Judge Thuma had three reasons for agreeing with the minority. First, he said, "the language of Section 362(a)(1) is clear" in the sense that it bars actions like the one by the accused that could have been brought before bankruptcy.

Second, Judge Thuma said that the minority view does not create "absurd results," because actions such as filing a claim, a dischargeability complaint or a stay relief motion could not have been brought before bankruptcy.

Third, Judge Thuma said that "suing the debtor in bankruptcy court is not equivalent to filing a proof of claim. Claims objections are contested matters, not adversary proceedings."

If the accused wants the archdiocese to remove his name from the list, Judge Thuma required the accused to take two steps. First, the accused must move for a modification of the automatic stay. If the motion is granted, the accused then must commence an adversary proceeding seeking a mandatory injunction. Or, the accused could remove the suit pending in state court that is

enjoined by the automatic stay. In that suit, the accused would be obliged to amend the complaint to seek equitable relief.

Once there is an adversary proceeding in bankruptcy court seeking an injunction, Judge Thuma said that "claim allowance would not be part of it." Judge Thuma said he would not take the claim for monetary relief "out of order" and adjudicate the amount of damages until the debtor lodges an objection to the claim.

Observations

There is more to the story than Judge Thuma could detail in his opinion.

Some of the court papers filed by the accused and the archdiocese are enlightening. Notably, the accused's motion seems not to allege that he never had sexual relations with anyone who was underage.

The accused, for instance, recounted how he wrote a letter to the archbishop in 2017 that could be interpreted as admitting that, when he was 19 years old, a priest introduced him to someone who was 17 and that he had a summertime relationship with that 17-year-old person. Following the relationship, the accused went to a monastery, where he remained for six years.

In a bankruptcy court filing, the accused recites how he was sued in 1993 with regard to the relationship. The court filing could be interpreted to mean that he settled the suit for $5,000, on the advice of counsel.

Allegations by the archdiocese in answering the defamation complaint in state court provide more detail. The archdiocese said that the accused "was credibly accused of committing child sexual abuse in 1970, including non-consensual forcible oral sodomy and attempted anal sodomy of a minor, in a lawsuit filed in 1994 against the Archdiocese of Santa Fe, [the accused], and the Benedictine Monks."

The archdiocese's pleading in the defamation suit went on to say that the accused, in "correspondence with the Archdiocese, . . . admitted to engaging in sexual conduct with the minor in 1970." The archdiocese's answer in the defamation suit alleges that the accused "was a seminarian in the Archdiocese of Santa Fe who has been credibly and publicly accused of child sexual abuse that he committed under the auspices of the Archdiocese of Santa Fe, while residing at the Benedictine Monastery in Pecos, New Mexico."

The allegations by and against the accused help explain why Judge Thuma is requiring the accused to abide punctiliously by the Bankruptcy Code and Rules. The gravity of the allegations and the possible dispute about the facts don't counsel procedural shortcuts.

The opinion is *Roman Catholic Church of the Archdiocese of Santa Fe*, 18-13027 (Bankr. D. N.M. May 13, 2021).

Compensation

Officers are presumptively disqualified from KERPs, "absent a strong showing that they do not perform any significant role in management," a district judge in New York says.

Being an 'Officer' Disqualifies Someone from a KERP, New York District Judge Says

Reversing a bankruptcy court in New York, District Judge J. Paul Oetken held that someone with the title of a corporate officer is not entitled to participate in a key employee retention program, or KERP, "absent a particularly strong showing that they do not perform a significant role in management."

In his July 9 opinion, Judge Oetken also held that the appeal was not equitably moot, even though the KERP payments had been made to six officers and the U.S. Trustee had not sought a stay pending appeal.

On the subject of who is or is not an "officer" for the purpose of Section 503(c), Judge Oetken referred to the "messy state of the law on this topic." The section prohibits retention payments to an "insider" absent evidence that the payment is "essential" to retain someone who has a *bona fide* offer from another business. In turn, an "insider" is defined in Section 101(31)(B)(ii) to include an "officer."

The Six Corporate Officers and the KERP

The chapter 11 debtor established an $8 million KERP for 190 employees. The group included six officers slated for retention bonuses aggregating $1.8 million.

Among the six, one was the deputy general counsel, three were senior vice presidents, and two were vice presidents. The debtor conceded that all six were deemed to be officers under Delaware law.

The U.S. Trustee objected to approval of the KERP as to the six officers. The bankruptcy judge overruled the objection and approved the KERP across the board, adopting the debtor's argument that the six were officers in name only and had no broad decision-making authority.

The U.S. Trustee appealed but did not seek a stay pending appeal. The KERP payments were made to everyone. The chapter 11 plan was confirmed and consummated.

Equitable Mootness

The debtor contended that the appeal was equitably moot because the U.S. Trustee had not sought a stay pending appeal and requiring repayment would be inequitable.

To determine whether the appeal was moot, Judge Oetken applied the five-part *Chateaugay* test. *See In re Chateaugay Corp.*, 10 F.3d 944, 952 (2d Cir. 1993).

Among the tests relevant to the case on appeal, Judge Oetken saw no reason he could not provide relief by compelling disgorgement. Further, the six officers knew about the appeal and had been represented by the debtor, effectively speaking.

It was "regrettable," Judge Oetken said, that the U.S. Trustee had not sought a stay, but clawing back the payments would not be "inequitable" if the payments were illegal in the first place.

Judge Oetken decided that the appeal was not equitably moot, noting that the lack of a stay "is much more dire" on appeal from a confirmation order.

The Significance of Being an 'Officer'

In approving the KERP, the bankruptcy court applied a functional test to determine whether the six officers had "sufficient authority" to be seen as officers under Section 503(c). The debtor argued that being an officer under Delaware law was neither controlling nor dispositive.

"From a policy standpoint," Judge Oetken said, "giving more weight to an objective criterion — whether an employee was appointed by the board — provides better guidance to parties than a functional, non-exhaustive test."

Although a "functional approach" may be appropriate "in many cases," Judge Oetken agreed "with the [U.S.] Trustee that with respect to officers *appointed or elected by the Board*, such individuals are 'officers' under the Bankruptcy Code, at least absent a particularly strong showing that they do not perform a significant role in management." [Emphasis in original.]

Judge Oetken concluded that the bankruptcy court "erred by inquiring beyond the fact that the six employees were appointed by [the] board." Even had he made a "more expansive analysis" beyond the fact that the six were appointed by the board and were officers under Delaware law, Judge Oetken said their designation as officers would be "dispositive, at least absent a strong showing that they do not perform any significant role in management."

In the case at hand, Judge Oetken said that the debtor "failed to overcome the strong presumption that, as board-appointed employees, the six employees are officers." He therefore reversed the order approving the KERP as to the six officers.

The Standards on Appeal

In a footnote at the conclusion of his decision, Judge Oetken said that the case presented mixed questions of law and fact, where the issues were "primarily legal." On that basis, he reversed on *de novo* review.

If the questions were "primarily factual," Judge Oetken said, then the bankruptcy court's conclusion that the six were not officers was "clearly erroneous."

The opinion is *Harrington v. LSC Communications Inc. (In re LSC Communications Inc.)*, 20-5006 (S.D.N.Y. July 9, 2021).

Closing a chapter 11 case after confirmation to avoid U.S. Trustee fees won't be necessary if the ruling by Judge Sontchi holds up.

Judge Sontchi Cuts Off U.S. Trustee Fees on Confirmation of a Chapter 11 Plan

When a trust created under a chapter 11 plan makes distributions to creditors, the distributions are not subject to fees for the U.S. Trustee system because transfers by a trust are not disbursements by the debtor, according to Delaware Chief Bankruptcy Judge Christopher S. Sontchi.

In his June 28 ruling, Judge Sontchi referred to the "absurdity" of the U.S. Trustee's position. He added, "I cannot stress enough how offensive I find the [U.S. Trustee's] attempt to double, or triple collect its 'tax.'" On the other hand, he said that the U.S. Trustee has "admirably" fulfilled its role "as the watchdog over the integrity of the administration of the U.S. bankruptcy system."

If Judge Sontchi's theory prevails, U.S. Trustees won't be collecting fees after confirmation of chapter 11 plans where distributions are made by trusts and not by the debtors. It will no longer be necessary to close chapter 11 cases to cut off taxes paid to the U.S. Trustee system.

The Litigation Trust

The facts were typical of significant chapter 11 cases. The debtors confirmed a plan in mid-2017 that created a litigation trust to which the debtors transferred their claims against third parties. For the quarter in which the assets were transferred to the trust, the debtors paid the maximum fee owing to the U.S. Trustee under 28 U.S.C. § 1930(a)(6).

After the transfers to the trust, the chapter 11 plan provided that the debtors would have no further interest in the assets transferred to the trust. The plan also provided that quarterly fees would be paid to the U.S. Trustee "when due in accordance with applicable law." In addition, the plan said that the debtors would remain obligated to pay the quarterly U.S. Trustee fees until the cases were closed.

The trust brought suit in late 2017 asserting claims transferred from the debtors. The trust negotiated a $90 million settlement this year. Judge Sontchi approved the settlement, and the trust received the settlement proceeds. The U.S. Trustee filed a motion asking Judge Sontchi to compel the trust to pay fees when the settlement proceeds are distributed to creditors.

Judge Sontchi denied the motion.

The Debtors Didn't Make Disbursements

The U.S. Trustee based the motion on 28 U.S.C. § 1930(a)(6), which calculates the fee based on "disbursements." The maximum quarterly fee is now $250,000, following the increase effective in the first quarter of 2018.

Judge Sontchi cited the Fifth Circuit for saying that several circuits define "disbursements" to mean payments made by or on behalf of the debtor. He went on to quote the Sixth Circuit for saying that "disbursements" is "commonly understood in this context to apply to payments made with the funds generated from the liquidation of the debtor's assets." *Robiner v. Danny's Mkts., Inc. (In re Danny's Mkts., Inc.)*, 266 F.3d 523, 525 (6th Cir. 2001).

For Judge Sontchi, the "common thread" in the opinions "'is the fact that the debtor had some interest in, or control over, the money disbursed,'" quoting *In re Hale*, 436 B.R. 125, 130 (Bankr. E.D. Cal. 2010). Quoting a district judge in Delaware, he said "'it is the ultimate payment of the expense by any entity on behalf of a debtor that is the subject of quarterly fees.'" *Walton v. Post-Confirmation Comm. of Unsecured Creditors of GC Companies, Inc. (In re GC Companies, Inc.)*, 298 B.R. 226, 230 (D. Del. 2003).

The trigger for payments of U.S. Trustee fees is commonly understood to be payments by or on behalf of the debtor, Judge Sontchi said. In the case at bar, the U.S. Trustee's motion failed because "the Trust is not paying expenses on behalf of any Debtors."

Rather, the disbursements triggering fees for the U.S. Trustee were made at confirmation when the debtors funded the trust. At the time, the debtors paid the maximum fees to the U.S. Trustee.

Judge Sontchi dug deeper into the plan to find further support for his conclusion. He cited the plan for providing that transfers to the trust were to be treated as transfers directly to trust beneficiaries — that is to say, to creditors.

Furthermore, the settlement proceeds were trust assets as to which the debtors had disavowed any further interest. Consistent with Section 1930, he said that the U.S. Trustee had already received its quarterly fee at confirmation based on transfers of claims made then by the debtor.

Judge Sontchi denied the U.S. Trustee's motion because transfers to creditors by the trust were not "disbursements" on behalf of the debtors.

Observations

Judge Sontchi's opinion gives tips on how to draft plans and related documents to cut off U.S. Trustee fees at confirmation.

In addition, the confirmation order could be written to provide that transfers by a trust will not be taxed by the U.S. Trustee. That way, the U.S. Trustee would be tasked with appealing the confirmation order and could not wait to claim fees after the trust makes disbursements.

The opinion is *In re Paragon Offshore PLC*, 629 B.R. 227 (Bankr. D. Del. June 28, 2021).

The Second Circuit split with the Fourth and Fifth Circuits by holding that the increase in fees for the U.S. Trustee system was unconstitutional because it was not imposed simultaneously in the two states with bankruptcy administrators.

Circuits Are Now Split on the Constitutionality of the 2018 Increase in U.S. Trustee Fees

Splitting with the Fourth and Fifth Circuits, the Second Circuit held that the 2018 increase in fees paid by chapter 11 debtors to the U.S. Trustee Program violates the Bankruptcy Clause of the Constitution because the increase did not apply immediately to debtors in two states with bankruptcy administrators.

Due to the limited nature of the relief sought by the debtor, the Second Circuit stopped short of declaring that a later version of the increase violates the constitution. However, the opinion could be read to mean that the increase was unconstitutional for all debtors whose cases were pending when the increase came into effect.

But there's more. Some readers may see hints in the May 24 opinion by Circuit Judge William J. Nardini that the dual system of U.S. Trustees and bankruptcy administrators by itself is constitutionally suspect.

By the way, dissenters in both the Fourth and Fifth Circuits believe that the increase was unconstitutional. As it now stands, five circuit judges see the increase as unconstitutional, while four circuit judges see no conflict with the Bankruptcy Clause.

The U.S. Trustee Fee Increase

The U.S. Trustee program has always been self-funding, with the cost paid by fees imposed on chapter 11 debtors based on the amount of their "disbursements." When the funds began to run dry, Congress raised the U.S. Trustee fees as part of the Bankruptcy Judgeship Act of 2017. Codified at 27 U.S.C. § 1930(a)(6)(B), the quarterly fee increased as of January 1, 2018.

The increase did not apply in the two states that employ bankruptcy administrators rather than U.S. Trustees. For those districts, the Judicial Conference increased the fees as of October 2018, nine months after the increase became effective in the other 48 states. More significantly, the increase in Alabama and North Carolina did not apply to pending cases.

The original 2017 version of Section 1930 said that the Judicial Conference "may" raise the fee for bankruptcy administrators. When there was an immediate outcry about an unconstitutional lack of uniformity, Congress passed the Bankruptcy Administration Improvement Act of 2020, Pub. L. No. 116-325, requiring the Judicial Conference to charge the same fees in bankruptcy administrator districts. However, the amendment in 2020 did not make the increase applicable to pending cases in bankruptcy administrator districts.

A debtor in Connecticut was reorganizing in chapter 11 when the increase came into effect in 2018. The debtor sued the U.S. Trustee in bankruptcy court, claiming that the increase violated the uniformity aspects of the Bankruptcy Clause of the Constitution. The debtor contended that it should be paying fees under the "old" schedule because its case was pending when the increase came into effect.

The bankruptcy court granted the U.S. Trustee's motion to dismiss. The Second Circuit granted a petition for direct appeal.

The Connecticut debtor confirmed its chapter 11 plan and closed the case before the 2020 amendment came into effect.

Two Circuits Find No Constitutional Violation

Both 2/1 decisions, the Fourth and Fifth Circuits found no constitutional violation in the increase. *See Siegel v. Fitzgerald (In re Circuit City Stores Inc.)*, 19-2240, 2021 BL 158721, 2021 U.S. App. Lexis 12845 (4th Cir. April 29, 2021), and *Hobbs v. Buffets LLC (In re Buffets LLC)*, 979 F.3d 366 (5th Cir. Nov. 3, 2020). To read ABI's discussion of *Circuit City* and *Buffets*, click here and here.

The dissenters in both cases found constitutional violations and at least hinted that the dual system of U.S. Trustees and bankruptcy administrators may in itself be unconstitutional.

The next circuit decision will come from the Federal Circuit on an appeal from the Court of Federal Claims, where the judge adopted the analysis of the Fifth Circuit and dismissed a purported class action. *See Acadiana Management Group LLC v. U.S.*, 19-496, 151 Fed. Cl. 121 (Ct. Cl. Nov. 30, 2020). For ABI's report on *Acadiana*, click here.

The Geographical Exception Didn't Work

Judge Nardini explained how the crux of the constitutional issue lay in two facts: The increase did not apply for nine months in bankruptcy administrator districts, and the increase never applied to cases pending in administrator districts when the increase came into effect.

To obviate the idea that uniformity was even required, the U.S. Trustee argued that the fee statute was not "a Law on the subject of Bankruptcies throughout the United States." U.S. Const. art. I, § 8, cl. 4.

Judge Nardini said the argument "has been repeatedly rejected by other courts." It "plainly fits" within the Supreme Court's broad definition of bankruptcy, because any increase affects how much creditors receive, he said.

Judge Nardini turned to the question of whether the statute was unconstitutional on its face by focusing on the "geographic discrepancy." He noted how the increase was "required" in U.S. Trustee districts but only "permitted" in two states.

Curiously, the U.S. Trustee contended that the failure of the Judicial Conference to invoke the increase immediately in administrator districts was an unauthorized act that should not render the statute non-uniform. Judge Nardini didn't buy the argument, because the statute used the word "may" and not "shall" when describing the Judicial Conference's ability to increase the fees in administrator districts.

Next, Judge Nardini rejected the theory espoused by the Fourth and Fifth Circuits that the fee discrepancy was permissible to deal with geographical differences, in the same sense that permitting differing exemptions among the states does not offend the notion of uniformity.

Supreme Court authority regarding the geographical exception to uniformity is found in *Blanchette v. Connecticut General Insurance Corp*., 419 U.S. 102 (1974), where the high court upheld bankruptcy laws pertaining to railroads in only one region of the U.S. The justices reasoned that a non-uniform law was permissible because, as Judge Nardini said, all railroad bankruptcies were confined to that region, making it "a geographically isolated problem."

Judge Nardini said that the two other circuits "overlooked a critical distinction." He cited *Ry. Labor Execs.' Ass'n v. Gibbons*, 455 U.S. 457, 473 (1982), where the Supreme Court said that a bankruptcy law "must at least apply uniformly to a defined class of debtors."

Judge Nardini found a lack of uniformity because two debtors, "identical in all respects save the geographic locations in which they filed for bankruptcy, are charged dramatically different fees." He also rejected the idea that the funding shortfall in U.S. Trustee districts resulted from a "geographically isolated problem."

The distinction "appears to exist," Judge Nardini said, "only because Congress chose — for politically expedient reasons — to create a dual bankruptcy system." He went on to say that "the [U.S. Trustee] program was intended to be a uniform, nationwide program, but lawmakers in Alabama and North Carolina resisted and, after receiving a number of extensions, ultimately were granted a permanent exemption from the [U.S. Trustee] program in an unrelated law."

Adopting a geographical exception to uniformity, Judge Nardini said, "would yield the following inexplicable rule: Congress must enact uniform laws on the subject of bankruptcy . . . except when Congress elects to treat debtors non-uniformly."

Relief Granted by the Appeals Court

Judge Nadini said that the debtor was only challenging Section 1930 as it read before the 2020 amendment. He therefore held that the 2017 statute, before adoption of the 2020 amendment, "was unconstitutional on its face insofar as it charged higher fees to debtors in [U.S. Trustee] Districts." He ruled that the debtor was entitled to a refund of anything it paid in excess of what it would have paid in a bankruptcy administrator district.

Judge Nardini limited the scope of the holding by saying, "We do not address the constitutionality of the current version, or of any other portion of § 1930, or of any other aspect of the [U.S. Trustee/bankruptcy administrator] District system."

Observations

"It's a nice, clearly written opinion," Prof. Stephen J. Lubben told ABI. He occupies the Harvey Washington Wiley Chair in Corporate Governance & Business Ethics at Seton Hall University School of Law.

Prof. Lubben went on to say that the opinion "does not greatly further our understanding of the Bankruptcy Clause, and it does leave open the question of whether the U.S. Trustee system itself is unconstitutionally nonuniform."

The dissents in the Fourth and Fifth Circuits could be read to insinuate that the dual system of U.S. Trustees and bankruptcy administrators may be non-uniform and unconstitutional. Judge Nardini seemed skeptical about the underpinnings of the dual system when he referred to the "politically expedient reasons" for rejecting U.S. Trustees in two states.

However, bankruptcy administrators and U.S. Trustees are not judges. They do not make law and do not enforce law on their own. In substance, they are debtors' government-financed adversaries. Does the Constitution mandate that debtors' adversaries must be identical throughout the country?

Instead of U.S. Trustees, would it have been unconstitutional had Congress instead permitted local courts to employ attorneys to appear as watchdogs, perhaps combining the roles of case trustee and U.S. Trustee?

If the dual system is unconstitutional, what about trustees in chapters 7, 11, 12 and 13? In some respects, trustees have more important roles and more authority than U.S. Trustees. Is our system of trustees unconstitutional because trustees are not employed by the same governmental agency?

Prof. Lubben is the author of the leading scholarly commentary on the Uniformity Clause, *A New Understanding of the Bankruptcy Clause*, 64 CASE W. RES. L. REV. 319 (2013).

Note: Judge Nardini received his commission in November 2019, immediately after being confirmed by an 86-2 vote in the Senate. He had been executive editor of the *Yale Law Journal* and clerked for both the Second Circuit and the Supreme Court. He was an assistant U.S. Attorney in Connecticut for 15 years, including service as chief of the criminal division.

The opinion is *Clinton Nurseries Inc. v. Harrington (In re Clinton Nurseries Inc.)*, 20-1209 (2d Cir. May 24, 2021).

Dissenters in the Fourth and Fifth Circuits evidently believe that the dual U.S. Trustee/Bankruptcy Administrator system is unconstitutional.

Another Circuit Upholds the 2018 Increase in U.S. Trustee Fees

Siding with majority in the split decision by the Fifth Circuit, the Fourth Circuit ruled 2/1 on April 29 that the 2018 increase in fees paid by chapter 11 debtors to the U.S. Trustee Program applies to pending cases and violates neither the Due Process nor the Bankruptcy Clauses of the U.S. Constitution.

In dissent, Fourth Circuit Judge A. Marvin Quattlebaum, Jr. would have held the increase to be unconstitutional because some debtors in two states pay lower fees. Although the issue was not before him, Judge Quattlebaum's dissent seems to say that the division of the country into U.S. Trustee and Bankruptcy Administrator districts is unconstitutional in itself.

The Large U.S. Trustee Fee Increase

To ensure that taxpayers do not finance the U.S. Trustee Program, Congress raised the U.S. Trustee fees as part of the Bankruptcy Judgeship Act of 2017. Codified at 27 U.S.C. § 1930(a)(6)(B), the quarterly fee increased as of January 1, 2018.

The increase did not apply in the two states that continue using Bankruptcy Administrators rather than U.S. Trustees. For those districts, the Judicial Conference increased the fees as of October 2018, about nine months after the increase became effective in the other 48 states. Perhaps more significantly, the increase in Alabama and North Carolina did not apply to pending cases.

Electronics retailer Circuit City had confirmed a liquidating chapter 11 plan in Virginia in 2010. The increase in 2018 obliged Circuit City's liquidating trust to pay $575,000 more than would have been owing under the old fee schedule.

After a bankruptcy court in Texas ruled that the increase was unconstitutional and not applicable to pending cases, Circuit City sued, making the arguments that prevailed in Texas.

In July 2019, the bankruptcy court in Virginia ruled in favor of Circuit City and held that the increase was not retroactive and did not apply to pending cases. In addition, the bankruptcy court decided that the increase was unconstitutional. *In re Circuit City Stores Inc.*, 08-35653, 2019 BL

264824, 2019 Bankr. Lexis 2121 (Bankr. E.D. Va. July 15, 2019). To read ABI's discussion of the bankruptcy court opinion, click here.

Both sides appealed, and the Fourth Circuit granted a direct appeal, overstepping an intermediate appeal to the district court. While the appeal was pending, the Fifth Circuit reversed the Texas bankruptcy court in a 2/1 opinion, holding that the increase applied to pending cases and did not offend the constitution. *See Hobbs v. Buffets LLC (In re Buffets LLC)*, 979 F.3d 366 (5th Cir. Nov. 3, 2020). To read ABI's discussion of *Buffets*, click here.

The Fourth Circuit's Majority Opinion

Fourth Circuit Judge Robert B. King handed down the opinion for the majority. In substance, he agreed with the Fifth Circuit's *Buffets* opinion. He said that the uniformity aspect of the Bankruptcy Clause does not "straightjacket" Congress by forbidding distinctions among classes of debtors. He said that "most courts" do not see a uniformity problem with the fee increase, although debtors with pending cases in two states do not pay the increase.

Like the Fifth Circuit, Judge King did not believe that the statute made arbitrary geographic distinctions based on the residence of the debtor. Rather, he said, the distinction is the result of Virginia's use of the U.S. Trustee system.

Judge King explained that fees rose in U.S. Trustee districts to solve the program's self-funding shortfall. There was not a similar problem in Bankruptcy Administrator districts where funding is from the judiciary's general budget. He thus held that the increase did not violate the uniformity mandates of either the Due Process or Bankruptcy Clauses.

Circuit City had cross-appealed the bankruptcy court's conclusion that the increase applied to pending cases.

Judge King first decided that Congress meant for the increase to apply to all cases, "without regard to the case's filing date." In his view, the increase was not retroactive because it "plainly applies only to *future* disbursements, which are triggered by a debtor's conduct occurring after the effective date." [Emphasis in original.]

Judge King said that the "increase merely upsets debtors' 'expectations as to amounts owed based on future distributions'" quoting *Buffets*, *supra*, 979 F.3d at 375. Debtors, he said, "reasonably expected to pay fees pursuant to some formula."

The appeals court's majority reversed in part and affirmed in part, ruling that the increase was constitutional and not impermissibly retroactive.

The Dissent

The dissent by Judge Quattlebaum bears reading by constitutional law buffs. Why? Because he and Fifth Circuit Judge Edith Brown Clement have all but said that the dual U.S. Trustee/Bankruptcy Administrator system is unconstitutional. Judge Clement was the dissenter in *Buffets*.

"Make no mistake about it," Judge Quattlebaum said in opening his dissent. We "have two bankruptcy courts in the U.S.," because two states have Bankruptcy Administrators. Given that the fees are lower for debtors whose cases were already pending in the two Bankruptcy Administrator states, he said that "many unsecured creditors in [48 states with U.S. Trustees] are receiving less of the amounts owed to them than similarly situated creditors in Alabama and North Carolina."

The two systems, Judge Quattlebaum said, are "candidly and unapologetically nonuniform. And the quarterly fees that Chapter 11 debtors pay in the Trustee Program and the Bankruptcy Administrator system are also non-uniform."

Judge Quattlebaum pointed out how the U.S. Trustee system is funded by debtors, while the Bankruptcy Administrators' budgets come from the appropriations for the judiciary. He rejected the contention that there is no constitutional problem because uniformity only applies to substantive bankruptcy laws.

In Judge Quattlebaum's view, causing similarly situated creditors to receive less in U.S. Trustee districts is "sufficiently substantive to implicate the Bankruptcy Clause." He also rejected the notion that the fees are nonetheless uniform. To illustrate his point, he cited the Bankruptcy Administration Improvement Act of 2020, Pub. L. 116-325, 134 Stat. 5085 (2021), which became law on January 12, 2021.

The change in January used the word "shall" to mandate the increase in Bankruptcy Administrator districts. Previously, Section 1930 had used the word "may."

"While [the amendment] likely ameliorates the uniformity issue going forward, it does not eliminate the problem in the as-applied challenge before us," Judge Quattlebaum said.

"Indeed," according to Judge Quattlebaum, "the difference in bankruptcy systems is arbitrary and financially damages unsecured creditors in every state other than Alabama and North Carolina." While "the constitutionality of the two types of bankruptcy systems is not before the court, I would nonetheless hold that the amended quarterly fee statute, as applied to [Circuit City], violates the Bankruptcy Clause."

If it were up to him, Judge Quattlebaum would have found "the amended quarterly fee statute [to be] unconstitutionally non-uniform."

The Pending Appeals

In split decisions, the Fourth and Fifth Circuits have now upheld the fee increase both as a matter of constitutional law and statutory interpretation.

On November 30, the U.S. Court of Federal Claims adopted the Fifth Circuit's analysis in *Buffets* and upheld the constitutionality of the increase in a class action. *See Acadiana Management Group LLC v. U.S.*, 151 Fed. Cl. 121 (Ct. Cl. Nov. 30, 2020). A petition for reconsideration is pending. To read ABI's report, click here.

However, District Judge John W. Holcomb of Riverside, Calif., held on April 1 that the 2018 increase in fees paid by chapter 11 debtors to the U.S. Trustee Program is unconstitutional and not applicable to pending cases. *USA Sales Inc. v. Office of the U.S. Trustee*, 19-02133, 2021 BL 121542 (C.D. Cal. April 1, 2021). To read ABI's report, click here.

Judge Holcomb stayed his judgment pending appeal. The time for appeal expires around the middle of May.

There is reason to believe that the Ninth Circuit might affirm *USA Sales*. In 1995, the Ninth Circuit held that Congress' decision to impose quarterly fees in U.S. Trustee districts, but not in Bankruptcy Administrator districts, violated the Bankruptcy Clause of the Constitution. *St. Angelo v. Victoria Farms Inc.*, 38 F.3d 1525 (9th Cir. 1994), amended by 46 F.3d 969 (9th Cir. 1995).

Congress soon thereafter required the judiciary impose the same fees in Bankruptcy Administrator districts. *St. Angelo* then became moot, until Congress again upset the uniformity applecart by raising the fees in 2018.

If the Ninth Circuit upholds *USA Sales* based on *St. Angelo*, there will be a split of circuits and nifty questions presented to the Supreme Court on petitions for *certiorari*. It is within the realm of possibility that the dual U.S. Trustee/Bankruptcy Administrator systems will be found unconstitutional.

Granted, there may be a uniformity problem regarding fees for debtors with pending cases. But is there a uniformity problem because a debtor has a different government adversary in two states?

The Supreme Court may think long and hard before issuing a uniformity opinion for bankruptcy that could have wide repercussions elsewhere.

The opinions are *Siegel v. Fitzgerald (In re Circuit City Stores Inc.)*, 19-2240 (4th Cir. April 29, 2021).

Preferences, Fraudulent Transfers & Claims

Circuit courts differ on their understanding of Supreme Court precedent and are now split 3/3 on whether a real estate tax foreclosure can be set aside as a constructive fraudulent transfer.

Split Grows on Barring Fraudulent Transfer Attacks on Real Estate Tax Foreclosures

Add the Sixth Circuit to the courts holding that real estate tax foreclosures can be attacked as fraudulent transfers despite *BFP v. Resolution Trust*, 511 U.S. 531 (1994), where the Supreme Court ruled that mortgage foreclosures are immune from fraudulent transfer attack.

Although the appeals court's decision was non-precedential, the opinion has equally important language about limitations on the *Rooker-Feldman* doctrine.

The Circuit Split

Regarding tax foreclosure, the Third, Sixth and Seventh Circuits now hold that they can be attacked as fraudulent transfers. Regarding the Third Circuit, *see Hackler v. Arianna Holdings Co., LLC*, 938 F.3d 473 (3d Cir. 2019). To read ABI's report, click here. Regarding the Seventh Circuit, *see Smith*, *infra*.

The Fifth, Ninth and Tenth Circuits hold to the contrary, having extended *BFP* from immunizing mortgage foreclosures to protecting tax foreclosures. The most recent of those decisions came from the Ninth Circuit. *See Tracht Gut, LLC v. Los Angeles County Treasurer*, 836 F.3d 1146 (9th Cir. 2016). To read ABI's report on *Tracht Gut*, click here.

Delinquent Taxes

In the Sixth Circuit appeal, the debtor had been several years behind in paying real estate taxes on his home. The county obtained a final judgment of foreclosure. Because the debtor did not redeem the property by paying the taxes on time, the city exercised its statutory right to purchase the property for the amount of the unpaid taxes, about $14,500.

At the time, the property was assessed for $104,000. The debtor alleged that the fair market value was $152,000.

The debtor filed a chapter 13 petition and a complaint alleging that the tax sale could be avoided as a constructively fraudulent transfer under Section 548(a)(1)(B). The city filed a motion for summary judgment and won.

The bankruptcy court reasoned that the *Rooker-Feldman* doctrine barred relitigating the state court foreclosure. The bankruptcy court also said that the fraudulent transfer attack was precluded by *BFP*.

The debtor appealed. The district court affirmed, but based only on *BFP*. The debtor appealed again and won a remand.

By the way, the debtor remains in chapter 13, having confirmed a plan.

Rooker-Feldman

In his December 27 opinion, Circuit Judge John M. Rogers first dealt with *Rooker-Feldman*. Named for two Supreme Court decisions, the doctrine bars lower federal courts from engaging in appellate review of state court judgments.

Judge Rogers quoted the Supreme Court for saying that *Rooker-Feldman* is a narrow doctrine that should not be applied broadly. He cited the Third Circuit for holding that the court may decide whether foreclosure amounted to a fraudulent transfer under Section 548 while still assuming that the state court foreclosure was proper. *See In re Philadelphia Ent. & Dev. Partners*, 879 F.3d 492, 500-01 (3d Cir. 2018). To read ABI's report, click here.

In the case on appeal, Judge Rogers ruled that *Rooker-Feldman* "does not apply here because this appeal does not involve a review of the merits of a state court judgment." He said that the debtor's "alleged injury in this case is not the state court foreclosure judgment, but instead is the fact that he could not use § 548 to avoid the foreclosure as a fraudulent transfer."

The bankruptcy court therefore erred in barring the fraudulent transfer claim under *Rooker-Feldman*.

BFP

Next, Judge Rogers tackled the bankruptcy court's second ground for dismissal, the expansion of *BFP* to cover real estate tax foreclosures.

Tersely, Judge Rogers said that the "Supreme Court's rule in *BFP* does not apply to the facts of this case," because the Supreme Court was ruling on mortgage foreclosure, not tax foreclosure.

Judge Rogers noted the differences between the two types of foreclosure. In tax foreclosure in Michigan, there is no public auction and no minimum bid. In the case on appeal, the sale price of $14,500 "had no apparent relation to the value of the property and was only about ten percent of the alleged fair-market value."

Based on the same factual distinctions, Judge Rogers cited the Seventh Circuit for "persuasively" holding "that *BFP* did not extend to the state court tax foreclosure at issue." *See In re Smith*, 811 F.3d 228, 234 (7th Cir. 2016). For ABI's report, click here.

Judge Rogers held that the two grounds for upholding dismissal of the suit are "insufficient at this juncture." However, he was unable to award judgment altogether to the debtor.

Remand

There were two undecided issues that precluded the Sixth Circuit from granting judgment in favor of the debtor. First, the lower courts had not decided whether the debtor was insolvent on filing and thus eligible to raise a claim for a constructively fraudulent transfer. Second, there was an unresolved question about the debtor's ability to attack the sale once the redemption period had elapsed.

So, Judge Rogers reversed and remanded, saying that the "district court may in its discretion further remand the case to the bankruptcy court."

The opinion is *Lowry v. Southfield Neighborhood Revitalization Initiative (In re Lowry)*, 20-1712 (6th Cir. Dec. 27, 2021).

Not having challenged pre-petition liens on time, a chapter 7 trustee was barred from taking over an adversary proceeding initiated by a now-dissolved chapter 11 creditors' committee.

Jevic Rises from the Dead to Bar Claims Brought Originally by the Creditors' Committee

Jevic is still making law!

You remember *Jevic*, don't you? That's where the Supreme Court held in March 2017 that a so-called structured settlement ending a chapter 11 case cannot include a distribution to creditors in violation of the priorities in Section 507(a).

Jevic has now made law on a different but equally important subject: Bankruptcy Judge Brendan L. Shannon of Delaware followed the Tenth Circuit by holding that a so-called DIP financing order can preclude a subsequent chapter 7 trustee from taking over a lawsuit originally filed by the chapter 11 creditors' committee challenging the liens of secured lenders.

Because a creditors' committee evaporates on conversion to chapter 7, the new *Jevic* opinion means that no one is left to attack the lenders' liens. The creditors have no one to blame but themselves, since they are the ones who agreed to the wording of the DIP financing order.

The new *Jevic* decision counsels committees to rethink language typically employed in DIP financing orders.

The Tortured History

Jevic Holding Corp. filed a chapter 11 petition in Delaware in 2008, almost exactly 13 years ago. One month after filing, the bankruptcy court entered an order, known as a DIP financing order, granting final approval for post-petition financing. In return for new financing, the debtor waived any claims it might have had against the lenders.

The financing order went on to say that the waivers "shall be binding upon the Debtors and any successor thereto (including without limitation any Chapter 7 or Chapter 11 trustee appointed or elected for any of the Debtors) in all circumstances."

In typical fashion, the financing order gave interested parties 75 days to investigate and challenge pre-petition liens. Within the time limit, the official creditors' committee sued the lenders, challenging their claims and liens.

After mediation, the debtor, the banks and the committee reached a settlement where the lenders would set aside some money for distribution to general unsecured creditors after dismissal. The distribution scheme in the settlement did not follow the priority rules contained in Section 507.

Pointedly, the settlement gave nothing to workers for their $8.3 million in priority claims for unpaid wages. The workers objected to the settlement because some settlement proceeds were going to lower-ranked general unsecured creditors.

The bankruptcy court approved the settlement, and the Third Circuit upheld the structured dismissal in a 2-1 opinion, eliminating any chance of recovery by priority wage claimants.

The Supreme Court reversed and remanded in a 6/2 opinion, with the two dissenters arguing that the petition for *certiorari* should have been dismissed as having been improvidently granted. *Czyzewski v. Jevic Holding Corp.*, 137 S. Ct. 973, 197 L. Ed. 2d 398, 85 U.S.L.W. 4115 (Sup. Ct. March 22, 2017). To read ABI's report on ***Jevic***, click here.

On remand, the case ended back in the lap of Judge Shannon, who once again nixed a revised settlement in May 2018 and converted the case to chapter 7. To read ABI's report, click here.

After conversion, the chapter 7 trustee filed a motion in 2019 for his substitution as plaintiff in the still-pending suit by the creditors' committee against the lenders. The lenders objected to substitution, contending that the trustee was a successor to the debtor and was thus barred from attacking the lenders' liens and claims.

The Tenth Circuit Paves the Way

Judge Shannon denied the substitution motion in an opinion on May 5 and adopted the approach by the Tenth Circuit in *Hill v. Akamai Tech. Inc. (In re MS55 Inc.)*, 477 F.3d 1131 (10th Cir. 2007).

Akamai taught that "a Chapter 7 trustee succeeds to the rights of the debtor-in-possession and is bound by prior actions of the debtor-in-possession to the extent approved by the court." *Id*. at 1135. In that respect, Judge Shannon said it was "undisputed" that the DIP financing order waived the debtor's claims against the lenders.

The debtor's waiver invoked the additional provision in the financing order saying that the debtor's waivers would be binding on a chapter 7 trustee "in all circumstances."

The lenders contended that *Akamai* was on point. Indeed, it was, although not precisely. In *Akamai*, the DIP financing order waived the debtor's claims against the lenders but gave the committee the right to investigate and challenge. Unlike the *Jevic* committee, however, the *Akamai* committee had not sued before conversion.

Judge Shannon characterized the Tenth Circuit as holding that "the Chapter 7 trustee's rights to pursue avoidance actions are derivative of the debtor's rights; so, the trustee was barred from bringing an avoidance action against the secured creditor because the court-approved financing order barred the debtor from doing so."

The *Jevic* trustee pointed out factual distinctions to argue that he was the proper party in interest to pursue the committee's lawsuit because the committee had dissolved on conversion.

Judge Shannon disagreed. The trustee was not appointed during the 75-day investigation period "and, therefore, cannot assert a challenge." Once the 75-day investigation period ended, he said that "a party in interest's right to challenge the Prepetition Indebtedness ended, including any right of a Chapter 7 Trustee appointed during that period."

Judge Shannon also quoted *Akamai* regarding the committee's challenge. The Denver-based appeals court said that the "creditors' committee may have retained a right of action, but that does not remove the existing bar against the debtor-in-possession or, post-conversion, the trustee enforcing those rights." *Id*. at 1135-1136.

In other words, the right of the committee to sue was "not transferrable to the Chapter 7 Trustee, who is bound by the provisions of the Final DIP Order," Judge Shannon said.

The trustee argued that bootstrapping on the committee was not necessary because the claims belong to the estate and therefore vested in the trustee on conversion. Again, Judge Shannon disagreed. The trustee could pursue claims after conversion, "***except*** when the debtor bars itself, and its successor, from asserting those rights." [Emphasis in original.]

In short, Judge Shannon denied the substitution motion because the trustee "is bound by the stipulations, admissions and waivers made by the Debtors pre-conversion."

Observations

The new *Jevic* decision should alter the negotiation over DIP lending orders. If everyone were to agree or the court were to order, a financing order presumably could permit a chapter 7 trustee to assume prosecution of a timely challenge.

The opinion is *Official Committee of Unsecured Creditors v. CIT Group/Business Credit Inc. (In re Jevic Holding Corp.)*, 08-51903, 2021 BL 168313 (Bankr. D. Del. May 5, 2021).

There can be no question about whether the beneficiary of a surety bond has been 'paid in full' before the surety has subrogation rights.

Third Circuit Makes Strict Rules Before Subrogation Rights Kick In

Affirming Bankruptcy Judge Christopher S. Sontchi of Delaware, the Third Circuit explained the meaning of Section 509(c), the most incomprehensible provision in the Bankruptcy Code.

In essence, the Third Circuit rigorously interpreted "paid in full" in Section 509(c) to benefit the beneficiary of a payment and performance bond. There can be no question about whether the beneficiary of the bond has been paid in full before the bonding company is subrogated to the claim and rights of the beneficiary.

The Contracts and the Bond

A contractor had multiple contracts with the U.S. government. The contractor was required to post a payment and performance bond.

The contractor defaulted on one of the construction contracts. The government tapped on the shoulder of the bonding company, which hired another contractor to complete the job.

According to the August 18 opinion by Chief Circuit Judge D. Brooks Smith, the bonding company was out of pocket by some $12 million more than the government paid to complete the project.

The defaulting contractor ended up in chapter 7. Just before bankruptcy, the contractor filed an income tax return and claimed a $5.5 million carryback refund from the IRS.

The bonding company was still paying to complete the project while the bankruptcy was in progress. The government notified the bonding company in February 2016 that the project was "sufficiently complete" to allow occupancy. However, the bonding company did not make the final payment to the replacement contractor until September 2016.

The government filed a claim against the contractor for some $170 million, including more than $80 million on the bonded project.

On the other side of the fence, the trustee was contending that the government owed more than $50 million on other projects.

The disputes led to a compromise with the bankruptcy trustee where the government agreed to release the $5.5 million refund to the trustee and waive its setoff rights. In return, the government was given an allowed unsecured, nonpriority claim for $170 million.

The bonding company objected to the settlement, claiming it was subrogated to the government's rights to the $5.5 million tax refund. The objection resulted in a companion settlement where the $5.5 million was held in escrow, and the bonding company was assured that the primary settlement would not waive the bonding company's claims, "if any," to the tax refund.

The bankruptcy court approved the primary settlement in June 2016, waiving the government's setoff rights. Note that the bonding company would not make the final payment to the replacement contractor until September 2016.

In approving the settlement and overruling the bonding company's objections, Bankruptcy Judge Sontchi granted summary judgment in favor of the secured lender that had a lien on the contractor's assets, including the tax refund. Judge Sontchi concluded that the government had not been "paid in full" when the waiver became effective. He therefore ruled that the government was entitled to waive its right of setoff and thus defeat the bonding company's subrogation rights.

The district court affirmed, and so did Judge Smith.

'Paid in Full' in Section 509(c)

Judge Smith began by laying out the common law elements of subrogation and explained how they were modified by Section 509.

Departing from common law, Judge Smith said that "Section 509(a) provides that a surety is partially subrogated to the rights of a creditor to the extent that the surety has made *any* payments (*i.e.*, short of payment in full)." [Emphasis in original.]

Fortunately for us, Judge Smith translated Section 509(c) into plain English. The subsection, he said, "provides that those subrogation rights are subordinated to the remainder of the creditor's claim until the creditor has been paid in full." He cited legislative history as reflecting the concern of Congress that the statute should not permit a bonding company to compete with the insured until the insured's claim has been paid in full.

Judge Smith said that the statute does not define "paid in full." There are broad and narrow interpretations of the words. Under either, the bonding company loses, he said.

The broad interpretation requires full payment of all claims that the beneficiary of the bond has against the contractor, not just the contract to which the bond applied. Under that definition, the bonding company would lose because the government had many other unpaid claims against the bankrupt contractor.

The narrow construction requires full payment of the claims covered just by the bond. Thus, Judge Smith launched into an analysis of whether the government had been paid in full by June 2016, when the government waived its right to set off the tax refund.

Judge Smith said there was "no evidence in the record" to show that the government had been paid in full when the waiver was made. To the contrary, he said, the government was not paid in full until the bonding company made the last payment to the replacement contractor months after the waiver.

Judge Smith also said that the bonding company's agreement years before to complete the project did not in itself "satisfy" the bonding company's suretyship obligations.

Affirming Judge Sontchi, Judge Smith held that the government had not been "paid in full" under Section 509(c) before the bankruptcy court approved the settlement waiving the government's right of setoff. The bonding company was not yet subrogated and had no right to object to the government's waiver of setoff rights.

The opinion is *Giuliano v. Insurance Co. of Pennsylvania (In re LTC Holdings Inc.)*, 20-3057 (3d Cir. Aug. 18, 2021).

Circuit Judge Ambro generously interprets Katz to mean that ratification of the Constitution waived state sovereign immunity broadly for suits to augment a bankrupt estate.

Third Circuit Finds Broad Waiver of Sovereign Immunity for Suits Augmenting the Estate

In *Katz*, the Supreme Court ruled that states waived sovereign immunity for some types of bankruptcy proceedings when the states ratified the Constitution with its Bankruptcy Clause.

Third Circuit Judge Thomas L. Ambro generously interpreted *Katz* to find a broad waiver of sovereign immunity when a debtor sues the state to augment the estate. More particularly, Judge Ambro ruled that sovereign immunity does not prevent a liquidating trustee from bringing an inverse condemnation suit against the state.

The Inverse Condemnation Suit

A company leased an offshore oil-production platform from the State of California and owned an onshore facility for processing and refining oil. A rupture in the pipeline forced the company into chapter 11, where it abandoned the lease for the platform. Walking away from the platform gave the state large claims for plugging and abandoning the wells.

Invoking police powers, the state took the position that it could take over the onshore facility without payment. After the company confirmed a liquidating chapter 11 plan, the liquidating trustee mounted an inverse condemnation suit against the state in bankruptcy court.

In his May 24 opinion, Judge Ambro explained that inverse condemnation occurs when an owner sues the government for the value of property that was taken. Direct condemnation is when the government initiates proceedings to acquire title under its eminent domain authority.

The state filed a motion to dismiss, claiming the suit was barred by sovereign immunity. The bankruptcy court denied the motion to dismiss, and the district court authorized a direct appeal, but only regarding sovereign immunity. The Third Circuit accepted the appeal and heard argument in late September 2020.

Constitutional Waiver via *Katz*

The opinion reads like a treatise laying out various circumstances when states have no sovereign immunity. Although not involved in the appeal, legislation can waive state sovereign immunity when "Congress unequivocally expresse[s] its intent to end immunity," Judge Ambro said. *See*, *e.g.*, Section 106.

Then came *Central Virginia Community College v. Katz*, 546 U.S. 356 (2006), where the Supreme Court ruled there was no sovereign immunity barring a debtor from suing a state instrumentality to recover a preference.

Judge Ambro identified three principles arising from *Katz*. First, by ratifying the Constitution containing the Bankruptcy Clause, states waived sovereign immunity in certain bankruptcy proceedings designed to "effectuate the *in rem* jurisdiction of the bankruptcy courts." *Id.* at 378.

Second, *Katz* did not say that foreign immunity is waived in all bankruptcy proceedings. *Id*.

Third, Judge Ambro said that *Katz* "does not require a proceeding to be technically *in rem*" if the action is ancillary to and in furtherance of *in rem* jurisdiction, even if the action involves *in personam* process. *Id*. at 370 and 372.

Judge Ambro summarized *Katz's* holding as follows: "States cannot assert a defense of sovereign immunity in proceedings that further a bankruptcy court's *in rem* jurisdiction no matter the technical classification of that proceeding."

Applying *Katz* to Inverse Condemnation

Judge Ambro read *Katz* as identifying three functions where proceedings are in furtherance of *in rem* jurisdiction: (1) exercising jurisdiction over estate property; (2) equitably distributing estate property; and (3) effectuating the debtor's discharge. The court, he said, "must focus on function, not form."

The inverse condemnation suit, Judge Ambro said, "furthers the Bankruptcy Court's exercise of jurisdiction over property of the Debtors and their estates, as it seeks a ruling on rights in the Onshore Facility." Although the suit was not clearly *in rem*, he said that "its function is to decide rights in [the debtor's] property" and whether the state can use the debtor's property "for free."

Because the onshore facility was a "significant asset," Judge Ambro said that the suit "also furthers the second critical function — facilitating equitable distribution of the estate's assets."

Confirming the plan did not reinstate the state's immunity. Judge Ambro held that "critical *in rem* functions did not end when the Plan became effective, as the Trust exists primarily to facilitate the 'equitable distribution of [the debtor's property] among the debtor's creditors,'" quoting *Katz*

at 546. Moreover, he said that the estate's *in rem* jurisdiction extended to estate property that was transferred to the liquidating trust.

Judge Ambro therefore held that the state's "defense of Eleventh Amendment immunity fails."

Finally, Judge Ambro rejected the idea that the state enjoyed sovereign immunity under California law. If that were true, he said that "state legislation [could] easily end-run the deemed waiver of state sovereign immunity effected by the Bankruptcy Clause and recognized in *Katz*."

Having found a constitutional waiver of sovereign immunity, Judge Ambro did not reach the additional question of whether the state had waived immunity by filing a proof of claim.

The opinion is *Davis v. California (In re Venoco LLC)*, 20-1061 (3d Cir. May 24, 2021).

Reducing a claim between the first and second bankruptcy didn't prevent the Fifth Circuit from employing res judicata.

Res Judicata Limits an Objection to a Claim Allowed in a Prior Bankruptcy

Res judicata limits the ability of a debtor in a second chapter 11 case to object to a claim allowed in a prior bankruptcy, the Fifth Circuit said.

A company and its individual owner were in parallel chapter 11 cases. The two debtors proposed and confirmed a joint plan.

The plan allowed the claim of a secured creditor for $1.8 million (rounded off). The plan called for the claim to accrue 5% interest and to be paid in 59 equal installments, with a so-called balloon payment in the 60th month.

After the 38th payment, the company filed in chapter 11 again and stopped making payments under the plan from the prior case. In the new case, the lender filed a proof of claim for $1.3 million (rounded off).

The corporate debtor objected to the $1.3 million claim, contending that most of the original $1.8 million claim was owing solely by the owner. Bankruptcy Judge Ronald B. King overruled the objection, holding that the objection was barred by *res judicata*, among other theories.

The district court affirmed, and so did Circuit Judge Edith Brown Clement in an opinion on November 15.

First, Judge Clement dealt with the bankruptcy court's subject matter jurisdiction.

The corporate debtor argued that most of the debt was owed only by the individual, thus giving the bankruptcy court no subject matter jurisdiction to rule on the allowance of a debt owed by a non-debtor.

"[W]hether the bankruptcy court's allowance of [the lender's] claim was *proper* is an entirely different question from whether it had the *jurisdiction* to do so," Judge Clement said. She held that the "*propriety* of the bankruptcy court's determination to allow or disallow a claim against the debtor's estate is simply not a jurisdictional inquiry." [Emphasis in original.]

Next, Judge Clement analyzed whether the requisites of *res judicata* were satisfied.

There was no dispute about three elements: (1) The lender and the debtor were both parties in the first bankruptcy; (2) confirmation in the first bankruptcy was final; and (3) the bankruptcy court had jurisdiction in the first bankruptcy.

The debtor disputed the fourth element: whether the objection in the second bankruptcy arose out of the same transaction that underlay the prior bankruptcy.

The Fifth Circuit employs a "transactional test," Judge Clement said. Citing *Nilsen v. City of Moss Point*, 701 F.2d 556, 560 (5th Cir. 1983) (*en banc*), she asked whether the two actions were based on the "same nucleus of operative facts."

In the case on appeal, Judge Clement inquired as to "whether the transactions at the heart of [the debtor's] claim objection in the second bankruptcy were the source of [the lender's] claim in the first bankruptcy." In other words, was the claim objection in the second bankruptcy "based on the same transaction or series of transactions that gave rise to the terms of the [chapter 11 plan in the first bankruptcy] as it relates to the amount of [the lender's] claim"?

Judge Clement held "that it is," because the objection in the second case "depends entirely on" the subject matter "that formed the basis" for the lender's claim in the first bankruptcy.

Even if all four elements were present, Judge Clement said that *res judicata* would not apply unless the debtor "could have or should have" raised the claim in the first bankruptcy.

Since the claim objection in the second bankruptcy was "undeniably a question" about the propriety of the claim in the first bankruptcy, Judge Clement said the debtor could have raised the objection in the first bankruptcy. Consequently, she said, the debtor was precluded from contending that the claim had been allowed "for the wrong amount."

Judge Clement raised a caveat. *Res judicata* did not prevent the debtor "from maintaining *any* claim objection in the second bankruptcy." [Emphasis in original.] The doctrine only barred "a claim objection that is premised, in part or in whole, on the impropriety of [the lender's] claim from the" plan in the first bankruptcy.

The claim had been reduced between the first and second bankruptcies, raising the question of whether the allowance of the claim in the second bankruptcy for $1.3 million was the correct amount. That issue, Judge Clement said, was "merely a factual determination reviewed for clear error."

Examining the evidence and the bankruptcy judge's findings in the second bankruptcy, Judge Clement found no clear error and affirmed.

The opinion is *BVS Construction Inc. v. Prosperity Bank (In re BSV Construction Inc.)*, 21-50274 (5th Cir. Nov. 15, 2021).

The Tenth Circuit will likely take sides on a split between the Ninth and Seventh Circuits on Section 544(b) state-law claims brought by a trustee in the shoes of an actual creditor.

Split Heading to the Tenth Circuit on Sovereign Immunity for Section 544(b) Claims

The Internal Revenue Service seems to be setting up the Tenth Circuit to take sides on the following circuit split:

> Does the waiver of sovereign immunity under Section 106(a)(1) bar a trustee from suing the government under Section 544(b) for receipt of a fraudulent transfer based on *state* law?

In 2017, the Ninth Circuit held in *Zazzali v. U.S. (In re DBSI Inc.)*, 869 F.3d 1004 (9th Cir. Aug. 31, 2017), that the waiver of sovereign immunity under Section 106(a)(1) allows a trustee to file a derivative suit against the IRS for receipt of a state-law fraudulent transfer under Section 544(b)(1). To read ABI's report, click here.

The Ninth Circuit had split with a Seventh Circuit opinion rendered three years earlier, *In re Equipment Acquisition Resources Inc.*, 742 F.3d 743 (7th Cir. 2014). The Chicago-based appeals court had reasoned that the waiver of immunity does not extend to Section 544(b)(1) suits because any actual creditor would have been barred from suing by the government's sovereign immunity.

The same issue is coming up in the Tenth Circuit from a district court decision in favor of the trustee finding a waiver of sovereign immunity.

Same Facts as *DSBI*

A corporation filed a chapter 11 petition in 2017. The case was converted to chapter 7.

More than three years before bankruptcy, the corporation had paid the IRS about $150,000, representing tax liabilities for two individuals who were officers, directors and shareholders of the debtor corporation.

Utilizing Section 544(b)(1), the chapter 7 trustee sued the IRS to recover the payments as fraudulent transfers under Utah's version of the Uniform Fraudulent Transfer Act.

The IRS agreed that the debtor corporation received no value and that the debtor was insolvent at the time of the transfer. The IRS also conceded there was an unsecured creditor in existence at the time who still held an allowable claim at the time of bankruptcy, to supply the requirement of an actual creditor under Section 544(b)(1).

The IRS argued, however, that no actual creditor could exist because any actual creditor would be barred from suing the government under the doctrine of sovereign immunity.

Bankruptcy Judge R. Kimball Mosier of Salt Lake City ruled in favor of the trustee on motion for summary judgment. *Miller v. United States (In re All Resort Group Inc.)*, 617 B.R. 375 (Bankr. D. Utah 2020).

The IRS appealed but lost again in an opinion on September 8 by District Judge Bruce S. Jenkins.

Judge Jenkins adopted Bankruptcy Judge Mosier's memorandum decision and order and affirmed "for the reasons set forth" by Judge Mosier.

We shall therefore discuss the opinion by Judge Mosier. To read Judge Mosier's opinion in full text, click here.

Same Facts as *DBSI*

The circumstances before Judges Mosier and Jenkins were the same as in *DBSI*, except that the IRS was held liable in the Ninth Circuit where the stakes were larger. In *DBSI*, the IRS was nailed for $17 million in fraudulent transfers resulting from tax payments made by a corporation on behalf of shareholders. In the Utah case, the trustee was only after $150,000.

After losing in the Ninth Circuit, the IRS twice sought and obtained extensions of time from the Supreme Court for filing a petition for *certiorari* that would have raised the split with the Seventh Circuit. Ultimately, either the IRS or the U.S. Solicitor General decided against filing a '*cert*' petition.

The IRS was represented before District Judge Jenkins by attorneys from the Tax Division of the Justice Department in Washington. With comparatively few dollars in the balance, it's a reasonable assumption that the IRS will appeal to the Tenth Circuit, aiming for a result like the Seventh Circuit's.

Win or lose, an enlarging circuit split may spin off a petition for *certiorari* to come before the Supreme Court in the term to begin in October 2022.

The Arguments on Sovereign Immunity

The Bankruptcy Code of 1978 contained a waiver of sovereign immunity, but the Supreme Court held that the waiver was not "unequivocally expressed." *United States v. Nordic Village Inc.,* 503 U.S. 30, 33. (1992). Congress legislatively overruled *Nordic Village* in the Bankruptcy Reform Act of 1994 by rewriting Section 106(a) entirely and listing 59 sections of the Bankruptcy Court as to which sovereign immunity was "abrogated as to a governmental unit."

Section 544 is one of the listed sections.

Judge Mosier acknowledged the spilt among the circuits and among lower courts with regard to the waiver of immunity for state-law claims under Section 544(b). He framed the question as whether the waiver extends to claims under state law.

Further complicating the question, the trustee admitted that sovereign immunity would have barred the "actual" creditor from suing the IRS if there were no bankruptcy. In other words, could there be an actual creditor to satisfy the requirement in Section 544(b) if no actual creditor could have sued successfully before bankruptcy?

Judge Mosier held that "the plain text of § 106(a)(l) unequivocally abrogates sovereign immunity as to the underlying state law cause of action." The statute, he said, "contains no exceptions, qualifiers or carve-outs in its language."

Regarding the disability of the actual creditor to sue the IRS on its own, Judge Mosier said it has no bearing on the availability of that defense against a trustee inside bankruptcy.

Judge Mosier buttressed his conclusion by legislative history and the "goal of estate maximization."

Preemption

The IRS made a second argument: federal "field" preemption.

The IRS Code would not allow someone to sue the IRS to recover funds voluntarily paid by someone else. The IRS therefore argued that Utah fraudulent transfer law intruded into an area exclusively controlled by federal law.

Judge Mosier saw no federal preemption. To begin with, the trustee's claim was under federal law, namely Section 544(b). Second, the trustee was not aiming to recover a tax payment. The trustee was after a fraudulent transfer.

Judge Mosier granted the trustee's motion for summary judgment and denied the IRS's cross-motion for summary judgment. He held that "§ 106(a)(1) unequivocally waives the federal

government's sovereign immunity with respect to the underlying state law causes of action incorporated through § 544(b) and that the IRC does not preempt such claims."

The district court's opinion is *U.S. v. Miller*, 20-00248 (D. Utah Sept. 8, 2021).

A standard provision in a trust indenture meant no recovery for the indenture trustee's attorneys.

Contingency Fees Under a Trust Indenture May Not Result in a Claim, Judge Shannon Says

An indenture trustee has no independent claim against the debtor for attorneys' fees incurred in efforts to recover on bonds unless the indenture trustee has paid or is obligated to pay counsel, according to Delaware Bankruptcy Judge Brendan L. Shannon.

The opinion means that trust indentures need to be rewritten if the holders and the issuer intend to cover circumstances where counsel are representing bondholders on a contingency and the lawyers drill a dry hole.

In a major chapter 11 reorganization, a bank served as indenture trustee for an issue of about $1.25 billion in unsecured bonds that were subordinated to almost all claims. The bondholders ended up receiving nothing in the confirmed chapter 11 plan.

Typical Indenture Provisions

When bonds go into default or bankruptcy, indentures typically provide that the indenture trustee is not required to incur expenses absent indemnification by the holders. In the case before Judge Shannon, a pair of bondholders agreed to indemnify the indenture trustee for $3 million.

The indenture trustee retained counsel. The engagement agreement gave the lawyers the right to recover the greater of their hourly rates or 10% of the bondholders' recovery. However, the engagement agreement went on to say that the indenture trustee's liability to pay counsel would be limited to the $3 million indemnification. The agreement also said that the indenture trustee would not be obligated to use its own funds to pay counsel.

Although not relevant to the case at hand, indentures usually also include a so-called trustee's lien. Based on the concept of a possessory lien, the provision means that the indenture trustee can recover its expenses from the distribution earmarked for noteholders before paying the remainder to noteholders. The indenture trustee's lien was inapplicable to the case before Judge Shannon because there was no distribution for bondholders in the plan.

The bondholders' lawyers went on to spend almost $30 million more than the $3 million indemnification. So, the indenture trustee filed an unsecured proof of claim for the $30 million.

Had the claim been allowed, the plan would have paid almost one-third, meaning that the lawyers would have been paid about $10 million for their trouble.

The $30 Million Unsecured Claim

The debtor objected to the $30 million claim, even though the confirmed plan specifically provided that the indenture trustee could file an unsecured claim for its fees and expenses. The lawyers still ended up with nothing under Judge Shannon's June 25 opinion.

The debtor did not base the objection on anything in the Bankruptcy Code or the plan. Rather, the debtor relied on the indenture to disallow the $30 million unsecured claim.

The indenture provided that the debtor must "reimburse the Trustee . . . for all reasonable expenses, disbursements and advances incurred or made by the Trustee . . . ." Naturally, the indenture trustee argued that it had "incurred" $30 million in unpaid counsel fees.

Judge Shannon framed the question as "whether professional fees are 'incurred' when the client has no obligation to pay them." He cited *Black's Law Dictionary* and caselaw for the notion that an expense is "incurred" only when there is liability for the expense. Of course, the indenture trustee had no liability for the $30 million in the case at hand as a consequence of the disclaimer in the engagement agreement.

Judge Shannon therefore held that the indenture did "not require [the debtor] to reimburse [the indenture trustee] for amounts that [the indenture trustee] is not obligated to pay, that is, amounts that were not incurred."

Having failed by relying on the words "incurred" and "reimburse," the indenture trustee proffered another provision in the indenture that did not include those words. Following default by the debtor, that section said that the debtor will "pay . . . such further amount as shall be necessary to cover the costs and expenses of collection."

The provision didn't underpin a valid claim for two reasons, Judge Shannon said.

First, if the indenture trustee "has not incurred any liability to pay the costs or expenses of collection, then there is no amount to pay to [the indenture trustee]."

Second, Judge Shannon said there were no "costs and expenses of collection" because the noteholders collected nothing.

Judge Shannon held that the other sections did "not create a right to payment for fees and costs *that [the indenture trustee] is not obligated to pay*." [Emphasis in original.]

Judge Shannon allowed the claim for $3 million, the amount of the indemnification, but disallowed the remainder.

The opinion is *In re Tribune Media Co.*, 08-13141 (Bankr. D. Del. June 25, 2021).

Hounding a debtor for payment and shortening credit terms defeated an 'ordinary course' defense to a preference.

Supplier Socked for $3.5 Million in Preferences Although All Bills Were Paid on Time

Even though the debtor paid its bills on time, a supplier who hounded the debtor for payment may be unable to prove the "ordinary course" defense and can be liable for a preference, as shown in an opinion by Chief Bankruptcy Judge Jeffrey J. Graham of Indianapolis.

As Judge Graham said in his January 13 opinion, a supplier may not have the ordinary course defense if the evidence shows that the debtor "prioritized paying [the preference defendant] over other creditors."

Trial counsel for plaintiffs and defendants in preference suits should read Judge Graham's opinion in full text for tips on the more effective evidence to be introduced at trial.

The time for appeal has not begun to run because Judge Graham is yet to rule on the amount of prejudgment interest. If there are one or more appeals, the outcome will indicate whether a supplier can be liable for a preference, even though payments were never late.

The 'Ordinary Course' Defense

The debtor was a 220-store appliance and electronics retailer. The supplier was one of the debtor's primary providers of consumer electronics and the sole supplier of some products. The debtor's same-store sales began declining about three years before the chapter 11 filing.

The creditors' committee was given the right to pursue preferences. The committee sued the supplier for about $4.7 million in preferences received in the three months before filing. On summary judgment, the committee had established all of the elements of a preference under Section 547(b). Disputed facts precluded summary judgment on the supplier's "ordinary course" defense.

Judge Graham held a trial regarding the "ordinary course" defense under Section 547(c)(2). The subsection gives the supplier a defense:

> to the extent that such transfer was in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee, and such transfer was—

> (A) made in the ordinary course of business or financial affairs of the debtor and the transferee; *or*
>
> (B) made according to ordinary business terms. [Emphasis added. Note the word "or," making "A" and "B" disjunctive.]

Judge Graham meticulously recited the trial testimony about the ordinary course defense. We shall mention only a few pivotal facts.

Three years before bankruptcy, the debtor's credit limit with the supplier was $12 million. Over the ensuing years, the supplier reduced the credit limit until it was $1 million. So the debtor could purchase $2 million in goods a month, the supplier gave the debtor 15-day terms. Leading up to bankruptcy, the debtor increased its purchases from the supplier because other suppliers were restricting or cutting off credit.

When the debtor filed bankruptcy, the supplier had been paid in full. In fact, the supplier paid the debtor $365,000 after filing on account of vendor credits.

The supplier did not file a claim but consented to permitting the bankruptcy court to enter final judgment.

The Tests for 'Ordinary Course'

Judge Graham laid out the law on what he referred to as the "subjective" ordinary course defense, where the supplier shoulders the burden of proof by a preponderance of the evidence. The supplier, he said, must establish a "baseline of dealing" to show whether the payments were "consistent with the parties' practice before the preference period." The testing period, he said, should be based on a time when the debtor "was financially healthy."

For the testing period, Judge Graham eliminated the 15 months before the chapter 11 filing when the debtor was in financial distress. The limitation didn't matter, he said, because 98% of the invoices within the preference period were paid either before or within the required 15 days of invoicing.

Judge Graham therefore found that the payments in the preference period "remained consistent" with payments in the testing period. He found other facts in favor of the supplier. For example, the supplier never (1) withheld shipments, (2) sought personal guarantees, (3) threatened to turn the receivables over to a collection agent, or (4) threatened litigation.

Still, the supplier was unable to prove the defense by a preponderance of the evidence because (a) the supplier "consistently" sought payment by communicating "frequently" with the debtor's senior management, (b) the supplier threatened to withhold shipments if payments were not made, (c) the debtor's employees "advocated" for payment to the supplier because they "valued their

relationship" with the supplier, and (d) the supplier "significantly" reduced the debtor's credit to $1 million "at a time when the Debtor's business with [the supplier] was at an all-time high."

Judge Graham said the outcome was "not an easy call." The evidence on both sides was in balance. He tipped the scale in favor of the debtor in view of the supplier's "concerted effort to limit [its] exposure," the significant reduction in the credit limit, and the supplier's frequent communications seeking payment.

The facts led Judge Graham to the "inescapable conclusion" that the debtor "prioritized paying [the supplier] over other creditors. And this is what Congress meant to remedy when drafting Section 547(b)."

Because the supplier failed to prove the defense by a preponderance of the evidence, Judge Graham gave the debtor a judgment for a net preference of about $3.5 million, given the supplier's $1.2 million offset for new value.

Observations

Is there anything wrong with this picture?

The supplier provided badly needed goods when other suppliers would not. For vigilantly policing the receivables, the supplier was slapped with a $3.5 million preference judgment.

When a debtor's finances are precarious, should suppliers be at risk of receiving preferences for restricting credit terms, even though the debtor pays on time?

Section 547 was designed to encourage suppliers to deal with companies in financial distress. Should suppliers be liable for hounding debtors for payment, or should suppliers remain silent and cut debtors off when they don't pay?

The foregoing are policy considerations, which don't matter much these days. The statute matters.

In terms of the statute, hounding the debtor for payments may not be in the ordinary course of business between the two parties, but did the supplier nonetheless qualify for the defense under Section 547(c)(2)(B)?

The credit terms were 15 days, and the debtor always paid within 15 days. Are 15 days not "ordinary business terms" for a retailer in financial distress? Were the terms not ordinary because the supplier hounded the debtor for payment?

The opinion is *Official Committee of Unsecured Creditors of Gregg Appliance Inc. v. D&H Distributing Co. (In re HHGregg Inc.)*, 17-50282 (Bankr. S.D. Ind. Jan. 13, 2022).

The 'average-lateness' test reveals payments that were not made in the 'ordinary course.'

Ordinary Course Defense Works When the Supplier Doesn't 'Hound' for Payment

Yesterday, we analyzed a case where hounding a debtor for payment and shortening credit terms defeated the "ordinary course" defense and saddled the supplier with a $3.5 million preference judgment, even though none of the payments was late.

Today, we review an "ordinary course" opinion by Bankruptcy Judge Robert E. Grossman where there was no unusual collection activity, the suppliers did not know the debtor was in financial trouble, and the suppliers did not pressure the debtor to pay during the so-called 90-day preference period before bankruptcy.

Judge Grossman, of Central Islip, N.Y., upheld the "ordinary course" defense under Section 547(c)(2)(A) and dismissed a passel of preference complaints on summary judgment.

After confirmation of a chapter 11 plan, the trustee of a creditor's trust sued several suppliers for a preference. For simplicity, we shall refer to the plan trustee as the debtor.

Previously, Judge Grossman ruled on motions for partial summary judgment that the debtor had established all of the elements of a preference under Section 547(b). In his February 3 opinion, Judge Grossman reviewed the undisputed facts about the debtor's payment history to apply the "ordinary course" defense under Section 547(c)(2)(A).

Section 547(c)(2) gives the supplier a defense:

> to the extent that such transfer was in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee, and such transfer was—
>
> (A) made in the ordinary course of business or financial affairs of the debtor and the transferee; or
>
> (B) made according to ordinary business terms.

Citing the *Collier* treatise, Judge Grossman said that Section 547(c)(2)(A) is a subjective test designed to protect customary credit transactions paid in the ordinary course of business of the debtor and the supplier. He said that the defense provides "a level of predictability so that suppliers

such as the Defendants are permitted to keep payments that would otherwise be deemed preferences."

Citing legislative history, Judge Grossman said that Congress intended for the defense to discourage "unusual activity" by either the debtor or creditors in the slide toward bankruptcy.

All of the suppliers in the cases before him had been dealing with the debtor for years and had scores of transactions among them.

In reviewing credit history, Judge Grossman said there are two predominant tests: the average-lateness method and the total-range method. The former compares the average days to pay in the pre-preference period to those in the preference period.

The total-range method comes into play if the averages are skewed by "outliers." Under the "total range of payments" test, Judge Grossman said:

> [T]the Court reviews all of the payments made during the Baseline Period (which is agreed by all parties as the two years prior to the 90-day preference period) and determines the range of payments from the earliest to the latest. If the payments made during the preference period fit within the range, they are protected by the ordinary course of business defense. If the Court finds that the range of payments during the Baseline Period is too broad, the Court may adopt the bucketing analysis. Under the bucketing analysis, the Court reviews the payments made during the baseline period and groups them into buckets by age, then applies an appropriately sized bucket to the preference period payments to determine what is ordinary and what is not. As this Court previously stated, a range from the Baseline Period that captures around 80% of the payments would be an appropriate size bucket. [Citation omitted.]

Judge Grossman sided with the suppliers and decided to apply the average-lateness test, because it "is more likely to 'weed out' payments that could skew the analysis."

In the cases before him, the average lateness in the two years before the preference period ranged between 39 and 47 days. In the preference period, payments ranged between four days early to seven days late.

Judge Grossman cited the Seventh and Eighth Circuits for holding that deviations of five to seven days from the pre-bankruptcy average were not enough to deprive the supplier of the defense. In the cases before him, he saw no reason to go beyond the average-lateness test to uphold the suppliers' defenses.

Had he employed the bucketing analysis, the result would be the same, Judge Grossman said. Eighty-two percent of the payments before the preference period would encompass all but one of the payments made in the preference period. In the case of that one payment, it was also covered by the new value defense.

Judge Grossman gave judgment to the suppliers on the preference claims. The debtor also had lodged fraudulent transfer claims.

Judge Grossman dismissed the fraudulent transfer claims because the allowance of the ordinary course defenses established that the suppliers had provided reasonably equivalent value.

The opinion is *Ryniker v. Bravo Fabrics Inc. (In re Décor Holdings Inc.)*, 20-08125 (Bankr. E.D.N.Y. Feb. 3, 2022).

Fifth Circuit opinion shows that disallowance of a class proof of claim may preclude individual class members from filing late claims.

No 'Excusable Neglect' for Late Claim if Class Claim Was Denied, Fifth Circuit Says

If a class has not been certified before bankruptcy, every member of the class should file an individual proof of claim before the bar date. That's the practice point gleaned from a Fifth Circuit opinion on March 10.

If the class is so numerous that individual claims are not practicable, the opinion by Circuit Judge Edith Brown Clement counsels the attorney for the class to file a motion in bankruptcy court for authority to file a class claim, followed by a motion in bankruptcy court to approve the class.

Why go to so much trouble? Easy answer: The bankruptcy court may not approve a class claim, and a court like the Fifth Circuit might not allow individual claims after the bar date.

The Two-Year, Nine-Month Delay in Filing Individual Claims

On behalf of a class of about 100 former employees, two plaintiffs filed a wages and hours class action before the employer's bankruptcy. Also before bankruptcy, the district court refused to enforce an arbitration clause. The employer appealed to the Ninth Circuit.

While the appeal was pending, the employer filed a chapter 11 petition and served a bar-date notice on each of the 100 former employees in the class. The named plaintiffs filed a $14 million proof of claim for the class, which had not been certified in any court.

Almost 30 class members filed individual claims before the bar date. The remaining 70 did not file claims. Before confirmation of the chapter 11 plan, the debtor signaled its intention to object to the class claim.

After modification of the automatic stay, the Ninth Circuit reversed the district court and directed that the wages and hours claims be arbitrated. As Judge Clement said, enforcing arbitration effectively disallowed the class claim and meant "that all claims by the purported 'class' members had to be arbitrated individually."

Only then, two years and nine months after the bar date, did the 70-some former workers file individual proofs of claim accompanied by a motion to allow late-filed claims for "excusable neglect." The bankruptcy court refused to allow the late-filed claims, but the district court reversed.

The Fifth Circuit reversed the district court and reinstated the bankruptcy court's disallowance of the late-filed claims.

Disallowing Late Claims Wasn't an Abuse of Discretion

The outcome of the appeal was governed by Supreme Court precedent laying out four factors to consider when deciding whether there was excusable neglect. *See Pioneer Investment Services Co. v. Brunswick Associates Ltd. Partnership*, 507 U.S. 380 (1993).

Although some circuits have held that one factor is more important than the others, Judge Clement said that the Fifth Circuit has not made any factor dominant. She reviewed the bankruptcy court's excusable-neglect decision for what she called the "exceptionally deferential" abuse of discretion standard.

The first *Pioneer* factor considers the danger of prejudice to the debtor. The bankruptcy court had found in favor of the debtor, but Judge Clement disagreed.

The debtor had notice of the wages and hours claims long before bankruptcy and "that they might ultimately be allowed in the bankruptcy proceeding," Judge Clement said. In addition, the plan had a disputed-claims reserve. The first factor "cuts in favor of the Claimants here," she said.

The second *Pioneer* factor considers the length of delay and the impact on judicial proceedings if creditors could file late claims. The bankruptcy court decided that the second factor favored the debtor, and Judge Clement agreed.

The debtor's knowledge of the claims before confirmation "does not mean that they expected to have to resolve those claims even if they were filed *late*," Judge Clement said. [Emphasis in original.]

Moreover, the claimants' counsel presented no evidence to the bankruptcy court regarding the impact on judicial proceedings. Even if the circuit court were to consider the claimants' argument, Judge Clement said "it permits the reasonable inference that the delay that would result from allowing [approximately 70] additional arbitrations to proceed could significantly impact the resolution of the wage litigation and bankruptcy."

Judge Clement agreed with the bankruptcy court that the length-of-delay factor favored the debtor.

The reason for the delay is the third *Pioneer* factor.

Judge Clement said that courts are "less likely to find excusable neglect when the reason for the delay was within the movant's reasonable control." She said that the claimants had notice that the debtor would object to the class claim, but they did not protect themselves, even though all 70 had notice of the bar date.

In other words, the "Claimants took a risk that a class proof of claim would be allowed; that risk did not pan out for the Claimants, and the Debtors are not responsible for the consequences that followed," Judge Clement said.

The third factor focuses on whether the failure to perform on time was "beyond the reasonable control" of the party seeking an extension of time, according to Judge Clement. In the case at hand, she said, "Most of what caused the delay in this case was not beyond the reasonable control of the Claimants, whose duty it was to file timely proofs of claim."

Judge Clement agreed with the bankruptcy court's finding that the third factor favored the debtor.

The fourth *Pioneer* factor weighs the claimants' good faith. In that respect, Judge Clement noted the bankruptcy court's observation that the action of the claimants' counsel "verged on malpractice." She said that "counsel's failure to act diligently throughout the bankruptcy proceeding was so severe that it undermines their argument that they acted in good faith."

Specifically, Judge Clement said that the claimants' counsel's failure to invoke Federal Rule 23 in the bankruptcy case "evinces both a severe lack of diligence and a misunderstanding of bankruptcy procedural rules." In that regard, she noted that the Fifth Circuit is yet to rule on whether a class claim is even permitted in bankruptcy.

Judge Clement agreed with the bankruptcy court: Good faith favored the debtor.

Even though one of the four factors favored the claimants, Judge Clement reversed the district court because she could not "say that the bankruptcy court abused its discretion by denying the Claimants' motion for relief from the bar date."

The opinion is *West Wilmington Oil Field Claimants v. Nabors Corporate Services Inc. (In re CJ Holding Co.)*, 21-20394 (5th Cir. March 10, 2022).

The transfer of title in a real estate foreclosure is not a transfer on account of an antecedent debt and therefore can't be a preference, at least in Florida.

Judge Isicoff Explains Why a Foreclosure Sale Can't Be a Preference

Although some courts reach the same result for different reasons, Bankruptcy Judge Laurel M. Isicoff of Miami explained why a mortgage foreclosure cannot be a preference in Florida.

In short, there is no payment of antecedent debt.

A homeowner defaulted on a $150,000 mortgage. The lender went through the steps required in Florida to take title through a credit bid: The lender filed a foreclosure complaint; the state court entered a final judgment of foreclosure; the lender was the successful bidder at the foreclosure sale with a $69,000 credit bid; a certificate of sale was entered; and after the homeowner unsuccessfully objected to the sale, the state court issued a certificate of title.

The same day the state court overruled the objection and said it would issue a certificate of title, the homeowner filed a chapter 13 petition and immediately filed a complaint to set aside the foreclosure sale as a preference under Section 547. The lender filed a motion to dismiss, contending that the complaint failed to state a claim.

The lender conceded that the home had been property of the debtor and that the debtor was insolvent in the 90 days before bankruptcy.

In her November 10 opinion, Judge Isicoff listed the two remaining questions: (1) Was the transfer on account of an antecedent debt; and (2) did the lender receive more than it would have in chapter 7?

The debtor argued that the transfer of the home to the lender was on account of the lender's status as a creditor and was therefore on account of antecedent debt.

Some courts, Judge Isicoff said, believe that the first transfer in foreclosure is a transfer to the lender that can be set aside as a preference if the lender recovers more than it would in a hypothetical liquidation. Other courts, according to Judge Isicoff, believe that a foreclosure sale is not on account of antecedent debt.

In Florida, a foreclosure entails two transfers, Judge Isicoff said. The first transfer is the issuance of the certificate of title. The payment of the sale proceeds to the foreclosing lender is the second transfer.

In Florida, though, lenders are entitled to credit bid, to avoid requiring the lender to pay cash that will be repaid to the lender almost immediately. Consequently, the transfer to the lender at a foreclosure sale "is in consideration of the payment of the bid amount," Judge Isicoff said.

Judge Isicoff explained how foreclosure works and where the transfers are found:

> [T]he transfer to [the lender] on account of the antecedent debt was the transfer of the sale proceeds (had there been sale proceeds) to [the lender]. The issuance of the certificate of sale to [the lender] was not on account of the antecedent debt, but rather on account of [the lender's] payment of the purchase price, which, in this case, was done by the credit bid.

Therefore, the lender received title in its capacity as a purchaser, not as a creditor, Judge Isicoff explained. As a result, the foreclosure sale could not be avoided as a preference because there was no transfer on account of antecedent debt.

Because one of the elements of a preference was not present, Judge Isicoff was not required to decide whether the lender received more than it would in chapter 7.

In a footnote, Judge Isicoff said she believes that *BFP v. Resolution Trust*, 511 U.S. 531 (1994), is not applicable to preferences. The Supreme Court held in *BFP* that a regularly conducted mortgage foreclosure cannot be set aside as a fraudulent transfer.

Under Florida law, the amount bid at a foreclosure sale is "conclusively presumed" to be sufficient consideration. On that basis, Judge Isicoff said she also would have granted the lender's motion to dismiss.

The opinion is *Nunez v. Wilmington Savings Fund Society (In re Nunez)*, 21-01157 (Bankr. S.D. Fla. Nov. 10, 2021).

An administrative creditor isn't a 'guarantor' of the success of the project, Delaware's Bankruptcy Judge Goldblatt says.

Increasing Debtor's Profit or Revenue Isn't Required to Establish an 'Admin' Claim

To establish an administrative claim, the creditor isn't required to show that the goods or services led to an increase in the debtor's value or profits.

Rather, Bankruptcy Judge Craig T. Goldblatt of Delaware said that it's enough if the debtor believed that the goods or services provided during chapter 11 would enhance revenue or the value of the business.

Judge Goldblatt was sworn in on April 26. He had been an advocate arguing in the Supreme Court and was a partner with Wilmer Cutler Pickering Hale & Dorr LLP. He was on the winning side in *City of Chicago v. Fulton*, 141 S. Ct. 585, 208 L. Ed. 2d 384 (Sup. Ct. Jan. 14, 2021), and had clerked on the Supreme Court for Justice David H. Souter.

The Abandoned Project

The debtor was an oil and gas exploration and production company operating in the Permian Basin in west Texas and southeastern New Mexico. The debtor built a facility for the disposal of toxic wastewater generated while drilling. Before and during the chapter 11 case, the debtor was working on a project to commercialize wastewater disposal and offer the service to other drillers.

The creditor provided consulting services for the wastewater commercialization project, generating invoices for more than $200,000. Having control of the debtor's use of cash collateral, the secured lenders told the debtor to abandon the project and refused allow the use of cash collateral to pay the consultant's bills connected to the project.

The creditor responded with a motion asking Judge Goldblatt to allow and direct immediate payment of an administrative expense claim under Section 503(b)(1)(A) for the "actual, necessary costs and expenses of preserving the estate."

In his June 2 opinion, Judge Goldblatt explained how the Third Circuit has said that administrative expenses must "yield a benefit to the estate." *In re Energy Future Holdings Corp.*, 990 F.3d 728, 741 (3d Cir. 2021). Earlier, however, the Third Circuit recognized that courts must allow administrative claims so that creditors will be encouraged to continue doing business with

debtors. *Pennsylvania Department of Environmental Resources v. Tristate Clinical Laboratories*, 178 F.3d 685, 690 (3d Cir. 1999).

Everyone agreed that the creditor provided the services. The debtor did not contest the amount but argued that the value of the services was "too speculative" to warrant administrative status. The debtor and the lender also contended that the creditor could only shoulder the burden of proof by showing that the services increased profit or revenue or enhanced the debtor's competitive position.

Judge Goldblatt disagreed. The caselaw, he said, "does not support the proposition that a non-insider third party that provides goods or services to a debtor-in-possession on ordinary commercial terms must prove that receipt of those goods or services led directly to increased profits. None of the cases cited by the parties so holds."

The record demonstrated the debtor's belief that the project would generate greater revenue or enhance the value of the business. "That is all that is required," Judge Goldblatt said.

When a commercial vendor provides goods or services at standard rates and under standard terms, the creditor "does not become a guarantor of the success of the venture," Judge Goldblatt said.

The debtor had pledged to file a chapter 11 plan "promptly" and to emerge from bankruptcy in three months. Judge Goldblatt allowed the administrative claim but did not order immediate payment. Nonetheless, he was "sensitive" to the fact that delayed payment "may adversely affect" the creditor and that other administrative claims had already been paid.

So, Judge Goldblatt allowed the claim and permitted the creditor to renew the motion for immediate payment if the claim is not paid within 60 days.

The opinion is *In re MTE Holdings LLC*, 19-12269 (Bankr. D. Del. June 2, 2021).

At least in New York, a litigation finance agreement can't be written to remove all of the lender's exposure to the borrower's bankruptcy.

Brooklyn Decision Shows Why Litigation Finance Is Risky if the Plaintiff Files Bankruptcy

Someone who finances prosecution of a personal injury claim in New York has nothing more than an unsecured claim if the debtor who holds the claim files bankruptcy before settlement or entry of judgment on the claim, according to Bankruptcy Judge Elizabeth S. Stong of Brooklyn, N.Y.

The debtor was injured before bankruptcy. Also before bankruptcy, the debtor signed a litigation finance agreement under which he received $20,000. He would be liable to return the $20,000 plus interest only if he settled or won the suit, and then only from the winnings.

In New York, personal injury claims cannot be sold or assigned. However, New York permits assignment of proceeds from a personal injury claim.

That's what happened. The litigation finance agreement gave the lender an assignment of proceeds of the claim to secure the debt. The finance agreement also granted the lender a security interest in the proceeds of the claim.

The debtor said in the litigation finance agreement that he did not intend to file bankruptcy at any time in the future. If there were a bankruptcy, the debtor agreed to schedule the litigation proceeds as having been assigned to the lender and not to show the agreement as giving rise to a debt owing to the lender.

By the time of bankruptcy, the lender's claim was almost $50,000, because interest on the claim was slightly above 50% *per annum*.

After the debtor filed a chapter 7 petition, the trustee retained special counsel, who promptly secured a $75,000 settlement. Judge Stong approved the settlement and payment of special counsel's $25,000 fee.

The lender had filed a secured claim for about $50,000 and claimed the remainder of the settlement.

Combining his personal injury exemption under Section 522(d)(11)(D) with his wildcard exemption under Section 522(d)(5), the debtor claimed exemptions totaling some $39,000, to be taken from the net settlement proceeds.

The lender objected to the debtor's exemption claim, contending that the assignment prevented the proceeds from becoming part of the estate, and if the proceeds were estate property, the lender claimed an equitable lien on the proceeds.

The debtor, of course, contended that the assignment of the proceeds was ineffective after bankruptcy.

What's paid first: the lender's claim or the debtor's exemption?

Judge Stong ruled in favor of the debtor in her May 6 opinion, concluding that the lender had neither an enforceable assignment of proceeds as of the filing date nor an equitable lien or constructive trust.

Judge Stong said there was no question about the validity of the debtor's claimed exemptions. The question was whether the lender's rights took the proceeds out of the estate and out of the hands of the debtor. In other words, did the claim and proceeds become estate property under Section 541?

Judge Stong concluded that the debtor at least had an equitable interest in the claim and potential proceeds on the filing date. However, the absence of a judgment or settlement on the filing date was pivotal.

As another bankruptcy judge in Brooklyn had held 10 years earlier, the assignment of future proceeds would come into effect on settlement or entry of judgment and would not relate back to the date of the assignment. That is to say, there was no prebankruptcy assignment of proceeds because none existed until after bankruptcy.

There being no assignment on the filing date and no relation back, the automatic stay in Section 362(a)(4) and the limitation on the postpetition effect of a security interest in Section 552(a) together preclude enforcement of the lien on proceeds that could only arise after filing.

Without a lien, could the lender nonetheless claim the proceeds via an equitable lien or constructive trust?

Among the criteria recognized in the Second Circuit for creation of a constructive trust, the most important is the prevention of unjust enrichment. In turn, unjust enrichment requires some prepetition unjust conduct, Judge Stong said.

There being no unjust conduct, Judge Stong ruled there was no equitable lien or constructive trust.

Judge Stong relegated the lender to the status of an unsecured creditor.

The opinion is *In re Reviss*, 628 B.R. 386 (Bankr. E.D.N.Y. May 6, 2021).

Small Biz. Reorg. Act

Apartment buildings are single asset real estate, but hotels aren't, says Orlando's Bankruptcy Judge Karen Jennemann.

Hotel Isn't 'Single Asset Real Estate' and Is Eligible for Subchapter V Reorganization

The owner and operator of a 79-room hotel is not a single asset real estate debtor and is therefore entitled to reorganize as a small business debtor under Subchapter V of chapter 11, according to Bankruptcy Judge Karen S. Jennemann of Orlando, Fla.

The debtor's principal secured creditor filed a motion for a declaration that the debtor owned single asset real estate and was therefore ineligible for reorganization under Subchapter V. The outcome was especially important, because the lender held both secured and unsecured claims since the property was worth less than the debt.

If it were to remain in Subchapter V, the debtor could confirm a plan without making a new value contribution because the absolute priority rule does not apply to unsecured creditors of a small business debtor. Section 1191(b) and (c).

Judge Jennemann stated the conclusion up front in her April 20 opinion. She said that "hotels generally, and this hotel in particular, do not constitute single asset real estate projects." She therefore concluded that "this Debtor is eligible to file this Subchapter V Chapter 11 case."

Why, you ask?

Judge Jennemann explained that a hotel is different from an apartment project. A hotel, she said, provides "additional value or activities (other than property management) that would remove it from categorization as a 'single asset real estate' project."

The outcome turned on two provisions in the definitions laid down in Section 101. First, Section 101(51D)(A) provides that a small business debtor may not be "a person whose primary activity is the business of owning single asset real estate."

In Section 101(51B), single asset real estate is defined to be "real property constituting a single property or project, other than residential real property with fewer than 4 residential units, which generates substantially all of the gross income of a debtor who is not a family farmer and on which no substantial business is being conducted by a debtor other than the business of operating the real property and activities incidental thereto."

Judge Jennemann distilled the three elements of single asset real estate based on Fifth Circuit precedent. They are (1) the ownership of real property constituting a single property or project, (2) which generates substantially all of the debtor's gross income, and (3) on which no substantial business is conducted aside from operating the real property and activities incidental thereto. *Ad Hoc Group of Timber Noteholders v. Pacific Lumber Co. (In re Scotia Pac. Co.)*, 508 F.3d 214, 220 (5th Cir. 2007).

Judge Jennemann laid out the hotel owner's activities other than ownership of the property. The debtor had 15 employees, cleaned rooms every day, served breakfast, maintained a swimming pool, and provided laundry, internet and phone services.

The additional operations and services, Judge Jennemann said, "constitute something more than 'operating the real property and activities incidental hereto.'" Hotels "provide many services besides just renting rooms."

Given the additional activities, Judge Jennemann said that courts "rarely find" that hotels are single asset real estate like vacant land and apartment buildings. A hotel requires more staff and constant maintenance as compared to an apartment building, where tenants sign a one-year lease "and require little additional assistance." A hotel demands that the debtor provide "substantially more day-to-day activities than operating an apartment building."

The creditor contended that the extra services didn't count because they generated no additional income. Judge Jennemann disagreed. The additional services, she said, "require[] the debtor to do something other than merely rent hotel rooms."

Judge Jennemann conceded there are "a few cases" holding that hotels are single asset real estate. She said they either reached their conclusions "without analysis," or the debtor conceded it was single asset real estate.

Judge Jennemann ruled that the debtor was entitled to proceed under Subchapter V.

The opinion is *In re Enkogs1 LLC*, 626 B.R. 860 (Bankr. M.D. Fla. April 20, 2021).

When drafting a statute, Congress cannot 'think of every single esoteric possibility,' Judge Mignault says.

West Virginia Judge Allows Conversion to Subchapter V After Deadlines Passed

Chief Bankruptcy Judge B. McKay Mignault of Charleston, W.Va., allowed a debtor to convert a chapter 13 case to Subchapter V of chapter 11 after the deadlines in the Subchapter V had passed.

In her April 16 opinion, Judge Mignault described Subchapter V as "a valuable tool for qualifying debtors and will facilitate reorganizations that were not possible before." It "would have been helpful," she said, if Congress had "provide[d] some guidance with respect to conversion from other bankruptcy chapters, but the drafters of our laws cannot be rightfully expected to think of every single esoteric possibility when undertaking their responsibilities."

"[I]t is up to the courts to interpret those laws as best they can when confronted with unanticipated fact patterns," Judge Mignault said.

Unexpected Ineligibility for Chapter 13

The debtor filed his chapter 13 plan alongside his chapter 13 petition. According to Judge Mignault, the debtor had "diligently progressed" until the Internal Revenue Service filed a proof of claim that put his total debt above the cap allowed in chapter 13.

Although the debtor "must have known" he was liable for federal taxes, Judge Mignault said "he was not aware of the amount of those taxes until the IRS processed his return."

Two months after the IRS claim hit the docket, the debtor reported to Judge Mignault that his debt was now too large for chapter 13 and that he intended to convert the case to Subchapter V of chapter 11.

Eighteen days later, the debtor filed a conversion motion along with a motion to extend the Subchapter V deadlines. The U.S. Trustee lodged a limited objection, opposing conversion because the Subchapter V deadlines had passed.

Debtor Wasn't 'Justly Accountable' for the Delay

Judge Mignault began analyzing the merits by mentioning the benefits of the Small Business Reorganization Act, which became effective in February 2020 and is codified primarily in

Subchapter V of chapter 11, 11 U.S.C. §§ 1181 – 1195. The benefits include the absence of the absolute priority rule, no mandatory creditors' committee, no mandatory disclosure statement, no U.S. Trustee fees and the possibility of confirming a plan even if all classes reject the plan.

In return for the benefits conferred by the SBRA, Judge Mignault said that Subchapter V includes "several tight deadlines," including a status conference within 60 days of the order for relief and a plan that must be filed within 90 days of the order for relief.

Because conversion to chapter 11 does not reset the order for relief, the two deadlines had elapsed by the time the debtor filed his conversion motion.

The debtor's potential salvation rested in Sections 1188(b) and 1189(b), where the court may extend the deadlines under "circumstances for which the debtor should not justly be held accountable."

So far, Judge Mignault said that only a "handful of courts" have ruled on the propriety of proceeding under the SBRA when the deadlines have already passed. The courts come down both ways, the judge said.

Among others, Judge Mignault at length discussed *In re Seven Stars on the Hudson Corp.*, 618 B.R. 333 (Bankr. S.D. Fla. 2020), one of the cases not permitting conversion after the deadlines passed. To read ABI's report, click here.

On the other side of the fence, Judge Mignault parsed several decisions permitting a switch to Subchapter V, including *In re Trepetin*, 617 B.R. 841 (Bankr. D. Md. 2020), a scholarly opinion by former professor and now Bankruptcy Judge Michelle M. Harner of Baltimore. To read ABI's report on *Trepetin*, click here.

Choosing sides, Judge Mignault followed her brother and sister judges in the Fourth Circuit by permitting a switch to Subchapter V. The judge said she "cannot endorse such a restrictive view of the applicable law as is counseled by the court in *Seven Stars*."

Judge Mignault said the debtor qualified for conversion under Section 1307(d) because he had not confirmed a chapter 13 plan. He had not been dilatory and was not aware of his disqualification for chapter 13 until the IRS filed its claim.

The debtor "promptly" filed the conversion motion and "should not justly be held accountable for the circumstances necessitating an extension of the deadlines," Judge Mignault said.

Judge Mignault granted the conversion motion and reset the deadlines.

The opinion is *In re Keffer*, 20-20334 (Bankr. S.D. W.Va. April 16, 2021).

Increasingly, courts are allowing defunct corporations to proceed under the SBRA while individual owners of defunct businesses aren't being treated as small business debtors in chapter 11.

Liquidating a Defunct Corporation Qualifies for the SBRA, Judge Lopez Says

Mopping up a defunct business qualifies a corporate debtor for liquidation under the flexible rules for chapter 11 laid down in the Small Business Reorganization Act, or SBRA.

According to Bankruptcy Judge Christopher M. Lopez of Houston, collecting accounts receivable and maintaining the physical assets qualify as being engaged in commercial activities, even when the historical business is no longer operating.

The Nonoperating Plant

The debtor owned and previously operated a facility that converted waste heat from a nearby plant into electricity and steam sold to other nearby plants. After disputes with its primary creditor and supplier of waste heat, the debtor halted operations. The debtor and its creditor were mired in litigation and arbitration when the debtor filed a chapter 11 petition and elected to be treated as a small business under the SBRA.

The debtor filed a chapter 11 plan to liquidate the assets, collect accounts receivable, prosecute claims and distribute proceeds to creditors.

The primary creditor and the U.S. Trustee objected to the SBRA election, because the debtor was no longer operating its historical business. Judge Lopez overruled the objection in his July 1 opinion and allowed the debtor corporation to continue as a small business.

Qualification Under the SBRA

The SBRA became effective in February 2020 and is codified primarily in Subchapter V of chapter 11, 11 U.S.C. §§ 1181 – 1195. The issue before Judge Lopez arose under the definition of a "debtor" in Section 1182(1)(A), which "means a person engaged in commercial or business activities . . . ."

Although the quoted terms are not defined in the Bankruptcy Code, Judge Lopez applied the "plain meaning" of the words. He agreed with cases holding that "'engaged in' commercial or

business activities means a debtor was actively participating in one of these activities on the petition date." The word "commercial," he said, means "'of or relating to commerce.'"

Although the debtor was no longer producing and selling steam and electricity, Judge Lopez identified the following commercial activities: The company was

- Managed by two principals of its limited partner and employed an independent contractor;
- Litigating a multi-million-dollar lawsuit with its principal creditor;
- Collecting $160,000 in accounts receivable from its principal creditor;
- Maintaining its facilities;
- Working on a plan to pay creditors by selling assets with an estimated value of $3 million; and
- Filing reports and tax returns with state and federal authorities.

Judge Lopez held that pursuing litigation, collecting accounts receivable, selling assets and maintaining assets "are all commercial and business activities."

The objectors argued that the debtor had no W-2 employees, but Judge Lopez said that "neither do many U.S. small businesses, and, regardless, that is not required under Section 1182(1)(A)." He said that the section "also does not require a debtor to maintain its core or historical business operations on the petition date."

Contending that Subchapter V was not intended for liquidations, the objectors relied on the SBRA's legislative history by saying it was designed to promote reorganizations. "But this does not change the outcome," Judge Lopez said. The language of the statute is clear, leaving no room to consider legislative history. To the contrary, he noted how the SBRA permits the sale of a debtor's assets.

Judge Lopez agreed with *In re Offer Space, LLC*, Case No. 20-27480, 2021 WL 1582625, at *2 (Bankr. D. Utah Apr. 22, 2021), where Bankruptcy Judge William T. Thurman of Salt Lake City held that a debtor need not be operational so long as it had a bank account and was managing its few remaining assets. To read ABI's report on *Offer Space*, click here.

Judge Lopez distinguished and declined to follow two cases where *individuals* owned defunct businesses and were held ineligible for Subchapter V, even though their debts arose from the defunct business. He was referring to *In re Johnson*, 2021 WL 825156 (Bankr. N.D. Tex. Mar. 1, 2021); and *In re Thurmon*, 2020 WL 7249555 (Bankr. W.D. Mo. Dec. 8, 2020). To read ABI's reports on those cases, click here and here.

Unlike *Johnson* and *Thurmon*, where the debtors were individuals, the debtor before Judge Lopez was a corporation. He found that this debtor was "engaged in commercial or business activities," overruled the objections and allowed the debtor to proceed under Subchapter V.

The opinion is *In re Port Arthur Steam Energy LP*, 629 B.R. 233 (Bankr. S.D. Tex. July 1, 2021).

Utah's Judge Thurman says that a corporation liquidating its remaining assets is engaged in business 'activities' and is therefore eligible for Subchapter V.

Corporations Are More Likely Eligible for the SBRA than Owners of Defunct Businesses

So long as it has a bank account and is managing its few remaining assets, a corporate "debtor's business need not be operational to be eligible for . . . relief" in Subchapter V of chapter 11, according to Bankruptcy Judge William T. Thurman of Salt Lake City.

The corporate debtor developed and sold software to direct marketers. The company had financial difficulty and sold the software, its primary asset, in August 2020 in exchange for the buyer's stock worth some $1 million.

The debtor filed a chapter 11 petition in December 2020 and elected treatment as a small business debtor under the Small Business Reorganization Act. The SBRA became effective in February 2020 and is codified primarily in Subchapter V of chapter 11, 11 U.S.C. §§ 1181 – 1195.

At the meeting of creditors, the debtor's principal testified that the company's remaining assets consisted of a bank account, accounts receivable, claims in a lawsuit against a third party, and stock from the buyer. The principal also testified that the company had no employees and was not conducting business as it had before the sale.

In addition, the principal said the company had no intention of reorganizing and was "using reasonable efforts to pay its creditors and realize value for its assets," Judge Thurman said.

The schedules declared that the debts totaled some $3.5 million and that the estimated value of the assets was about $400,000.

Immediately after the meeting of creditors, the U.S. Trustee filed a motion objecting to the debtor's eligibility to proceed under Subchapter V.

In his April 22 opinion, Judge Thurman laid out the four requisites for Subchapter V eligibility: the debtor (1) must be a person, which includes a corporation; (2) must be engaged in commercial or business activity; (3) may not have more than $7.5 million in debt on the petition date, and (4) must have more than 50% of its debt from commercial or business activities.

The U.S. Trustee only challenged the second test, which arises from Sections 1182(1)(A) and 101(51D). The term "small business debtor" means "a person engaged in commercial or business activities . . . ."

In sum, the U.S. Trustee argued that the debtor was ineligible for Subchapter V because the company was not operational on the filing date, had no employees and no intention of reorganizing, and aimed only to liquidate its remaining assets, including the purchaser's stock.

Parsing the statute, Judge Thurman was constrained by Tenth Circuit authority, which calls for interpreting the Bankruptcy Code liberally in favor of debtors and "strictly against the creditor." *In re Woods*, 743 F.3d 689, 694 (10th Cir. 2014).

First, Judge Thurman held that the debtor "must be *presently* 'engaged in commercial or business activities' on the date of filing the petition for relief." [Emphasis added.] In that regard, he agreed with three recent cases holding that formerly being in business is insufficient. *See In re Johnson*, 2021 WL 825156 (Bankr. N.D. Tex. Mar. 1, 2021); *In re Thurmon*, 2020 WL 7249555 (Bankr. W.D. Mo. Dec. 8, 2020); and *In re Ikalowych*, 20-17547, 2021 BL 138960, 2021 Bankr. Lexis 997 (Bankr. D. Colo. April 15, 2021). To read ABI's reports on those cases, click here, here and here.

Next, Judge Thurman decided that the debtor was "actively engaged in commercial or business activities by" having a bank account, holding accounts receivable, exploring claims against a third party, managing the stock of the seller, and "winding down its business and taking reasonable steps to pay its creditors and realize value for its assets."

In reaching this conclusion, Judge Thurman said that the statutory words "activities" and "operations" are not "interchangeable." The word "activities" is broader.

Had the statute only used "operations," Judge Thurman said he would have ruled for the U.S. Trustee because the business was not operational on the filing date. When "considering the totality of the circumstances," he concluded that the debtor's "activities adequately demonstrate that it was "'engaged in commercial or business activities' on the Petition Date."

Judge Thurman found "nothing in the legislative history or the text of the statute [that] precludes a small business debtor, who has gone out of business, from availing itself of Subchapter V and pursuing a liquidation plan."

Along the way, Judge Thurman rejected the notion that filing bankruptcy and everything it entails would satisfy the requirements of Subchapter V. If filing were enough, "then any and every debtor that filed for bankruptcy relief and elected to proceed under Subchapter V would automatically satisfy the 'engaged in commercial or business activities' requirement."

Ending his opinion, Judge Thurman addressed cases like *Thurmon* and *Johnson* and their holdings that someone who owns a nonoperating business is not eligible for Subchapter V. He agreed with *Ikalowych's* "rationale that a debtor's actions in winding down its business constitute 'commercial or business activities.'"

Distinguishing *Thurmon* and *Johnson*, Judge Thurman said that both involved debtors who were individuals, not the defunct businesses they had owned. In those cases, he said, the debtors "were a level removed from the businesses themselves."

Judge Thurman said that the factual distinction was "an important aspect of the eligibility analysis when considering the totality of the circumstances."

Observations

"I believe that guarantors of commercial/business debt are eligible for Subchapter V even if the business is shuttered and will not reopen at the time of the individual's filing," Robert J. Keach told ABI.

Mr. Keach was involved in drafting the SBRA and testified for its passage before the Senate and House subcommittees. He believes that the "the statute was intended to be interpreted broadly, to facilitate restructuring and rehabilitation of businesses and individuals with business debt."

In Mr. Keach's opinion, "restructuring a commercial/business debt — the guaranty — is commercial 'activity' in and of itself, and that activity is ongoing at the time of filing." In his view, "courts on the other side of this issue are interpreting 'engaged in commercial or business activities' too narrowly."

Like Judge Thurman, Mr. Keach said that the "use of the word 'activities' as opposed to just 'engaged in business' expresses that breadth." Indeed, Mr. Keach went further when he said that "the additional inclusion of a required nexus between the current activity and the qualifying debt is not found anywhere in the statute, although that nexus exists in the guaranty case."

"A narrow interpretation, in my humble opinion, runs counter to the purpose of the statute," Mr. Keach said.

The chair of the business restructuring and insolvency practice group at Bernstein Shur Sawyer & Nelson P.A. in Portland, Maine, Mr. Keach was the co-chair of the ABI commission that recommended the legislation Congress adopted in the SBRA.

The opinion is *In re Offer Space LLC*, 629 B.R. 299 (Bankr. D. Utah April 22, 2021).

A fast-food worker can (conceivably) qualify as a small business debtor under Subchapter V, according to Bankruptcy Judge Thomas B. McNamara.

Denver Judge Opens the SBRA Door Wide for People with Debt from Failed Companies

Regarding eligibility for reorganization under the Small Business Reorganization Act, Subchapter V of chapter 11, Bankruptcy Judge Thomas B. McNamara of Denver took a novel approach.

Although the debtor must be *currently* engaged in business at the time of filing, he said that a fast-food worker flipping hamburgers would qualify if half of the debt arose from the "commercial or business activities of the debtor." In other words, in the opinion of Judge McNamara, a debtor's debt must arise from business, but the debtor isn't required to be engaged in that business when she or he files under Subchapter V. The debtor isn't even required to be an owner of the business in which she or he is employed on the filing date.

The Defunct Business

The debtor indirectly owned a business repairing hail damage to cars. He was the sole owner of a limited liability company that in turn owned 30% of the LLC that performed car repairs.

The repair business failed, terminated operations and turned the assets over to the secured lender, leaving the debtor on the hook for about $6.4 million in debt on the repair business that he had personally guaranteed. Losing income from the repair business, the debtor started working as an insurance salesman shortly before filing his chapter 11 petition and asking for treatment as a small business debtor under Subchapter V.

Totaling all of his scheduled debt, the debtor owed about $7.4 million, just below the $7.5 million cap for Subchapter V. Both before and after the chapter 11 filing, the debtor said he was engaged in "winding down" the repair business, although neither he nor the business was generating any income.

The U.S. Trustee and the primary secured creditor of the repair business filed a motion for a declaration that the debtor was not eligible for Subchapter V because he was not currently engaged in business. The Subchapter V trustee supported the debtor by contending that he was eligible.

'Engaged' Means Currently Engaged in Business

In his April 15 opinion, Judge McNamara first tackled the question of whether someone must be engaged in business on the filing date to be eligible for Subchapter V. The question turned on the statute, Section 1182(1)(A), which says that a small business debtor "means a person engaged in commercial or business activities," other than owning single-asset real estate.

Agreeing with the objectors, Judge McNamara applied the test as of the filing date. However, he gave the debtor some leeway by examining the "relevant . . . circumstances immediately preceding and subsequent to the Petition Date as well as the Debtor's conduct and intent." He cautioned that courts should not add qualifiers "where Congress imposed none."

Judge McNamara launched into a lengthy statutory and grammatical analysis. The statute and dictionaries, he said, give an "exceptionally broad" meaning to "commercial or business activities."

Alluding to similar statutory language regarding eligibility for reorganization as a railroad or family farmer, Judge McNamara said that courts require "that a person or entity is presently doing something."

Judge McNamara conceded that there was "some contrary authority," citing *In re Wright*, 2020 WL 2193240 (Bankr. D.S.C. April 27, 2020), where the bankruptcy court held that Subchapter V is not limited to someone engaged in business on the filing date. To read ABI's report on *Wright*, click here.

Previously, Judge McNamara said, the *Collier* treatise did not require being in business on the filing date. He noted, however, that "the treatise authors changed their minds and no longer argue against a temporal restriction as of the Petition Date."

Finally, Judge McNamara cited "more persuasive subsequent case law" requiring engagement in business on the filing date. He cited *In re Johnson*, 2021 WL 825156, at *6 (Bankr. N.D. Tex. Mar. 1, 2021), and *In re Thurmon*, 2020 WL 7249555, at *3 (Bankr. W.D. Mo. Dec. 8, 2020). To read ABI's reports on those cases, click here and here.

At that point, 20 pages into the opinion, it appeared as though Judge McNamara was on the cusp of tossing the debtor out of Subchapter V. Not so fast!

The debtor was still the direct or indirect owner of two LLCs, neither of which had been dissolved by the state. As a manager of both, the debtor continued to have corporate responsibility and was performing some services (albeit limited) in winding down the repair business.

Judge McNamara's next assignment was to distinguish cases he had just cited approvingly, such as *Johnson* and *Thurmon*. In *Johnson*, he said, the businesses had been "dissolved and no

longer existed." *Thurmon* was different because the debtor before Judge McNamara still owned two LLCs, one of which was not liquidated and was looking for new business.

The Blockbuster

Two pages from the end, Judge McNamara dropped the blockbuster, based on his understanding of the statute's "exceptionally broad" meaning given to "commercial or business activities." He held that being a "wage earner" selling insurance for someone else still constitutes "commercial or business activity."

Judge McNamara saw "no reason that 'commercial or business activities' are somehow reserved only for business titans, company owners, or management." In other words, he said that "virtually all private sector wage earners may be considered as 'engaged in commercial or business activities.'"

Judge NcNamara nonetheless cautioned that "not . . . every private sector wage earner is eligible for relief under Subchapter V of the Bankruptcy Code. Not at all." More than 50% of the debt must have arisen from "the commercial or business activities of the debtor," as required by Section 1182(1)(A).

"The typical hamburger artist, earning just minimum wage, will almost never be putting his own capital at risk and incurring debts which arise from his work. So, Subchapter V will not be for everyone," Judge McNamara said.

The 26-page opinion boiled down to two significant facts: (1) More than half of the debt was attributable to the debtor's guarantee or his company's obligations, and (2) the debtor was employed selling insurance, although for a company in which he was only an employee and had no ownership interest.

Judge McNamara overruled the eligibility motion and permitted the debtor to proceed toward confirmation.

The opinion is *In re Ikalowych*, 629 B.R. 261 (Bankr. D. Colo. April 15, 2021).

Part-time self-employment, coupled with debt from a defunct business, qualified the debtor for reorganization under Subchapter V of chapter 11.

Debt from a Defunct Business Can Help to Qualify for Subchapter V

The owner of a defunct business was eligible for reorganization under Subchapter V of chapter 11 when she earned "material" income from part-time personal services not attributable to employment by a company she didn't own.

The May 7 opinion by Bankruptcy Judge Benjamin A. Kahn of Durham, N.C., isn't altogether favorable to a prospective debtor under the Small Business Reorganization Act, which became effective in February 2020 and is codified primarily in Subchapter V of chapter 11, 11 U.S.C. §§ 1181 – 1195.

The debtor had owned a corporation in the business of providing information transport consulting services. The company went out of business about two years ago and has no assets. The debtor did not intend to resurrect the corporate business.

Following the failure of her corporate business, the debtor became a salaried employee of a company in the same industry. She had no ownership interest in her new employer and received a W-2 as an employee.

In addition, the debtor worked part-time as an independent contractor-consultant for two other companies, where she helped with their information technology. She received 1099s from both.

The debtor filed a chapter 11 petition and elected treatment as a small business debtor. The U.S. Trustee and the SBRA trustee both objected. Judge Kahn denied the objections.

First, Judge Kahn dealt with the question of whether the debtor was "engaged in commercial or business activities," as required by the definition of a small business debtor in Section 101(51D). There is no definition in the statute and "scant" legislative history, the judge said.

Judge Kahn recited how the "majority" of recent decisions require the debtor to be currently engaged in business, citing *Offer Space*, *Ikalowych* and *Thurman*. To read ABI's reports on those decisions, click here, here and here.

Although she was no longer operating her failed company, Judge Kahn did not rule against the debtor, because he held that her 1099 work as a sole proprietor and consultant "is clearly the delivery of services in exchange for a profit." Persuaded particularly by *Offer Space*, he said that her services as a sole proprietor "provide a material contribution to Debtor's income."

Judge Kahn found nothing in the statute or legislative history requiring that the debtor's self-employment be full-time.

The U.S. Trustee and the Subchapter V trustee also objected, claiming there must be a nexus between the business debt arising from the defunct business and the debtor's current business activities.

Judge Kahn rejected the idea, finding "no such implication" in the statute. Furthermore, requiring the debt to have arisen from current business activities "would be far too limiting for the remedial purposes of Subchapter V."

Judge Kahn found support for his conclusion in *Blanchard*, where a bankruptcy court in New Orleans held that personal guarantees of a defunct business's debts will suffice for an individual to qualify as a debtor under the SBRA. To read ABI's report on *Blanchard*, click here.

Finding no requirement for a nexus in the statute, Judge Kahn said that a contrary rule would "disqualify meritorious small businesses from the remedial purposes of subchapter V simply by having significant debts from former operations."

There being no theoretical disqualification, Judge Kahn turned the numbers and the question of whether more than half of the debtor's debt arose from "commercial or business activities," as required by Section 101(51D).

The debtor owed about $60,000 on a home mortgage that originally had been her principal residence. However, the debtor now lived elsewhere and had rented the home continuously for almost 20 years. The debtor had been unable to rent the home for the last two years because she could not afford the necessary repairs to make the home habitable.

Judge Kahn decided that the debtor could not count the mortgage among her business debts because she had originally obtained the mortgage as her residence. It therefore "did not arise from the Debtor's commercial or business activities," he said.

On the other hand, Judge Kahn did count debt incurred to repair the previously rented home as business debt.

Counting the business debts against personal debts, Judge Kahn found that just over half qualified the debtor for Subchapter V. He overruled the objections to proceeding under the SBRA.

The opinion is *In re Blue*, 21-80059, 2021 BL 189811 (Bankr. M.D.N.C. May 7, 2021).

If a loan benefits both a debtor and someone else, the loan still may be included in counting whether the debt "arose from the commercial or business activities of the debtor."

To Count in Subchapter V, Loans Need Not Benefit Only the Small Business Debtor

Loans made to finance a leveraged buyout may be included in calculating eligibility for reorganization under Subchapter V of chapter 11, even if the loan also conferred benefits on the buyers, according to Bankruptcy Judge Thomas J. Catliota of Greenbelt, Md.

In his October 26 opinion, Judge Catliota said that Section 1182(1)(A) does not require "excluding debt that directly benefitted others," such as the buyers in a leveraged buyout, or LBO.

The LBO Loans

Two individuals arranged to buy a corporation. To effect the purchase, the buyers formed a holding company of which they were the exclusive owners.

For the holding company to acquire the equity interests in the target corporation, a lender made three loans totaling $5.75 million. The target corporation (soon to be the chapter 11 debtor) was the borrower and pledged all of its assets.

The corporate borrower filed a chapter 11 petition and elected treatment as a small business debtor under Subsection V of chapter 11. The debtor listed debts of about $6.4 million.

The former owner (that is, the seller in the LBO) purchased a $500 claim to have status as a creditor. As a creditor, the former owner objected to the debtor's eligibility to proceed as a small business debtor.

Must a Debt Benefit Only the Debtor?

The outcome of the objection was controlled by Section 1182(1)(A), which says that a small business debtor must be

> a person engaged in commercial or business activities . . . that has aggregate noncontingent liquidated secured and unsecured debts as of the date of the filing of the petition or the date of the order for relief in an amount not more than $7,500,000 . . . not

> less than 50 percent of which arose from the commercial or business activities of the debtor.

The creditor conceded that the debtor was a "person" with no more debt that the statute allows. The creditor also admitted that the loans were "commercial or business activities."

However, the creditor argued that the $5.75 million in LBO loans could not be counted because they did not arise "from the commercial or business activities *of the debtor*." [Emphasis added.] According to the creditor, the LBO loans primarily benefitted the two buyers in acquiring the corporate debtor.

Interpreting "the commercial or business activities of the debtor," Judge Catliota said that "virtually" all courts "have applied a liberal construction of the phrase in keeping with the [Small Business Reorganization Act's] purpose and the language of § 1182(1)(A)." He cited Bankruptcy Judge Thomas B. McNamara of Denver, who said in *In re Ikalowych*, 629 B.R. 261, 276 (Bankr. D. Colo. 2021), that the phrase is "exceptionally broad." To read ABI's report on *Ikalowych*, click here.

The creditor relied on *In re Ventura,* 615 B.R. 1 (Bankr. E.D.N.Y. 2020). To read ABI's report on *Ventura*, click here.

To Judge Catliota's way of thinking, *Ventura* was inapposite. *Ventura* decided whether a debt was primarily a commercial or consumer debt under Section 101(8).

Judge Catliota said:

> The primary purpose test is applied to resolve the binary question of whether a debt is commercial or consumer. A transaction can have both commercial and consumer attributes, and a court must determine whether it is one or the other by assessing why the debt was "primarily" incurred. § 101(8). The language of § 1182(1)(A) does not require, or even invite, this inquiry where the debt so clearly arose from the commercial or business activities of the debtor.

"Primacy," Judge Catliota said, "is not included in the assessment once the debt is determined to be incurred through the debtor's commercial or business activities." The statute, he said, "does not require the court to dissect the various benefits obtained by all the parties and, for purposes of § 1182(1)(A), include only debt that is linked to a direct benefit obtained by a debtor, while excluding debt that directly benefitted others."

Judge Catliota noted several benefits received by the debtor from the LBO loans. Among other things, he pointed to a $250,000 working capital loan and a covenant requiring $600,000 in working capital.

"It simply cannot be disputed," Judge Catliota said, "that, under the ordinary, contemporary, common meaning of the phrase, the debt 'arose from the commercial or business activities . . . of the debtor.'" He denied the objection to treatment under Subchapter V because the objection was "not consistent with the statutory language and ignores the substance of the transaction, including an assessment of the direct and indirect benefits the Debtor obtained."

The opinion is *Lyons v. Family Friendly Contracting LLC (In re Family Friendly Contracting LLC)*, 21-14213 (Bankr. D. Md. Oct. 26, 2021).

Consumer Bankruptcy

Discharge/Dischargeability

No circuit split: The Second Circuit agrees with the Fifth and Tenth Circuits that only a subset of private student loans is automatically nondischargeable.

All Private Student Loans Are Not Excepted from Discharge, Second Circuit Holds

Employing emphatic language, the Second Circuit joined two other circuits by holding that all student loans are not excepted from discharge simply because they are student loans.

Technically speaking, the appeals court held that private student loans are not excepted from discharge under Section 523(a)(8)(A)(ii). The only subset of private student loans excepted automatically from discharge are those falling under Section 523(a)(8)(B).

As Circuit Judge Dennis Jacobs said in his July 15 opinion, a private loan is excepted from discharge under Section 523(a)(8)(B) only if it was "made to individuals attending eligible schools for certain qualified expenses."

The Loans in the Class Action

The facts of the case explain the breadth of the holding.

A student took down about $12,500 in loans from a private lender in the course of obtaining an undergraduate degree. The loans were not made through the college's financial aid office and were disbursed directly to the student's bank account. The student alleged that the loans were not made solely to cover the cost of attendance.

Soon after college, the student filed a chapter 7 petition, listed the student loans among his debts and received a general discharge. Of course, the discharge order did not specify which debts were discharged and which were not.

As Judge Jacobs said, the lender hired a collection agent "to pester" the debtor. Assuming the loans had not been discharged, the debtor paid them off.

In 2017, the debtor reopened his bankruptcy case and filed a purported class action in bankruptcy court. According to Judge Jacobs, the debtor's adversary proceeding alleged that the lender "employed a scheme of issuing dischargeable loans to unsophisticated student borrowers and then demanding repayment even after those loans are discharged in bankruptcy."

The lender filed a motion to dismiss that was denied by Bankruptcy Judge Elizabeth S. Stong of Brooklyn, N.Y. The lender appealed, and the district court certified a direct appeal to the Second Circuit. The appeals court accepted the appeal.

No Circuit Split

The lender argued on appeal in the Second Circuit that Congress intended in Section 523(a)(8) to bar discharge of all private student loans. The Fifth and Tenth Circuits already disagreed. *See Crocker v. Navient Sols. LLC (In re Crocker)*, 941 F.3d 206 (5th Cir. 2019); and *McDaniel v. Navient Sols. LLC (In re McDaniel)*, 973 F.3d 1083 (10th Cir. 2020). To read ABI's reports on those cases, click here and here.

As the Second Circuit is wont to do, Judge Jacobs assigned little import to the circuits with which he would agree. He launched into his own analysis, which he defined as solely a question of statutory interpretation subject to *de novo* review. Indeed, he said that the "inquiry begins (and in this case ends) with the statutory text."

The lender conceded that the loan could be nondischargeable only under Section 523(a)(8)(A)(ii), which makes a debt automatically nondischargeable if it was "an obligation to repay funds received as an educational benefit, scholarship, or stipend."

Therefore, Judge Jacobs said, the debt would be excepted from discharge only if it was "an educational benefit," a term not defined in the statute. On that point, the lender relied on a nonprecedential Second Circuit opinion that appears to say that a private loan is nondischargeable under Section 523(a)(8)(A)(ii).

Reflexively, Judge Jacobs said that his panel was not bound by a nonprecedential opinion. Furthermore, he said that the prior panel dealt with a different issue and "did not squarely take on the statutory interpretation question."

Looking at the statutory language, Judge Jacobs said that the lender's argument was "unsupported by plain meaning." He quoted the Tenth Circuit for saying that "no normal speaker of English" would read the language as the lender urged. *McDaniel, supra*, 973 F.3d at 1096.

If Congress had intended to make all private loans nondischargeable, "it would not have done so in such stilted terms," Judge Jacobs said. The statutory text "more naturally" coincides with "educational benefits that students may become obligated to repay, such as conditional grants."

Notably, Section 523(a)(8)(A)(ii) does not use the word "loan" but is "sandwiched" between two other subjections that do use the word. Judge Jacobs surmised that the omission was "intentional."

If the lender's reading were law, Judge Jacobs said, "virtually all student loans" would be made nondischargeable under Section 523(a)(8)(A)(ii), leaving the other subjections with no work. He parsed the section's history and concluded that the 2005 amendments to the Bankruptcy Code were not designed to make all student loans dischargeable.

The "more significant modification" in the 2005 amendments was the introduction of Section 523(a)(8)(B), Judge Jacobs said. That new subjection "excepts a subset of private loans," namely "any other educational loan that is a qualified education loan, as defined in section 221(d)(1) of the Internal Revenue Code of 1986, incurred by a debtor who is an individual."

In other words, the lender was contending that Congress enacted Section 523(a)(8)(B) to preclude the discharge of a type of loans that were already excepted from discharge.

Judge Jacobs supported his reading of the statute with the canon of construction known as *noscitur a sociis*. He said that the rule "instructs us to cabin [the words 'educational benefit'] such that its scope aligns with that of its listed companions — 'scholarship' and 'stipend.'"

In that respect, Judge Jacobs said that "scholarship" and "stipend" are conditional grants not generally required to be repaid. The "defining characteristic" of a loan, "by contrast, is an unconditional obligation to pay it back."

Judge Jacobs summarized the types of student loans that are discharged and those that are not. Nondischargeable debts in Section 523(a)(8)(A)(i) are "government and nonprofit-backed loans and educational benefit overpayments," along with "private loans made to individuals attending eligible schools for certain qualified expenses" under Section 523(a)(8)(B).

The only nondischargeable obligations under Section 523(a)(8)(A)(ii) are "scholarships, stipends and conditional education grants," not loans.

Judge Jacobs upheld denial of the lender's motion to dismiss, holding that an educational benefit "is therefore best read to refer to conditional grant payments similar to scholarships and stipends."

The opinion is *Homaidan v. Sallie Mae Inc.*, 20-1981 (2d Cir. July 15, 2021).

Bankruptcy Judge Eduardo Rodriguez explained why the Second Circuit was wrong in ruling that violators of Rule 3002.1 are only liable for compensatory damages.

Texas Judge Disagrees with Second Circuit on Sanctions for Violating Rule 3002.1

Taking sides with the dissenter and disagreeing with the Second Circuit's majority opinion on August 2, Bankruptcy Judge Eduardo Rodriguez from the Southern District of Texas held that a debtor can mount a claim for sanctions and punitive damages under Bankruptcy Rule 3002.1(i)(2) when a lender violates Rule 3002.1(b) and (c) by failing to give notice of changes in the payment, charges, fees and expenses claimed by a secured lender.

The facts were complex but boil down to this: A couple filed a chapter 13 petition in 2011 and confirmed a plan. The plan cured arrears on their home mortgage and called for the trustee to make monthly payments. Throughout, the debtors paid what the plan specified in terms of monthly mortgage payments.

The debtors completed their plan payments. The trustee issued a notice of plan completion, and the debtors received a discharge.

Rule 3002.1 Notices Not Given

As later revealed, the lender had changed the monthly payments three times during the life of the chapter 13 plan but never filed the notices required by Rule 3002.1(b) and (c).

After discharge, the lender began claiming the mortgage was in default and threatened foreclosure. To stop foreclosure, the debtors filed a second chapter 13 petition in 2020. The servicer filed a claim that included about $33,000 in arrears on the mortgage.

The debtors filed a complaint against the lender, making a plethora of claims. The adversary proceeding also objected to the claim on the mortgage.

Of principal significance for our story, the debtors sought monetary sanctions and punitive damages under Bankruptcy Rule 3002.1(i)(2) for failure to give the notices required by subparts (b) and (c) of the Rule.

The lender filed a motion to dismiss, claiming that the rule is procedural and does not give rise to a claim for damages. In large part, the lender relied on *PHH Mortgage Corp. v. Sensenich (In re Gravel)*, 6 F.4th 503 (2d Cir. Aug. 2, 2021), rehearing and rehearing en banc *den*. Nov. 1, 2021. To read ABI's report, click here.

The Second Circuit's *Gravel* Decision

Gravel made two landmark holdings. First, all three circuit judges agreed that the standard in *Taggart v. Lorenzen*, 139 S. Ct. 1795 (2019), for violation of the automatic stay applies to all contempt citations in bankruptcy court. In *Taggart*, the Court held that there can be no sanctions for civil contempt of the discharge injunction if there was an "objectively reasonable basis for concluding that the creditor's conduct might be lawful under the discharge order." *Id*. at 1801. To read ABI's discussion of *Taggart*, click here.

Over a vigorous dissent, two circuit judges in *Gravel* held that bankruptcy courts may not impose contempt sanctions for violating Bankruptcy Rule 3002.1. Rather, the majority ruled that a debtor may only recover compensatory damages, which often will be nominal.

Judge Rodriguez Disagrees with *Gravel*

Judge Rodriguez opened his discussion of the lender's Rule 3002.1 dismissal motion by laying out the requirements and purpose of the rule. It applies to claims secured by a mortgage on a debtor's principal residence where the debtor or the trustee is making payments under a chapter 13 plan.

Within 21 days, Rule 3002.1(b) requires the lender to serve notice on the trustee, the debtor and the debtor's counsel anytime there is a change in the payment. Rule 3002.1(c) similarly requires notice regarding fees, expenses and charges allegedly incurred by the debtor after filing.

If the lender has not given the required notices, Rule 3002.1(i) provides that the court may prevent the lender from presenting evidence about the omitted information or "award other appropriate relief, including reasonable expenses and attorney's fees caused by the failure."

The rule was adopted to obviate situations where debtors complete their plan payments, receive discharges and then face foreclosure on a mortgage allegedly in default throughout the chapter 13 case.

The lender argued that Rule 3002.1 is a procedural rule that does not give rise to a cause of action. Judge Rodriguez knocked down that and other arguments.

Judge Rodriguez said he was not required to decide whether the rule creates an independent cause of action because the "plain language" in subsection (i)(2) permits the court to award "other appropriate relief." He therefore denied the motion to dismiss the claim for damages under (i)(2).

The sanction that the court could impose was a "different question," Judge Rodriguez said.

The lender argued that the debtor could not pursue sanctions in the second chapter 13 case that occurred during the first chapter 13 case. Again, Judge Rodriguez disagreed.

Finding no cases on point, Judge Rodriguez observed that the lender's failure to give notices during the first case was continuing to harm the debtors, because the failure to abide by the rules caused them to incur expenses and file the second chapter 13 case.

Judge Rodriguez therefore decided that the plaintiffs could raise a claim in the second case for shortcomings during the first case.

Next, Judge Rodriguez addressed *Gravel* and the debtors' right to claim sanctions and punitive damages.

Judge Rodriguez Sides with the *Gravel* Dissenter

Judge Rodriguez explained why the Second Circuit majority concluded that Rule 3002.1 is limited to non-punitive sanctions. He quoted the dissenter who saw the rule's plain meaning as giving the court discretion to impose punitive monetary sanctions.

If there were no possibility of punitive damages, Judge Rodriguez paraphrased the dissenter as saying that "mortgagees have little incentive to make the systemic changes required to service loans properly in chapter 13."

Judge Rodriguez said he "respectfully disagrees with the majority and agrees with the dissent. The plain language of Rule 3002.1(i) places few restrictions on the types of remedies bankruptcy courts can issue." The rule's only limit, he said, is the word "appropriate" while the word "including" is not limiting.

For Judge Rodriguez, going beyond compensatory damages "best serves the policy goals underlying the bankruptcy system." Costs and attorneys' fees alone "may be insufficient," he said, because violations "may either go unnoticed by the debtor or the debtor will find it easier to pay the small fees rather than litigate them."

Judge Rodriguez therefore denied the lender's motion to dismiss by holding that "sanctions and punitive damages may be assessed under Rule 3002.1(i)(2) as 'other appropriate relief' where circumstances warrant. Plaintiffs must nevertheless satisfy their evidentiary trial burden to prove they are entitled to such relief."

The opinion by Judge Rodriguez has several other holdings on issues that arise from time to time in consumer bankruptcies. He analyzed whether claim preclusion or judicial estoppel would bar the debtor from attempting to avoid the mortgage in the second case when there had been no claim to that effect in the first case.

Judge Rodriguez also denied the lender's motion to dismiss the debtors' claims about violating the automatic stay and the discharge injunction.

Observations

Don't hold your breath waiting for a ruling on appeal. The decision by Judge Rodriguez is interlocutory, and the case doesn't seem an attractive candidate for an interlocutory appeal.

There may be a settlement, precluding us all from knowing whether the Fifth Circuit would disagree with the Second Circuit.

Without a settlement, the lender will face the expense of a trial before Judge Rodriguez, followed by appeals to the district court and the circuit.

Since appeals could go in favor of the debtor and make bad law for lenders and servicers, the financial community could be better off having *Gravel* as the only appellate authority regarding Rule 3002.1.

The opinion is *Blanco v. Bayview Loan Servicing LLC (In re Blanco)*, 20-10078, 2021 BL 347772, 2021 Bankr Lexis 2502 (Bankr. S.D.N.Y. Sept. 14, 2021).

On an upcoming certified appeal, the Eleventh Circuit can decide whether violating a PACA trust is a 'defalcation while acting in a fiduciary capacity' that makes a debt nondischargeable.

PACA Violation Doesn't Result in Nondischargeability for Defalcation, Tampa Judge Says

On a question where the lower courts are split, Bankruptcy Judge Roberta A. Colton of Tampa, Fla., sided with the minority and held that violating a PACA trust does not make a debt nondischargeable under Section 523(a)(4) for defalcation while acting in a fiduciary capacity.

With no controlling precedent from the Eleventh Circuit and a split among courts in Florida, Judge Colton certified a direct appeal to the court of appeals.

The facts were typical for a case involving the Perishable Agricultural Commodities Act, known as PACA, 7 U.S.C. § 499a *et seq.* A company that purchased and resold produce was unable to pay its suppliers. A couple owned and controlled the business and therefore had personal liability to the sellers under PACA.

To dispense with their personal liability, the couple filed chapter 7 petitions. The suppliers responded with a complaint to declare that the debts owing to them were incurred by "fraud or defalcation while acting in a fiduciary capacity" and thus were not dischargeable under Section 523(a)(4).

The Genesis of PACA

To protect farmers and dealers of fresh produce, Congress originally adopted PACA in 1930. The statute was later amended to impose a floating trust on a purchaser's inventory and proceeds. The floating trust gives rights in a debtor's inventory and accounts receivable to beneficiaries of the PACA trust ahead of secured creditors. In other words, produce suppliers have priority over secured lenders.

For individuals who have personal liability under PACA, violation of the statutory trust raises the specter of having their debts declared nondischargeable.

The details about the floating trust were critical for Judge Colton, because the statute does not require segregation. Section 499e(c) of PACA provides that "a buyer's produce, products derived

from that produce, and the proceeds gained therefrom are held in a non-segregated, floating trust for the benefit of unpaid suppliers who have met the applicable statutory requirements."

On the question of dischargeability, Judge Colton said in her April 2 opinion that the "well-reasoned majority view" will not allow individuals to escape debt to suppliers. She cited the "equally well-reasoned minority approach" coming down in favor of dischargeability. Bankruptcy Courts in Florida have opinions on both sides.

Lack of Segregation Is Dispositive

Regarding Section 523(a)(4), Judge Colton began with fundamental principles, starting with Supreme Court authority from 1934 saying that the fiduciary exception is "strict and narrow." *Davis v. Aetna Acceptance Co.*, 293 U.S. 328, 333, (1934). Moving to the Eleventh Circuit, she said that "a breach of an express or technical trust is potentially non-dischargeable." *Guerra v. Fernandez-Rocha (In re Fernandez-Rocha)*, 451 F.3d 813, 816 (11th Cir. 2006).

Judge Colton went on to paraphrase *Guerra* by saying that breaches of constructive or resulting trusts do not fall within the Section 523(a)(4) discharge exception. She said that a PACA trust "falls somewhere between an express trust and a constructive trust."

Again citing binding precedent, Judge Colton noted that the Eleventh Circuit found a debt to be nondischargeable when the state statute required segregation of insurance premiums paid to a broker. *Quaif v. Johnson*, 4 F.3d 950, 953-954 (11th Cir. 1993).

Synthesizing authorities, Judge Colson said that "a statutory trust [like PACA] will only meet the definition [of 'fiduciary capacity'] if it effectively creates a technical trust."

Significantly, PACA permits and contemplates comingling and "fails to create the same type of a relationship characteristic of the conventional fiduciaries," Judge Colton said. She cited the Fifth Circuit for finding that a debt was dischargeable because state lottery law did not require segregation. *Texas Lottery Comm'n v. Tran (In re Tran)*, 151 F.3d 339 (5th Cir. 1998).

For Judge Colton, the lack of segregation was outcome-determinative. She interpreted the Eleventh Circuit as steering "the lower courts toward narrowing the scope of Section 523(a)(4) and [pointing] toward the need to have, at a minimum, 'some' segregation."

Although she said that "reasonable minds can and do differ," Judge Colton came down on the side of the debtors by dismissing the dischargeability complaint. In view of "the importance of this issue and the split of authority within this circuit," she certified a direct appeal to the Eleventh Circuit on May 5.

The opinion is *Spring Valley Produce v. Forrest (In re Forrest)*, 20-00447 (Bankr. M.D. Fla. April 2, 2021).

Arbitration

Decision by Bankruptcy Judge Michelle Harner demonstrates the flaw in the Fourth Circuit's rule requiring parallel proceedings in bankruptcy court and in arbitration when disputes are both core and non-core.

Arbitration Clause Results in Temporary Stay of 'Core' Proceedings in Bankruptcy Court

Although she would have reached "a very different conclusion" if a dissent had been governing authority in the Fourth Circuit, Bankruptcy Judge Michelle M. Harner of Baltimore temporarily halted proceedings in bankruptcy court in favor of arbitration, even on "core" claims arising under the Bankruptcy Code.

In her June 1 opinion, Judge Harner said that consolidating all disputes in bankruptcy court — rather than allowing arbitration to proceed — would have been "most efficient and fair . . . [and] also most consistent with the objectives of the Code." Saying she could not "ignore precedent," Judge Harner instead halted proceedings in bankruptcy court temporarily on disputes between the debtor and its principal creditor, which had filed a proof of claim.

Judge Harner could not have written a more persuasive opinion suggesting that the Fourth Circuit should reconsider *Moses v. CashCall, Inc.*, 781 F.3d 63 (4th Cir. 2015), where the circuit's *per curiam* opinion was accompanied by four separate opinions, including a dissent.

Judge Harner was the Francis King Carey Professor of Law and the Director of the Business Law Program at the University of Maryland Francis King Carey School of Law before her appointment to the bankruptcy bench in 2017.

The Uncertain Status of Arbitration in Bankruptcy

In the Supreme Court, the leading authority on the enforceability of arbitration agreements is (had been?) *Shearson/American Express Inc. v. McMahon*, 482 U.S. 220, 226 (1987). In view of the Federal Arbitration Act, the high court held that an arbitration agreement can only be overridden by a "contrary congressional command." *Id*. at 226.

Some circuit courts interpret *McMahon* more liberally by overriding arbitration agreements in bankruptcy cases, even though the Bankruptcy Code contains no express language barring enforcement of the FAA. For example, the Second Circuit refused to enforce an arbitration agreement and allowed a class action to proceed in bankruptcy court, alleging violations of the

discharge injunction. *Credit One Bank NA v. Anderson (In re Anderson)*, 884 F.3d 382 (2d Cir. March 7, 2018), *cert denied*, 139 S. Ct. 144 (2018). To read ABI's report, click here.

Similarly, the Fifth Circuit held in *Henry v. Educational Finance Service (In re Henry)*, 944 F.3d 587 (5th Cir. Oct. 17, 2019), that the bankruptcy court has discretion not to enforce an arbitration agreement when a debtor has initiated a class action contending that a creditor had violated the discharge injunction. To read ABI's report, click here.

Two months after *Anderson*, the Supreme Court compelled employees to arbitrate wages and hours claims governed by the Fair Labor Standards Act. *Epic Systems Corp. v. Lewis*, 200 L. Ed. 2d 889 (Sup. Ct. May 21, 2018). *Epic* said that a statute like the FLSA did not manifest a clear intention to override the Federal Arbitration Act.

Epic raised the following question: Does the Bankruptcy Code manifest a clear intention to override arbitration agreements, or does bankruptcy for some reason represent an exception to *Epic*'s exacting standard?

Although "a few courts have questioned the ongoing force of *McMahon* given subsequent Supreme Court decisions, most courts have continued to follow its guidance," Judge Harner said.

Whatever other circuits may be saying, Judge Harner was bound by *CashCall*.

Even before *Epic*, the Fourth Circuit interpreted *McMahon* more strictly. In *CashCall*, the Fourth Circuit ruled that a bankruptcy court has discretion to refuse arbitration of "core" claims.

More specifically, *CashCall* allowed the bankruptcy court to decide whether a loan bearing 149% interest was void under state law. In other words, the debtor was not compelled to arbitrate a core issue involving the allowance of a claim.

On the other hand, *CashCall* required arbitration of a noncore claim where the debtor sought damages under state law for a loan that was allegedly void.

The rationale underpinning *CashCall* lacks clarity because there were five opinions among the three circuit judges on the panel, including the *per curiam* opinion for the court and a dissent.

The Facts Before Judge Harner

The creditor had an agreement to provide financing for the debtor in return for an interest in some of the debtor's whistleblower lawsuits. The financing was allegedly secured by recoveries in the lawsuits.

Disputes arose before bankruptcy, and the creditor invoked an arbitration clause in the financing agreement. The arbitration was stayed automatically when the debtor filed a chapter 11 petition.

In bankruptcy, the creditor filed a motion to modify the automatic stay to allow the arbitration to proceed. The creditor also filed an adversary proceeding seeking a ruling that debts were not dischargeable.

The debtor commenced an adversary proceeding making six claims against the creditor.

The parties' litigations in bankruptcy court and in arbitration fell into three categories: (1) claims on both sides to decide who breached the financing agreement; (2) the debtor's claims that the creditor violated the federal Fair Debt Collection Practices Act and state law governing the financing agreement; and (3) the debtor's claims under Sections 502, 510, 523, 543, 544, 547 and 553 of the Bankruptcy Code.

Applying *CashCall* to the Facts

Judge Harner interpreted *CashCall* and other authorities for the proposition that characterizing a claim as "constitutionally core is indicative of Congressional intent to limit arbitrations." The question is more complex, she said, when issues are both core and non-core.

When a claim is constitutionally core, Judge Harner deduced that she had discretion to override an arbitration agreement. Citing a concurring opinion in *CashCall*, she saw her discretion as "far more limited with respect to non-constitutionally core or non-core proceedings."

Indeed, Judge Harner interpreted *CashCall* to mean that she must allow arbitration of "certain state law issues in this case, despite the potential attendant delay and adverse effects on the Debtor's estate."

Before ruling definitively, Judge Harner addressed the debtor's claims arising entirely under the Bankruptcy Code that could not have been asserted before bankruptcy. She found "strong support" that they were constitutionally core. For instance, deciding who breached the financing agreement would be resolved in ruling on the allowance of the creditor's proof of claim.

The debtor's fraudulent transfer claims could have been brought under state law, but Judge Harner said that the creditor had filed a proof of claim, "making the alleged fraudulent transfer claim part of the claims administration process and potentially subject to section 502(d) of the Code."

Judge Harner concluded that the fraudulent transfer claims were "more closely aligned" with a constitutionally core proceeding.

On the other hand, the debtor's FDCPA claims were aimed at augmenting the estate and were not constitutionally core.

Likewise, the debtor's claims for breach of contract "are grounded in state law and are likely non-core proceedings" that could be decided under state law either by an arbitrator or a state court. Still, Judge Harner said, "certain of those claims intersect with several of the Debtor's Bankruptcy Claims, raising the specter of inconsistent results and potential conflicts between this chapter 11 case and the prepetition arbitration proceeding."

Bifurcation Required by *CashCall*

Judge Harner interpreted *CashCall* as requiring "a bifurcation of the constitutionally core and the non-core claims," but she quoted the dissenter as expressing "concern regarding such bifurcation and its potentially adverse effect on the bankruptcy case and the objectives of the Code." *CashCall*, *id*., 781 F.3d at 66, 88.

In referring to bifurcation, Judge Harner meant the Fourth Circuit majority's requirement that proceedings must run parallel in bankruptcy court and in arbitration when there are core and non-core claims arising from the disputes.

Although saying that bifurcation was "suboptimal" and that she "agrees with [the dissenter's] concerns," Judge Harner found herself "bound both by the circuit's position in *CashCall*, as well as other precedent underscoring the important role played by arbitration in the judicial system, including in bankruptcy cases."

Finding herself required to bifurcate, Judge Harner ruled that the bankruptcy claims must remain in bankruptcy court while non-bankruptcy claims proceed in arbitration.

Judge Harner didn't like the result. If she were "writing on a clean slate, or if [the dissenter's opinion] in *CashCall* had been that of the circuit, the Court likely would have reached a very different conclusion." Consolidating all disputes in bankruptcy court would have been "not only most efficient and fair to all potentially affected parties, but also most consistent with the objectives of the Code. The Court cannot, however, ignore precedent."

Bankruptcy Proceedings Temporarily Stayed

Bifurcation "presents opportunities for overlap in facts, duplication in effort, and conflicting results," Judge Harner said. She therefore sought "procedural mechanisms to protect the parties."

With regard to the "overlap" between the claims in bankruptcy court and in arbitration, Judge Harner felt "compelled to defer to the arbitrator, but solely on the resolution of the state law and non-bankruptcy claims subject to arbitration."

If the chapter 11 petition had been filed before arbitration commenced, Judge Harner said she "might reach a different conclusion and delay any requested arbitration pending resolution of the Bankruptcy Claims."

"Nonetheless," Judge Harner modified the automatic stay in Section 362(a) "to allow the prepetition arbitration proceeding to continue." She cautioned the arbitrator not to rule on any bankruptcy claims and precluded the parties from enforcing any arbitration ruling "outside" of the bankruptcy court.

There was more to Judge Harner's decision because there might be conflicting results or the possibility that one forum could be bound by the other's decision.

To avoid the "uncertainty introduced" by bifurcation, Judge Harner issued a temporary, 90-day stay halting the debtor's adversary proceeding and its claims under the Bankruptcy Code. During the stay, the judge said she would "monitor how these matters progress . . . to guard against undue delay or gamesmanship."

Judge Harner said she "dislike[d] the element of uncertainty introduced by this approach" but decided it was "warranted and most appropriate" in the absence of "clear authority under the Code or case law giving this Court more discretion to refuse arbitration in the context of nonconstitutionally core or non-core claims."

Observations

Judge Harner's opinion has shown how bifurcation required by the majority in *CashCall* is unworkable, in this writer's opinion and as predicted by the dissenter.

If arbitration proceeds quickly, the arbitrator could make fact findings compelling the result on bankruptcy issues such as dischargeability and claim allowance. Of course, arbitral awards are not subject to appeal, and there is little or no discovery in arbitration. Results might be different in bankruptcy court where there is discovery.

In other words, arbitrators may end up deciding core claims like dischargeability, because the Fourth Circuit requires parallel proceedings in bankruptcy court and in arbitration.

Perhaps the Supreme Court eventually will decide whether or to what extent disputes in bankruptcy cannot be arbitrated. However, the Court denied *certiorari* in *Anderson*. A few more

certiorari petitions about arbitration in the bankruptcy context may persuade the justices to rule on the question.

Keep this in mind, though: The high court might tell us that arbitration agreements are always enforceable even in bankruptcy cases.

The opinion is *In re McPherson*, 21-10205 (Bankr. D. Md. June 1, 2021).

Stays & Injunctions

Pennsylvania's Judge Conway hints that failure to stop proceedings after bankruptcy can be an automatic stay violation, even after Fulton.

Refusing to Release an Attachment After Filing Is No Stay Violation Following *Fulton*

After *Fulton*, a creditor's refusal to lift the attachment of a bank account is no violation of the automatic stay under any subsection Section 362(a), according to Bankruptcy Judge Mark J. Conway of Wilkes-Barre, Pa.

The October 6 opinion by Judge Conway hints that a creditor must stop legal proceedings after bankruptcy that would impair the debtor's interest in property, *Fulton* notwithstanding.

The Pre-Filing Attachment

Before bankruptcy, the creditor obtained a $33,300 judgment against the soon-to-be debtor. Also before bankruptcy, the creditor obtained a writ of execution and served it on a credit union holding an account belonging to the debtor that contained about $1,100.

Service of the writ froze the account and gave the creditor a judicial lien. After service of the writ, the debtor filed a chapter 13 petition. The creditor did not undertake further proceedings in state court after bankruptcy that would have been required to transfer the funds in the account from the credit union to the creditor.

On several occasions after filing, counsel for the debtor contacted the lender and demanded the lifting of the attachment. The lender declined.

A few months after filing, the debtor commenced an adversary proceeding against the lender, alleging a willful violation of the automatic stay under Section 362(k), thereby opening the door to actual and punitive damages and attorneys' fees. The complaint also sought turnover.

The debtor and the creditor filed cross-motions for summary judgment. Before the hearing, the debtor confirmed a plan promising to pay the creditor in full, and the lender released the funds in the account to the debtor.

Judge Conway was therefore only required to rule about a stay violation and contempt.

Nothing Offended in Section 362(a)

Naturally, *Fulton* was front and center. *See City of Chicago v. Fulton*, 141 S. Ct. 585, 208 L. Ed. 2d 384 (Sup. Ct. Jan. 14, 2021). The Supreme Court held "that mere retention of property does not violate the [automatic stay in] § 362(a)(3)." *Id*. 141 S. Ct. at 589. Section 362(a)(3), the Court said, only "prohibits affirmative acts that would disturb the *status quo* of estate property." *Id*. at 590.

In *Fulton*, the City of Chicago was itself holding the debtor's car at the time of the chapter 11 filing. Admitting that the lender had taken no action after bankruptcy, the debtor contended that *Fulton* did not apply because the credit union was in possession of the funds, not the judgment creditor.

Judge Conway first analyzed the facts under Section 362(a)(3), the same subsection at issue in *Fulton*. That section prohibits "any action" to obtain possession or exercise control over estate property.

In the case at hand, Judge Conway said that the creditor's actions were "perhaps more appropriately characterized as inactions." He paraphrased *Fulton* as holding that "the mere retention of estate property" is no stay violation.

Applying *Fulton*, Judge Conway held that the creditor's refusal to withdraw the prepetition attachment "does not violate Section 362(a)(3)." Rather, the creditor only maintained the *status quo*. Further, withdrawing the attachment could have deprived the creditor of its judicial lien on the account.

Judge Conway found no violation of the other subsections in Section 362(a).

Subsections (a)(4) through (a)(6) likewise bar "any action" to create or enforce a lien or to recover on a prepetition claim. Given that the creditor had a lien before the filing date, Judge Conway said that the creditor "had to have done something post-petition" to violate subsections (a)(4) or (a)(5). Likewise, he held that the "mere retention of a valid pre-petition" attachment does not violate (a)(4) through (a)(6).

Next, Judge Conway examined Section 362(a)(1). The debtor claimed there was an (a)(1) violation because the subsection does not begin with "any act." Rather the subsection bars the "commencement or continuation" of a proceeding to collect on a claim.

Judge Conway approvingly cited *In re Iskric*, 496 B.R. 355 (Bankr. M.D. Pa. 2013), where the court found a stay violation because the creditor allowed the continuation of state court proceedings resulting in the debtor's incarceration.

Judge Conway read *Iskric* as "an example of a factual scenario where if a creditor has put a process into effect that, without intervention, causes a change in the *status quo* as to property of the estate or the debtor, then a creditor must act to avoid that change."

Cases like *Iskric* did not apply, in Judge Conway's opinion, because the creditor "did nothing to further or 'continue' the garnishment process."

Similarly, the creditor did not violate Section 362(a)(2), prohibiting enforcement of a judgment. Judge Conway held that the failure to withdraw the attachment "cannot be construed as, or equated with, taking an affirmative action to enforce a judgment."

In short, Judge Conway granted summary judgment in favor of the creditor by dismissing the complaint.

The opinion is *Margavitch v. Southlake Holdings LLC (In re Margavitch)*, 20-00014 (Bankr. M.D. Pa. Oct. 6, 2021).

Wages & Dismissal

Disagreeing with two other circuits, the Sixth Circuit finds no power in the bankruptcy court to avoid dismissing a chapter 13 case even if the debtor filed repeatedly in bad faith to avoid foreclosure.

Sixth Circuit Creates a Split by Requiring Dismissal of an Abusive Chapter 13 Filing

Splitting with two other circuits, the Sixth Circuit ruled that the bankruptcy court must dismiss a chapter 13 petition, even when the latest repeat filing was in bad faith.

The debtor bought a home with a $530,000 mortgage and defaulted a year later. Days before the scheduled foreclosure in 2007, he filed a chapter 13 petition. The sale was cancelled, and the debtor dismissed the petition a few days later.

The debtor used the same tactic in 2017 and in 2019, stopping a foreclosure sale with a chapter 13 filing and dismissing the petition a few days later.

In his five-page opinion on June 9, Circuit Judge Raymond M. Kethledge mentioned that the lender in the most recent chapter 13 filing had not made a motion before dismissal seeking sanctions under Rule 9011 for filing petitions in bad faith, nor had the lender filed a motion to modify the automatic stay.

However, the lender in the last case filed a motion four months after dismissal to reopen the case under Rule 9024. The bankruptcy court granted the motion and lifted the automatic stay for two years.

The debtor appealed and filed a motion for a stay in district court. The district judge denied the stay motion but granted leave for an interlocutory appeal. The appeals court agreed to hear the appeal, to determine whether the district court's denial of a stay amounted to an abuse of discretion.

The outcome turned on Section 1307(b). If a chapter 13 case has not been previously converted from chapters 7, 11, or 12, the section provides that, "On request of the debtor at any time, . . . the court shall dismiss a case under this chapter."

Judge Kethledge said that the "provision is mandatory," by use of the word "shall." In comparison, Section 1307(c) says that the court "may" dismiss a case for "cause." He found "nothing in § 1307 that renders § 1307(b) discretionary in cases where the debtor filed the bankruptcy petition in bad faith."

The Fifth and Ninth Circuits, Judge Kethledge said, relied on *Marrama v. Citizens Bank of Massachusetts*, 549 U.S. 365 (2007), to hold that the bankruptcy court has discretion to deny dismissal of a chapter 13 case if the petition was filed in bad faith. *See Jacobsen v. Moser (In re Jacobsen)*, 609 F.3d 647, 660 (5th Cir. 2010); and *Rosson v. Fitzgerald (In re Rosson)*, 545 F.3d 764, 773–74 (9th Cir. 2008).

In *Marrama*, the majority's opinion said:

> On the contrary, the broad authority granted to bankruptcy judges to take any action that is necessary or appropriate "to prevent an abuse of process" described in § 105(a) of the Code, is surely adequate to authorize an immediate denial of a motion to convert filed under § 706 in lieu of a conversion order that merely postpones the allowance of equivalent relief and may provide a debtor with an opportunity to take action prejudicial to creditors.

Marrama, *supra*, 549 U.S. at 375.

Judge Kethledge proceeded to pick apart the precedential value of *Marrama*. First, *Marrama* involved a motion under Section 706(a) for conversion of a chapter 7 case to chapter 13. That section provides that the court "may" convert, not "shall." He also characterized the language quoted above as *dicta*.

More to the point, Judge Kethledge interpreted *Law v. Siegel*, 571 U.S. 415 (2014), as "largely reject[ing] that *dictum*." He read *Law* as "flatly reject[ing] the idea that § 105(a) vests in the bankruptcy courts equitable power to disregard the Code's provisions when they lead to results that seem unfair."

Judge Kethledge said that the "command of § 1307(b) is no mere procedural nicety, which is likely why no circuit court has accepted [the lender's] argument since *Law* was decided in 2014."

Judge Kethledge reversed the district court's denial of a stay and remanded with instructions for the bankruptcy court to dismiss the most recent chapter 13 filing. However, he said that the "bankruptcy court need not take any action to restore the *status quo* prior to its . . . reinstatement of [the chapter 13] case."

Observations

With respect, the federal judiciary is a co-equal branch of government. Do our courts today believe that Congress is capable of adopting statutes that cannot be abused? Why can't courts exercise powers under Section 105 of the Bankruptcy Code to prevent abuse of title 11?

Law was a different type of case. There, the bankruptcy court attempted to deprive a debtor of his statutory right to the ownership of property, based on equitable considerations. The appeal in the Sixth Circuit dealt with delaying a procedural right to afford time to prevent an abuse of the Bankruptcy Code.

In the case on appeal, the debtor's home was sold at foreclosure after the bankruptcy was reopened and the stay modified in favor of the lender. By saying that the bankruptcy court was not required to restore the *status quo*, the Sixth Circuit is apparently suggesting that the violation of the debtor's procedural right didn't require setting aside actions in reliance on court orders.

Perhaps the Sixth Circuit's opinion means that a bankruptcy court may delay dismissal to afford time for a creditor to petition the court for relief to avoid an abuse of the Bankruptcy Code.

If that's what it means, debtors won't be able to abuse the right to dismiss. If it means more, we have a problem.

The foregoing are the opinions and commentary of this writer, not ABI.

The opinion is *Smith v. U.S. Bank N.A. (In re Smith)*, 999 F.3d 452 (6th Cir. June 9, 2021).

The Ninth Circuit leaves the door open for a bankruptcy court to sanction a misbehaving chapter 13 debtor before granting the debtor's motion for voluntary dismissal.

Another Circuit Holds that Dismissal Is Mandatory Under Section 1307(b)

Concluding that *Law v. Siegel*, 571 U.S. 415 (2014), implicitly overruled its own precedent, the Ninth Circuit held on September 1 that a bankruptcy court must dismiss a chapter 13 case on motion by the debtor under Section 1307(b), regardless of the debtor's abusive conduct.

Significantly, the appeals court left the door open for the bankruptcy court to address the debtor's misconduct alongside dismissal.

The Sixth Circuit reached the same result less than three months ago. *See Smith v. U.S. Bank N.A. (In re Smith)*, 20-3150, 2021 BL 318517 (6th Cir. June 9, 2021). There, the Cincinnati-based appeals court held that the bankruptcy court must dismiss a chapter 13 petition, even when the latest repeat filing was in bad faith. To read ABI's report, click here.

Like the Ninth Circuit, the Sixth Circuit hinted that a debtor cannot dismiss to evade the consequences of misconduct.

The Facts

Husband and wife debtors filed a chapter 13 petition. Later, they were indicted in federal court for fraud.

According to the opinion by Circuit Judge Diarmuid F. O'Scannlain, the debtors refused to make disclosures in bankruptcy court for fear of compromising their defenses in the criminal action. They refused to hold a meeting of creditors, did not file tax returns, and did not propose a plan.

The creditor who was the victim of the alleged fraud filed a claim in the chapter 13 case, along with a motion for conversion to chapter 7 under Section 1307(c). The bankruptcy court decided that conversion would be proper under Section 1307(c) and (e), but the debtors asked for more time to cure their defaults.

The bankruptcy court gave them 30 days. The debtors did not comply but filed a motion for voluntary dismissal under Section 1307(b) before the 30 days ran out.

Relying on Ninth Circuit authority, *Rosson v. Fitzgerald (In re Rosson)*, 545 F.3d 764 (9th Cir. 2008), the bankruptcy court denied the motion to dismiss and converted to chapter 7. The debtor appealed, but the Ninth Circuit Bankruptcy Appellate Panel affirmed.

The outcome in the Ninth Circuit turned on *Law* and Section 1307(c), which provides that, "On request of the debtor at any time, . . . the court shall dismiss a case under this chapter."

Law Overrules *Rosson*

In *Rosson*, the debtor had been directed to deposit proceeds from an arbitration award. When the debtor didn't, the bankruptcy court intended to convert the case to chapter 7 *sua sponte*. Before the bankruptcy court could convert, the debtor filed a motion to dismiss under Section 1307(b). The bankruptcy court converted and denied the motion to dismiss.

Noting a circuit split but upholding conversion, the Ninth Circuit in *Rosson* read *Marrama* to mean that an unqualified right to dismiss was subject to the bankruptcy court's powers under Section 105(a). *Id.* at 773.

Six years later, the Supreme Court handed down *Law*, reversing the Ninth Circuit. Judge O'Scannlain paraphrased *Law* as making clear "that a bankruptcy court may not use its equitable powers under § 105(a) to contravene express provisions of the Bankruptcy Code."

Judge O'Scannlain had "no doubt that *Law* undercuts the reasoning of *Rosson*." He therefore held that "*Rosson* has been effectively overruled by *Law* and is no longer binding precedent in this Circuit."

Freed from circuit precedent, Judge O'Scannlain held:

> Section 1307(b)'s text plainly requires the bankruptcy court to dismiss the case upon the debtor's request. There is no textual indication that the bankruptcy court has any discretion whatsoever.

Judge O'Scannlain acknowledged that the Fifth and Eighth Circuits had held to the contrary, but both decisions came down before *Law*. Those decisions, he said, both rely on a "now-discredited theory." He noted that no circuit has aligned itself with those two circuits after *Law*.

Judge O'Scannlain said that the "absolute right" to dismiss is "entirely consistent" with the policy of Section 303(a), designed to make chapter 13 a voluntary alternative to chapter 7. He thus held that the "debtor [has] an absolute right to dismiss a Chapter 13 bankruptcy case, subject to

the single exception" in Section 1307(b) for debtors whose cases previously had been converted from chapters 7, 11 or 12.

Immediately before reversing and remanding, Judge O'Scannlain said:

> We are confident that the Bankruptcy Code provides ample alternative tools for bankruptcy courts to address debtor misconduct.

Observations

Can a chapter 13 debtor play fast and loose with the court and creditors, then lay down a get-out-of-jail-free card if it doesn't go well? Does the Ninth Circuit mean that a bankruptcy court must dismiss *immediately* when the debtor files a voluntary dismissal motion under Section 1307(b)?

In line with Judge O'Scannlain's reference to "ample alternative tools," perhaps a court could defer dismissal long enough for a creditor to obtain relief from the automatic stay.

Perhaps also, the bankruptcy court could defer dismissal for long enough to impose sanctions under Rule 11.

And most significantly, perhaps the bankruptcy court could dismiss, but dismiss with prejudice, and thereby render claims nondischargeable.

It is difficult to believe that Congress wrote a statute to mean that debtors can evade the consequences of their own misconduct.

The opinion is *Nichols v. Marana Stockyard & Livestock Market Inc. (In re Nichols)*, 20-60043, 2021 BL 330861 (9th Cir. Sept. 1, 2021).

Ninth Circuit BAP doesn't require a formal motion to dismiss with prejudice when a debtor files a voluntary motion to dismiss as of right under Section 1307(b).

A Motion to Dismiss as of Right Doesn't Bar the Court from Dismissing with Prejudice

A chapter 13 debtor filed a motion under Section 1307(b) for dismissal of right. Had he succeeded, the debtor would have been entitled to file again and attempt to discharge all his debts, because Section 349(a) says that dismissal does not bar discharging debts in a later case, unless the court orders otherwise for cause.

However, a creditor opposed the debtor's motion for dismissal without prejudice and asked for the dismissal to be made with prejudice. Significantly, the creditor never filed a cross motion seeking dismissal with prejudice under Section 1307(c).

Finding "egregious" conduct by the debtor, the Bankruptcy Judge Martin R. Barash of Woodland Hills, Calif., dismissed the chapter 13 case with prejudice. Dismissal with prejudice had the same effect as a denial of discharge of the debtor's then-existing debts.

Was there an error in dismissing with prejudice in the absence of a formal motion to that effect?

Writing for the Ninth Circuit Bankruptcy Appellate Panel on July 27, Bankruptcy Judge Christopher M. Klein found no error and upheld dismissal with prejudice.

Judge Klein's erudite opinion reads like a treatise, laying out everything there is to know about the proper procedures, standards, burdens of proof and burdens of persuasion when it comes to dismissal with or without prejudice.

The Misbehaving Debtor

The debtor had filed chapter 12 petitions in 2010 and 2012. The 2012 case converted to chapter 7 followed by the entry of discharge.

The debtor filed a chapter 13 petition in 2018. A creditor, whom Judge Klein called the debtor's nemesis, opposed confirmation of the debtor's plan. In the objection, the creditor said that the case should be either dismissed or converted. The creditor did not file a motion to dismiss or convert.

The bankruptcy court heard witnesses and took evidence at a two-day confirmation trial. The issues included the debtor's good faith, or lack of it.

In post-trial briefing, the creditor urged the court to dismiss with prejudice for bad faith. Again, the creditor did not file a motion to convert or dismiss with prejudice under Section 1307(c).

Conceding that his plan could not be confirmed, the debtor filed a motion to dismiss under Section 1307(b). The creditor filed an opposition to the motion to dismiss and asked for dismissal with prejudice under Section 349(a) for egregious bad faith. Again, the creditor did not file a motion to dismiss under Section 1307(c).

Section 1307(c) allows the U.S. Trustee or a party in interest to move for conversion or dismissal by showing "cause."

The bankruptcy court held another hearing and considered the entire record. Technically speaking, the only motion before the court was the debtor's motion to dismiss under Section 1307(b) and the creditor's opposition with a request for dismissal with prejudice under Section 349(a).

In his decision, Bankruptcy Judge Barash cited the four-part test in *Leavitt v. Soto (In re Leavitt)*, 171 F.3d 1219 (9th Cir. 1999), *aff'g* 209 B.R. 935 (9th Cir. BAP 1997), as governing authority to determine whether the totality of the circumstances warranted dismissal with prejudice. Judge Barash dismissed with prejudice, after finding egregious and inequitable bad faith plus manipulation and abuse of the Bankruptcy Code.

The debtor appealed, to no avail.

Procedures for Dismissal with Prejudice Under Section 349(a)

For the BAP, Judge Klein surveyed the subtle differences about dismissal under Sections 1307(b), 1307(c) and 349. "The salient point," he said, "is that Section 349(a) is an independent question that applies to all forms of dismissal, including Section 1307(b)."

For example, Judge Klein explained how Section 349(a) and 1307(c) require "cause," while a debtor's motion under Section 1307(b) does not. "Unless the court, for cause, orders otherwise," Section 1307(b) says that "the dismissal of a case under this title does not bar the discharge, in a later case under this title, of debts that were dischargeable in the case dismissed. . . ."

There are different forms of dismissal with prejudice. The weak form, Judge Klein said, can contain a temporary refiling prohibition or provide that a new filing will not apply the automatic stay to a particular creditor. The strong form, he said, "is tantamount to denial of discharge" and

is reserved "for egregious circumstances and necessitates that courts proceed with caution and pay attention to due process requirements consistent with denial of discharge."

The bankruptcy court properly applied *Leavitt*, Judge Klein said. Although *Leavitt* dealt with "cause" for dismissal under Section 1307(a), he saw "no principled reason" why it should not also apply to Section 1307(b) dismissals.

Procedurally speaking, Judge Klein ran into a problem. Although *Leavitt* may be the standard, the rules and the Code don't say when or how the Section 349(a) prejudice issue must be raised.

In the case on appeal, the procedures afforded due process consistent with complaints to deny discharge under Section 727. In addition, the creditor's opposition to the debtor's motion to dismiss without prejudice "was a correct procedure for presenting the Section 349(a) issue to the court."

Next, Judge Klein said that the bankruptcy court correctly treated the dispute as a Rule 9014 contested matter. He therefore found no error in the procedure leading to dismissal with prejudice.

Next, Judge Klein dealt with the burden of persuasion. The creditor, he said, has the burden because dismissal with prejudice is "tantamount to denying discharge."

With regard to how much evidence it takes to carry the burden of persuasion, Judge Klein said that the "quantum" required to overcome the presumption of discharge without prejudice "is likewise influenced by the emphasis on egregious circumstances and the similarity to the consequences of denial of discharge."

Even if the quantum for a strong form of dismissal with prejudice were more than the preponderance of the evidence, Judge Klein said that the creditor had proven "a 'huge' and egregious manipulation of bankruptcy process in bad faith." The evidence, he said, was "overwhelming."

The evidence and the findings were more than sufficient to justify dismissal with prejudice.

Given the findings, did the bankruptcy court abuse its discretion in dismissing with prejudice?

The bankruptcy court had employed the proper *Leavitt* standard and made findings supported by the record that were neither illogical nor implausible. Judge Klein thus concluded there was no abuse of discretion in dismissing with prejudice.

In short, "the debtor's 'right' to dismiss under §1307(b) does not immunize the debtor from the consequences of an adverse § 349(a) determination," Judge Klein said.

Observations

There is a split of circuit on the question of whether a court must dismiss when a debtor files a motion to dismiss under Section 1307(b).

Splitting with the Fifth and Ninth Circuits, the Sixth Circuit held in June that the bankruptcy court must dismiss a chapter 13 petition, even when the latest repeat filing was in bad faith. *See Smith v. U.S. Bank N.A. (In re Smith)*, 999 F.3d 452 (6th Cir. June 9, 2021). To read ABI's report, click here.

Smith and Judge Klein's opinion are not necessarily incompatible. If importuned and if the evidence were sufficient, a court could respond to a debtor's motion under Section 1307(b) by dismissing, except with prejudice.

If that's true, a debtor's motion to dismiss isn't a get-out-of-jail-free card, nor should it be.

On Language — Old Word Resurrected

Near the end of the opinion, Judge Klein said that the debtor's "Nemesis was not willing to let [the debtor] absquatulate."

Quoting an academic, Judge Klein said that the word absquatulate was invented following the Panic of 1837:

> The newly independent Republic of Texas gained a reputation as a popular destination for dishonorable failures. . . . "Gone to Texas," abbreviated in "three ominous letters G.T.T.," became a shorthand symbol found on abandoned businesses. . . . Absconding to squat on western lands and perambulate from one property to another had become so common a practice that writers invented a new verb to describe this process: to absquatulate.

The opinion is *Duran v Gudino (In re Duran)*, 20-1045, 2021 BL 283667 (B.A.P. 9th Cir. July 27, 2021).

Debtor accepted a bar to refiling to avoid dismissal with prejudice of her chapter 13 case.

Bad Faith Permits Dismissal of a Chapter 13 Case with Conditions, Judge Waites Says

In an area where the courts are split and the Fourth Circuit has no precedent, Bankruptcy Judge John E. Waites of Columbia, S.C., decided that the Bankruptcy Code allowed him to attach conditions when a debtor asks for dismissal of her chapter 13 case as of right under Section 1307(b).

The debtor refused to appear at her continued meeting of creditors. The chapter 13 trustee was hot on her trail, suspecting that she had not fully disclosed her assets and may have made voidable transfers.

The trustee filed a motion for conversion to chapter 7 under Section 1307(c). The debtor responded with a motion to dismiss as of right under Section 1307(b), which provides, "On request of the debtor at any time, . . . the court *shall dismiss* a case under this chapter." [Emphasis added.]

The trustee and creditors objected to dismissal.

In his September 29 opinion, Judge Waites laid out the split. The Second, Sixth and Ninth Circuits, he said, give a chapter 13 debtor "an absolute and unqualified right to dismiss a Chapter 13 case that has not been previously converted." In the Ninth Circuit, the case is *Nichols v. Marana Stockyard & Livestock Market Inc. (In re Nichols)*, 20-60043, 2021 BL 368629, 2021 Us App Lexis 29302 (9th Cir. Sept. 1, 2021). To read ABI's report on *Nichols*, click here.

On the other side of the fence, Judge Waites cited opinions from the Fifth and Eighth Circuits holding that dismissal under Section 1307(b) may be conditioned on the debtor's good faith.

The Fifth and Eighth Circuits rested their decisions in part on *Marrama v. Citizens Bank of Massachusetts*, 549 U.S. 365 (2007), where the Supreme Court held under Section 706(a) that the bankruptcy court has discretion to deny conversion of a chapter 7 case to chapter 13 as a consequence of the debtor's bad faith.

But then came *Law v. Siegel*, 571 U.S. 415 (2014), where the Supreme Court held that a bankruptcy court may not use its equitable powers under Section 105(a) to contravene express provisions of the Bankruptcy Code. More particularly, the Court held that a bankruptcy court may not employ equitable powers to invade a debtor's homestead exemption.

Judge Waites also mentioned that *Marrama* was a 5/4 decision. The dissenters in *Marrama* saw nothing in the text of Section 706(a) to deprive the debtor of the right to convert.

On motions by a debtor to dismiss under Section 1307(b), Judge Waites said that "[r]ecent and more convincing authorities" have taken *Law* to mean that a chapter 13 debtor may not "be precluded from voluntarily dismissing his or her Chapter 13 case in the face of a pending motion to convert or allegations of bad faith conduct."

Nonetheless, Judge Waites said that his understanding of Section 1307(b) "does not preclude the view that other portions of the Bankruptcy Code, such as 11 U.S.C. § 349(a) or 11 U.S.C. § 109(g), provide the Court with authority to issue remedial orders in addition to an order granting a debtor's motion to dismiss under § 1307(b) to address a debtor's bad faith conduct or abuse of the bankruptcy process."

Judge Waites was prepared to hold a hearing to decide whether he would dismiss with prejudice. Had he done so, the debtor's debts outstanding on the filing date would have become nondischargeable if the debtor were to file again.

To fend off a disastrous ending to her chapter 13 case, the debtor negotiated a settlement where she agreed that the order of dismissal would bar another filing for two years. She also agreed that creditors could serve process by mail in state court proceedings.

Judge Waites entered an order dismissing and effecting the compromise.

The opinion is *In re Minogue*, 21-01779 (Bankr. D.S.C. Sept. 29, 2021).

Tenth Circuit splits with the Third and Seventh Circuits on allowing a debtor to cure defaults after a five-year plan has ended.

Circuits Split on Allowing Debtors to Cure Chapter 13 Plan Defaults After Five Years

Splitting with the Third and Seventh Circuits, the Tenth Circuit held that a chapter 13 debtor cannot cure a post-confirmation default on a mortgage after the five-year plan has expired. In other words, the appeals court believes that a belated payment would be an impermissible modification of the plan after the term of the plan has ended.

Even though the debtor had tendered cure payments, the appeals court upheld dismissal of the case, with the effect of denying the debtor's discharge, although she had made all plan payments to the chapter 13 trustee.

The Accident and the Default

In 2014, the debtor confirmed her chapter 13 plan, with monthly mortgage payments going directly to the lender. She was current on the mortgage at filing and remained current until she had an auto accident in 2018. With additional expenses after the accident, the debtor missed two mortgage payments "in the final months of her five-year plan," Circuit Judge Robert E. Bacharach said in his July 23 opinion for himself and Circuit Judge David M. Ebel.

Parenthetically, Judge Bacharach said the debtor missed two more mortgage payments after the plan was over.

Following the conclusion of the plan, the bank filed a motion to dismiss. The debtor opposed the motion, tendered the defaulted payments and proposed that she be granted a discharge after paying the arrears.

Although not mentioned in Judge Bacharach's opinion, the debtor evidently did not file a motion asking for a hardship discharge under Section 1328(b).

Bankruptcy Judge Elizabeth E. Brown of Denver granted the motion to dismiss and denied a motion for reconsideration. The Tenth Circuit granted a direct appeal, overstepping an intermediate appeal to the district court or the Bankruptcy Appellate Panel.

A Cure or a Plan Modification?

Judge Bacharach stated the question as follows: Were the tendered payments a permissible cure or an impermissible attempt to modify the plan after the term of the plan had ended?

More precisely, Judge Bacharach asked whether the proffered cure would be a payment made "under the plan," therefore entitling the debtor to a discharge under Section 1328(a). That section provides that the court "shall" grant a discharge "after completion by the debtor of all payments under the plan." Of course, the debtor contended that cure payments would be made "under the plan."

The bank argued, successfully, that the proffered payments were not a cure but were an impermissible modification of the plan after the five-year term of the plan had ended.

What Does 'Under the Plan' Mean?

Judge Bacharach said that the courts differ on the meaning of "after completion by the debtor of all payments under the plan." He cited a string of cases holding that untimely payments are allowable, while "many other courts" believe that late payments are not made "under the plan."

While the lower courts are split on whether late payments are permissible, the Third and Seventh Circuits have found discretion to allow a final payment after five years. *See In re Klaas*, 858 F.3d 820 (3d Cir. 2017); and *Germeraad v. Powers*, 826 F.3d 962 (7th Cir. 2016). For ABI's reports on those cases, click here and here.

Judge Bacharach said the disagreement was "understandable" given "the ambiguity inherent in the combination of §§ 1307(c), 1322, 1325, 1328(a), and 1329."

To resolve the ambiguity, Judge Bacharach took counsel from *Fla. Dep't of Revenue v. Piccadilly Cafeterias Inc.*, 554 U.S. 33 (2008), which he interpreted to mean that "the payments are 'under the plan' only if they are subject to or under the authority of the plan."

In the case on appeal, "the more natural reading here is that the payments could fall 'under' a plan only if the plan remained in existence," Judge Bacharach said. In other words, payments "would permit a discharge only if they had been made during the existence of the plan."

Of course, the term of the plan had ended, making the debtor ineligible to modify the plan and receive a discharge.

As a backstop, Judge Bacharach looked at legislative history because he had found the statute to be ambiguous. He was persuaded by the House Report and the notion that amended chapter 13 was designed to have "strict deadlines" preventing plans from running longer than five years.

Judge Bacharach upheld dismissal because "the plan's expiration left the bankruptcy court without authority to grant a discharge."

The Concurrence

Circuit Judge Allison H. Eid concurred in the judgment. She found no ambiguity in the statute. In her view, "a plan can only last five years."

A "plan expires after five years," Judge Eid said, "and payments cannot be 'under' a plan that has come to an end." She concurred only in the judgment and not in finding the statute to be ambiguous.

Observations

The Tenth Circuit's strict reading creates problems, particularly if the default occurs shortly before the end of the term of the plan, leaving the debtor no time to cure. Or, what if the trustee has miscalculated required payments? Is the debtor barred from making up the shortfall after the plan ends?

In the case on appeal, the debtor would have been a good candidate for a hardship discharge. In that regard, the court's ability to grant a hardship discharge under Section 1328(b) suggests there is flexibility in the statute. The section allows the court to grant a discharge "at any time after the confirmation of the plan" if the default "is due to circumstances for which the debtor should not justly be held accountable."

Although not free from doubt, the words "at any time after confirmation" suggest that the end of the term of the plan is not a cutoff for filing a hardship discharge motion. If that's true, then why can't a court provide a better result for creditors by allowing the debtor to make all payments required by the plan?

Although not considered in the circuit's opinion, barring a debtor from curing plan defaults seems grossly unfair for someone who has diligently made payments for five years, to the best of her or his ability. Indeed, if the debtor might be entitled to a hardship discharge, why not allow the debtor to cure defaults and ensure her right to a discharge?

The opinion is *Kinney v. HSBC Bank USA N.A. (In re Kinney)*, 20-1122, 2021 BL 280759 (10th Cir. July 23, 2021).

If a case is dismissed, all assets revest in the debtor and nothing remains in the bankruptcy estate, not even undisclosed assets.

Undisclosed Assets Revest in the Debtor After Dismissal but Not After Closing, BAP Says

Unscheduled, undisclosed property is treated altogether differently when a case was dismissed compared to what happens if the case was closed, as the Ninth Circuit Bankruptcy Appellate Panel explained in an April 2 opinion.

If the case was administered and closed, undisclosed or unscheduled property remains in the estate, perhaps indefinitely. On the other hand, if the case was dismissed, all property reverts to the debtor, including undisclosed property.

The debtor's standing is also different after dismissal. Because all property revested in the debtor, the debtor can pursue undisclosed property after dismissal. If the case was administered and closed, the debtor would not have standing to collect undisclosed property.

The Undisclosed Malpractice Claim

Two individuals owned a corporate debtor that owned apartment buildings. The owners conferred with bankruptcy lawyers about the efficacy of filing a chapter 11 petition for the corporation. The lawyers advised against a filing in chapter 11 and recommended filing a chapter 7 petition instead.

The owners consulted another bankruptcy lawyer, who put the debtor corporation into chapter 11, but not before the lender had installed a receiver in state court. The owners did not put themselves into bankruptcy.

In the chapter 11 case, the debtor did not schedule malpractice claims as an asset.

The bankruptcy court approved a sale of the corporation's property, but the estate was administratively insolvent. The debtor corporation filed a motion to dismiss the chapter 11 case under Section 1112(b)(1). When no one objected, the bankruptcy court granted the dismissal motion.

Using the district's standard form, the order dismissed the case and closed it, "but only for administrative purposes."

The Malpractice Suit

After dismissal, the owners and the debtor corporation sued the lawyers they first consulted, claiming malpractice for not recommending a chapter 11 filing before the receiver was installed.

In state court, both sides agreed that the malpractice claim was a prepetition asset. They disagreed about whether the claim was owned by the bankruptcy estate or the debtor corporation.

Not sure who owned the claim, the judge in state court asked the parties to reopen the bankruptcy, schedule the malpractice claim, and have the bankruptcy court decide who owned the claim.

The debtor corporation filed a motion asking Bankruptcy Judge Peter C. McKittrick of Portland, Ore., to reopen the chapter 11 case. He reopened the case, but "for administrative purposes only, including but not limited to filing amended schedules." He said it was impossible to reopen the dismissed chapter 11 case under Section 350(b) because it has not been closed under Section 350(a).

The case reopened, and the debtor amended the schedules to list the malpractice claim as an asset.

The Appeal Dismissed in the BAP

The malpractice defendants appealed the order to the BAP that reopened the chapter 11 case.

Writing for the BAP, Bankruptcy Judge Julia W. Brand dismissed the appeal because the malpractice defendants lacked standing.

Judge Brand noted that the malpractice defendants were not creditors of the debtor corporation. Reopening the chapter 11 case, she said, did not diminish their property, impose any burdens on them, or detrimentally affect their rights. Reopening the case would require the firm to defend the suit in state court but did not preclude them from asserting any defenses.

Consequently, the law firm was not a "person aggrieved" and therefore had no standing to appeal.

The Discussion of Dismissal vs. Closing under Section 350

The significance of the opinion lies in the BAP's discussion of the distinction between closing a case after dismissal and closing a case under Section 350(a) after the case has been "fully administered."

If the case has been "fully administered," Section 350(a) requires the court to close the case.

Judge Brand pointed out that the chapter 11 case had been administratively closed after dismissal. It was not a statutory closing mandated by Section 350(a) after the case has been fully administered.

Judge Brand noted that no one had moved to vacate dismissal. She said that administrative reopening did not vacate the dismissal, reinstate the case, create a bankruptcy estate to administer, or trigger the automatic stay.

Had the case been administered and closed under Section 350(a), all scheduled property would have been "abandoned to the debtor" under Section 554(c). If there had been an administration and closure, Bankruptcy Judge Christopher M. Klein said in a concurring opinion that "unscheduled property is neither abandoned nor administered and remains property of the estate, essentially forever," citing Section 554(c) & (d).

However, the case had not been administered and closed. It had been dismissed, making Sections 350 and 554 inapplicable. On the other hand, Section 349 was applicable.

After dismissal, Section 349(b)(3) "revests the property of the estate in the entity in which such property was vested immediately before the commencement of the case under this title."

In the case of dismissal, Judge Brand characterized the section as saying that "**all** of the estate property revested in them at that time under § 349(b)(3), '**regardless of whether the property was scheduled**,'" citing *Menk v. LaPaglia (In re Menk)*, 241 B.R. 896, 912 (B.A.P. 9th Cir. 1999). [Emphasis in original.]

Consequently, Judge Brand said, the malpractice claim "is now owned by" the debtor corporation. "In short, the [debtor corporation is] the proper plaintiff," she said.

Judge Klein's Concurrence

Judge Klein wrote a concurring opinion to "foster informed communication with state courts" about the distinction between closing and dismissing a case and the consequences for property of the estate.

As guidance for state courts when there has been an administered and closed case followed by the debtor's prosecution of an unscheduled asset, Judge Klein said that judicial estoppel is not the issue. Rather, the debtor lacks standing to prosecute a claim that belongs to the estate. The trustee is the real party in interest, and the debtor lacks standing.

When a dismissed case is administratively reopened, Judge Klein said that "an unscheduled cause of action could not be property of the estate," because nothing was left in the estate. He went on to say that "amending the schedules would have no legal effect." He surmised that the bankruptcy judge allowed the debtor to amend the schedules "apparently as an accommodation to the state court's requirement that schedules be amended so there would be no doubt about the state court's authority."

Judge Klein ended his concurrence with a hint about what might happen next in state court. He said that the BAP expressed no view "regarding what, if anything, the Oregon state court should do in consequence of the omission from the schedules of the prepetition cause of action."

In other words, Judge Klein was hinting that judicial estoppel might bar the owners and the debtor corporation from prosecuting claims they had not scheduled in the bankruptcy case.

Other Observations

What happens next in state court?

Judicial estoppel could be a problem for the owners and the debtor, but better-reasoned opinions are saying that judicial estoppel does not preclude a trustee from liquidating an unscheduled asset.

Let's assume, however, that the suit proceeds in state court and judicial estoppel doesn't knock out the owners and the debtor. Also assume that the plaintiffs obtain a judgment against the malpractice defendants.

The malpractice claim had not been abandoned in chapter 11, so ownership did not vest permanently in the debtor.

The U.S. Trustee or a creditor could have the bankruptcy2 court revoke dismissal, convert to chapter 7 or appoint a chapter 11 trustee, and take the judgment into the estate. Or, the U.S. Trustee or a creditor could revoke dismissal sooner and take over prosecution of the suit if the state court was on the verge of dismissing based on judicial estoppel.

From the BAP's opinion, it is unclear whether further proceedings in bankruptcy court would serve any purpose because the debtor said that no remaining unsecured creditors existed.

The opinion is *Sandford Landress v. Cambridge Land Co. II LLC (In re Cambridge Land Co. II LLC)*, 20-1110 (B.A.P. 9th Cir. April 2, 2021).

Section 1326(a)(2) by itself does not bar garnishment of funds held by a trustee on dismissal before confirmation.

On Dismissal of a '13,' *Barton* May (or May Not) Bar Garnishments

If a chapter 13 case has been dismissed before confirmation, the Tenth Circuit Bankruptcy Appellate Panel seems inclined to allow judgment creditors to garnish funds that the trustee would otherwise return to the debtor.

The nonprecedential opinion on April 27 by Bankruptcy Judge Michael E. Romero includes an in-depth survey of the split on Section 1326(a)(2) and questions like the right of a chapter 13 trustee to collect a fee when dismissal occurs before confirmation. The opinion examines decisions going both ways on the right of creditors to garnish funds held by the trustee on dismissal of a chapter 13 case.

$29,000 Held by the Trustee on Dismissal

In the case before the BAP, the debtor had filed three successive chapter 13 petitions. The previous two had been dismissed quickly.

In the third and last case, the debtor filed to prevent state court clerks from collecting some $30,000 in judgments made in sanction for frivolous and vexatious litigation.

Eventually, the bankruptcy court refused to confirm the debtor's chapter 13 plan. Together with denial of confirmation, the bankruptcy court dismissed the chapter 13 case. On dismissal, the chapter 13 trustee was holding about $29,000, after deducting the trustee's fees.

The debtor's former wife and the state court clerks filed motions for authority to garnish the funds being held by the trustee that would otherwise be distributed to the debtor under Section 1326(a)(2). The wife contended that her domestic support obligations were prior to the clerks' judgments.

Section 1326(a)(2) and the *Barton* Doctrine

Section 1326(a)(1) requires a chapter 13 debtor to commence making payments to the trustee within 30 days of filing.

Subsection (a)(2) provides that payments made by the debtor "shall be retained by the trustee until confirmation or denial of confirmation. . . . If a plan is not confirmed, the trustee shall return any such payments not previously paid . . . to creditors . . . , after deducting any unpaid claim allowed under section 503(b)."

The bankruptcy court denied the motions, finding that the burden and inconvenience imposed by the garnishments on the trustee would not permit an exception to the *Barton* doctrine. The bankruptcy judge also decided that the plain language of Section 1326(a)(2) precluded diverting the funds away from the debtor in garnishment. The bankruptcy judge stayed his order pending appeal.

First pronounced by the Supreme Court in 1881 in *Barton v. Barbour*, 104 U.S. 126 (1881), the Supreme Court made a "general rule" that receivers could not be sued without permission from the appointing court. *Id.* at 128. The doctrine was expanded to cover bankruptcy trustees after adoption of the Bankruptcy Act of 1898. Later still, *Barton* was broadened to protect court-appointed officials and fiduciaries, such as trustees' and debtors' counsel, real estate brokers, accountants, and counsel for creditors' committees.

As Judge Romero said in his opinion, *Barton* was further extended to cover trustees after dismissal.

Barton Applies to the Garnishments

The BAP agreed with the bankruptcy court that *Barton* applied, meaning that the creditors could not garnish funds held by the trustee without the bankruptcy court's permission. As Judge Romero said, however, the holding "speaks only to whether pre-suit leave is required, not whether such leave should or should not be granted."

Next, Judge Romero analyzed caselaw laying out factors to consider when deciding whether actions should be permitted despite *Barton*. For the BAP, he ruled that the "mere possibility of inconvenience cannot serve as a blanket protection for trustees from a legal process to which any other person may ordinarily be subjected."

On *de novo* review, the BAP agreed that *Barton* required court approval before initiating garnishment. On the other hand, the panel ruled that the bankruptcy court had "abused its discretion by denying *Barton* leave based upon unsupported allegations of potential inconvenience to the Trustee without weighing the other important factors bearing upon such a decision."

Section 1326(a)(2)

Regardless of *Barton*, the bankruptcy court had also decided that Section 1362(a)(2) barred the proposed garnishment.

As Judge Romero explained, there are two lines of cases interpreting Section 1362(a)(2). The courts taking a "plain meaning" approach conclude generally that a chapter 13 trustee must return everything to the debtor. For example, he cited an unpublished Alabama decision holding that the section preempts state law garnishments.

The other line of cases, Judge Romero said, take "a more practical approach" and view the section in a broader context. Those courts as a general matter would permit a trustee to deduct his or her fee before returning the remainder to the debtor, after payment of outstanding administrative claims.

More on point factually, Judge Romero discussed "debtor-of-a-debtor" cases that "approve of post-dismissal garnishments" by "taking a more nuanced and functional approach to applying the statute."

In the debtor-of-a-debtor cases, Judge Romero said that the chapter 13 trustee "is effectively no longer operating as a court-appointed fiduciary" following dismissal and "can no longer be thought of as a representative of the estate exercising control over property of the estate."

After dismissal, Judge Romero decided that "the legal relationship between the debtor and a trustee following dismissal is akin to a traditional bailment." A bank, he said, "is not excused from complying" with a garnishment. He therefore saw "no reason why a different rule should apply to trustees merely because they were formerly an estate representative and the property used to be in *custodia legis* through an estate which no longer exists."

In terms of the purpose of Section 1326(a)(2), Judge Romero saw the trustee as "in fact . . . returning the property to the debtor, not in the form of a cash payment, but in the form of a debt reduction . . . . The transfer may not be to the debtor, but it is nevertheless made for the debtor's benefit."

In short, the BAP ruled that Section 1326(a)(2) by itself did not preclude honoring the garnishments. The panel reversed and remanded for the bankruptcy court to conduct further proceedings on the *Barton* doctrine.

Observations

In the case before the BAP, the fee of the chapter 13 trustee was about $1,500.

In the case on appeal, the trustee was faced with competing garnishments. Who comes first? The court clerks or the former wife?

To ensure no liability in disbursing the funds, the trustee would become ensnared in further litigation in bankruptcy court or state court to decide who should be paid and how much. The $1,500 fee would quickly become a losing proposition if the trustee were involved in deciding whom to pay.

A bright-line rule calling for payment to the debtor would aid the trustee in preventing the case from becoming a loser.

Jurisdiction is also an issue. Surely, the bankruptcy court at least has "related to" jurisdiction to decide which garnishment comes first. Why should the bankruptcy court rather than state court make such decisions after dismissal?

If the trustee were to return the funds to the debtor, the creditors would be justly concerned that the debtor would squirrel the money away before they could locate and attach the debtor's bank account. Is it the purpose of the bankruptcy court to assist in the collection of judgments when the distribution is not being made under the Bankruptcy Code?

Courts are always inclined to sort out disputes when the parties and the *res* are before the court. Sometimes, however, the desire to resolve disputes should take second place behind regard for the court's limited jurisdiction and the purpose of the forum.

Congress intended to give debtors incentives for attempting chapter 13 arrangements. That's why Section 1326 gives funds back to the debtor on dismissal before confirmation. If the bankruptcy court becomes a collection agent when chapter 13 fails, is the intent of Congress being fulfilled?

Disallowing garnishments would not mean, by analogy, that a chapter 13 trustee cannot be paid if dismissal precedes confirmation. Trustees rely on 28 U.S.C. § 586(e) as statutory authority for being paid after dismissal. Creditors have no similar statutory authority to demand payments from a chapter 13 trustee on dismissal.

The foregoing factors could be considered in deciding whether *Barton* precludes honoring a garnishment.

The opinion is *Warren v. Bednar (In re Bednar)*, 20-041 (B.A.P. 10th Cir. April 27, 2021).

Plans & Confirmation

Courts are split on whether a debtor may amend a chapter 13 plan to cure post-petition defaults on a principal residence.

Amended Chapter 13 Plan Allowed to Cure Post-Petition Mortgage Defaults

On a question where the courts are split, Bankruptcy Judge Jerrold N. Poslusny, Jr. of Camden, N.J., allowed a debtor to pay post-petition mortgage arrears through an amended chapter 13 plan.

Siding with the two circuits that ruled in favor of the debtors, Judge Poslusny decided that the amendment was in accord with the plain language of the statute, along with the legislative history and "the underlying principles of Chapter 13."

Three Post-Petition Mortgage Defaults

The debtor confirmed a 36-month plan in 2018 that would cure mortgage arrears while the debtor made post-petition mortgage payments directly to the servicer. Twice after confirmation, the debtor defaulted on post-petition mortgage payments. After the lender moved for stay relief, Judge Poslusny entered a consent order both times requiring the debtor to cure the defaults.

Following the third default, the servicer again sought stay relief. The debtor opposed, saying that her husband lost his job as a result of the pandemic. In addition, the debtor sought to modify her plan to cure the post-petition defaults and to extend the duration of the plan to 73 months.

The servicer opposed plan modification, contending that a modified plan may not cure post-petition defaults on a home mortgage. Judge Poslusny disagreed in his June 24 opinion.

The Split

Judge Poslusny said that the courts are split. However, the Fifth and Eleventh Circuit both permit modified plans to cure post-petition home mortgage defaults.

The outcome turned largely on the language of Section 1322(b)(2) and (5). Subsection (2) bars a chapter 13 plan from modifying a mortgage on the debtor's principal residence. However, subsection (5) allows a plan to cure "any default within a reasonable time."

The two circuits found the answer in the plain language of subsection (5) that allows a plan to cure "any default," notwithstanding the anti-modification language in subsection (2). According

to Judge Poslusny, the two circuits emphasized the lack of language in subsection (5) limiting cures to prepetition defaults.

Judge Poslusny paraphrased the Eleventh Circuit by saying that an amendment would be "'consistent' with legislative intent, legislative history, and underlying principles of Chapter 13 to provide for flexible payments plans" while giving homeowners "'continuing rights to cure default and preserve their primary assets.'" *Green Tree Acceptance Inc. v. Hoggle (In re Hoggle)*, 12 F.3d 1008, 1010 (11th Cir. 1994).

Judge Poslusny found the circuits more persuasive than other courts "adopting a restrictive reading of the Code." He noted how subsection (5) has no restrictive language and "makes no distinction between a pre-petition default and a post-petition default."

A Plan Longer than 60 Months

Having decided that the debtor may cure a post-petition default, Judge Poslusny turned to the question of whether the debtor could extend the plan for a total of 73 months.

The debtor rested her proposition of a plan longer than 60 months on the Coronavirus Aid, Relief and Economic Security Act of 2020. It allows extending a chapter 13 plan up to 83 months if the debtor has incurred "material financial hardship" as a result of the pandemic.

No one contested the debtor's claims that her husband lost his job as a result of the pandemic. Judge Poslusny therefore approved the amended plan, with a proviso that the debtor must remain current on mortgage payments.

The opinion is *In re Smith*, 18-23830 (Bankr. D.N.J. June 24, 2021).

Courts are split on whether chapter 13 effectively prohibits debtors from making voluntary contributions to 401(k) plans.

Congress Must Decide: May Chapter 13 Debtors Contribute to 401(k) Plans?

Congress needs to fix the mess it made in Section 541(b)(7) and say clearly whether chapter 13 debtors are entitled to make voluntary contributions to 401(k) retirement plans. As it now stands, there are four interpretations of the section, typically giving three different results.

So far, only the Sixth Circuit has tackled the issue. It will be years before there is enough appellate authority for the Supreme Court to resolve what assuredly will be a split.

As a matter of public policy, it is imperative that Congress decide whether debtors are required to suffer the effects of bankruptcy years later in retirement, if they happen to live in districts and circuits that do not permit 401(k) contributions during chapter 13.

The New and Newer Sixth Circuit Opinions

In a 2/1 decision, the Sixth Circuit held last year that a chapter 13 debtor who was consistently making contributions to a 401(k) for six months before bankruptcy may continue contributions in the same amount by deducting the contributions from "disposable income" in Section 1325(b)(2).

The majority in *Davis* rejected the holding by some courts that contributions are never included in disposable income, whether or not the debtor was making contributions before bankruptcy. The dissenter would have held that a debtor cannot make contributions after bankruptcy, even if he or she was making them beforehand. *Davis v. Helbling (In re Davis)*, 960 F.3d 346 (6th Cir. 2020). To read ABI's report on *Davis*, click here.

In a unanimous opinion on August 10, the Sixth Circuit held that a chapter 13 debtor may not make 401(k) contributions if the debtor had not been making contributions before bankruptcy, even if (1) the debtor had a history of making contributions in prior years when he was able, and (2) the debtor was not eligible for a 401(k) plan in the months before bankruptcy.

The new opinion was authored by Circuit Judge Joan Larsen. She was also the writer of the majority opinion last year in *Davis*.

The Four-Way Split

Section 541(b)(7)(A) is one of the most poorly drafted provisions in the Bankruptcy Code. It was added in 2005 by the Bankruptcy Abuse Prevention and Consumer Protection Act because courts were mostly holding that wages voluntarily withheld as 401(k) contributions were part of disposable income.

As amended, the section provides that property of the estate does not include contributions to 401(k) plans. The end of the subsection includes a so-called hanging paragraph that says, "except that such amount under this subparagraph shall not constitute disposable income as defined in section 1325(b)(2)."

There are four interpretations of the statute, with three results: (1) Retirement contributions can never be deducted from disposable income, even if the debtor was making contributions before bankruptcy; (2) a debtor may continue making contributions, but not more than the debtor was making before bankruptcy; and (3) a debtor may make contributions after bankruptcy up to the maximum allowed by the IRS, even if the debtor was making none before bankruptcy.

This writer respectfully submits that none of the interpretations inexorably flows from the statutory language.

Facts in the New Case

For most of his 17 years working for a former employer, the debtor had been making contributions to his 401(k) plan. In 2017, he took a new job with an employer that did not offer a 401(k) plan, so he could not make contributions.

Six weeks before filing a chapter 13 petition in June 2018, the debtor went to work for a different employer offering a 401(k) plan and began making contributions. Judge Larsen said the record was unclear about when the debtor began making the contributions.

Before *Davis* came down, the bankruptcy court ruled that the debtor could not deduct the contributions from his payments to creditors. Also before *Davis*, the district court affirmed. To read ABI's report on the district court opinion, click here. The appeal to the circuit was held in abeyance pending the outcome in *Davis*.

The new case presented facts not present in *Davis*. Although he had a history of making contributions, the debtor had made none consistently in the six months before bankruptcy.

Contributions Before Bankruptcy Are Required

The debtor argued that the circuit court should expand *Davis* by allowing the debtor to rely on his history of making voluntary contributions when he had been able to so do.

"Because neither the statute nor our caselaw supports" the argument, Judge Larsen upheld the lower courts.

Judge Larsen laid out the four interpretations of the statute and explained how *Davis* rejected the idea that a chapter 13 debtor may never make voluntary contributions. She cited the Sixth Circuit Bankruptcy Appellate Panel for having ruled that "to the extent a debtor is making recurring 401(k) contributions 'at the time' of filing, she may continue to do so post-petition." *Burden v. Seafort* (*In re Seafort*), 437 B.R. 204, 209-210 (B.A.P. 6th Cir. 2010).

"But that also means that a debtor may not begin, resume, or otherwise increase the amount of such contributions post-filing in an attempt to reduce payments to unsecured creditors," Judge Larsen said, again interpreting the BAP. *Id.* at 210.

Judge Larsen stated the circuit's holding as follows:

> We hold only that the bankruptcy code's text does not permit a Chapter 13 debtor to use a history of retirement contributions from years earlier as a basis for shielding voluntary post-petition contributions from unsecured creditors. This is true even if the debtor had no ability to make further contributions in the six months preceding filing; the code makes no exception for such circumstances.

Commentary

In years past, employers offered defined-benefit pension plans that were protected in employees' bankruptcies. Today, they are few and far between.

If a typical consumer is to provide for retirement, she or he must make contributions to 401(k)s and individual retirement accounts. Otherwise, a worker will be left with nothing more than Social Security benefits and retirement in abject poverty.

A financially struggling consumer may be unable to make 401(k) contributions, even if offered by the employer. Consequently, requiring consistent 401(k) contributions by chapter 13 debtors before bankruptcy flies in the face of reality. Furthermore, a consumer eligible for chapter 7 is not precluded from making contributions immediately after filing.

Typically, requiring a chapter 13 debtor to include 401(k) contributions in disposable income will not result in an additional major recovery by each unsecured creditor.

Congress needs to decide whether chapter 13 debtors must suffer the consequences of bankruptcy in retirement years later, when the benefit to each creditor was nominal.

Chapter 13 was designed not to be punitive when someone files a chapter 13 petition but does not succeed. Barring individuals from providing for retirement makes chapter 13 punitive for debtors who succeed.

The opinion is *Penfound v. Ruskin (In re Penfound)*, 19-2200, 2021 BL 300792 (6th Cir. Aug. 10, 2021).

A chapter 13 debtor was permitted to make a fraction of the pension contributions permitted by the IRS Code.

Chapter 13 Debtor May (Sometimes) Contribute to Retirement Plans

With qualifications implying that all chapter 13 debtors may not qualify, Chief Bankruptcy Judge Helen E. Burris of Spartanburg, S.C., sided with the majority and allowed the debtor to continue making voluntary contributions to her retirement account.

Before bankruptcy, the 36-year-old debtor had been making monthly contributions of some $470 to her retirement account, enough to qualify for her employer's maximum contribution. The debtor had been making the contributions for three years. The balance in her retirement account was $38,000, Judge Burris said in her May 20 opinion.

Originally, the debtor's chapter 13 plan called for $98,400 in payments over the five-year life of the plan. The chapter 13 trustee objected, leading to a compromise where the debtor upped the payments to $109,000.

A creditor objected to confirmation of the amended plan, contending that the debtor was not devoting all her disposable income to the plan and that the plan was not filed in good faith, given ongoing contributions to the retirement plan.

To the extent the statute provides an answer, several sections are pertinent. To confirm the plan, the debtor is required to devote all of her "projected disposable income" to unsecured creditors under Section 1325(b)(1).

Section 541(b)(7)(A), one of the most poorly drafted provisions added in 2005 by the Bankruptcy Abuse Prevention and Consumer Protection Act, provides that property of the estate does not include contributions to 401(k) plans. The end of the subsection includes a so-called hanging paragraph that says, "except that such amount under this subparagraph shall not constitute disposable income as defined in section 1325(b)(2)."

Finally, Section 707(b) provides grounds for dismissal and uses the term "current monthly income." While charitable contributions are specifically excluded as grounds for dismissal, the statute is silent about contributions to a retirement plan.

There have been four interpretations of the statute, with three results: (1) Retirement contributions can never be deducted from disposable income, even if the debtor was making

contributions before bankruptcy; (2) a debtor may continue making contributions, but not more than the debtor was making before bankruptcy; and (3) a debtor may make contributions after bankruptcy up to the maximum allowed by the IRS, even if the debtor was making none before bankruptcy.

So far, only the Sixth Circuit has tackled the split. *See Davis v. Helbling (In re Davis)*, 960 F.3d 346 (6th Cir. 2020). In a 2/1 decision, the majority held that a debtor who was making contributions to a 401(k) before bankruptcy may continue making contributions in the same amount by deducting the contributions from "disposable income."

The majority in *Davis* rejected the holding by some courts that contributions are never included in disposable income, whether or not the debtor was making contributions before bankruptcy. The dissenter would have held that a debtor cannot make contributions after bankruptcy, even if he or she was making them beforehand. To read ABI's report on *Davis*, click here.

The Fourth Circuit ducked the split on statutory interpretation in 2017. *See Gorman v. Cantu (In re Cantu)*, 713 F. App'x 200, 202 (4th Cir. 2017). To read ABI's report, click here.

Two of the circuit judges in *Cantu* believed that the trustee had only appealed the bankruptcy court's good faith finding and not a second question of statutory interpretation. The appeals court decided that the bankruptcy court's finding of good faith was not clearly erroneous because the debtor was only planning to contribute $3,200 a year when the maximum permissible contribution under tax law would have been $18,000.

The creditor wanted Judge Burris to adopt the approach of the dissenter in *Davis* and bar contributions to retirement plans, even if the debtor was making contributions before bankruptcy.

Tackling the question herself, Judge Burris noted that neither Section 1325 nor Section 707 "explicitly authorizes" deduction of retirement contributions from disposable income.

Judge Burris declined to follow the *Davis* dissent and "instead joins the majority and other courts within the Fourth Circuit that have held that post-petition voluntary retirement contributions are not considered disposable income, so long as such contributions are made in good faith." She interpreted the hanging paragraph to show the intent of Congress "to exclude retirement contributions from available disposable income under Section 1325(b)."

Turning to the question of good faith, Judge Burris saw the Fourth Circuit as calling for an examination of the totality of the circumstances.

First, Judge Burris refused to infer bad faith solely because the debtor would continue making retirement plan contributions.

The creditor had defeated the debtor regarding good faith when the original plan came on for confirmation. The amended plan, Judge Burris said, "is significantly different and provides far more" for creditors.

In addition, the debtor had been making contributions for several years "and in amounts consistent with what she intends post-petition," Judge Burris said. Although she was only 36 years of age, "her monthly contribution is well within the allowable limit" of $19,500.

Furthermore, Judge Burris said that a "substantial portion" of unsecured debts would be paid by the plan. She therefore overruled the objection regarding good faith and directed entry of an order confirming the plan.

Observations

The issue raises questions of policy and statutory interpretation. Given that the statutory muddle has been on the books for 16 years, the prospect of a congressional fix is remote. "It is more likely that the issue will continue to be left to the judiciary to clean up," Jamie Olinto told ABI.

Mr. Olinto is a partner in the Jacksonville, Fla., office of Adams & Reese LLP. He saw this newest case as showing a tendency for courts to "settle on a standard which allows for flexibility in balancing the oft-competing interests of debtors and their creditors to reach what the jurist reasons to be a fair and equitable result rooted in whether the debtor is acting in good faith."

In other words, debtors in different parts of the country will live under different regimes until Congress or the Supreme Court resolves the split.

Given the lack of clarity in the statute itself, this writer submits that courts are entitled to use their common sense and notions of fairness to divine an answer.

Fewer and fewer Americans have defined benefit pension plans funded altogether by their employers. If a worker is lucky enough to have any retirement plan, it likely will be a defined contribution plan where the employer may only make matching contributions.

Barring or limiting pension contributions precludes chapter 13 debtors from cashing in on significant tax advantages available to other Americans and means they will have lower incomes in retirement. When retirees may have nothing more than meager Social Security benefits and whatever they have been able to contribute to 401(k)s or IRAs, preventing chapter 13 debtors from providing for their retirements is bad policy, in this writer's view.

Courts should not make policy choices preventing some Americans from taking advantage of tax benefits, unless the result is clearly commanded by the Bankruptcy Code, in this writer's view.

The opinion is *In re Pizzo*, 20-01758, 2021 BL 188943, 2021 Bankr Lexis 1393 (Bankr. D.S.C. May 20, 2021).

Judge Grossman didn't abolish 'chapter 20' entirely. He required the debtor to treat the subordinate mortgage lender like all other unsecured creditors, even though the debtor's personal liability to the lender had been discharged in the prior chapter 7 case.

In 'Chapter 20,' Discharged Mortgage Claim Resurrects as Unsecured, EDNY Judge Says

He didn't abolish so-called chapter 20 entirely, but Bankruptcy Judge Robert E. Grossman of Central Islip, N.Y., has made it unworkable for many chapter 13 debtors.

The typical chapter 20 case works like this: The consumer first files under chapter 7 to extinguish personal liability on a subordinate, underwater home mortgage. Later, sometimes the day after receiving a chapter 7 discharge, the consumer files a separate chapter 13 case to strip off the mortgage lien that survived chapter 7 as an *in rem* liability solely against the real property.

When chapter 20 works, the debtor emerges from the subsequent chapter 13 case with the underwater mortgage stripped off and no personal liability on the subordinate mortgage debt.

The Ninth Circuit Bankruptcy Appellate Panel has validated chapter 20, at least when the debtor receives a discharge in chapter 13. *See Washington v. Real Time Resolution Inc. (In re Washington)*, 602 B.R. 710 (B.A.P. 9th Cir. July 30, 2019). To read ABI's report on *Washington*, click here.

In Judge Grossman's modified version of chapter 20, the lien is stripped off in the subsequent chapter 13 case. Although the debtor's personal liability on the mortgage note was discharged in the prior chapter 7 case, he ruled that the mortgage debt is nonetheless an unsecured claim to be treated like all other unsecured claims in the chapter 13 plan.

The Underwater, Subordinate Mortgage

The facts demonstrate why Judge Grossman's modified chapter 20 was likely unpalatable for the debtor in the case before him.

The debtor had received a chapter 7 discharge 12 years earlier. She filed a chapter 13 petition in early 2021, listing her home with a value of about $550,000. The home was subject to an $850,000 first mortgage and a $300,000 second mortgage. The second, or subordinate, mortgage was underwater, meaning there was no equity in the property above the first mortgage to satisfy any portion of the second mortgage.

The debtor's personal liability on the subordinate mortgage had been discharged in the prior chapter 7 case. However, the second mortgage remained a lien on her home as a consequence of *Dewsnup v. Timm*, 502 U.S. 410 (1992).

The debtor filed a chapter 13 plan promising to pay unsecured creditors 100%.

Aiming to escape all liability on the second mortgage and effectively void the second mortgage lien, the debtor filed a motion asking Judge Grossman to strip off the subordinate lien and declare that the lender's unsecured claim would be zero under the chapter 13 plan.

In his August 5 opinion, Judge Grossman said he would strip off the lien, but he ruled that the entire amount of the mortgage debt would be a valid, unsecured claim in the debtor's chapter 13 plan to be paid in full over the life of the plan, if the debtor were to confirm the plan.

The decision may have made chapter 13 unworkable for the debtor, given that she was proposing a 100% plan for unsecured creditors. Chapter 13 still might work if the best interests test would allow the debtor to reduce the percentage payout to an amount she could realistically afford.

Critique of Courts Permitting Chapter 20

Judge Grossman said that courts disagree on a chapter 13 debtor's ability to strip off an underwater mortgage when the *in personam* obligation on the mortgage loan was discharged in a prior chapter 7 case.

Courts that eliminate subordinate mortgage debt in a subsequent chapter 13 rely on "several problematic assumptions," Judge Grossman said. Those courts "equate[] the discharge injunction with the elimination of the underlying debt." The discharge does not eliminate the debt, it only bars collection as a personal liability of the debtor, Judge Grossman said.

Judge Grossman went on to say that the claim filed by the mortgage holder in the chapter 13 case "is not an act to collect a discharged debt and does not run afoul of § 524."

Courts that eliminate the debt in chapter 13 also overlook Section 522(c), Judge Grossman said. That section provides "that the property remains liable during and after the case for debt secured by a lien that is (i) not avoided under subsections (f) or (g), and (ii) not void under § 506(d)." Therefore, he said that "the *in rem* lien securing the mortgage claim that survives bankruptcy is protected to the extent that it is not void under § 506(d)."

Judge Grossman went on to say that Section 506(d) does not provide a mechanism to disallow a claim. As such, he said that the claim on the subordinate mortgage "is fully enforceable and cannot be disallowed under § 502."

Judge Grossman held that the debtor "is required to treat [the subordinate lender] the same as all unsecured creditors. [The lender] and the Debtor's other unsecured creditors are entitled to payment consistent with § 1325(a)(4) (the best interest of creditors test) and § 1325(b) (the disposable income test), which could mean payment of a small percentage of their claims or payment in full."

Judge Grossman granted the debtor's motion by allowing the debtor to strip off the lien but disallowed the motion to the extent that the debtor sought to reduce the amount of the claim to zero, based on an assumption that the debtor confirms a plan and receives a discharge.

Observations

There are good arguments on both sides of chapter 20. The aversion to eliminating both the claim and lien rests in part on the idea that the lender's efforts at collecting the claim in the chapter 13 case is not in violation of the discharge injunction. Is the filing of a claim in chapter 13 an act to collect a discharged debt as a personal obligation of the debtor?

Section 102(2) cuts both ways. The section says a "claim against the debtor" includes a claim against property of the debtor. On the one hand, the section suggests that the lender's *in rem* claim against the property is a claim against the debtor in chapter 13. On the other hand, does the section also suggest that the lender is violating the discharge injunction by asserting an *in rem* claim?

One day, the issue will reach several courts of appeals. There may be a split dropped into the laps of the justices on the Supreme Court, who may once again be asked to reexamine whether *Dewsnip* was correctly decided.

If the justices are inclined to believe that *Dewsnup* was a mistake that ignored the plain meaning of the statute (as the late Justice Antonin Scalia argued), debtors may prevail by stripping off the underwater lien while eliminating the mortgage debt in a later chapter 13 case.

Advocates of chapter 20 may have an attractive argument based on the plain language of the statutes, but those in Judge Grossman's camp appeal to a sense of fairness in believing that a subordinate lender should have a claim paid the same percentage as other unsecured creditors.

The opinion is *In re Hopper*, 21-70139 (Bankr. E.D.N.Y. Aug. 5, 2021).

No more informal 'no-look' fees in the courtroom of Bankruptcy Judge Robert Grossman.

Long Island Judge Ends 'Loss Mitigation' in His Courtroom

Having decided that "Chapter 13 has morphed into the pursuit of loss mitigation as its sole purpose in which debtors file cases they never intend to bring to confirmation," Bankruptcy Judge Robert E. Grossman decided it's time to end so-called loss mitigation in his court.

In his February 28 opinion, Judge Grossman also decided it's time to adopt a so-called no-look fee of $5,500 for chapter 13 cases in his court. Judge Grossman sits in Central Islip, N.Y.

Although Judge Grossman ended loss mitigation in his court, the case before him resulted in a confirmed chapter 13 plan after the debtor and the home mortgage lender agreed on a loan modification. Aside from the case before him, Judge Grossman said he would no longer approve attorneys' fees for participation in loss mitigation, "absent extraordinary circumstances."

The Protracted Loss Mitigation

We will assume everyone knows what "loss mitigation" means. For those who don't, it's typically a local rule where bankruptcy judges on request enter orders compelling the debtor and the mortgage lender to negotiate with the aim of agreeing on loan modification. Some courts have entered contempt citations against lenders who did not negotiate in good faith.

Until now, at least, most bankruptcy judges have had favorable views about loss mitigation. They would typically say that loss mitigation has allowed debtors to keep homes they otherwise would have lost absent court-mandated negotiations.

In the case before Judge Grossman, the debtor filed a chapter 13 petition and obtained an order directing loss mitigation. The process took two years but resulted in a confirmed plan and an agreed loan modification approved by the court.

The delay in reaching accord on loan modification, according to Judge Grossman, was occasioned mostly by the lender's mistakes and ineptitude. The debtor and the debtor's bankruptcy counsel carried out their part of the negotiations and documentation with dispatch.

The delay came at a cost. Before bankruptcy, the debtor had paid counsel a retainer of $3,000. In the engagement agreement, the debtor consented to an additional $2,500 counsel fee to be paid under the chapter 13 plan.

The client also agreed that the $5,500 would only cover specified services. Notably, the $5,500 fee did not cover participation in loss mitigation.

After confirmation, the debtor's counsel filed a fee application for payment of about $9,200 on top of the $3,000 retainer. In other words, counsel's fees for the chapter 13 case totaled some $12,200.

The Eastern District of New York has no local rule establishing a so-called no-look fee for chapter 13 cases. Without filing a fee application, courts with no-look fees will allow payment so long as it doesn't exceed the prescribed amount. For greater compensation, counsel must file a traditional fee application.

In the absence of a formal no-look fee, some chapter 13 trustees in the New York Eastern District developed a practice where they would review counsel's time records and advocate approval of the plan (and payment of the fee) if the trustee had no objection to the requested fee.

And so it was in the case before Judge Grossman. The chapter 13 trustee had no objection to confirmation of the plan and payment of the additional $9,200 fee to be paid by the trustee under the plan.

No More Informal No-Look Fees

In substance, the chapter 13 trustee in the case before Judge Grossman had implemented an informal no-look fee where compensation would be approved by the court if the trustee had no objection. No more, Judge Grossman said.

The informal fee approval process, Judge Grossman said, "was never the intent of the statute and is a process that will cease . . . . [T]he awarding of fees is the sole responsibility of the Court."

Judge Grossman said he would be drafting "new rules" for his court "which give counsel to Chapter 13 debtors the option of either proceeding under what we designate a 'presumptively reasonable [$5,500] fee' which will allow the Court to award fees without the need for a hearing or filing a fee application."

Judge Grossman said he would not require a fee hearing for fees of less than $5,500.

No More Loss Mitigation

"The Court will no longer entertain motions for loss mitigation in Chapter 7 or 13 cases," Judge Grossman said.

During the housing crisis, Judge Grossman said that loss mitigation allowed "many families" to keep their homes, because otherwise it would have been "difficult for debtors to identify the party that held the mortgage."

"While the aim of the loss mitigation program is noble, the circumstances that led to its implementation are now absent," Judge Grossman said.

Now that the "onslaught of foreclosures and bankruptcy filings . . . has abated," Judge Grossman said,

> [L]oss mitigation has morphed into an institutionalized process not supported by the Bankruptcy Code. It now seemingly exists not for the purpose originally intended but rather for the benefit of professionals, trustees, and institutions, often to the economic detriment of the creditors. This is the antithesis of what Chapter 13 was designed to do.

"There is nothing in the Code," Judge Grossman said, "which permits a bankruptcy court to forcibly restructure a residential mortgage." Disagreeing with some other courts, he saw no power in Section 105(a) for mandatory loss mitigation.

Judge Grossman said he would still "encourage Chapter 13 debtors and their secured creditors to reach a consensual arrangement." The judge said he would still order mediation, "but only on consent of the parties."

The Remedy

Judge Grossman examined the attorney's fee request, found it reasonable, and allowed payment "in the full amount requested." He said it would be "the last application for compensation this Court approves which seeks additional fees for loss mitigation absent extraordinary circumstances."

Judge Grossman said his "decision does not modify, amend, or limit loss mitigation procedures for any other judge in this Court or the Court generally."

The opinion is *In re Tcherneva*, 19-71413 (Bankr. E.D.N.Y. Feb. 28, 2022).

Compensation

Local or state bar groups should work up standard-form retainer agreements and disclosures to facilitate bifurcated fee arrangements.

Standards Laid Down for Bifurcated Fee Arrangement in the Southern District of Florida

Chief Bankruptcy Judge Laurel M. Isicoff of Miami wrote an opinion that serves the purpose of a local rule by explaining how and when a consumer can sign up for a so-called bifurcated arrangement to pay fees for filing a chapter 7 petition in the Southern District of Florida.

Judge Isicoff said that the rulings in her June 16 opinion represented "the legal conclusions of all of the judges of the Bankruptcy Court of the Southern District of Florida." She drew on prior opinions allowing bifurcated fee arrangements, such as *In re Carr*, 613 B.R. 427 (Bankr. E.D. Ky. 2020). To read ABI's report on *Carr*, click here.

The Access-to-Justice Problem

Judge Isicoff began her 41-page opinion by laying out the "access to justice" problem created in 2004 when the Supreme Court handed down *Lamie v. U.S. Trustee*, 540 U.S. 526, 538 (2004). The high court's decision meant that a chapter 7 lawyer cannot require the debtor, after filing, to pay for post-petition services if the obligation arose pre-petition.

Lamie became a burden for many consumers who can't afford to pay the entire fee before filing. For those unable to pay up front, the decision left consumers with four options: (1) the debtor can delay filing until enough money is in hand; (2) the lawyer can perform the services and hope the debtor pays after filing; (3) the lawyer can bifurcate the fee arrangement; or (4) the debtor can file a chapter 13 petition to pay counsel as part of the plan.

The Bifurcated Arrangement

The cases before Judge Isicoff involved bifurcated fee arrangements with three different chapter 7 debtors and two law firms. In one case, the debtor paid $335 before filing. In the other two cases, the debtors paid nothing before filing. In other words, the lawyer in those two cases advanced the filing fee.

Post-petition, the debtors were to pay between $1,300 and $1,600 under separate engagement agreements signed after filing. All three debtors received discharges.

The law firms had separate pre-petition and post-petition engagement agreements with their clients, explaining services to be provided before and after filing. Essentially, the debtors could pay their lawyers after filing, hire a new lawyer, or proceed *pro se* after filing. Judge Isicoff's opinion contains details about the disclosure that the lawyers made to their clients and the disclosures made to the court about the fee arrangements.

The Objections and the Rulings

The U.S. Trustee filed objections. Although not opposing bifurcated fee arrangements altogether, the U.S. Trustee wanted Judge Isicoff to, among other things, prohibit the post-petition payment for pre-petition services. The U.S. Trustee found shortcomings in some of the disclosures to the clients and to the court.

In short, none of the fee arrangements passed muster entirely. However, Judge Isicoff did not require the lawyers to disgorge any fees but told them to obey the dictates of her opinion in new cases.

For consumers' lawyers in Florida, and for counsel elsewhere relying on Judge Isicoff's opinion as authority for what works and what doesn't work, the opinion must be read line by line. There are dozens of fine points throughout the opinion that must be obeyed punctiliously. We will make no effort to note them all here.

For this writer, the main takeaway from Judge Isicoff's opinion is the excruciating detail that must be included in engagement agreements and in fee disclosures to ensure compliance with the Bankruptcy Code, the Bankruptcy Rules and the ethical standards for the state bar association.

Reading between the lines, the opinion means that local or state bar groups and judges should draft standard form engagement agreements and disclosures to be used by consumers' lawyers to ensure that debtors are properly advised about their rights and the implications inherent in bifurcated fee arrangements.

Several of Judge Isicoff's holdings are noteworthy:

- Post-petition agreements cannot be used to pay for pre-petition services.
- Before filing, the lawyer (not a nonlawyer) must meet with the client and analyze whether filing is appropriate and, if it is, under what chapter.
- Before filing, the lawyer at a minimum must prepare the petition, the creditor matrix, a statement of attorney compensation, the credit-counseling certificate and a motion to pay the filing fee in installments, if required.
- If the post-petition engagement agreement is filed immediately after filing, there must be a 14-day rescission period.

- When the lawyer has advanced the filing fee, reimbursing the lawyer after filing violates the Bankruptcy Code and the Rules of the Florida Bar Association. In other words, a no-money-down chapter 7 filing only works when the debtor pays the fee in installments after filing or the court waives the filing fee.
- The $335 that one client paid before filing was a reasonable fee for pre-filing services.
- The zero-dollar prefiling fee was also reasonable.
- In reviewing the reasonableness of fees paid after filing, the court takes into account not just the services that were actually rendered but also those that might have been required. Judge Isicoff found that the fees were all reasonable.

Observations

Judge Isicoff has a point. There is a problem with equal access to the bankruptcy process. Too many people file *pro se*, with predictably disastrous results. Others are shunted into a more expensive and lengthy chapter 13 case due simply to the inability to pay a retainer before filing. And others don't file at all.

Until Congress acts, this writer recommends that local or state bar groups and judges should work up standard forms to facilitate bifurcated fee arrangements for chapter 7 debtors.

The opinion is *In re Brown*, 20-23632 (Bankr. S.D. Fla. June 16, 2021).

Curiously, bifurcated fee arrangements are sometimes permitted in the Eastern District of Kentucky.

Bifurcated Fee Arrangements Barred in Western District of Kentucky

The bankruptcy judges in the Western District of Kentucky have effectively banned so-called bifurcated fee arrangements where chapter 7 debtors pay counsel fees after filing. The October 5 opinion by Bankruptcy Judge Joan A. Lloyd of Louisville, Ky., also bars lawyers from advancing the filing fee before filing and collecting the filing fee after filing.

Although the decision by Judge Lloyd largely follows holdings by Bankruptcy Judge Laurel M. Isicoff of Miami, Judge Lloyd declined to adopt Judge Isicoff's decision to allow bifurcated fee arrangements so long as disclosures are up to snuff. *See In re Brown*, 631 B.R. 77 (Bankr. S.D. Fla. June 16, 2021). To read ABI's report on *Brown*, click here.

Judge Lloyd declined to follow one of her sister judges from the Eastern District of Kentucky who allowed the use of bifurcated fee arrangements in certain delineated circumstances. *See In re Carr*, 613 B.R. 427 (Bankr. E.D. Ky. 2020). To read ABI's report on *Carr*, click here.

Judge Lloyd discussed the issue with the other judges in her district, who agreed that her legal conclusions would be the opinion of all judges in the district.

The Arrangement to Pay Fees After Filing

The fee bifurcated arrangement on review by Judge Lloyd was the most aggressive that a debtor's lawyer could employ. The arrangement was designed as an end run on *Lamie v. U.S. Trustee*, 540 U.S. 526, 538 (2004), where the Supreme Court held that a chapter 7 lawyer cannot require the debtor to pay for post-petition services after filing if the obligation arose pre-petition.

Judge Lloyd was reviewing a dozen chapter 7 cases filed by the same lawyer. The debtor-clients paid nothing before filing. The lawyer even advanced the filing fee before filing.

The client signed two engagement agreements, one before filing and one afterward. Under the prefiling agreement, the client paid nothing. However, the lawyer interviewed the client, prepared and filed the petition, paid the filing fee and filed a list of creditors. The client was not obligated to sign a post-filing engagement agreement.

When the client signed the post-filing agreement, the lawyer became obligated to prepare and file the other required documents and attend the meeting of creditors. The post-filing agreement did not require the lawyer to appear in adversary proceedings.

Under the post-filing agreement, the client became obligated to pay a total of $2,500 in monthly installments in the first year after filing. In addition to the lawyer's services, the payments covered the $335 filing fee paid by the lawyer before filing.

Unknown to the client, the lawyer had a factoring agreement with a secured lender. Immediately after filing, the lender would pay the lawyer 60% of the $2,500 fee. The lender collected the client's monthly payments and had a security interest in the lawyer's receivables.

For its services, the lender was entitled to retain 25% of collections from the client. The lender retained another 15% of the fee to cover its advances under the $50,000 line of credit with the lawyer.

In her opinion, Judge Lloyd said that the same lawyer "consistently charged" a $1,250 flat fee for clients who paid the entire fee before filing.

After an initial hearing about the fee arrangements, Judge Lloyd required the lawyer to seek an ethics opinion from the Kentucky Bar Association. The bar group declined to offer an opinion, for a variety of reasons.

The fee and factoring arrangements failed on many levels. Judge Lloyd found multiple violations of the Bankruptcy Code, the Bankruptcy Rules and the Kentucky Rules of Professional Conduct.

Lawyer Can't Walk Away After Filing the Petition

Judge Lloyd said that the factoring agreement was "clearly designed to defeat existing bankruptcy law and rules enacted over at least a century ago to protect debtors, and all the machinations inherent in its processes will not save it from review and censure. Further, the Kentucky Rules of Professional Conduct are no less forgiving to counsel."

Judge Lloyd was no less critical about the notion that the lawyer has no obligations after filing if the client declines to sign a post-filing engagement agreement. Under the local rules, she said that filing the petition obligated the lawyer to perform all services in the ensuing chapter 7 case. In other words, the client's failure to sign the post-petition engagement agreement could not relieve the lawyer from the obligation to prepare and file the remaining required papers and represent the client in the chapter 7 case, other than in adversary proceedings.

Furthermore, the client's obligation to repay the $335 filing fee after filing was a discharged debt that the lawyer could not collect after filing.

More particularly, Judge Lloyd held that advancing the filing fee and the concomitant repayment obligation in the post-filing agreement violated both the Bankruptcy Code and the Kentucky ethics rules. In addition to violating the automatic stay and the discharge injunction, advancing the filing fee violated Section 526(a)(4), because the lawyer was advising the client to incur more debt in advance of bankruptcy.

Judge Lloyd saw a "serious conflict of interest" when the lawyer asked the client to sign the post-petition agreement although the lawyer was already obligated to perform the post-filing services and was barred from collecting the filing fee.

Judge Lloyd concluded that the lawyer made inadequate disclosure about the bifurcated agreement and none regarding the factoring arrangement. She said, among other things, that the client was paying far more for representation and had no role in negotiating the factoring costs that raised the price for the debtor. The failure to disclose the factoring agreement was "[p]articularly troublesome," Judge Lloyd said.

Judge Lloyd concluded that the factoring agreement violated the Bankruptcy Code, the Bankruptcy Rules, the local rules, and the state's ethics rules. With regard to the factoring agreement, Judge Lloyd said "it is doubtful that any amount of disclosure can remedy the problem."

Judge Lloyd also identified undisclosed fee-splitting as a consequence of the factoring agreement, a failure of disclosure in the lawyer's Rule 2016 disclosure, and a violation of Section 329. She said that the failure to disclose was "particularly troubling" because the client was being charged "a higher fee" than someone who paid in advance of filing.

Finally, Judge Lloyd held that the fee was not "reasonable," given the $1,250 flat fee the same lawyer would charge clients who paid in advance of filing.

Judge Lloyd said that similar arrangements may not be used "by any attorney" in the district.

For a client who can't pay the filing fee in advance of filing, Judge Lloyd noted at the end of her opinion that debtors may pay the filing fee in installments or ask for a waiver of the fee. To pay counsel fees after filing, she said that debtors can use chapter 13.

The opinion is *In re Baldwin*, 20-10009 (W.D. Ky. Oct. 5, 2021).

District judge in Idaho finds no ambiguity in a statute that doesn't explicitly say whether a chapter 13 trustee is paid if the case is dismissed before confirmation.

District Court Says Chapter 13 Trustee Is Paid Even if Dismissal Precedes Confirmation

A standing chapter 13 trustee in Idaho twice appealed the denial of her fees because the cases were dismissed before plan confirmation. She won both times, once in the Bankruptcy Appellate Panel in July and now in district court.

In a 2/1 nonprecedential opinion, the Ninth Circuit Bankruptcy Appellate Panel reversed and ruled that the trustee was entitled to her fee. *See McCallister v. Harmon (In re Harmon)*, 20-1168, 2021 BL 276666, 2021 Bankr Lexis 1960, 2021 WL 3087744 (B.A.P. 9th Cir. July 20, 2021). To read ABI's report, click here.

Courts around the country are split; there is no authority from a circuit court, and the facts are always the same: A chapter 13 case is dismissed before plan confirmation, and the bankruptcy court must decide whether the standing trustee is entitled to her or his fee.

In the case on appeal to Chief District Judge David C. Nye of Boise, Idaho, the bankruptcy court had decided that the statutes were ambiguous and concluded that a chapter 13 trustee is paid only if a plan is confirmed. *See In re Evans*, 615 B.R. 290 (Bankr. D. Idaho Feb. 13, 2020). To read ABI's report, click here.

Judge Nye reversed on February 8. His 15-page opinion takes a refreshingly different approach to answering the question.

The Pertinent Statutes

28 U.S.C. § 586(e) says that a standing trustee "shall *collect* such percentage fee from all payments . . . under [chapter 13] plans. . . ." [Emphasis added.]

Section 1326(a)(1) requires a chapter 13 debtor to commence making payments to the trustee within 30 days of filing. Subsection (a)(2) provides that payments made by the debtor "shall be retained by the trustee until confirmation or denial of confirmation. . . . If a plan is not confirmed, the trustee shall return any such payments not previously paid . . . to creditors . . . , after deducting any unpaid claim allowed under section 503(b)." The subsection says nothing explicitly about the standing trustee's fee.

Chapter 12 and Subchapter V of chapter 11 explicitly say what happens when dismissal precedes confirmation. Section 1226(a)(2) specifically allows the trustee to retain the statutory fee if a plan is not confirmed, and Section 1194(a) allows a Subchapter V trustee to be paid if the case is dismissed before confirmation.

No Statutory Ambiguity

Judge Nye saw no ambiguity in Section 586(e). He looked at the statute word by word.

The first pertinent phrase, "shall collect," Judge Nye said, "conveys something final. There is no condition or exception — collect it and its yours." Collectors, he said, "are not in the business of returning payments." When Congress wants a collection to be conditional or reversible, it says so.

Judge Nye said that the second phrase, "'from all payments' [,] . . . does not limit the percentage fees to those taken from payments received after confirmation. Section 586(e)(2), by itself, does not express any exception to collecting the percentage fee."

The third phrase is "under plans." Judge Nye said that the "statute places no limitations or exceptions on which plans are subject to the percentage fee. This generalization of 'plans' includes confirmed, not yet confirmed, and denied plans. If there is a plan, there is also a percentage fee."

The fourth phrase is "serves as the standing trustee." Judge Nye noted that the trustee serves before plan confirmation. "She gets the percentage fee as payment for her work as the standing trustee — not only for the work of the standing trustee after plan confirmation," he said.

Judge Nye concluded that Section 586(e)(2) "is plain and unambiguous." It has no "further qualifiers, limitations or exceptions." Because "the fee is already paid to Trustee before confirmation, § 1326(a)(2) does not direct the Trustee to return it if confirmation does not happen."

Judge Nye found ambiguity "only when you look to § 1226 and see that it directs the standing trustee in chapter 12 bankruptcy cases to retain the percentage fee, which is superfluous if § 586(e)(2) already directs the same. Thus, it is inappropriate to apply the rule against surplusage to alter the plain language of § 586(e)(2)."

Judge Nye said that the debtor and the trustee both had "sensible arguments" about policy. "However," he said, "the Debtors' arguments have failed to overcome or cast into doubt the plain language of § 586(e)(2)."

Judge Nye reversed and remanded for the bankruptcy court to enter an order allowing the trustee to retain her fee.

The opinion is *McCallister v. Evans*, 20-00112 (D. Idaho Feb. 8, 2022).

The Ninth Circuit BAP joins the minority on an issue that's headed for the court of appeals.

Chapter 13 Trustees Are Paid Even if Dismissal Comes Before Confirmation, BAP Says

In a split decision, the two judges on the Ninth Circuit Bankruptcy Appellate Panel took sides with the minority of courts around the country by ruling in a nonprecedential opinion that a standing chapter 13 trustee is entitled to retain her fee if the case is dismissed before confirmation.

All three judges on the panel offered their opinions. Bankruptcy Judge Gary A. Spraker wrote a concurring opinion to support the majority opinion by Bankruptcy Judge Scott Gan. Bankruptcy Judge William J. Lafferty penned a dissent. The three opinions consume 53 pages.

Combined, the opinions are the best exposé so far on both sides of the question. The opinions are a particularly fine discussion of the plain meaning doctrine, and when or whether it should be the end of the discussion. The opinions on both sides also analyze every conceivable canon of statutory construction applicable to the issue.

Typical Facts

A couple filed a chapter 13 petition in December 2019. Four months later, the court granted their voluntary motion to dismiss. On dismissal, the trustee was holding about $2,200. No one objected to the allowance and payment of the debtors' counsel fee of some $1,800.

The bankruptcy court struck language in the proposed dismissal order that would have allowed the standing chapter 13 trustee to take her fee from the remaining $400. Instead, the bankruptcy judge ruled in substance that the trustee was not entitled to her fee because the case was dismissed before confirmation.

As authority, the bankruptcy court cited *In re Evans*, 615 B.R. 290 (Bankr. D. Idaho Feb. 13, 2020), by Chief Bankruptcy Judge Joseph M. Meier of Boise, Idaho. To read ABI's report on *Evans*, click here. *Evans* was appealed, but there is no decision as yet.

Likely more concerned about the precedent than the $400, the chapter 13 trustee appealed and won in a 2/1 decision.

The Dueling Statutes

28 U.S.C. § 586(e) says that a standing trustee "shall *collect* such percentage fee from all payments . . . under [chapter 13] plans. . . ." [Emphasis added.]

Section 1326(a)(1) requires a chapter 13 debtor to commence making payments to the trustee within 30 days of filing. Subsection (a)(2) provides that payments made by the debtor "shall be retained by the trustee until confirmation or denial of confirmation. . . . If a plan is not confirmed, the trustee shall return any such payments not previously paid . . . to creditors . . . , after deducting any unpaid claim allowed under section 503(b)." The subsection says nothing explicitly about the standing trustee's fee.

To add further confusion, chapter 12 and Subchapter V of chapter 11 explicitly say what happens when dismissal precedes confirmation. Section 1226(a)(2) specifically allows the trustee to retain the statutory fee if a plan is not confirmed, and Section 1194(a) allows a Subchapter V trustee to be paid if the case is dismissed before confirmation.

What's to be taken from chapter 13's failure to say explicitly whether a trustee is paid if the case is dismissed before confirmation?

The Majority Opinion – No Ambiguity – 28 U.S.C. § 586(e) Controls

Judge Gan found no ambiguity in the statutes. He held that "a standing trustee is entitled to collect the statutory fee under § 586(e) upon receipt of each payment under the plan and is not required to disgorge the fee if the case is dismissed prior to confirmation." He also held that the standing trustee "obtains ownership of her percentage fee" when the debtor makes a payment under the plan.

In addition to what he said was the "common sense" and controlling meaning of "collect," Judge Gan pointed out how a standing trustee's compensation is controlled entirely by Section 586(e). The court has no control over the amount or payment via Section 330.

Simply stated, Judge Gan said "that the plain meaning of 'shall collect such percentage fee' means that a standing trustee obtains the fee upon receipt of each plan payment."

Judge Gan reversed and remanded, devoting much of his opinion to explaining why Section 1326(a)(2) was not pertinent.

Concurring, Judge Spraker said that a chapter 13 trustee's fee is akin to a "user fee," where "payment does not depend upon the success of the endeavor that generates the fee." Mirroring Judge Gan and disagreeing with *Evans*, he said that "the trustee is entitled to her fee as she receives the debtor's plan payments whether that plan is confirmed or not."

Judge Spraker said he did not base his conclusion on the idea that a standing chapter 13 trustee should be paid for her services regardless of whether the plan is confirmed. Rather, he agreed with Judge Gan "because I find [his] reasoning more natural and less damaging statutorily to give effect to the plain and ordinary meaning of § 586(e)."

The Dissent

From a "purely policy standpoint," Judge Lafferty said in his dissent that he would agree with the majority and pay the chapter 13 trustee. However, he gave weight to the different result that Congress has mandated for chapter 12 and Subchapter V cases.

Judge Lafferty said he disagreed "vigorously" with the idea that the conclusion is found in the "'unambiguous' language in one provision of what [the majority] believes to be the only relevant statute."

Judge Lafferty was not inclined to ignore legislative history. The House Report said that the fee is "fixed" by Section 586(e) but is payable under Section 1326(a)(2). Judge Lafferty's dissent is an admirable survey of theories about when the plain meaning doctrine should or should not be invoked.

Recommendation and Observations

For anyone confronting the issue, the BAP opinion and *Evans* have everything there is to say.

There likely will be no appeal to the Ninth Circuit from the BAP opinion because the debtor was not motivated to appear on the first level of appeal. With only $400 in the balance, the debtor is not likely to appeal to the circuit.

However, *Evans* is *sub judice* in district court. Odds are, there will be an appeal to the circuit regardless of the outcome.

We salute the BAP for making its decision nonprecedential. Although BAP opinion are not binding except in the case on appeal, making the opinion nonprecedential signals to bankruptcy judges throughout the Ninth Circuit that they are at liberty to rule on the issue as they see fit.

The opinion is *McCallister v. Harmon (In re Harmon)*, 20-1168, 2021 BL 276666, 2021 Bankr Lexis 1960 (B.A.P. 9th Cir. July 20, 2021).

A chapter 13 trustee is not a federal employee for the purposes of the Federal Tort Claims Act.

'13' Trustees Are Paid Even if Dismissal Comes Before Confirmation, District Judge Says

Upholding Bankruptcy Judge Robert E. Grossman, a district judge in Brooklyn, N.Y., ruled that a chapter 13 trustee is entitled to compensation if the case is dismissed before confirmation.

In most chapter 13 cases, the money held by the trustee is so small that it's not worth litigating whether the trustee is entitled to payment if the dismissal precedes plan confirmation. No so in the case that was before Judge Grossman in Central Islip, N.Y.

The debtor filed a chapter 13 plan where she paid the trustee $362,000 in a lump sum. Thirteen months later, the debtor voluntarily dismissed the case. After dismissal, the trustee returned about $341,500 to the debtor but retained some $20,500 as his fee.

The debtor filed a motion asking the court to require the trustee to disgorge the fee. Judge Grossman rebuffed all of the debtor's arguments, finding no ambiguity in the statutes. *In re Soussis*, 624 B.R. 559 (Bankr. E.D.N.Y. Nov. 12, 2020). To read ABI's report, click here.

The debtor appealed. In a tightly worded opinion on January 24, District Judge Joan M. Azrack affirmed Judge Grossman's holdings.

The principal issue revolved around three statutory provisions.

28 U.S.C. § 586(e) says that a trustee "shall *collect* such percentage fee from all payments . . . under [chapter 13] plans . . . ." [Emphasis added.]

Section 1326(a)(1) requires a chapter 13 debtor to commence making payments to the trustee within 30 days of filing.

Subsection (a)(2) provides that payments made by the debtor "shall be retained by the trustee until confirmation or denial of confirmation. . . . If a plan is not confirmed, the trustee shall return any such payments not previously paid . . . to creditors . . . , after deducting any unpaid claim allowed under section 503(b)."

Subsection (a)(2) says nothing explicitly about the trustee's fee if the case is dismissed before confirmation.

Recognizing that not all courts agree, Judge Azrack said that she concurred "with the Bankruptcy Court's well-reasoned interpretation that Section 586 entitles the Chapter 13 Trustee to 'collect[] his percentage fee regardless of whether the plan is confirmed' and that this interpretation of Section 586 is consistent with 11 U.S.C. § 1326."

Judge Azrack cited a split decision by the Ninth Circuit Bankruptcy Appellate Panel as "further [support for] this interpretation." *McCallister v. Harmon (In re Harmon)*, 20-1168, 2021 WL 3087744 (B.A.P. 9th Cir. July 20, 2021). To read ABI's report on *Harmon*, click here.

Like Judge Grossman, Judge Azrack concluded that the debtor had no claim under the Federal Tort Claims Act, because the debtor failed to exhaust her administrative remedies.

Judge Azrack also said that the FTCA only applies to federal employees, and that the chapter 13 trustee "is not an employee of the government."

The opinion is *Soussis v. Macco*, 20-05673 (E.D.N.Y. Jan. 24, 2022).

District judge in Colorado sides with the majority and doesn't allow a chapter 13 trustee to be paid if dismissal occurs before plan confirmation.

On a Split, District Judge Doesn't Pay '13' Trustee if Dismissal Precedes Confirmation

On a question where the lower courts are split, District Judge R. Brooke Jackson of Denver sided with the majority, reversed the bankruptcy court and held that a chapter 13 trustee is not entitled to be paid if the case is dismissed before confirmation of a plan.

The debtor filed a chapter 13 petition in 2017. The bankruptcy court dismissed the case in 2020 because the debtor never confirmed a plan. While the case was pending, the debtor had paid the chapter 13 trustee almost $30,000.

Following dismissal, the chapter 13 trustee paid the debtor's counsel almost $20,000 on an allowed fee application and distributed another $7,500 in payment of a priority tax claim. Toward partial payment of the chapter 13 trustee's fee, the bankruptcy court allowed the trustee to retain the remainder, some $2,600.

With the $2,600 in controversy, the debtor appealed. Judge Jackson reversed in an opinion on December 6.

The Statutes

Arguably, the statutes don't have an explicit answer to whether the trustee gets paid if dismissal precedes confirmation.

28 U.S.C. § 586(e) says that a standing trustee "*shall collect* such percentage fee from all payments . . . under [chapter 13] plans. . . ." [Emphasis added.]

Section 1326(a)(1) requires a chapter 13 debtor to commence making payments to the trustee within 30 days of filing. Subsection (a)(2) provides that payments made by the debtor "shall be retained by the trustee until confirmation or denial of confirmation. . . . If a plan is not confirmed, the trustee shall return any such payments not previously paid and not yet due and owing to creditors pursuant to paragraph (3) to the debtor, after deducting any unpaid claim allowed under section 503(b)."

The subsection has nothing explicit to say about the standing trustee's fee if dismissal precedes confirmation.

However, Chapter 12 and Subchapter V of chapter 11 explicitly say what happens when dismissal precedes confirmation. Section 1226(a)(2) specifically allows the trustee to retain the statutory fee if a plan is not confirmed, and Section 1194(a) allows a Subchapter V trustee to be paid if the case is dismissed before confirmation.

Absence of Specific Language Was Pivotal

Judge Jackson found no controlling authority in the Tenth Circuit. He did cite the recent decision by the Ninth Circuit Bankruptcy Panel in a 2/1, nonprecedential opinion that a chapter 13 trustee is paid if dismissal comes before confirmation. *McCallister v. Harmon (In re Harmon)*, 20-1168, 2021 WL 3087744 (B.A.P. 9th Cir. July 20, 2021).

Harmon contains a lengthy compendium of every argument on both sides of the issue. To read ABI's report on *Harmon*, click here.

In his five-page opinion, Judge Jackson said that Section 586 "could be read as implying that the collected fee may be retained regardless of whether the plan is confirmed."

"However," Judge Jackson said, "it does not expressly address the question, and I conclude that it does not compel that result."

"If the payments must be returned" under Section 1326(a)(2), "it follows that fees collected from such payments must be returned," Judge Jackson said.

Judge Jackson noted there was no language in Section 1326(a)(2) requiring payment to the trustee that is comparable to the language in chapter 12 mandating payment.

Judge Jackson quoted the *U.S. Trustee's Handbook* calling for the return of the fee "if there is controlling law in the district requiring such reversal." He declined "to apply *Chevron* deference, because I conclude that the answer can be found in the language of the statutes."

While reversing the bankruptcy court's order that allowed the trustee to retain the fee, Judge Jackson said that he "might" prefer, "as a policy matter, . . . that the trustee be fairly compensated for his efforts."

The opinion is *Doll v. Goodman (In re Doll)*, 21-00731 (D. Colo. Dec. 6, 2021).

Judge Jacobvitz told counsel for chapter 13 debtors how to write their engagement agreements to ensure being paid from funds held by the trustee if the case converts to chapter 7 before confirmation.

Judge Tells '13' Debtors' Counsel How to Write their Retention Agreements

Debtors' counsel have a problem. If a case *converts* to chapter 7 before confirmation of a chapter 13 plan, they might not be paid.

If a chapter 13 case is *dismissed* before confirmation, Section 1326(a)(2) says that the trustee pays administrative expenses (such as allowed counsel fees) before the remainder is returned to the debtor. However, the statute doesn't say how or whether debtor's counsel is paid if the case *converts* to chapter 7 before confirmation.

Previously, Bankruptcy Judge Robert H. Jacobvitz of Albuquerque, N.M., held that counsel are not paid if the case *converts* before confirmation. He found a solution, however.

Chapter 13 debtor's counsel should include a provision in the retention agreement assigning funds in the trustee's possession to the lawyer to the extent of the lawyer's allowed fees, in the event that the case *converts* to chapter 7 before confirmation.

Conversion to '7' Before '13' Confirmation

A couple's chapter 13 case was on the verge of dismissal or conversion to chapter 7 before confirmation of a chapter 13 plan. The debtors' counsel had withdrawn, but Judge Jacobvitz had granted a fee application by the debtors' counsel. Following Section 1326(a)(2), it called for the chapter 13 trustee to pay the lawyer's allowed compensation if the debtors were to elect having their case *dismissed*.

The fee order was silent about how or whether the allowed fees would be paid if the debtors elected for *conversion* to chapter 7.

That's what happened. The case *converted* to chapter 7, and Judge Jacobvitz was tasked with deciding whether there were any circumstances under which the debtors' counsel could be paid. In other words, could counsel be paid, or was Judge Jacobvitz compelled to return everything to the debtors that was being held by the chapter 13 trustee?

Harris v. Viegelahn, 575 U.S. 510 (2015), did not provide an answer but may have suggested the outcome, although adverse to counsel. In *Viegelahn*, the chapter 13 plan had been confirmed, but the case later converted to chapter 7. The disposition of the money held by the chapter 13 trustee was not answered by Section 1326.

The Supreme Court held that undistributed money goes back to the debtor. After conversion, the Court also said that the services of the chapter 13 trustee terminate and that "no Chapter 13 provision holds sway." *Id.* at 520.

In 2015 after *Viegelahn*, Judge Jacobvitz and his colleague on the Albuquerque bench, Bankruptcy Judge David T. Thuma, ruled together that the court cannot pay counsel fees if the case converts to chapter 7 before confirmation. *See In re Beauregard*, 533 B.R. 826, 832 (Bankr. D.N.M. 2015). However, Judge Jacobvitz cited judges from elsewhere who found reasons for paying counsel in a case converted to chapter 7 before confirmation.

Judge Jacobvitz found a method for (sometimes) paying counsel by following *dicta* in *Beauregard*.

Paraphrasing *Beauregard*, Judge Jacobvitz said that a "possible way" to pay counsel would be the inclusion "in [the lawyer's] engagement letter [of] an assignment of such funds to debtor's counsel." In his November 12 opinion, he held "that such an assignment is permissible."

Viegehahn was no roadblock, Judge Jacobvitz said, because he was giving no effect to any provision in chapter 13, nor was he calling on the chapter 13 trustee to carry out a chapter 13 service. Instead, he was only directing the chapter 13 trustee to "honor the private agreement" between the debtors and their counsel.

Of greater significance, Judge Jacobvitz said he was furthering "an important public policy of giving individuals in financial distress who wish to take advantage of the chapter 13 fresh start access to counsel willing to represent them in a chapter 13 case with little or no upfront payment."

Judge Jacobvitz cited Bankruptcy Judge David E. Rice for having agreed with the *dicta* in *Beauregard*. *See In re Brandon*, 537 B.R. 231, 236-37 (Bankr. D. Md. 2015).

Judge Jacobvitz told bankruptcy lawyers in New Mexico that an "assignment by the debtor to the debtor's bankruptcy counsel of the debtor's right to payment from the chapter 13 trustee upon conversion to chapter 7 may be included in the engagement letter by which the debtor retained bankruptcy counsel."

In the case before him, the retention agreement was not in the record. If debtors' counsel were to file the agreement with the court, and if it had an assignment, Judge Thuma directed the chapter 13 trustee to pay the allowed fee and return the remainder to the debtors.

If the retainer agreement had no assignment, Judge Jacobvitz threw the lawyer a lifeline: The lawyer could have the client sign an assignment belatedly.

In an ordinary case, asking a client to sign an assignment after filing would be ethically "problematic," Judge Thuma said. Because the lawyer had already withdrawn, he said there was not the same "inherent undue pressure."

If the lawyer was to have the clients sign an assignment for the first time after conversion, Judge Thuma required counsel to file a certification to prove that the assignment was voluntary. The certification must read:

> [The debtors] (1) understand that they are under no obligation to direct the former Chapter 13 Trustee to pay any moneys to [the lawyer], (2) understand that if the Chapter 13 Trustee does not pay monies she has on hand to the [lawyer,] she will refund the monies to [the debtors], and (3) of their own free will, and without any duress or pressure, direct the Chapter 13 Trustee to pay the monies she has on hand to the [the lawyer] up to the amount of the court-allowed unpaid compensation, with any excess funds returned to the [the debtors].

The opinion is *In re McCune*, 20-12326 (Bankr. D.N.M. Nov. 12, 2021).

Exemptions

By adopting a BAP opinion, the Ninth Circuit backed away from disallowing exemptions when a debtor disposes of exempt property after the filing date.

Ninth Circuit Joins the Fifth by Endorsing the 'Snapshot Rule' for Exemptions

By adopting an opinion by the Bankruptcy Appellate Panel "in full," the Ninth Circuit has limited its own precedents constricting a debtor's ability to exempt a homestead.

In *Wolfe v. Jacobson (In re Jacobson)*, 676 F.3d 1193 (9th Cir. 2012), and *England v. Golden (In re Golden)*, 789 F.2d 698 (9th Cir. 1986), the Ninth Circuit declared that the debtors were not entitled to exemptions because the debtors sold their homesteads before or after filing. Both cases have now been limited to their particular facts.

Prior Ninth Circuit Authorities

In *Golden*, the earlier of the two cases, the chapter 7 debtor sold her home *before* bankruptcy and claimed an exemption to cover the proceeds. However, the debtor did not reinvest the proceeds in another home within six months, as required by California law. The Ninth Circuit ruled that the failure to reinvest under state law resulted in the loss of the homestead exemption, even though she would have been entitled to exempt the proceeds on the filing date.

In *Jacobson*, the Ninth Circuit expanded on *Golden*. The chapter 7 debtor sold her home *after* filing but did not reinvest the proceeds within six months as required by California law. Interpreting *Golden*, the Ninth Circuit reversed the BAP and held that the debtor lost the exemption, even though she would have been entitled to the exemption on the filing date.

The Case on Appeal

The case on appeal involved a chapter 7 debtor who co-owned a home in Washington State with her parents. She said that her interest was worth $90,000 and claimed a $125,000 homestead exemption.

She resided in the home on the filing date but married a short time later and moved in with her new husband. The chapter 7 trustee objected to the exemption, contending that she lacked the intent to reside in the home on the filing date and lost the exemption under Washington law when she moved out.

The BAP Opinion

The bankruptcy court overruled the objection, and the BAP affirmed in an opinion on March 23 by Bankruptcy Judge William J. Lafferty of Oakland, Calif. Others on the panel were Bankruptcy Judges Julia W. Brand and Scott H. Gan.

The trustee appealed the BAP's opinion. The Ninth Circuit heard argument on February 5. In a *per curiam* but precedential opinion on March 5, the appeals court affirmed "for the reasons stated" by the BAP. The circuit court went further by adopting the BAP opinion "in full."

Note: In nonprecedential opinions, appellate courts frequently affirm "for the reasons stated below." However, taking the next step in a precedential opinion and adopting the lower court's opinion is rare. In this instance, adopting the BAP opinion is significant because it has the effect of limiting *Jacobson* and *Golden*.

Washington Law

The debtor elected Washington exemptions, which grant a homestead exemption to property where the owner resides or intends to reside and that is "actually intended or used" as a principal residence. If the owner is not residing in the home, the owner may have an exemption by recording a declaration of exemption.

However, Washington law presumes a homestead to be abandoned if, in the absence of a declaration, the owner abandons the home continuously for six months.

Washington liberally construes the exemption in favor of debtors.

The BAP's Reasoning

Judge Lafferty laid out what is commonly known as the snapshot rule. He cited Section 522(b)(3)(A) for the proposition that "exemptions are to be determined in accordance with the state law applicable on the date of filing," citing *Jacobson*.

Although the debtor moved out shortly after filing, Judge Lafferty said:

> [T]he plain language of Washington's homestead statute reflects that Debtor was entitled to an automatic homestead exemption *on the petition date*, so long as she was occupying the Property as her principal residence, regardless of her future plans . . . . In other words, *if the owner is occupying the homestead property as of the petition date, the inquiry ordinarily ends there*; intent comes into play only if the owner does not occupy the property. [Emphasis added.]

The trustee countered by arguing that the exemption was conditioned on the debtor's remaining in the property or filing a declaration of nonabandonment. Naturally, the trustee relied on *Jacobson* and *Golden*, where the debtors' actions before or after filing resulted in loss of the exemption for failure to abide by state law.

Judge Lafferty conceded that the two cases "support the trustee's position," but he said in a footnote that "*Jacobson* appears to be an outlier in holding that post-petition events may impact a debtor's right to an exemption. In any event, that case is both factually and legally distinguishable from the matter presented here."

Rather than expand circuit precedent, Judge Lafferty instead focused on Washington law and "decline[d] to read the statute so broadly, particularly in light of the principle that Washington exemption statutes are to be interpreted liberally in favor of protecting family homes."

Judge Lafferty went on to say that the cases cited by the trustee, including the two Ninth Circuit precedents, were "all distinguishable" on their facts. The debtor resided in the home on the petition date, and that "was sufficient to confer automatic protection of the homestead," he said.

Moving out of the home was "simply irrelevant," Judge Lafferty said. He saw "no policy that would be served by denying Debtor her exemption under these facts." Indeed, he indicated that policy bent in favor of the debtor. He said that "a debtor's right to a homestead exemption in a chapter 7 case should not be predicated on the happenstance of how long the case remains pending."

Judge Lafferty (and therefore the Ninth Circuit) affirmed and remanded the case for the bankruptcy court to determine the amount of the exemption.

Observations

The opinion by Judge Lafferty is a ringing endorsement of the snapshot principle, where exemptions are determined as of the filing date and subsequent events do not matter, even if they would matter under state law.

Jacobson is indeed an "outlier," as Judge Lafferty said. The Fifth Circuit has moved away from results like *Jacobson*.

In In re Frost, 744 F.3d 384 (5th Cir. 2014), a couple owned a home when they filed a chapter 13 petition. Later, they sold the home but did not reinvest the proceeds in another exempt homestead. Without saying in the opinion whether the case was in chapter 7 or 13, the Fifth Circuit held in *Frost* that the proceeds lost their exempt status, relying in part on *In re Zibman*, 268 F.3d 298 (5th Cir. 2001). In *Zibman*, the debtors sold their home before filing but did not reinvest within the time required by state law.

In *Hawk v. Engelhart (In re Hawk)*, 871 F.3d 287 (5th Cir. Sept. 5, 2017), the Fifth Circuit backed away from *Frost* and *Zibman* by holding that property in an exempt individual retirement account on the filing date did not lose its exempt status if it was converted to nonexempt property after the filing of a chapter 7 petition.

Six months later, the Fifth Circuit expanded *Hawk* to cover homesteads, thus allowing a chapter 7 debtor to sell a home after filing but not lose the exemption, even if the proceeds were not reinvested in another house. *Lowe v. DeBerry (In re DeBerry)*, 884 F.3d 526 (5th Cir. March 7, 2018).

In other words, *DeBerry* and *Jacobson* are irreconcilable. They reach opposite results on the same facts. Indeed, *DeBerry* is squarely on point for the appeal in the Ninth Circuit and leads to the same holding and conclusion as the opinion by Judge Lafferty.

To read ABI's reports on *Hawk* and *DeBerry*, click here and here.

The opinion is *Klein v. Anderson (In re Anderson)*, 20-60014 (9th Cir. March 1, 2021).

Having a family member in the home who made a formal request for legal residence will suffice to permit a Florida homestead exemption, Judge Jennemann said.

Lack of Permanent Resident Status Doesn't Always Defeat a Homestead Exemption

Someone who does not have legal residence in the U.S. will still qualify for a Florida homestead exemption if she has at least one family member in the home who "hopes" to gain legal residency and has made a formal request for permanent residency, according to Bankruptcy Judge Karen S. Jennemann of Orlando, Fla.

The debtor owned a half interest in the home where she had lived for more than 20 years. Her half interest was worth almost $150,000, and she claimed a Florida homestead exemption of more than $36,000 in her chapter 7 case.

In her May 27 opinion, Judge Jennemann said the debtor was not entitled to reside permanently in the U.S.

"Courts uniformly hold" that someone lacking permanent resident status in the U.S. is ineligible for the Florida homestead exemption. Why? Because Florida law has both a subjective and an objective test.

Objectively speaking, the debtor must actually use and occupy the home. Subjectively, the debtor "must express an actual intent to live permanently in the home," Judge Jennemann said. Someone without permanent resident status cannot satisfy the subjective test.

The debtor's daughter saved the debtor's homestead exemption.

The daughter had lived in the home since she arrived in the U.S. as a minor. The daughter had enrolled in the Deferred Action for Childhood Arrivals program in 2012 and "hopes to gain legal residency under DACA," Judge Jennemann said.

The daughter was married to a U.S. citizen serving abroad in the U.S. military. The son-in-law listed the home as his permanent residence.

Judge Jennemann denied the trustee's objection to the homestead exemption claim.

Judge Jennemann said that a "few courts" have allowed the Florida homestead exemption "when the debtor has family members residing at the claimed homestead who are legally authorized to permanently reside in the U.S." She cited a Florida appellate court for allowing the exemption based on a temporary visa held by the homeowners and their son, who was a U.S. citizen.

In two other cases, the exemption was allowed to immigrants who did not have so-called green cards but had arrived legally in the U.S. under temporary visas and promptly applied for political asylum. They "had the intent to permanently reside in the U.S.," Judge Jennemann said.

Judge Jennemann found the case before her to be "even more compelling." The daughter had enrolled in the DACA program and "hopes one day to receive permanent legal residency." If unsuccessful, the daughter had applied for a green card after marrying a citizen.

Judge Jennemann overruled the objection because the debtor had at least one family member living in the home who had made a "formal legal request" to "gain legal status of a permanent resident."

The opinion is *In re De Bauer*, 20-04228 (Bankr. M.D. Fla. May 27, 2021).

Estate Property

The Tenth Circuit left an unanswered question: Do debtors retain post-filing appreciation in a home that is not sold before the case converts from chapter 13 to chapter 7?

Tenth Circuit: Debtors Retain Appreciation in a Home Sold Before Conversion to '7'

One of the great unanswered questions in consumer law these days is whether appreciation in the value of a home becomes part of the chapter 7 estate if the case converts from chapter 13. The courts are split.

Affirming the bankruptcy court and the Bankruptcy Appellate Panel, the Tenth Circuit held that the appreciation in the value of a home sold after confirmation of a chapter 13 plan belongs to the debtor, not to creditors, if the case converts to chapter 7.

In the January 19 opinion by Chief Circuit Judge Timothy Tymkovich, the appeals court was careful to say that it was not ruling on what the result would be in a chapter 13 case converted to chapter 7 before the home was sold.

The Facts

A couple filed a chapter 13 petition and confirmed their plan in 2016. The plan cured arrears on their home mortgage, and the debtors were making payments directly to the mortgagee on the regular monthly payments.

In the petition, the debtors listed the house with a value of about $396,000, subject to a mortgage for some $337,000. The Colorado homestead exemption at the time was $75,000, so they claimed that the equity of about $60,000 was exempt.

While current on their plan payments, the debtors sold the home in 2018 for $520,000, generating net proceeds of $140,000. Two weeks later, they converted the case to chapter 7. Having spent some of the proceeds, they were holding about $100,000 from the sale of the home on the date of conversion.

When the chapter 7 trustee let it be known that he considered the nonexempt portion of the proceeds to be estate property, the debtors attempted to reconvert the case to chapter 13, but the bankruptcy judge denied the motion. The trustee then filed a motion asking the court to compel the debtors to turn over the nonexempt portion of the proceeds.

The trustee stipulated that the value of the home on the original filing date was $396,000, the amount scheduled by the debtors.

Bankruptcy Judge Elizabeth E. Brown of Denver found the statute ambiguous and referred to legislative history. She ruled in favor of the debtor, reasoning that "property" as used in Section 348(f)(1)(A) does not include appreciation in the value of a home. The Bankruptcy Appellate Panel affirmed in an opinion by Bankruptcy Judge Terrence L. Michael, but the trustee appealed. *See In re Barrera*, 620 B.R. 645 (Bankr. D. Colo. 2020); and *Rodriguez v. Barrera (In re Barrera)*, 20-003, 2020 BL 381720 (B.A.P. 10th Cir. Oct. 02, 2020). To read ABI's report, click here.

The Circuit's Analysis

The pivotal statute is Section 348(f)(1), which underwent substantial amendment in 1994.

When a chapter 13 case converts to chapter 7, the section now provides that "property of the estate in the converted case shall consist of property of the estate, as of the date of filing of the petition, that remains in the possession of or is under the control of the debtor on the date of conversion."

The amendment was intended overrule caselaw holding that property obtained after filing a chapter 13 petition becomes estate property once the case converts to chapter 7.

Narrowing his holding to cases where the home was sold before conversion, Judge Tymkovich found the answer in the plain language of the statute, without need for analysis of legislative history.

Judge Tymkovich identified proceeds as a property interest different from the home itself. On the original chapter 13 filing date, there were no proceeds, only the home itself. "Based on the plain language of Section 348(f)(1)" — that estate property in a converted case is estate property "as of the date of filing of the petition" — he held that the sale proceeds "do not enter the converted Chapter 7 estate."

Judge Tymkovich found support for his conclusion in other aspects of the statute's plain language.

On conversion, the debtors no longer owned the home. Under the words of Section 348(f)(1), the home itself was not "under the control of the debtor on the date of conversion" and therefore was not estate property in chapter 7.

Judge Tymkovich saw additional support in Sections 1327(b) and 541(a)(6). Section 1327(b) automatically vests estate property in the debtor on confirmation of a chapter 13 plan, and under Section 541(a)(6), proceeds from estate property become property of the estate.

"Thus," Judge Tymkovich said, "proceeds generated from the debtor's property after confirmation do not become property of the estate as the underlying property no longer belongs to the estate."

The Unanswered Question

Judge Tymkovich pointedly declined to say whether appreciation would have become property of the chapter 7 estate if there had been no sale of the home before conversion to chapter 7.

Had there been no sale, the home would have become estate property in chapter 7. Generally speaking, a chapter 7 trustee can sell a home and take proceeds into the estate in excess of encumbrances and the debtor's exemption.

Given that the home and its proceeds would be estate property in chapter 7, it would seem that the trustee would retain appreciation. But perhaps that's not the end of the story.

Assume the facts were like those in the Tenth Circuit appeal. That is to say, the chapter 13 debtors claimed an exemption in the entire equity. Further assume that there was no timely objection to the homestead exemption.

A debtor would argue that the chapter 7 trustee could not revisit the homestead exemption that supposedly locked in when there was no objection. It's set in stone, the debtor would say, barring the chapter 7 trustee from claiming there were proceeds in excess of the homestead exemption.

On a question where the courts are split, the First Circuit has taken the position that a debtor's homestead exemption, valid on the chapter 13 filing date, is not lost if the debtor sells the home but does not reinvest the proceeds within six months as required by state law. *See Rockwell v. Hull (In re Rockwell)*, 968 F.3d 12, 23 (1st Cir. 2020), *cert. denied*, 141 S. Ct. 1372 (2021). To read ABI's report on *Rockwell*, click here.

The opinions by Judge Brown and the BAP offer more elaborate explanations for why appreciation would not vest in a chapter 7 estate on conversion from chapter 13. For ABI's discussion of a recent case where the debtors lost appreciation in a homestead on conversion, click here.

The opinion is *Rodriguez v. Barrera (In re Barrera)*, 20-1376 (10th Cir. Jan. 19, 2022).

Disclosing a lawsuit in the SOFA and discussing the suit with the trustee was no substitute for listing the suit among a debtor's assets, the Ninth Circuit held.

Disclosing a Lawsuit Only in the SOFA Won't Result in Abandonment, Circuit Says

On an issue where the lower courts are split, the Ninth Circuit affirmed the Bankruptcy Appellate Panel by holding that an asset is not automatically abandoned if it was disclosed only in the statement of financial affairs and not on the schedule of assets.

No matter what the practice might have been before adoption of the Bankruptcy Code, disclosure to the trustee does not satisfy the requirements of Section 554(c), according to the October 19 opinion by Circuit Judge Ryan D. Nelson.

Lawsuit Not Scheduled but Listed on the SOFA

A couple had begun a lawsuit against their mortgage servicer before filing in chapter 7. They disclosed the suit in the statement of financial affairs but did not list the claim or its value in the schedule of assets. The couple also discussed the claim with the trustee and gave him copies of the pleadings.

Although not mentioned in Judge Nelson's opinion, the bankruptcy court docket reveals that the trustee decided not to pursue the lawsuit given the cost of prosecution and the uncertainty of a favorable result.

The trustee issued a no-asset report and certified that he had fully administered the estate. The court discharged the trustee and closed the case.

The debtors continued prosecuting the suit after discharge. With a hearing on summary judgment approaching, the defendant servicer approached the trustee and made a settlement proposal. After the trustee reopened the case, the bankruptcy court approved the settlement. Concluding that the lawsuit had not been abandoned, the bankruptcy court gave the proceeds to the trustee for distribution to creditors.

The debtors appealed and lost in a July 2, 2020, opinion for the Ninth Circuit Bankruptcy Appellate Panel by Bankruptcy Judge Laura S. Taylor. *See Stevens v. Whitmore (In re Stevens)*, 617 B.R. 328 (B.A.P. 9th Cir. July 2, 2020). To read ABI's report, click here.

The debtors argued in the BAP that the lawsuit had been abandoned automatically under Section 554(c). Although not mentioned by the BAP or the circuit, the bankruptcy court's docket shows that the defendant offered $50,000 to settle. Judge Nelson said that the debtors were looking for 10 times more if they had maintained control of the lawsuit.

'Plain Language' Dictates the Outcome

The outcome in the circuit turned on the interactions between Sections 554(c) and 521(a)(1). The former provides that an asset not administered is "abandoned to the debtor" if it was "scheduled under section 521(a)(1)."

For Judge Nelson, the analysis was largely a linguistic exercise. No circuit court has addressed the issue. The lower courts are split. Some believe that an asset is abandoned only if it was scheduled as an asset under Section 521(a)(1)(B)(i). Others believe that an asset will have been abandoned if it was included in the statement of affairs under Section 521(a)(1)(B)(iii).

Among the circuits, only the Second Circuit mentioned the issue but left the question undecided. *See Ashmore v. CGI Grp. Inc.*, 923 F.3d 260 (2d Cir. 2019). To read ABI's report on *Ashmore*, click here.

Judge Nelson said that the dictionary meaning of the word "scheduled" as used in Section 554(c) means "to include something on a literal schedule." The court, he said, "must give 'schedule' and 'scheduled' similar meanings: scheduled means included on a schedule." Listing on the statement of affairs won't suffice.

Judge Nelson found support in the Bankruptcy Rules, which, he said, "routinely distinguish between the bankruptcy petition itself, bankruptcy schedules, the SOFA, and other documents."

The debtors urged the Ninth Circuit to follow pre-Code law and the understanding that property was abandoned if the trustee knew about it. Now that Congress has enacted the Bankruptcy Code, Judge Nelson said, "we cannot disregard its plain language."

Judge Nelson conceded that the omission from the schedules may have been "an inadvertent oversight." Given the statute's "plain text, . . . we cannot consider equitable arguments," he said.

Judge Nelson affirmed, holding that "§ 554(c) requires property to be disclosed on a literal schedule, and thus that, absent Trustee or court action, property disclosed only on a statement (*e.g.*, the Statement of Financial Affairs) cannot be abandoned under § 554(c)."

Judge Nelson did not explain what he meant by "Trustee or court action." Evidently, a trustee's analysis of an unscheduled claim does not measure up if we can credit facts not mentioned in the circuit opinion.

Observations

In representing corporate and individual debtors before turning to journalism, this writer would confront circumstances where it was unclear whether something should be scheduled as a debt or asset or disclosed in the statement of financial affairs. In those situations, it was our practice to both schedule and list.

Was it malpractice for the debtors' lawyer not to schedule the lawsuit against the servicer?

Kudos

The debtors paid the filing fee but could not afford the counsel. Recognizing the importance of the issue, the circuit appointed Kellam M. Conover from Gibson, Dunn & Crutcher LLP in Washington, D.C., as *pro bono* counsel for the debtors. With him on the brief were Mark A. Perry and Suria M. Bahadue. Mr. Conover argued. He had clerked on the Ninth Circuit.

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

The opinion is *Stevens v. Whitmore (In re Stevens)*, 20-60044 (9th Cir. Oct. 19, 2021).

Exemptions never come into play with inherited 401(k)s because they aren't estate property in the first place, Judge Hodges explains.

Unlike IRAs, Debtors Keep Inherited 401(k)s Because They Aren't Estate Property

In *Clark v. Rameker*, 573 U.S. 122 (2014), the Supreme Court held that individual retirement accounts inherited before bankruptcy are not exempt and belong to creditors. It follows, does it not, that a debtor cannot keep a 401(k) inherited before bankruptcy?

Answer: Wrong. Unlike an IRA, an inherited 401(k) does not become estate property, for reasons explained by Bankruptcy Judge George R. Hodges of Asheville, N.C.

The Inherited IRA

Not long before filing a chapter 7 petition, the debtor inherited a 401(k) from someone who was neither her spouse nor a relative. The debtor told the trustee about the inherited 401(k) but did not list it among her assets, nor did she claim an exemption. Rather, the debtor took the position that the 401(k) was not estate property, thus making exemptions and scheduling irrelevant.

Disagreeing, the trustee filed a turnover motion, relying largely on *Clark*, where the Supreme Court held that an inherited IRA is not exempt under Section 522(b)(3)(C) because it doesn't fit the description of "retirement funds."

In his June 4 opinion, Judge Hodges concluded that an inherited 401(k), unlike an inherited IRA, never becomes estate property. He wasn't required to decide whether an inherited 401(k) is an exempt asset, the focus of *Clark*.

Clark Distinguished

Judge Hodges distinguished *Clark*. There, the question was whether an inherited IRA fell under Section 522(b)(3)(C), which exempts "retirement funds" if they are exempt from taxation under specified provisions of the Internal Revenue Code.

Clark focused on the characteristics of inherited IRAs that make them something other than "retirement funds." Unlike retirement funds, the holder of an IRA cannot make additional investments, must continually make withdrawals, and may withdraw everything without incurring a penalty.

Judge Hodges observed that inherited 401(k)s have "the same legal characteristics," but the result was not the same.

Unlike IRAs, the trusts holding 401(k)s must have anti-alienation provisions as required by both the IRS Code and ERISA.

The anti-alienation provisions in 401(k) trusts invoke Section 541(c)(2), which provides that "a restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable nonbankruptcy law is enforceable in a case under this title." Property in a trust that complies with Section 541(c)(2) does not become estate property.

Judge Hodges held that the outcome was not controlled by *Clark*, but by Section 541(c)(2) and *Patterson v. Shumate*, 504 U.S. 753 (1992). In *Patterson*, the Supreme Court held that "applicable nonbankruptcy law" includes ERISA-qualified plans. *Id*. at 759.

IRAs, Judge Hodges said, "are not qualified plans under ERISA." By way of contrast, "a 401(k) plan is a qualified plan under ERISA and qualifies for tax benefits and protection that an IRA does not."

To qualify under ERISA, the trust for a 401(k) must provide that it "may not be assigned or alienated." For tax benefits, the IRS Code also requires that assets in a 401(k) may not be assigned or alienated.

Judge Hodges therefore concluded that "401(k) plans contain enforceable transfer restrictions for purposes of § 541(c)(2)'s exclusion of property from the bankruptcy estate."

Furthermore, Judge Hodges mentioned how the "Supreme Court in *Patterson* even acknowledge[d] that ERISA-qualified plans receive greater protection than IRAs in bankruptcy," because IRAs are not included in ERISA's anti-alienation provision.

Judge Hodges noted that Section 541(c)(2) does not mention "retirement funds" like Section 522(b)(3)(C), the focus of *Clark*. Thus, he said, "the legal characteristics of inherited IRAs relevant to the Supreme Court's analysis in *Clark* are not relevant to the analysis of 401(k)'s."

In the case before Judge Hodges, the funds had not been withdrawn from the 401(k) before bankruptcy, meaning that they were protected by the trust's anti-alienation provisions. He therefore held that the funds in the 401(k) "are not property of the estate" under Section 541(c)(2) and belong to the debtor. The lack of an exemption didn't matter because exemptions only apply to estate property.

The opinion is *In re Dockins*, 20-10119 (Bankr. W.D.N.C. June 4, 2021).

Fair Debt Collection Practices Act

A statutory violation by itself won't necessarily give a plaintiff constitutional standing.

Sixth Circuit Erects Barriers to FDCPA Suits by Consumers in a 2/1 Opinion

Over a dissent, the Sixth Circuit held that a debt collector's failure to identify itself accurately does not give the creditor constitutional standing to file suit for violation of the federal Fair Debt Collection Practices Act, or FDCPA, 15 U.S.C. § 1692-1692p.

The August 16 opinion is the latest example of courts striving to understand the Supreme Court's recent rulings about constitutional standing in *Spokeo Inc. v. Robins*, 136 S. Ct. 1540 (2016), and *TransUnion LLC v. Ramirez*, 141 S. Ct. 2190 (2021). To read ABI's reports, click here and here.

The trend is not favorable for consumers who file suits based on statutory violations and not much more.

The Simple Facts

The essential facts underpinning the appeal to the Sixth Circuit are few and simple.

A consumer owed a small debt to a hospital. The hospital turned over collection to an outfit that was allegedly a debt collector whose activities would be regulated by the FDCPA.

The debt collector sent a handful of letters to the consumer asking for payment. The letters correctly identified the debt collector. The consumer did not allege that the letters violated the FDCPA.

The debt collector also left several voicemail messages that did not state the debt collector's full corporate name. The failure to give the full name could have been confusing because there was another company with a similar name.

After receiving three or four voicemail messages, the consumer contacted a lawyer and sent a cease and desist letter to an entity that was not the debt collector who had left the voicemail messages. After the letter, the consumer received one more voicemail message, indicating that the cease and desist letter may not have accomplished its purpose.

A few months later, the consumer sued the alleged debt collector, claiming violations of the FDCPA. After the close of discovery, the defendant filed a motion for summary judgment. The district court granted the motion and dismissed the suit, having decided that the defendant was not a debt collector subject to the FDCPA.

The Majority's Opinion

The consumer appealed. In an eight-page opinion for the majority, Circuit Judge R. Guy Cole, Jr. vacated the order granting summary judgment and remanded with instructions to dismiss the suit for lack of jurisdiction.

The circuit court raised standing for the first time on appeal because, as Judge Cole said, a court has an independent duty to establish its own jurisdiction, and a plaintiff's lack of Article III standing is jurisdictional.

Under *Spokeo*, Judge Cole explained that a plaintiff has constitutional standing under Article III if there was an injury in fact that was "fairly traceable" to the defendant's conduct and that is likely to be redressed by a favorable court ruling.

To establish injury in fact, *Spokeo* decreed that the injury must be "particularized" and "concrete." The parties agreed that the injury was particularized but disagreed about whether the consumer had suffered a concrete injury.

The consumer contended that his harm was concrete because he was confused about the identity of the caller, consulted a lawyer, sent a cease and desist letter to the wrong entity and then received another call.

On that score, Judge Cole cited *Spokeo* for teaching that a statutory violation is a violation of a procedural right that by itself may not satisfy the requirement of injury in fact. He went on to cite *TransUnion* for the proposition that the mere risk of future harm by itself does not qualify as concrete harm.

Judge Cole therefore said that the consumer was required to show that the procedural violation itself was a concrete injury "of the sort traditionally recognized" or caused an independent concrete injury.

For Judge Cole, the defendant's failure to identify itself accurately was not close enough to an invasion of privacy to bestow standing.

With regard to independent concrete injury, the consumer claimed he was harmed because he was confused, hired counsel, sent a cease and desist letter to the wrong entity and received another voicemail.

Judge Cole ruled that the consumer could not show concrete harm simply by having hired counsel. If that were enough, he said, hiring "counsel to affirmatively pursue a claim would nullify the limits created under Article III."

In conclusion, Judge Cole said the consumer had shown nothing more than "a bare procedural violation of the FDCPA" and therefore lacked constitutional standing to mount suit. He reversed and remanded with instructions to dismiss the suit for lack of jurisdiction.

The Dissent

Circuit Judge Karen Nelson Moore "respectfully" dissented. For her, confusion about the debt collector's proper corporate name and the resulting voicemail message was a "sufficiently concrete" injury to confer standing, constitutionally speaking.

Judge Moore said that misidentification of the debt collector and the subsequent voicemail "resembles a harm recognized under the common-law tort of intrusion upon seclusion." In her view, the "difference between one unwanted call and many is one of degree, not of kind." A single unwanted call, she said, "is a concrete harm" conferring standing.

"We may think that Congress has elevated a relatively insignificant harm, but that was Congress's decision to make, and it is not a reason to hold that [the plaintiff] lacks standing to sue," Judge Moore said.

"In sum," Judge Moore said, there was constitutional standing, and therefore jurisdiction, in view of the "single unwanted voicemail." Although one voicemail "may seem trivial or insignificant, . . . it is concrete and that is all that we are to decide under the Court's standing precedent."

Observations

Much like substantive due process violations found by the Supreme Court during the Franklin Roosevelt administration, the lack of Article III jurisdiction flowing from a statutory violation isn't something Congress can address through legislation.

Lawyers for consumers must hope that federal courts will follow Judge Moore's dissent and find constitutional standing even for "trivial" injuries.

Even if trivial injury suffices to establish standing, it doesn't mean that a court or jury would find liability for violating the FDCPA.

This case is an example. Even if the consumer had standing, the district court still dismissed on summary judgment after ruling that the defendant was not a debt collector.

The opinion is *Ward v. National Patient Account Services Solutions Inc.*, 20-5901. 2021 BL 308015, 2021 Us App Lexis 24369 (6th Cir. Aug. 16, 2021).

Cross-Border Insolvency

Judge Vaughan explains why a foreign debtor isn't required to have a presence in the U.S. before the debtor's foreign representatives can win recognition under chapter 15.

Eleventh Circuit Predicted to Split with the Second Circuit on Foreign Recognition

Bankruptcy Judge Lori V. Vaughan of Orlando, Fla., predicts that the Eleventh Circuit will split with the Second Circuit and hold that a bankruptcy court may grant foreign main recognition under chapter 15 even if the debtor has no residence, domicile, place of business or property in the U.S.

Judge Vaughan was referring to a Second Circuit decision, *In re Barnet*, 737 F.3d 238 (2d Cir. 2013), where Australian liquidators of a corporation were seeking foreign main recognition under Section 1517. The bankruptcy court granted recognition even though the debtor had no residence, domicile, place of business or property in the U.S., a seeming requirement under Section 109(a).

On direct appeal, the Second Circuit reversed, based on the plain language of Section 103, which makes Section 109 applicable in chapter 15 cases.

Believing that *Barnet* was wrongly decided, Prof. Jay L. Westbrook told ABI that Judge Vaughan wrote an "excellent opinion, reflecting the fact that chapter 15 is fundamentally different in focus and procedure and its unique definition of 'debtor' should obviously prevail over the general one."

Prof. Westbrook is the country's leading authority on cross-border insolvency and occupies the Benno C. Schmidt Chair of Business Law at the University of Texas School of Law. He was an author of a scholarly article debunking *Barnet* line by line. *See* Glosband and Westbrook, "Chapter 15 Recognition in the U.S.: Is a Debtor 'Presence' Required?," *Int. Insolv. Rev.*, Vol. 24: 28–56 (2015).

The Individual Debtor in Judge Vaughan's Case

The debtor was an individual in the case before Judge Vaughan. He had been adjudicated bankrupt in the High Court of Justice of England and Wales. The joint liquidators filed a chapter 15 petition and sought recognition of the proceedings in the U.K. as the foreign main proceeding.

The standards for recognition are contained in Section 1517(a), which provides that the court "shall" grant recognition if:

> (1) such foreign proceeding for which recognition is sought is a foreign main proceeding or foreign nonmain proceeding within the meaning of section 1502;
> (2) the foreign representative applying for recognition is a person or body; and
> (3) the petition meets the requirements of section 1515.

The debtor conceded that the liquidators satisfied all three requirements for recognition under Section 1517. Still, the debtor argued that the court should not grant recognition because he did not fit the description of a debtor in Section 109. That section says:

> [O]nly a person that resides or has a domicile, a place of business, or property in the United States, or a municipality, may be a debtor under this title.

The debtor claimed that he did not have a residence or domicile in the U.S. and no longer had any business or property in the U.S. Relying on *Barnet*, the debtor called on Judge Vaughan to deny recognition.

Judge Vaughan declined the invitation. For a host of reasons, she concluded that "the Eleventh Circuit would likely disagree with the *Barnet* holding."

Section 109(a) Yields to More Specific Provisions

Judge Vaughan's August 31 opinion leaves the reader with the impression that Section 109(a) was thoughtlessly drafted and inconsistent with other, more specific provisions in chapter 15 regarding recognition.

Because the facts met all three requirements of Section 1517(a), Judge Vaughan said that the "plain language" of the section "requires this Court to recognize the U.K. bankruptcy."

"For the purposes of this chapter [15]," Section 1502(1) defines a "debtor" to mean "an entity that is the subject of a foreign proceeding." Judge Vaughan therefore concluded that Section 109(a) does not apply in chapter 15 cases. Were it otherwise, Section 1502(1) would have no meaning.

Judge Vaughan also took guidance from 28 U.S.C. § 1410(3), which places venue of chapter 15 cases where there is a lawsuit against a debtor who has no business or assets in the U.S.

Judge Vaughan alluded to subsections (b) through (g) of Section 109, which specifies who may be debtors under chapters 7, 9, 11, 12 and 13. Chapter 15 is "[n]otably absent," she said.

Section 109(h) requires individuals to have taken a course in credit counseling. Because a foreign debtor would always have been declared bankrupt in another country, Judge Vaughan said that the "plain language" of Section 109(h) "would always require a waiver by the Court or an exception to apply."

"[A]s a whole," Judge Vaughan held that "the plain language" of Section 109 "demonstrates it should not apply to recognition of foreign debtors under chapter 15."

Barnet Won't Be Followed

To conclude her opinion, Judge Vaughan considered whether the Eleventh Circuit would follow *Barnet*. She cited *In re Goerg*, 844 F.2d 1562 (11th Cir. 1988), where the Eleventh Circuit held under former Section 304 that a foreign representative could conduct ancillary proceedings regarding a foreign debtor that did not qualify as a debtor under Section 109. Section 304 was the predecessor to chapter 15.

Because Section 109 was on the books when *Goerg* was written, Judge Vaughan concluded that the Eleventh Circuit would continue to follow *Goerg* and would reject *Barnet*.

Even if *Barnet* were the standard, Judge Vaughan held that the debtor met the requirements of Section 109(a), because he was an indirect owner of corporations that owned property in the district. Further, the foreign representatives held claims that would qualify as property in the U.S.

Judge Vaughan granted recognition as a foreign main proceeding.

Observation

The ink was barely dry on *Barnet* before it was emasculated by the bankruptcy courts. Even though she was reversed in *Barnet*, the bankruptcy judge granted recognition on remand, finding that the retainer given to U.S. counsel for the foreign representatives and claims in the U.S. satisfied Section 109(a). *In re Octaviar Administration Pty Ltd*, 511 B.R. 361 (Bankr. S.D.N.Y. June 19, 2014). Other courts have used the same rationale to grant recognition.

The article by Prof. Westbrook and Mr. Glosband, *supra*, picks apart every flaw in *Barnet*. Fundamentally, they explain why the Second Circuit "confuse[d] the foreign debtor with the foreign insolvency representative." *Id*. at 28. In detail, they explain why the Second Circuit "either reject[ed] or ignore[d] the meaning, plain or otherwise, of other sections of title 11 that establish that the debtor subject to the foreign proceeding is not a debtor under title 11 and that the foreign proceeding, not the debtor, must be eligible for recognition." *Id.* at 44.

The two commentators say that Section 109(a) does apply in chapter 15 cases, but they explain the limited circumstances where it governs. For instance, the foreign debtor must have a presence

in the U.S. when foreign representatives use their power under Section 1511 to file a "full" case under Sections 301, 302 or 303. Section 109(a) also applies when a foreign debtor files a bankruptcy case in the U.S. to enforce a foreign discharge.

"Conversely," Prof. Westbrook and Mr. Glosband said, "the reason that section 109(a) does not apply to recognition is that the debtor in the foreign proceeding will not, by virtue of chapter 15 recognition of the foreign proceeding, become 'a debtor under this title.'"

The two commentators faulted the Second Circuit for failing to "explain why the plain meaning of section 109(a) trumps the plain meaning of section 1502." "For the purposes of this chapter," Section 1502(1) says that the term "'debtor' means the entity that is the subject of a foreign proceeding."

Prof. Westbrook and Mr. Glosband meticulously explain why "section 1502(1) supplants section 101(13) within and without Chapter 15; the phraseology 'for purposes of' does not permit the application of dual definitions."

Whenever a court or counsel faces a question similar to the issue confronting Judge Vaughan, we recommend extensive reliance on the article by Prof. Westbrook and Mr. Glosband.

The opinion is *Al Zawani*, 21-10251, 2021 BL 329515, 2021 Bankr Lexis 2367 (Bankr. M.D. Fla. Aug. 31, 2021).

Citing Ritzen as the reason, the Eleventh Circuit disagreed with the Second Circuit regarding the finality of Rule 2004 discovery orders in chapter 15 cases.

Circuits Split on Finality of Rule 2004 Discovery Orders in Chapter 15 Cases

In a nonprecedential opinion, the Eleventh Circuit split with the Second Circuit by holding that a discovery order in a chapter 15 case under Bankruptcy Rule 2004 is nonfinal and thus not appealable, even if the discovery was not sought in a pending adversary proceeding or contested matter.

The Atlanta-based appeals court appears to have ruled that a discovery order is not final and therefore not appealable if the fruits of discovery could be used in an adversary proceeding or contested matter that might be brought later.

Discovery by the Foreign Representative

The foreign representative of a Brazilian airline had received recognition of the Brazilian liquidation as a foreign main proceeding under chapter 15. According to the July 19 opinion by Circuit Judge Beverly B. Martin, the chapter 15 case was designed to locate assets of the debtor that were in the U.S. or transferred through the U.S.

In Brazil, the Brazilian trustee was in litigation attempting to pierce the corporate veil as to certain nondebtor third parties. The Brazilian trustee was aiming to include the third parties' assets in the bankrupt estate.

Not having yet pierced the corporate veil, the Brazilian court had frozen the third parties' assets and indicated in an order that the freeze should be implemented in the U.S. chapter 15 case.

The Brazilian trustee, as the foreign representative, obtained subpoenas from the bankruptcy court in Miami under Bankruptcy Rule 2004, directing several financial institutions to produce documents about the third parties' banking and financial information.

The bankruptcy court denied the third parties' motion for a protective order. The third parties appealed, but the district court dismissed the appeal for lack of appellate jurisdiction. The district court reasoned that the discovery order was nonfinal and thus not appealable. The third parties appealed once again to the circuit.

Ritzen Governs

Judge Martin began from the "general proposition" that discovery orders are nonfinal. However, the primary authority on finality in the bankruptcy context is *Ritzen Group Inc. v. Jackson Masonry LLC*, 140 S. Ct. 582, 205 L. Ed. 2d 419 (Sup. Ct. Jan. 14, 2020), where the Supreme Court held that an order denying a motion to modify the automatic stay is a final order that may be appealed. To read ABI's report on *Ritzen*, click here.

More specifically, Judge Martin quoted the Supreme Court for holding that orders in a bankruptcy case "qualify as 'final' when they definitively dispose of discrete disputes within the overarching bankruptcy case." *Id.*, 140 S. Ct. at 586.

To decide whether an order is final and appealable, the Supreme Court went on to command that the appellate court must identify "the appropriate procedural unit for determining finality." *Id.*, 140 S. Ct. at 588-589.

In the case on appeal, Judge Martin said that the procedural unit was the implementation of the freeze order in the chapter 15 case. She arrived at this conclusion because "the record is clear" that the foreign representative was seeking discovery to aid in implementation of the Brazilian freeze order.

The Split with the Second Circuit

The third parties relied on Second Circuit authority that was almost, if not exactly, on point, despite Judge Martin's statements to the contrary. *Drawbridge Special Opportunities Fund LP v. Katherine Elizabeth Barnet* (*In re Barnet)*, 737 F.3d 238 (2d Cir. 2013).

In *Barnet*, a foreign representative was seeking foreign main recognition and sought discovery from a company. The court denied the company's motion to stay discovery. On appeal, Judge Martin said that the Second Circuit "categorically" held that a discovery order in a chapter 15 case is immediately appealable.

Primarily, the Second Circuit analogized the chapter 15 case to discovery in aid of a foreign proceeding under 28 U.S.C. § 1782(a), where discovery orders are immediately appealable. In Section 1782 matters, a discovery order would be the final resolution of the dispute.

The Second Circuit reasoned that chapter 15 cases, like petitions under Section 1782, are ancillary to a suit in another tribunal, "such that there will never be a final resolution on the merits beyond the discovery relief itself." *Id.* at 244.

Judge Martin said that *Barnet* was "distinguishable," because it was decided before *Ritzen*. Therefore, she said, the Second Circuit "did not wrestle with the question of whether discovery

under Chapter 15 is a 'discrete' or 'separate' proceeding or 'merely a preliminary step' in some other proceeding." *Ritzen*, *supra*, 140 S. Ct. at 589–90.

Judge Martin also rejected the Second Circuit's analogy between chapter 15 and Section 1782. In Section 1782, she said, "there is nothing but discovery." In chapter 15, by contrast, she said that "a discovery order is ordinarily a 'preliminary step' of a larger proceeding."

In the case on appeal, Judge Martin said that the discovery order was only a preliminary step in a forthcoming freeze proceeding in bankruptcy court.

Judge Martin rejected arguments that the discovery order fell within exceptions to the final order doctrine. She dismissed the appeal for lack of appellate jurisdiction.

Observations

According to a brief filed by third parties in the circuit, the foreign representative had not brought any proceedings in the bankruptcy court to extend the freeze order to the U.S. through the chapter 15 case.

This writer therefore interprets the Eleventh Circuit's opinion to mean that the mere possibility of a later contested matter or adversary proceeding is sufficient to render a discovery order under Bankruptcy Rule 2004 beyond the pale of appeal, assuming the court does not grant leave to take an interlocutory appeal.

This writer questions whether *Ritzen* entirely altered the analysis regarding appeals of discovery orders in chapter 15 cases, where there may or may not be proceedings aside from discovery.

Considerations such as these may explain why the Eleventh Circuit's opinion is nonprecedential.

The opinion is *Estate of Omar Fontana v. ACFB Administracao Judicial Ltda (In re Transbrasil S.A. Linhas Aereas)*, 20-12238 (11th Cir. July 19, 2021).


ROCHELLE'S DAILY WIRE

The bankruptcy court has no discretion to deny recognition in chapter 15 if the requirements of Section 1517(a) have been met.

Bad Faith Filings in Chapter 15 Entitled to 'Foreign Main Recognition,' BAP Says

A bad faith filing is no basis for denying recognition of a foreign main proceeding under chapter 15 "if all three requirements of § 1517(a) are met," the Ninth Circuit Bankruptcy Appellate Panel recently held.

A foreign representative is entitled to recognition even if the filing was not a legitimate use of chapter 15, Bankruptcy Judge Julia W. Brand said in her February 17 opinion for the BAP.

Before concluding that the BAP lost its mind by condoning bad faith, be sure to read the end of this report, where Judge Brand lays out the relief available to a creditor who can show that chapter 15 is being misused.

The Bankruptcy in Monaco

Incorporated in Monaco, the debtor was the sole distributor in Europe for a California-based producer of lubricants. The California creditor held 96% of the debt owing by the debtor.

The creditor alleged that the debtor had misappropriated its trade secrets and customer lists to establish a competing business. The creditor initiated an arbitration in California where the arbitrator awarded the creditor almost $1.1 million. The federal court in California confirmed the arbitration award.

Believing that the debtor's owner had fraudulently transferred the debtor's assets, the creditor was undertaking discovery in California aimed at identifying assets or transfers of assets.

The debtor filed an insolvency proceeding in Monaco followed by a chapter 15 petition in Oakland, Calif. The chapter 15 filing imposed an automatic stay on discovery.

The Monegasque trustee sought recognition of the proceedings in Monaco as a foreign main proceeding under Section 1517(b)(1). The creditor opposed.

The creditor argued in bankruptcy court that the Monegasque bankruptcy and the chapter 15 cases were shams to protect the debtor's owner and shield fraudulently transferred assets.

Among other things, the bankruptcy court found that the owner was paying the Monegasque trustee's attorneys' fees and that the trustee's lawyers had also represented the debtor in California district court. According to Judge Brand, the bankruptcy judge found that the trustee was not a "true fiduciary" and that the facts "cast doubt on the integrity of the proceeding and [the debtor's] good faith."

The bankruptcy court denied recognition, concluding that the case was not a legitimate use of chapter 15 for the purposes intended by Section 1501. According to Judge Brand, the bankruptcy court "believed that the real purpose of the filing was to preclude [the creditor] from recovering on its Judgment and to protect [the owner and another business he owned] from their own wrongful conduct."

"Because the [bankruptcy] court found the filing to be improper under § 1501, it made no findings under § 1517," Judge Brand said. The debtor appealed to the BAP, which reversed.

The Standards for Recognition

Judge Brand devoted several pages to laying out the nuts and bolts of reorganization and liquidation proceedings in Monaco. Although insolvencies in Monaco do not mimic U.S. bankruptcies precisely, the Monegasque law struck this writer as similar to the laws of other countries entitled to recognition under chapter 15.

Judge Brand laid out the two most relevant statutes, Sections 1501 and 1517(a).

Section 1501 contains the statement of purpose for chapter 15, including cooperation between courts in the U.S. and those abroad with the provision of "effective mechanisms for dealing with cases of cross-border insolvency."

Section 1517(a) demands that recognition "shall" be granted if (1) the foreign proceeding is main or non-main, (2) the foreign representative is a person or body and (3) the petition meets the requirements of Section 1515.

In bankruptcy court, there had been no dispute about the satisfaction of the three requirements.

Reversal was foretold early in her opinion when Judge Brand said she "could not locate . . . another case where a court has applied § 1501 to determine recognition of a foreign proceeding." She said that the bankruptcy court "impermissibly engaged in a more discretionary analysis than what recognition under § 1517 authorizes."

Judge Brand said that "Section 1501 does not control recognition of a foreign proceeding. Rather, recognition is governed by §§ 1515 through 1524."

However, there is a safety valve in Section 1506, Judge Brand said. It says,

> Nothing in this chapter prevents the court from refusing to take an action governed by this chapter if the action would be manifestly contrary to the public policy of the United States.

In other words, "recognition is mandatory if all three requirements of § 1517(a) are met and there is no public policy basis to deny it," Judge Brand said.

Given that the requirements of Section 1517(a) were satisfied, Judge Brand examined whether recognition would be "manifestly contrary" to U.S. public policy.

With the facts not in dispute, Judge Brand found nothing "manifestly contrary" to U.S. public policy. She analyzed several other chapter 15 cases where "a party's misconduct or bad faith [was] not a proper basis for invoking § 1506 to deny recognition." She cited a case with "more egregious" facts where recognition had been granted.

Judge Brand reversed and ruled that the proceedings in Monaco were entitled to foreign main recognition.

The Safety Valve

Although the foreign proceeding was entitled to recognition, Judge Brand said the court is not "helpless when faced with misconduct or bad faith in a chapter 15 case." After recognition, she said that the court "has a considerable amount of discretion."

If there is misconduct or bad faith, Judge Brand said that the court's tools include relief from the automatic stay, abstention or dismissal.

The opinion is *Samba v. International Petroleum Products & Additives Co. (In re Black Gold SARL)*, 21-168 (B.A.P. 9th Cir. Feb. 17, 2022).

Bankruptcy Judge Garrity didn't impose a good faith filing requirement onto foreign main recognition of a chapter 15 case.

Filing Chapter 15 as a 'Litigation Tactic' Didn't Bar 'Foreign Main Recognition'

Writing an opinion that reads like a treatise, Bankruptcy Judge James L. Garrity, Jr. of New York granted foreign main recognition even when the purpose of the chapter 15 filing was to enjoin a shareholders' suit in New York.

Contrasted to a chapter 11 case that can be dismissed if bankruptcy was a litigation tactic, Judge Garrity held that foreign liquidators are not held to the same standard when the issue is whether to grant foreign main recognition. That is to say, the standards for a legitimate chapter 11 filing are not imported onto gatekeeping functions in chapter 15.

The eventual import of Judge Garrity's more relaxed approach to chapter 15 recognition is unclear because he left the door open to modifying the automatic stay on motion by the plaintiffs in the New York suit.

Prior Operations Exclusively in the U.S.

The debtor operated in the U.S. It was acquired in a $610 million leveraged buyout in 2004. In 2006, the debtor repaid the buyer's $200 million investment. In 2007, the debtor borrowed $850 million to pay off $400 million in existing debt and make a $375 million dividend to shareholders.

In 2012, the debtor transferred all of its operating assets to another company. According to Judge Garrity's July 2 opinion, the debtor was solvent after the transfer, having cash but no other assets. In 2013, the debtor initiated a so-called members' voluntary liquidation in Bermuda, where the debtor was incorporated. Two accountants from Bermuda were appointed as joint liquidators.

Later in 2012, holders of 3.8% of the debtor's stock filed a derivative action in New York State court. The suit was aimed at directors and controlling shareholders. The debtor was a nominal defendant. The plaintiffs were attacking the $200 million return of capital and the $375 million dividend.

In 2017, the transferee from 2012 paid the debtor almost $12 million. The liquidators distributed most of the cash to shareholders, reserving $500,000 to cover expenses in the New

York suit. Judge Garrity said that the New York plaintiffs had received almost $400,000 in the distribution by the joint liquidators.

By June 2019, the cash held by the liquidators had dwindled to less than $300,000 when they decided that the debtor had become insolvent, in part due to expected future costs of the New York action. On the liquidators' petition, the court in Bermuda converted the case to a court-supervised liquidation and continued the liquidators in their roles.

Meanwhile, the New York state court had dismissed the suit several times, but it had been reinstated on appeal repeatedly. By 2020, the plaintiffs were on their fifth amended complaint and facing another motion to dismiss, which the state court had not decided by the time Judge Garrity wrote his decision.

In September 2020, the liquidators filed the chapter 15 petition in New York, having received authorization from the court in Bermuda. The chapter 15 case was explicitly designed to halt the New York suit, which would occur automatically once the Bermudian liquidation was recognized as a foreign main proceeding under Sections 1515, 1517 and 1520. The plaintiffs objected to recognition of the Bermudian liquidation as a foreign main or foreign nonmain proceeding.

Liquidators' Control Established COMI

The plaintiffs argued that the chapter 15 petition had been filed in bad faith to bar prosecution of the New York suit, where the debtor was only a nominal defendant that would suffer no damages. The plaintiffs also claimed that the chapter 15 petition amounted to forum-shopping.

Judge Garrity found that the liquidators had met all the requirements for foreign main recognition. His 39-page opinion is a compendium laying out the standards for winning foreign main recognition.

The plaintiffs contended that the debtor had no office, operations or assets in the U.S. to underpin the chapter 15 case in New York. To satisfy the Second Circuit's requirement for assets in the U.S., Judge Garrity pointed to the retainer held in a trust account by the liquidators' New York counsel.

The plaintiffs argued that Bermuda was not the debtor's center of main interests, or COMI, as required by Section 1517(b)(1). When it was an operating company, the debtor's operations and assets all had been in the U.S, the plaintiffs said. Furthermore, the debtor's sole remaining asset was the New York suit, according to the plaintiffs.

Correct though the historical statements may have been, Judge Garrity pointed out how the affairs of the debtor had been managed in Bermuda by the liquidators since 2013. Furthermore,

the debtor's tangible cash assets were in Bermuda; the debtor had few or perhaps no creditors, and the plaintiffs were equity holders, not creditors.

Bad Faith Filing Not Considered

In a last effort at forestalling recognition, the plaintiffs argued that allowing chapter 15 relief would be "manifestly contrary to public policy of the U.S." under Section 1506.

In that regard, Judge Garrity agreed that the "admittedly entire" purpose of the chapter 15 filing was "to prevent the New York Plaintiffs from continuing the New York Action." However, he said, no one had argued "that the proceedings in Bermuda themselves are, by their nature, contrary to United States public policy."

Judge Garrity therefore found "that this [public policy] exception is not met by a simple finding that the Chapter 15 Petition has been filed as a litigation tactic." He declined "to import a good faith requirement into the determination of a main/nonmain proceeding." The court, he said, has "limited discretion to deny recognition except when it would be manifestly contrary to the public policy of the United States."

Judge Garrity therefore ruled that Bermuda was the COMI and that the liquidators were entitled to recognition of the proceedings in Bermuda as a foreign main proceeding.

The plaintiffs wanted Judge Garrity to give them relief from the automatic stay. Judge Garrity said he would consider a lift-stay motion "in due course," after the plaintiffs have "properly moved for stay relief." Otherwise, he said, "the application of the stay is mandatory upon a finding of a foreign main proceeding," citing Section 1520(a)(1).

The opinion is *In re Culligan Ltd.*, 20-12192 (Bankr. S.D.N.Y. July 2, 2021).

Judge Garrity wasn't required to rule on whether Bankruptcy Rule 2004 applies in chapter 15 cases.

Chapter 15 Permits Discovery to Lay Groundwork for a Lawsuit, New York Judge Says

Bankruptcy Judge James L. Garrity, Jr., authorized the foreign representative of a South African airline to take discovery from Boeing under Section 1521(a)(4) regarding claims and defenses related to a purchase agreement for eight 737 MAX 8 aircraft.

The airline had 27 aircraft and 2,000 employees. In 2013, the airline contracted to buy the eight aircraft from Boeing.

The airline's finances were deteriorating even before the pandemic. Eventually, the airline was forced to ground all aircraft.

Under the aegis of joint business rescue practitioners, or BRPs, the airline commenced business rescue proceedings in South Africa in May 2020 under Chapter 6 of the South African Companies Act of 2008. Later, the BRPs obtained approval of a business rescue plan.

Before the airline's insolvency proceedings, the airline had paid for and Boeing had delivered the first of the eight new aircraft. The new aircraft was delivered just before the second crash of a 737 MAX 8, which resulted in the grounding of the MAX 8 fleet worldwide. The airline had also made pre-delivery payments for additional aircraft.

Before the insolvency proceedings, the airline had purported to cancel the purchase agreement for all eight aircraft. The BRPs confirmed the airline's cancellation. The rescue plan also authorized the cancellation of the purchase agreement.

The BRPs commenced a chapter 15 case in New York in February 2021. The bankruptcy court granted foreign main recognition and recognized the BRPs as foreign representatives. The recognition order authorized the foreign representatives to exercise the powers of a trustee provided by Sections 1520 and 1521.

In March 2021, the foreign representatives sent a letter to Boeing outlining claims for breach of contract and fraudulent inducement. Boeing responded by confirming that the purchase agreement was terminated but otherwise reserved its rights against the airline.

In August 2021, the foreign representative filed a motion in bankruptcy court under Section 1521 and Bankruptcy Rule 2004 to take discovery from Boeing. The aircraft manufacturer objected on a variety of grounds, but Judge Garrity granted the motion in an opinion on November 14.

Judge Garrity explained how Section 1521(a) contains a non-exclusive list of relief available to a foreign representative. "[T]o effectuate the purpose of this chapter and to protect the assets of the debtor," the section provides that "the court may, at the request of the foreign representative, grant any appropriate relief, including . . . (4) providing for the examination of witnesses, the taking of evidence or the delivery of information concerning the debtor's assets . . . or liabilities."

Section 1522(a) provides that the court may grant relief under Section 1521 "only if the interests of the creditors and other interested entities, including the debtor, are sufficiently protected."

Bankruptcy Rule 2004 provides that the court may allow an examination, but it "may relate only to the acts, conduct, or property or to the liabilities and financial condition of the debtor, or to any matter which may affect the administration of the debtor's estate."

The grant of chapter 15 recognition did not "bar the requested relief," Judge Garrity said, because the foreign representatives have a statutory duty under South African law to investigate the company's affairs. He therefore ruled that "the requested discovery is necessary to facilitate his efforts to assess the viability, strength, and magnitude of potential causes of action against Boeing and the likelihood and extent of a monetary recovery."

Section 1521, Judge Garrity said, authorizes discovery "without any limitation based on how the foreign representative intends to use the fruits of the requested discovery." He therefore found that the requested discovery would "effectuate the purpose" of chapter 15.

The aircraft manufacturer contended there was no need to protect the airline's assets because it was preserving the evidence that the foreign representatives might seek to discover when there is a lawsuit. Boeing also argued that the foreign insolvency proceeding was "essentially complete" because the plan had been approved.

Judge Garrity said there had been no "Termination Events" under South African law. "Accordingly," he said, "the Rescue Plan and South African law do not foreclose the Foreign Representative from pursuing claims against Boeing in furtherance of his effort to rescue the company."

"Moreover," Judge Garrity said, "the fact that the Debtor can seek discovery under the applicable rules of civil procedure if it ultimately commences litigation against Boeing . . . is not

a bar to the relief sought in the Motion." [Reference omitted.] Ruling otherwise, he said, "would completely eviscerate the investigatory function that section 1521(a)(4) is designed to serve."

Judge Garrity therefore concluded that discovery was "necessary to protect [the airline's] assets." He said that the foreign representatives were pursuing discovery to satisfy their duties under South African law and had "established grounds under section 1521(a)(4) to conduct discovery of Boeing relating to causes of action that [the airline] may hold against Boeing and the extent of [the airline's] potential monetary recovery from Boeing."

Last, Judge Garrity held that Boeing's interests were "sufficiently protected," although Boeing argued that the foreign representatives' 40 document requests were "massively overbroad."

With regard to Boeing's contention that the document requests were overbroad, Judge Garrity directed the parties to meet and confer. In the absence of agreement, he called on them to arrange a discovery conference under the district's local rules.

Boeing argued that Rule 2004 does not apply in chapter 15 cases. Judge Garrity said the issue was "academic" because the foreign representatives were entitled to discovery under Section 1521(a)(4).

Judge Garrity granted the motion allowing the foreign representatives to conduct discovery.

The opinion is *In re Comair Ltd.*, 21-10298 (Bankr. S.D.N.Y. Nov. 14, 2021).

Filing a chapter 15 petition wasn't required for a U.S. district court to dismiss a civil action against a German company undergoing insolvency in Germany.

U.S. Suit Dismissed After German Defendant Files Insolvency in Germany

Invoking Second Circuit authority, a magistrate judge in New York dismissed a suit against a German company undergoing insolvency proceedings in Germany, as a matter of comity. The opinion is authority for the proposition that a foreign liquidator can stop lawsuits in the U.S. without obtaining recognition under chapter 15.

A plaintiff sued a German company in a New York state court for breach of a distribution agreement. The German company removed the suit to federal court. Represented there by U.S. counsel, the German company consented to the entry of an order finding liability.

The German company said it conceded liability because it lacked the resources to defend itself in the U.S. or in Germany if the plaintiff sought to enforce a U.S. judgment.

The district judge referred the case to Magistrate Judge Stewart D. Aaron to determine damages. The parties consented to allowing Judge Aaron to enter final judgment.

Before proceedings on damages before Judge Aaron, the German company initiated insolvency proceedings in Germany, resulting in the appointment of an insolvency administrator. The insolvency proceedings stayed legal actions in Germany.

U.S. counsel for the German defendant then filed a motion to be relieved as counsel and either to stay or dismiss the suit. Counsel explained that he had been advised by the insolvency administrator that his authority to act on behalf of the defendant terminated on commencement of insolvency proceedings.

The plaintiff opposed the motions but lost in a May 17 opinion by Judge Aaron.

The "mere existence" of a parallel proceeding abroad does not override the district court's "virtually unflagging obligation" to exercise jurisdiction, Judge Aaron said, quoting the Second Circuit in *Royal & Sun Alliance Ins. Co. of Canada v. Century Int'l Arms. Inc*., 466 F.3d 88, 92 (2d Cir. 2006). However, he went on to say, "Foreign bankruptcy proceedings . . . generally are an exception to this rule."

Again quoting *Royal & Sun*, Judge Aaron said that a foreign country's interest in an equitable and orderly distribution "is an interest deserving of particular respect and deference." *Id*. at 92-93.

Deference "is appropriate," Judge Aaron said, "where 'the foreign proceedings are procedurally fair and . . . do not contravene the laws or public policy of the United States.' *JP Morgan Chase Bank v. Altos Hornos de Mexico. S.A. de C.V.*, 412 F.3d 418, 424 (2d Cir. 2005)."

Judge Aaron recognized that the party seeking to invoke comity carries the burden. In successfully shouldering that burden, he recited how the German company had demonstrated that "the German insolvency proceedings are procedurally fair and do not contravene the laws or public policy of the United States." He noted that Germany imposes a stay and shares a policy with the U.S. of equal distribution of assets, giving no preference to German creditors.

The defendant argued that the German company's U.S. counsel lacked authority to file the motion to dismiss or stay. Judge Aaron said that objection was "meritless" because the attorney was the German company's counsel of record when the motion was filed.

Judge Aaron dismissed the suit and granted the motion to withdraw because the attorney "no longer has authority to act on behalf of" the defendant.

The opinion is *Moyal v. Munsterland Gruppe GmbH & Co.*, 19-04946 (S.D.N.Y. May 17, 2021).

Faculty

Hon. Janet S. Baer is a U.S. Bankruptcy Judge for the Northern District of Illinois in Chicago, appointed on March 5, 2012. She also acts on a regular basis as the presiding judge in the Northern District of Illinois for naturalization ceremonies. Previously, Judge Baer was a restructuring lawyer for more than 25 years and was involved in some of the most significant chapter 11 bankruptcy cases in the country. The majority of her practice focused on the representation of large, publicly held debtors in both restructuring and chapter 11 matters, and she also represented companies in commercial litigation matters, including lender liability, fraud, breach of contract and breach of fiduciary duty. Prior to forming her own firm in 2009, Judge Baer was a partner at Kirkland & Ellis LLP, Winston & Strawn and Schwartz, Cooper, Greenberger & Krauss. She is a member of the ABI and NCBJ Boards of Directors, the CARE National and Chicago Advisory Boards, and the Chicago IWIRC Network Board, as well as several committees. She also is a frequent speaker for ABI, the ABA, the Chicago Bar Association, IWIRC and NCBJ, and she regularly acts as the presiding judge for the Northern District of Illinois in naturalization ceremonies. Judge Baer earned her B.A. from the University of Wisconsin - Madison and her J.D. from DePaul College of Law.

Hon. Daniel P. Collins is a U.S. Bankruptcy Judge for the District of Arizona in Phoenix, appointed on Jan. 18, 2013. He served as chief judge from 2014-18. Previously, he was a shareholder with the law firm of Collins, May, Potenza, Baran & Gillespie, P.C. in downtown Phoenix, practicing primarily in the areas of bankruptcy, commercial litigation and commercial transactions. Judge Collins serves on the Ninth Circuit's Bankruptcy Education Committee, is the education chair for the National Conference of Bankruptcy Judges, will be NCBJ's president in 2022-23, is a member of ABI's Board of Directors, sits on ABI's Education Committee and Diversity Committee, is on the Board of the Phoenix Chapter of the Federal Bar Association, is a Fellow of the American College of Bankruptcy and is a member of the University of Arizona Law School's Board of Visitors. He also is a founding member of the Arizona Bankruptcy American Inn of Court. Judge Collins received both his B.S. in finance and accounting in 1980 and his J.D. in 1983 from the University of Arizona.

Hon. John T. Gregg is a U.S. Bankruptcy Judge for the Western District of Michigan in Grand Rapids, appointed on July 17, 2014. Previously, he was a partner with the law firm of Barnes & Thornburg LLP, where he focused on corporate restructuring, bankruptcy and other insolvency matters. Judge Gregg is the chair of the education committee of the National Conference of Bankruptcy Judges for 2022, serves on the ABI's Board of Directors, was recently inducted as a Fellow of the American College of Bankruptcy, and is a member of the American Law Institute. He is a frequent writer and speaker on bankruptcy and other commercial issues, and he has written and co-edited numerous secondary sources, including *Collier Guide to Chapter 11*, published by LexisNexis; *Strategies for Secured Creditors in Workouts and Foreclosures*, published by ALI-ABA; *Issues for Suppliers and Customers of Financially Troubled Auto Suppliers*, published by ABI; *Michigan Security Interests in Personal Property*, published by the Institute of Continuing Legal Education; *Handling Consumer and Small Business Bankruptcies in Michigan*, published by the Institute of Continuing Legal Education; *Interrupted! Understanding Bankruptcy's Effects on Manufacturing Supply Chains*, published by ABI; and *Receiverships in Michigan*, published by the Institute of Continuing

Legal Education. Judge Gregg received his B.A. in 1996 from the University of Michigan and his J.D. in 2002 from DePaul University College of Law.

Hon. Lisa S. Gretchko is a U.S. Bankruptcy Judge for the Eastern District of Michigan in Detroit, sworn in on April 5, 2021. Prior to her judicial appointment, she spent several decades as a bankruptcy/creditors' rights attorney and represented nearly every constituency in bankruptcy courts around the country, including secured creditors, unsecured creditors' committees, landlords, licensors of intellectual property, customers, suppliers, business debtors and trustees. Judge Gretchko has written and lectured extensively for various organizations on numerous bankruptcy and creditors' rights issues. She currently serves as ABI's Vice President-Publications and as a member of its Executive Committee and Board of Directors, and chairs its Publications Committee. Judge Gretchko is a former Executive Editor of the *ABI Journal* and a former co-chair of the ABI's Unsecured Trade Creditors Committee, which named her 2014 Committee Person of the Year. She also has been named in *Michigan Super Lawyers* and *The Best Lawyers in America*, and she was honored as a Woman in the Law by *Michigan Lawyer's Weekly* in 2011. Judge Gretchko received her B.A. with honors in 1976 from the University of Michigan, where she was elected Phi Beta Kappa, and her J.D. with honors in 1978 from the University of Detroit.

Hon. Bruce A. Harwood is Chief U.S. Bankruptcy Judge for the District of New Hampshire in Concord, appointed to the bench in March 2013. He also serves on the First Circuit's Bankruptcy Appellate Panel. Prior to his appointment to the bench, Judge Harwood chaired the Bankruptcy, Insolvency and Creditors' Rights Group at Sheehan Phinney Bass + Green in Manchester, N.H., representing business debtors, asset-purchasers, secured and unsecured creditors, creditors' committees, trustees in bankruptcy, and insurance and banking regulators in connection with the rehabilitation and liquidation of insolvent insurers and trust companies. He was a chapter 7 panel trustee in the District of New Hampshire and mediated disputes arising in debtor/creditor relations. Judge Harwood serves on ABI's Board of Directors on its Communication, Information and Technology Committee. He served as co-chair of ABI's Commercial Fraud Committee, as program co-chair of (and presently as judicial advisor to) ABI's Northeast Bankruptcy Conference; and as Northeast Regional Chair of the ABI Endowment Fund's Development Committee. He also served on ABI's Civility Task Force. Judge Harwood is a Fellow in the American College of Bankruptcy and was consistently recognized in the bankruptcy law section of *The Best Lawyers in America*, in *New England SuperLawyers* and by *Chambers USA*. He received his B.A. from Northwestern University and his J.D. from Washington University School of Law.

William J. Rochelle, III is ABI's editor-at-large, based in New York. He joined ABI in 2015 and writes every day on developments in consumer and reorganization law. For the prior nine years, Mr. Rochelle was the bankruptcy columnist for Bloomberg News. Before turning to journalism, he practiced bankruptcy law for 35 years, including 17 years as a partner in the New York office of Fulbright & Jaworski LLP. In addition to writing, Mr. Rochelle travels the country for ABI, speaking to bar groups and professional organizations on hot topics in the turnaround community and trends in consumer bankruptcies. He earned his undergraduate and law degrees from Columbia University, where he was a Harlan Fiske Stone Scholar.

Hon. Brendan L. Shannon is a U.S. Bankruptcy Judge for the U.S. Bankruptcy Court for the District of Delaware in Wilmington, appointed in 2006. He manages a full chapter 11 docket and also handles all chapter 13 consumer bankruptcy cases filed in Delaware. He served as Chief Judge from 2014-18. Prior to his appointment to the bench, Judge Shannon was a partner with Young Conaway Stargatt & Taylor, LLP in Wilmington, Del., where he primarily represented corporate debtors and official committees in chapter 11 cases. He is an adjunct professor in the Bankruptcy LL.M. Program at St. John's University School of Law in New York, and at Widener School of Law in Delaware. He also serves on the board of editors of *Collier on Bankruptcy* (16th ed.) and is a contributing author for *Collier Forms* and for several chapters covering the Federal Rules of Bankruptcy Procedure. In addition, he serves on the editorial board of the *American Bankruptcy Institute Law Review*. In 2011, Judge Shannon was appointed to serve as a member of the National Bankruptcy Conference. In 2020, he was inducted as a member of the American College of Bankruptcy. Judge Shannon is a member of the Delaware State Bar Association, the American Bar Association, ABI and the Rodney Inns of Court in Wilmington, Del. He is also a member of the board of directors of the Delaware Council on Economic Education. Judge Shannon received his undergraduate degree from Princeton University and his J.D. from the Marshall-Wythe School of Law at the College of William and Mary.