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BANKRUPTCY
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2017 Midwestern Bankruptcy Institute

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PLENARY SESSION

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American Bankruptcy Institute; New York

2017

American Bankruptcy Institute

Abundant Splits and Other Significant Bankruptcy Decisions

Midwestern Bankruptcy Institute

Kansas City, Missouri
October 27, 2017
8:15 A.M.

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Decided This Term

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

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

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

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

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

The Facts

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

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

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

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

Justice Breyer's Opinion

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

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

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

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

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

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

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

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

The Standing Question

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

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

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

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

'Gift' Plans

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

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

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

The Dissent

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

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

The opinion in the Supreme Court is *Czyzewski v. Jevic Holding Corp.*, 15-649, 2017 BL 89680, 85 U.S.L.W. 4115 (Sup. Ct.). The opinion in the Third Circuit is *Official Committee of Unsecured Creditors v. CIT Group/Business Credit Inc. (In re Jevic Holding Corp.)*, 787 F.3d 173 (3d Cir. May 21, 2015).

High court allows a business model that is based on the inadvertence of trustees and creditors.

Supreme Court Allows Debt Collectors to File Time-Barred Proofs of Claim

Resolving a split of circuits, the Supreme Court held 5/3 today in *Midland Funding LLC v. Johnson* that a debt collector who files a claim that is "obviously" barred by the statute of limitations has not engaged in false, deceptive, misleading, unconscionable, or unfair conduct and thus does not violate the federal Fair Debt Collection Practices Act.

Writing the opinion for the majority in favor of the debt collector, Justice Stephen G. Breyer said that the conclusion on one issue — false, deceptive or misleading — was "reasonably clear." The second issue — unfair or unconscionable — presented a "closer question," he said.

Although importuned to do so by the debt collector, the majority did not rule that the later adoption of the Bankruptcy Code impliedly repealed aspects of the FDCPA. However, the opinion opens the door for debt collectors to purchase time-barred claims for pennies on the dollar and profit by filing those otherwise uncollectable claims, because trustees and debtors will not always object.

Justice Sonia Sotomayor dissented, in an opinion joined by Justices Ruth Bader Ginsburg and Elena Kagan. Justice Sotomayor said, "It takes only common sense to conclude that one should not be able to profit on the inadvertent inattention of others." Justice Neil M. Gorsuch did not participate because he had not been seated on the Supreme Court when the case was argued in January.

Before the high court adjourns for the summer in late June, the justices will rule on a second FDCPA case, *Henson v. Santander Consumer USA Inc.*, and decide whether someone who purchases a claim outright becomes exempt from the FDCPA.

The Facts

The Supreme Court granted *certiorari* to review a decision from the Eleventh Circuit holding that the filing of a stale claim violates the FDCPA, thereby enabling the debtor to recover attorneys' fees and up to $1,000 in statutory damages. The case involved a proof of claim filed by a debt collector where the statute of limitations "had long since run," Justice Breyer said.

The face of the proof of claim disclosed the date of the last activity, from which a lawyer would have known that the claim would be uncollectible.

The chapter 13 debtor objected to the claim, and it was disallowed. The debtor then filed suit under the FDCPA in federal district court in Alabama. The district judge dismissed the suit, saying the FDCPA did not apply. The Eleventh Circuit reversed in May 2016. To read ABI's discussion of the Eleventh Circuit's opinion and the splits of circuits, click here and here.

The Majority Opinion

Justice Breyer broke his majority opinion into two parts. First, he asked whether filing a stale claim was "false, deceptive or misleading." The answer to that question, he said, was "reasonably clear."

Like "the majority of Courts of Appeals that have considered the matter," he said that filing stale claims was neither false, deceptive, nor misleading, in part because Alabama, like most other states, provides that "a creditor has a right to payment of a debt even after the limitations period has expired." He also said that Congress adopted the "broadest available definition of claim," defining the term in Section 101(5)(A) to include a disputed claim. The statute of limitations, Justice Breyer said, has always been an affirmative defense.

He said that the "audience" in a chapter 13 case is a trustee who "is likely to understand" when a claim is time-barred.

Although the courts of appeals have uniformly found a violation of the FDCPA when debt collectors file ordinary civil suits to collect a time-barred claims, Justice Breyer was careful to say that the Court was not deciding that issue.

The second issue — whether filing a time-barred claim is unfair or unconscionable — was a "closer question," Justice Breyer said. The "context of a civil suit differs significantly from" a bankruptcy claim, he explained, since a "knowledgeable trustee is available" when a debtor files a bankruptcy petition.

The FDCPA and the Bankruptcy Code, Justice Breyer said, have "different purposes and structural features." The FDCPA "seeks to help consumers," but not necessarily by "closing a loophole in the Bankruptcy Code." To invoke the FDCPA would upset a "delicate balance" and "authorize a new significant bankruptcy-related remedy in the absence of language in the [Bankruptcy] Code providing for it."

Effectively barring debt collectors from filing stale claims, Justice Breyer said, would require creditors to investigate the merits of affirmative defenses. "The upshot could well be added complexity" and a "change in settlement incentives."

Justice Sotomayor's Dissent

Joined by Justices Ginsburg and Kagan, Justice Sotomayor devoted a significant portion of her dissent to explaining how "[p]rofessional debt collectors have built a business out of buying stale debt, filing claims in bankruptcy . . . and hoping no one notices that the debt is too old." She mentioned that the very same debt collector before the Supreme Court had entered into a consent decree with the government prohibiting the filing of further civil suits to collect stale debts and had paid $34 million in restitution.

Justice Sotomayor believes that filing a stale claim is unfair and unconscionable, just like filing an ordinary civil suit. She said, "Debt collectors do not file these claims in good faith; they file them hoping and expecting the bankruptcy system will fail."

"[E]veryone with actual experience in the matter insists" it is false, Justice Sotomayor said, to believe that bankruptcy trustees are effective gatekeepers who weed out time-barred claims.

The opinion is *Midland Funding LLC v. Johnson*, 137 S. Ct. 1407, 197 L. Ed. 2d 790, 85 U.S.L.W. 4239 (Sup. Ct. May 15, 2017).

Justice Gorsuch's maiden opinion is a unanimous decision favoring debt purchasers.

A Debt Purchaser Is *Not* a 'Debt Collector' Regulated by the FDCPA, Supreme Court Holds

In a unanimous opinion written by Justice Neil M. Gorsuch, the Supreme Court ruled today that someone who purchases a defaulted debt is not a "debt collector" and is therefore not subject to the federal Fair Debt Collection Practices Act, or FDCPA.

The case, *Henson v. Santander Consumer USA Inc.*, was argued on April 18, the second day Justice Gorsuch sat on the bench after being sworn in the week before as the high court's 113th justice. The opinion was Justice Gorsuch's first for the Supreme Court, even though he did not ask a single question or make any comments at oral argument.

Santander had purchased a portfolio of defaulted auto loans from a bank. The district court and the Fourth Circuit both held that Santander was not a "debt collector" and thus not subject to the regulations and remedies afforded to consumers under the FDCPA. The Supreme Court granted *certiorari* to resolve a split because other circuits had held that purchasing debt did not give a debt collector immunity from the FDCPA.

The FDCPA only applies to debt collectors, a term defined in 15 U.S.C. § 1692a(6) as anyone who "regularly collects or attempts to collect . . . debts owed or due . . . another." Justice Gorsuch set about deciding how to classify entities "who regularly purchase debts originated by someone else and then seek to collect those debts for their own account." He framed the question as whether the FDCPA treats "the debt purchaser . . . more like the repo man or the loan originator?"

Justice Gorsuch said the "plain language" of the definition "focuses our attention on third party collection agents working for a debt owner – not on a debt owner seeking to collect debts for itself." He said the statute "does not appear to suggest that we should care how a debt owner came to be a debt owner."

"All that matters," he said, "is whether the target of the lawsuit regularly seeks to collect debts for its own account or does so for 'another.'" That analysis, he said, "would seem" to mean that a debt purchaser does not fall under the statutory definition.

Justice Gorsuch then launched into a complex statutory and grammatical analysis, focusing largely on the word "owed." He cited two grammar books alongside the Oxford English Dictionary to debunk the notion that "owed," a past participle, means a debt previously owed to another.

Harping on the use of the past participle "doesn't follow even as a matter of good grammar, let along ordinary meaning," Justice Gorsuch said. Focusing also on how "owed" is used elsewhere in the FDCPA, he could not "see why a defaulted debt purchaser like Santander couldn't qualify as a creditor" under the "statute's plain terms."

The debtor did not fare any better with a policy argument based on the idea that the business of purchasing defaulted debt did not exist when the FDCPA was adopted. The debtor wanted the Court to believe that Congress would have viewed defaulted debt purchasers more like debt collectors than debt originators.

Justice Gorsuch declined to consult a crystal ball because "it is never our job to rewrite a constitutionally valid statutory text under the banner of speculation about what Congress might have done." He said the "proper role of the judiciary" is to "apply, not amend, the work of the People's representatives."

The opinion theoretically leaves the door open for a different result in a later case given two questions the Court did not decide. First, the debtor argued that Santander fell under the FDCPA because it regularly collected debts for another. Justice Gorsuch said that question was not raised in the petition for *certiorari*, and the Court did not agree to review it.

Second, Justice Gorsuch said the Supreme Court had not agreed to address another aspect of the definition of a debt collector in Section 1692a(6), which includes someone "in any business the principal purpose of which is the collection of any debts."

Today's decision was the high court's second venture this term into the FDCPA. On May 15 the Court held 5/3 in *Midland Funding LLC v. Johnson*, 16-348, 2017 BL 161314, 85 U.S.L.W. 4239 (Sup. Ct. May 15, 2017), that filing a time-barred claim does not violate the FDCPA. To read ABI's discussion of *Midland Funding*, click here.

The opinion is *Henson v. Santander Consumer USA Inc.*, 137 S. Ct. 1718, 198 L. Ed. 2d 177, 85 U.S.L.W. 4346 (Sup. Ct. June 12, 2017).

The Bristol-Myers decision on state class actions may eventually affect bankruptcy venue.

Did the Supreme Court Hint that Bankruptcy Venue Is Too Broad?

In June, the Supreme Court took a long step toward allowing plaintiffs to mount nationwide class actions in state court only in states where the defendants are incorporated or headquartered, or maintain their principal assets. Will *Bristol-Myers Squibb v. Superior Court of California*, 16-466, 2017 BL 208398, 85 U.S.L.W. 4400 (Sup. Ct. June 19, 2017), prompt courts to revisit rulings under the bankruptcy venue statute that allow companies to reorganize in Delaware or New York regardless of where they are located?

The answer is: By emphasizing the due process rights of defendants, *Bristol-Myers* could be read to imply that courts should assign more significance to the interests of creditors and employees in making bankruptcy venue decisions.

Bankruptcy Venue Standards

The bankruptcy venue statute, 28 U.S.C. § 1408, allows companies to file chapter 11 petitions in the states where they are incorporated or have a principal place of business, or where their principal assets are located. Since many of the country's larger companies are incorporated in Delaware or New York, those states are proper venues, even if the debtor has virtually no operations there.

There is another loophole: the affiliate venue provision in subsection 1408(2). As happened with Eastern Airlines, a large company with an inconsequential affiliate can file in New York or Delaware if that affiliate is incorporated in one of those states or has its principal assets there, even if the parent might not otherwise be eligible for venue in those favored jurisdictions.

If venue is proper under the generous bankruptcy venue rules, a court will change venue under 28 U.S.C. § 1412 "in the interest of justice or for the convenience of the parties." Assuming venue was proper in the first place, courts are generally prone to allow the case to proceed in the district chosen by the debtor and preferred by the major institutional lenders. The preferences of ordinary trade creditors and employees usually do not carry the day on a change of venue motion.

Bristol-Myers and Class Actions

In *Bristol-Myers*, the plaintiffs tried using a notion of jurisdiction that could be called the class action cousin of expansive bankruptcy venue. They sued a huge pharmaceutical company in

California, alleging harmful effects from a blockbuster drug that was generating billions a year in sales throughout the U.S.

Among the 600 plaintiffs, only 86 were California residents. The remainder were from 33 other states.

In the 8/1 opinion for the majority on June 19, Justice Samuel A. Alito Jr. said that the pharmaceutical defendant was incorporated in Delaware, had its head office in New York, and had substantial operations in New York and New Jersey. In California, the company had about 400 employees and five research facilities. The drug was neither developed nor manufactured in California; the marketing, manufacturing and regulatory approval for the drug were managed in New York or New Jersey.

In view of the Supreme Court's decision in *Daimler AG* v. *Bauman*, 571 U.S. 134 S. Ct. 746, 187 L. Ed. 2d 624, 82 U.S.L.W. 4043 (2014), the California Supreme Court concluded that the state trial court did not have general jurisdiction over the manufacturer. However, the state's high court did find specific jurisdiction. The Supreme Court granted *certiorari* to decide whether the exercise of specific jurisdiction violated the Due Process Clause of the Fourteenth Amendment.

Justice Alito explained the differences between general and specific jurisdiction. General jurisdiction arises where the defendant is "at home," for instance, in the state of incorporation. As Justice Alito said, a state court with general jurisdiction can "hear any claim against that defendant, even if all the incidents underlying the claim occurred in a different state."

"Specific jurisdiction is very different," he said. To exercise specific jurisdiction within the bounds of the Constitution, the suit must "'aris[e] out of or relat[e] to the defendant's contacts with the forum.'" Quoting another high court precedent, he said that specific jurisdiction is limited to "'issues deriving from, or connected with, the very controversy that establishes jurisdiction.'"

Justice Alito said there was no specific jurisdiction within constitutional boundaries for the non-California residents, because they did not claim to have suffered harm in that state and all of the conduct giving rise to their claims arose in other states.

Justice Alito made several observations that might be relevant in the bankruptcy context. It is often argued that bankruptcy venue far from a company's employees and the bulk of its trade creditors puts a burden on them and makes participation difficult or expensive. In the context of class actions, Justice Alito that the "the 'primary concern' is the 'burden on the defendant.'" He also alluded to "practical problems resulting from litigating in that forum."

On a topic that is arguably less significant in federal courts, he mentioned the "coercive power of a state that may have little legitimate interest in the claims in question."

At the end of his opinion, Justice Alito cited the defendant's admission that all of the plaintiffs could have sued together in either New York or Delaware.

Of ominous significance for bankruptcy cases and class actions alike, he said the opinion leaves "open the question of whether the Fifth Amendment imposes the same restrictions on the exercise of personal jurisdiction by a federal court."

The sole dissenter, Justice Sonia Sotomayor, summarized the majority opinion as meaning that "a corporation that engages in a nationwide course of conduct cannot be held accountable in a state by a group of injured people unless all of those people were injured in the forum state." She said, "there is nothing unfair about subjecting a massive corporation to suit in a state for a nationwide course of conduct that injures both forum residents and nonresidents alike."

She interpreted the opinion to mean that the Court has barred "nationwide class actions in any state other than those in which a defendant is 'essentially at home.'"

In substance, the majority and the dissent focused on fairness, although the majority focused on fairness to the defendant while Justice Sotomayor focused on fairness to the injured plaintiffs.

Implications of *Bristol-Myers* in Bankruptcy

Does *Bristol-Myers* mean anything about bankruptcy venue? Facially, the opinion means nothing at all.

Bristol-Myers deals with constitutional limitations on state courts' exercise of jurisdiction. In that sense, *Bristol-Myers* is irrelevant because bankruptcy courts clearly have subject matter jurisdiction, and, within the limits of *Stern v. Marshall*, its predecessors and progeny, bankruptcy courts exercise personal or *in rem* jurisdiction over the debtor, its assets and its creditors. Furthermore, most courts have upheld venue in the popular districts despite a debtor's lack of connections with those forums, as long as venue is technically proper.

Bristol-Myers, however, focused on fairness to the defendants as a matter of constitutional law. If that is the test, the identity of the defendant is not so clear in bankruptcy. Are creditors the defendants in bankruptcy? Or is the debtor more akin to the defendant? Or does *Bristol-Myers* imply there must be fairness to both creditors and debtors?

Bankruptcy venue has not been thought to raise questions of due process. In light of *Bristol-Myers*, should courts consider whether a distant bankruptcy venue impinges the due process rights of a debtor's employees and creditors? What about the rights of institutional lenders with the most dollars at risk?

It seem clear that the bankruptcy venue statute does not raise a due process violation on its face. If there is a conflict with the Constitution, it would arise "as applied." In venue decisions, though, courts already weigh the interests of distant creditors and employees, but perhaps not with the weight required if there were constitutional issues afoot.

If *Bristol-Myers* means anything in the bankruptcy context, it may mean that bankruptcy courts should give more weight to the interests of creditors and employees when deciding venue disputes. *Bristol-Myers* could therefore mean that a debtor's choice of venue may not be as broad as it seems on the face of the statute.

If the Supreme Court drops the other shoe and someday rules that the Fifth Amendment imposes the same restrictions in federal court, the direct implications for bankruptcy will be unavoidable. If class actions in federal court are limited to states of incorporation, principal office or principal assets, using a subsidiary as a venue hook for the entire enterprise may no longer be available if *Bristol-Myers* is expanded to cover federal courts. And if there are constitutional considerations beyond the language of the venue statutes, courts may begin forcing companies to reorganize closer to home.

Although broad bankruptcy venue has been criticized for decades, Congress has not been moved to amend that statute. Congressional acquiescence will not matter, however, if constitutional issues are at the forefront.

The opinion is *Bristol-Myers Squibb v. Superior Court of California*, 16-466, 2017 BL 208398, 85 U.S.L.W. 4400 (Sup. Ct. June 19, 2017).

Next Term

High court won't decide whether a claim purchaser automatically takes seller's insider status.

Supreme Court Grants '*Cert*' on Appellate Standards for Non-Statutory Insider Status

The Supreme Court granted *certiorari* today in *U.S. Bank NA v. The Village at Lakeridge LLC*, but the high court will *not* review the more important question for chapter 11 practice.

The justices will not decide whether the purchaser of a claim automatically takes on the seller's insider status, perhaps because the justices perceive no conflict among the circuits. Rather, the court will decide whether the standard of review for non-statutory insider status is *de novo* or clearly erroneous, or a combination of both.

Curiously, the Acting Solicitor General recommended denial of *certiorari*, believing that in reality there are no circuit splits and that the Ninth Circuit made the correct holdings. To the contrary, the petitioner contends that the Third, Seventh and Tenth Circuits employ the *de novo* standard while the Ninth Circuit "for the first time" employed the clearly erroneous standard.

The Ninth Circuit Opinion

In the chapter 11 case that came to the Ninth Circuit, there were only two creditors. One was a bank with a $10 million secured claim. The other was the debtor's general partner, with a $2.8 million unsecured claim. As an insider, the general partner's vote in favor of the plan could not be counted under Section 1129(a)(10). For lack of an accepting class, the plan could not have been confirmed and crammed down, because the bank opposed the plan.

Hoping to confirm using cramdown, the general partner sold his claim for $5,000 to a close friend of one of the owners of the general partner. The plan called for a $30,000 distribution on the unsecured claim.

The bankruptcy judge ruled that the buyer automatically became an insider upon purchasing the claim and thus could not be the accepting class. The Bankruptcy Appellate Panel reversed and was upheld in a 2-1 opinion in February 2016, with Circuit Judge N. Randy Smith writing for the majority.

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

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

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

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

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

The *Certiorari* Petition

The lender filed a petition for *certiorari* in June 2016, raising three issues: (1) whether the purchaser of an insider's claim automatically acquires the seller's insider status under Sections 1129(a)(10) and 101(31); (2) whether the standard of review on non-statutory insider status is *de novo* or clear error; and (3) whether the test for non-statutory insider status is an "arms' length" analysis or a "functional equivalent" test.

In October, the justices invited the Acting Solicitor General to file a brief "expressing the views of the United States."

In a brief filed in February, the Acting Solicitor General recommended that the Court deny the *certiorari* petition, saying that the circuit court properly articulated and applied the standards for appellate review. The government also could not discern any conflict among the circuits on the issues presented in the petition.

According to the government, the Ninth Circuit correctly applied the appellate standards: The bankruptcy court's conclusions of law are reviewed *de novo*, and its findings of fact are reviewed for clear error. Concluding that "[f]urther review is not warranted," the government said that the Ninth Circuit's "application of the governing legal standard in conducting clear error review of the bankruptcy court's factual findings raises no issue of general importance."

The Supreme Court Cogitates

The justices were originally scheduled to pass on the *certiorari* petition at a conference on March 17. On March 20, the Court rescheduled the conference for March 24. Rescheduling consideration of a petition is sometimes an indication that the justices may be inclined to review the case.

In an order on March 27, the Court granted the petition, but "limited [review] to Question 2 presented in the petition," regarding the standard of review. Not granting review of the first issue may be an indication that the justices see no conflict of circuits on the holding that the purchaser of a claim does not automatically assume the seller's insider status.

The petition was granted too late for the Court to hold argument in time for a decision to be made before the current term ends in late June. Argument likely will be scheduled not long after the new term begins in October, assuming there are no delays in the parties' submissions of briefs on the merits.

To read ABI's discussion of the Ninth Circuit opinion, click here. For discussion of the Acting Solicitor General's views, click here.

To read the Ninth Circuit opinion, click here. The opinion is officially reported at *U.S. Bank NA v. The Village at Lakeridge LLC (In re The Village at Lakeridge LLC)*, 814 F.3d 993 (9th Cir. 2016).

The case in the Supreme Court is *U.S. Bank NA v. The Village at Lakeridge LLC,* 15-1509 (Sup. Ct.).

ROCHELLE'S DAILY WIRE

Justices to rule on a narrow issue regarding the 'safe harbor' and leveraged buyouts.

Supreme Court to Decide Whether Using a 'Mere Conduit' Invokes the 546(e) 'Safe Harbor'

The Supreme Court granted *certiorari* today to resolve a split of circuits and decide whether the "safe harbor" for securities transactions applies under Section 546(e) when a financial institution acts only as a "mere conduit" with no beneficial interest in the stock being sold in a leveraged buyout.

The Court will review the Seventh Circuit's decision in *FTI Consulting Inc. v. Merit Management Group LP*, 830 F.3d 690 (7th Cir. July 28, 2016), where "mere conduit" is the only issue.

The justices are yet to act on the *certiorari* petition in *Deutsche Bank Trust Co. Americas v. Robert R. McCormick Foundation,* 16-317 (Sup. Ct.), which raises the "mere conduit" question along with several others under Section 546(e). Indeed, the Second Circuit gave the broadest possible interpretation of the safe harbor by holding that it supersedes state law and precludes creditors from bringing fraudulent transfer claims of their own against third parties when the selling corporation goes bankrupt.

Chief Circuit Judge Diane P. Wood wrote the decision for the Seventh Circuit in July 2016. Her opinion stands for the proposition that routing consideration for an LBO of a non-public company through a financial institution cannot preclude a fraudulent transfer attack if the seller was rendered insolvent. How her decision would apply to a leveraged buyout of a public company is not clear.

Judge Wood's decision was in the minority. Only the Eleventh Circuit has similarly held that using a financial institution as a conduit does not invoke the "safe harbor." The Second, Third, Sixth, Eighth and Tenth Circuits take the contrary view and apply the safe harbor when a financial institution is nothing more than a conduit.

The Seventh Circuit employed a powerful bench to decide the safe harbor question. With her on the panel were Circuit Judges Richard A. Posner and Ilana D. Rovner. The appeals court denied rehearing *en banc*.

With today's grant of *certiorari*, the Supreme Court already has two bankruptcy cases on the calendar for the term to begin in October 2017. In late March, the justices agreed to hear *U.S. Bank*

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NA v. The Village at Lakeridge LLC, 15-1509 (Sup. Ct.), and decide whether the purchaser of a claim automatically takes on the seller's insider status.

To read ABI's discussion of Judge Wood's decision, click here.

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

A settlement prompts the high court to ditch a case deciding whether state or federal law governs recharacterization.

Supreme Court Will Not Resolve Circuit Split on Recharacterization

There are now only two bankruptcy cases on the Supreme Court's calendar for the upcoming term because the high court dismissed the petition for *certiorari* that it had granted in late June in *PEM Entities LLC v. Levin*, 16-492 (Sup. Ct.).

In *PEM*, the Supreme Court would have resolved a split of circuits by deciding whether bankruptcy courts must employ state or federal law in recharacterizing debt as equity.

All circuits empower bankruptcy courts to recharacterize debt. The Fifth and Ninth Circuits follow state law and Section 502, while the Third, Fourth, Sixth, Tenth and Eleventh Circuits invoke federal law, relying on Section 105(a).

The *PEM certiorari* petition was fully brief in mid-March and was first scheduled for conference on March 31. The conference was rescheduled several times until the Court ultimately considered and granted the petition on June 27.

In April, however, the parties settled. The debtor, who had not been a party to proceedings in the Supreme Court, filed papers in July seeking permission to be granted status as a party and defend the ruling from the Fourth Circuit.

Evidently, the justices concluded that the dispute had become moot, or perhaps it appeared there was insufficient adversariness. Although the reasons are not spelled out in the Aug. 10 order, the Court dismissed the petition for having been improvidently granted.

The split remains, so the Court well might grant *certiorari* when another case on recharacterization percolates through a circuit court.

Two bankruptcy cases remain on the high court's docket for the term beginning in October. Of perhaps greater significance for the bankruptcy bar and the investment community, the Supreme Court will decide in *Merit Management Group LP v. FTI Consulting Inc.*, 16-784 (Sup. Ct.), whether the "safe harbor" for securities transactions applies under Section 546(e) when a financial institution acts only as a "mere conduit." The case should be argued before the year's end. To read ABI's discussion of *Merit Management*, click here.

In *U.S. Bank NA v. The Village at Lakeridge LLC,* 15-1509 (Sup. Ct.), the justices will decide whether the purchaser of a claim automatically takes on the seller's insider status. Lakeridge also should be argued before the new year. To read ABI's discussion of *Lakeridge*, click here.

The recharacterization case was *PEM Entities LLC v. Levin*, 16-492 (Sup. Ct.).

ROCHELLE'S DAILY WIRE

Reorganization

ROCHELLE'S DAILY WIRE

Sales

Adequate protection is a 'powerful check' on selling real estate free of leases, circuit says.

Ninth Circuit Joins Minority in Allowing Sales Free & Clear of Leases

Joining the Seventh Circuit and embracing a result reached by a minority of courts, the Ninth Circuit held that a "free and clear" sale under Section 363 can extinguish a lease of real property, at least when the bankruptcy sale is a rough equivalent of mortgage foreclosure and the lessee does not have a nondisturbance agreement or a subordination of the mortgage.

The July 13 opinion, written by Senior District Judge Frederic Block, sitting by designation from the Eastern District of New York, deals with the seeming conflict between Section 363(f), which permits sale of property free and clear "of any interest," and Section 365(h), which allows a lessee of a rejected lease to retain possession of the property for the remainder of the term of the rejected lease.

The case involved a resort where one of the owners had two leases for commercial property. Both leases called for annual rent of about $1,000. One lease was for 99 years and the other for 60 years. When the project filed a chapter 7, the debtor owed more than $120 million on the mortgage. The bankruptcy court later found that the fair market value of the leases was between $40,000 and $100,000 a year.

The mortgage lender agreed to allow a sale of the property, where the winning bid was about $26 million. The insider-tenants contended that the sale could not be free and clear of the leases in view of Section 365(h). The bankruptcy court ruled that the leases did not survive the sale. The district court affirmed.

Judge Block said that a majority of courts – none at the circuit level – hold that Section 365(h), the more specific provision, protects tenants when property is sold free and clear under Section 363(f).

The minority, Judge Block said, is represented by the Seventh Circuit, which held in *Qualitech Steel* that property can be sold free and clear of a lease so long as the lessee is given adequate protection, as required by Section 363(e).

Coming down on the side of the Seventh Circuit, Judge Block held that Section 363 alone governed and there was no conflict between the sections because there had been no rejection of the lease prior to or alongside the sale. Therefore, he said, "Section 365 was not triggered."

Although Section 365(h) may not apply, Judge Block said that "the broad definition of adequate protection makes it a powerful check on potential abuses of free-and-clear sales." In that respect, he cited *Dishi & Sons* from the Southern District of New York, where adequate protection took the form of continued possession.

Judge Block was not required to decide what adequate protection the tenant was entitled to receive because there was no request by the tenant until after the sale. He therefore turned to the question of whether Section 363(f) entitled the trustee to sell the property free of leases.

Focusing on Section 363(f)(1), which permits free and clear sales under applicable nonbankruptcy law, Judge Block said that the "bankruptcy proceeded, practically speaking, like a foreclosure sale." Were there no bankruptcy, he "confidently" said there would have been an actual foreclosure coupled with termination of the leases, because the mortgage was not subordinated to the leases and there were no nondisturbance agreements.

Upholding the sale free of the leases because they had not been rejected, Judge Block said that Section 365(h)(1)(A)(ii) shows an intent "to protect lessees' rights outside of bankruptcy, not an intent to enhance them."

Although the opinion avoids saying whether the insider-tenants would have been entitled to adequate protection had they made a timely request, Judge Block implies there would have been none because occupancy rights would have been extinguished in foreclosure.

Likewise, the opinion does not say whether the result would have been different had the trustee rejected the leases before selling the property. Given that rejection of a lease equates to a court-authorized breach, the result might have been the same since the right to possession would have been terminated by a subsequent foreclosure.

The opinion is *Pinnacle Restaurant at Big Sky LLC v. CH SP Acquisitions LLC (In re Spanish Peaks Holdings II LLC)*, 862 F.3d 1148 (9th Cir. July 13, 2017).

Equity is required to claim a homestead exemption, Sixth Circuit holds.

Sixth Circuit Widens Split on Mooting Appeals from Sale Orders

The Sixth Circuit widened an existing split on mooting appeals from sale orders and went on to hold that a consumer cannot claim a homestead exemption without equity in her residence, even if the trustee has cobbled together a deal with a distribution of sale proceeds to unsecured creditors that cuts out the debtor.

A woman in Michigan filed a chapter 7 petition and scheduled her home as worth $170,000 but encumbered by mortgages totaling almost $220,000. Originally, the debtor stated her intention to surrender the property and claimed no homestead exemption.

With the lenders' consent, the trustee sold the home for $160,000. The holder of the first mortgage agreed to take about $148,000 in full satisfaction of the debt, with $6,000 earmarked for the second mortgagee. After paying the brokerage fee and closing costs, the trustee would have money left for distribution to unsecured creditors.

Now claiming a homestead exemption, the debtor objected and contended that she was entitled to some of the sale proceeds. The bankruptcy judge overruled the debtor's objection and approved the sale. The district court affirmed in May.

When the debtor appealed to the Sixth Circuit, the trustee argued that the appeal was moot under Section 363(m), which provides that reversal or modification of a sale-approval order "does not affect the validity of a sale" to a good faith purchaser in the absence of a stay pending appeal.

In his March 20 opinion for the appeals court, Circuit Judge Gilbert S. Merritt noted the existing split of circuits on Section 363(m). He said a majority of circuits employ a *per se* rule and automatically dismiss an appeal from a sale order in the absence of a stay.

The Third and Tenth Circuits, he said, take an opposing view and impose an additional condition by requiring the appellee to prove that the court cannot grant effective relief before the appeal is dismissed.

Judge Merritt sided with the Third and Tenth Circuits. He held that the appellate court must be "unable to grant effective relief without affecting the validity of the sale" before dismissing under Section 363(m).

According to Judge Merritt, the additional condition to dismissal "is in line with the plain language" of the statute and upholds "the validity of bankruptcy sales without unduly restricting the appellant's right to contest errors of law made by the bankruptcy court."

Because the trustee had not shown why effective relief was impossible, Judge Merritt concluded that the appeal was not moot. He then turned to the merits.

In a nonprecedential opinion called *Baldridge*, the Sixth Circuit said in 2014 that a debtor cannot claim an exemption without equity in the property. Although *Baldridge* was not binding precedent, Judge Merritt followed it.

He said that the Third Circuit and the Ninth Circuit Bankruptcy Appellate Panel reached the same conclusion based on similar facts. He cited the BAP for the proposition that the "value that can be exempted is the unencumbered portion."

To read ABI's discussion of the district court opinion, click here.

The opinion is *Brown v. Ellmann (In re Brown)*, 851 F.3d 619 (6th Cir. March 20, 2017).

ROCHELLE'S DAILY WIRE

Estate Property

Michigan law enables a lender to short circuit an attempted reorganization.

Circuit Says a Perfected Assignment of Rents Takes Property Out of the Estate

Perfecting an assignment of rents under Michigan law takes that income out of the estate and can render reorganization impossible, according to a May 2 decision from the Sixth Circuit.

The holding means that an owner of real estate in Michigan or in states with similar laws cannot wait until the last minute before filing a chapter 11 petition.

The case involved a defaulted mortgage on a multi-family residential project. According to the opinion by Circuit Judge Jane B. Stranch, the loan was secured by a mortgage on the property and an absolute assignment of rents.

After giving notice of default, Judge Stranch said the lender gave additional notices and took all steps necessary under Michigan law "to make the assignment of rents binding on both [the debtor] and the tenants." Among other things, the lender gave notice to the tenants that they must pay rent to the lender, not the debtor.

Later, the debtor filed a chapter 11 petition and negotiated a cash collateral order allowing the debtor to use some of the rents to operate the property. A month later, the lender filed a motion to prohibit the debtor from using rent. The bankruptcy court denied the motion, saying the lender had cash collateral and was entitled to adequate protection.

On appeal, the district court reversed and held that the rent was not property of the estate. In her opinion for the Sixth Circuit, Judge Stranch affirmed.

Citing *Butner*, she said that property rights are determined by state law. After surveying the history of the Michigan statute, she made an *Erie* guess and held that "a completed assignment of rents [is] a transfer of ownership." Michigan courts, she said, consistently hold that ownership of rent transfers once the lender has taken all the steps to perfection required by statute.

The debtor argued, unsuccessfully, that *Whiting Pools* justified the bankruptcy court's ruling. In that case, the Supreme Court held that property seized by the Internal Revenue Service before bankruptcy under a tax lien was part of the bankruptcy estate because the debtor had an ownership interest until a tax sale to a *bona fide* purchaser had taken place.

"Despite the broad scope of chapter 11 bankruptcy estates," Judge Stranch concluded that *Whiting Pools* was not controlling because "assigned rents in this case are not properly included in" the estate.

Judge Stranch cited several lower court opinions reaching the same result under Michigan law and holding that assigned rents are not property of the estate. In one of the opinions, a bankruptcy judge in New York refused to confirm a plan because, under Michigan law, the debtor lost ownership of the rent and could not fund a plan.

Although Michigan law can benefit a lender whose borrower is headed toward bankruptcy, the statute can also work against the lender. According to authority cited by Judge Stranch, a judgment creditor can obtain an interest in rent ahead of the lender if the lender has not taken all steps necessary for perfection.

The opinion is *Town Center Flats LLC v. ECP Commercial II LLC (In re Town Center Flats LLC)*, 855 F.3d 721 (6th Cir. May 2, 2017).

Jurisdiction & Power

Seventh Circuit complicates life for bankruptcy judges in deciding a case involving magistrates.

Seventh Circuit Requires *Stern* Consent from Unserved Defendants in Non-Core Suits

In a case involving a plaintiff proceeding *in forma pauperis*, or IFP, the Seventh Circuit created doubt about the ability of a bankruptcy judge, in a non-core suit involving numerous named defendants, to enter a final order on consent of the plaintiff and a defendant who was served when there are named but unserved defendants.

The Case Before the Magistrate

Intending to proceed IFP without paying the filing fee under 28 U.S.C. § 1915, an individual filed suit in federal district court naming the Wisconsin labor department as defendant. The plaintiff consented to proceeding before a U.S. magistrate judge for all purposes.

Employing screening procedures invoked in IFP proceedings, the magistrate judge examined the complaint and dismissed the suit under 28 U.S.C. § 1915(e) for failure to state a claim, before the defendant had even been served.

The plaintiff appealed. *Sua sponte*, the appeals court identified "significant questions of appellate jurisdiction" and appointed Travis Crum from the Washington, D.C., office of Mayer Brown LLP to represent the plaintiff-appellant. Crum had been a clerk for Supreme Court Justices M. Anthony Kennedy and John Paul Stevens.

The Seventh Circuit was tasked with deciding whether the magistrate judge had power to enter a final order of dismissal when the unserved defendant had not consented. After briefs were filed and oral argument was held in early November 2016, the decision came down on June 16, and it was a humdinger, with Seventh Circuit judges all over the map.

Disagreements Among Seventh Circuit Judges

On the three-judge panel, Chief Circuit Judge Diane P. Wood wrote the majority opinion, joined by Circuit Judge Ann Claire Williams. They concluded that the IPF statute, the Magistrate Judges Act and constitutional considerations in the wake of *Stern v. Marshall* require waiver from at least one unserved defendant before an Article I judge can enter a final order.

Circuit Judge Richard A. Posner dissented, believing no consent is required from non-served parties.

The panel distributed the opinion to determine whether sufficient circuit judges favored rehearing *en banc*. Circuit Judges Frank H. Easterbrook and Diane S. Sykes dissented from the denial of rehearing *en banc*, agreeing with the result advocated by Judge Posner but disagreeing with how he got there.

There is another curious feature to the opinion. On the issue before the appeals court, there were two prior Seventh Circuit opinions 12 years apart that seemingly reached differing results, with the more recent case not citing the former. Perhaps because the facts and the procedural contexts were not precisely the same, the more recent panel may not have felt bound by the first, which had issued a *per curiam* opinion where the issue was mentioned in a footnote. Consequently, the majority opinion by the three-judge panel says it overrules the more recent of the two prior decisions in the circuit without rehearing *en banc*, although the judges did vote on rehearing. Possibly also, the majority believed that the more recent three-judge panel had no authority to overrule the decision made 12 years earlier.

The Three Opinions

Before we explain how the opinions may affect bankruptcy practice, let's explain the majority holding and the views of the dissenters.

The Magistrate Judges Act, in 28 U.S.C. § 636(c)(1), allows a magistrate judge to enter final judgment "upon the consent of the parties." The appeals court was called on to decide whether "parties" means all the named parties or only the parties before the court that have been served.

The circuits are already split. The Fifth Circuit and one of the Seventh Circuit opinions hold that "parties" does not include unserved defendants. The Eighth Circuit and the other Seventh Circuit opinion concluded that "parties" includes named defendants, whether or not they have been served.

After lengthy study of the statute, the majority concluded that an unserved defendant is a party whose consent is required. The majority appeared to say that consent from one defendant is sufficient if there are multiple defendants.

Significant for bankruptcy cases, the majority said that any doubt about the interpretation of the statute "would be laid to rest by the constitutional problem that would arise if we were to hold that the consent of one party alone was enough to permit an Article I judge to resolve the case on the merits." Citing *Wellness International*, *Marathon Pipeline* and *Stern*, the majority said that "institutional concerns" give "final decision making authority only to Article III judges, unless all parties consent to an alternative."

The majority held that consent by an unserved defendant is "more consistent" with the statute and better respects the "constitutional line" between Article III judges and "other adjudicators."

Further linking the decision about magistrate judges to bankruptcy judges, the majority said that "the role of the magistrate judge must parallel that of the bankruptcy judges after *Stern*."

Dissenting, Judge Posner believed that express consent is not required from unserved defendants. Citing *Wellness International*, which held that implied consent is sufficient in the bankruptcy context, he said that an unserved defendant's consent "can be taken for granted because the defendant has no interest in having the case continue."

Dissenting from the denial of hearing *en banc*, Judges Easterbrook and Sykes would not require consent from unserved parties under Section 636(c).

Important for bankruptcy practice, Judges Easterbrook and Sykes disagreed with Judge Posner's view that an unserved defendant consents "implicitly, constructively, or in any other way."

More significant for bankruptcy, the two judges said that the majority's opinion would require a district judge in "every suit with an un-served or unknown defendant." They disagreed with the majority's view that consent from one defendant is enough when there are multiple defendants.

Since *res judicata* would not bind an unserved defendant, the two judges would require consent under Section 636(c) only from the parties who would be bound by the judgment.

Implications for Bankruptcy

The implications are ominous for bankruptcy cases. For example, assume a plaintiff files a non-core suit against several defendants, but serves only one. Also assume that the plaintiff and the served defendant consent to final adjudication in bankruptcy court.

The Seventh Circuit case means that the bankruptcy court must decide whether there is constitutional authority to issue a final judgment even though other named defendants have not been served.

Now that the cat is out of the bag on yet another obtuse issue raised by *Stern*, let's hope that Wisconsin latches onto the conflict of circuits and files a petition for *certiorari*, allowing the Supreme Court to decide whether consent is required from non-served defendants.

The opinion is *Coleman v. Labor & Industry Review Commission of the State of Wisconsin*, 860 F.3d 461 (7th Cir. June 16, 2017).

First Circuit narrowly interprets 'arising in' jurisdiction.

Retention of Jurisdiction by Itself Does Not Confer Subject Matter Jurisdiction, Circuit Holds

Despite retention of jurisdiction provisions in a sale-approval order and a chapter 11 confirmation order, the bankruptcy court lacked jurisdiction over a dispute between third parties involving an asset purchase agreement because there was no "arising in" jurisdiction, the First Circuit held.

In other words, retention of jurisdiction is a necessary but not sufficient condition to exercise jurisdiction, according to the June 2 opinion by Circuit Judge Kermit V. Lipez. Retired Supreme Court Justice David H. Souter was on the unanimous panel.

The corporate debtor sold its hospital pursuant to a sale-approval order shortly after filing a chapter 11 petition. The contract obligated the buyer to pay severance to employees it did not retain. The sale-approval order contained a provision providing for the bankruptcy court to retain jurisdiction over any disputes arising under or related to the sale contract. The plan and confirmation order provided for the retention of jurisdiction to enforce orders providing for the sale of property.

Immediately after closing, the buyer fired two senior executives and refused to pay severance. The executives sued, and the bankruptcy court awarded them severance. The bankruptcy court found jurisdiction based on the retention of jurisdiction provisions.

The district court reversed, finding no subject matter jurisdiction. Judge Lipez upheld dismissal for the same reason.

Judge Lipez said it was "erroneous" for the bankruptcy court to find jurisdiction "solely on the basis of the retention of jurisdiction provisions in the sale order and the plan." Although a federal court may enforce its prior orders, he said it may not "retain" jurisdiction "it never had – *i.e.*, over matters that do not fall within" 28 U.S.C. § 1334.

Judge Lipez therefore analyzed whether there was "arising under," "arising in" or "related to" jurisdiction under Section 1334. There was no "related to" jurisdiction because there was no potential effect on the bankrupt estate since the bankruptcy judge had decided that the executives had no claims against the debtor.

There was no "arising under" jurisdiction, Judge Lipez said, because the Bankruptcy Code itself did not create the cause of action. That left "arising in" as the executives' only jurisdictional hook.

The executives contended there was "arising in" jurisdiction because the bankruptcy court had approved the purchase agreement. Judge Lipez responded by saying, "[I]t is not enough for 'arising in' jurisdiction that a claim arose in the context of a bankruptcy case." He said the claim "must have 'no existence outside of the bankruptcy,'" citing *Middlesex Power Equip. & Marine Inc. v. Town of Tyngsborough, Mass. (In re Middlesex Power Equip. & Marine Inc.)*, 292 F.3d 61 (1st Cir. 2002).

For "arising in" jurisdiction, Judge Lipez said the "fundamental question" is whether the claim "could arise *only* in the context of a bankruptcy case." [Emphasis in original.]

To adjudicate the executives' severance claims on the merits, a court "would only need to perform a state law breach of contract analysis." Therefore, Judge Lipez said, the executives' "claims 'look like ones that could have arisen entirely outside the bankruptcy context.'"

There was no "arising in" jurisdiction because the executives "failed to identify any provision of the sale order itself or any related questions of bankruptcy law underlying their claims that would require interpretation by the bankruptcy court."

Jurisdictionally speaking, Judge Lipez's opinion therefore appears to make a distinction between a sale-approval order and the contract it approved. Enforcing the contract by itself does not give rise to jurisdiction, unless there were an effect on the estate. Or, the bankruptcy court may have had jurisdiction if there were an ambiguity in the sale order, or perhaps if the sale order itself had required payment.

The opinion therefore seems to mean that third parties may have difficulty calling on a bankruptcy court to approve a court-approved contract absent an effect on the estate.

The opinion is *Gupta v. Quincy Medical Center*, 858 F.3d 657 (1st Cir. June 2, 2017).

Bankruptcy courts can't issue final orders approving third-party releases in chapter 11 plans.

Delaware District Judge Issues Important Opinion on Third-Party Releases

Without making a definitive ruling, a district judge in Delaware said that *Stern v. Marshall* and its progeny preclude a bankruptcy court from entering a final order granting non-consensual third-party releases of non-bankruptcy claims, even as part of a chapter 11 confirmation order.

In his March 17 opinion, District Judge Leonard P. Stark implied that a bankruptcy court must submit proposed findings and conclusions to the district court, which would have the power to enter a final order approving third-party releases contained in a chapter 11 plan.

Judge Stark's opinion seems to mean that a creditor objecting to confirmation of a plan with third-party releases will have an automatic stay pending appeal while the district court conducts *de novo* review of the bankruptcy court's proposed findings and conclusions regarding non-consensual releases.

Judge Stark's opinion has another important consequence: The district court will review findings on third-party releases *de novo* and not use the clear-error standard, thus giving a district court theoretically wider latitude to reject releases.

Ruling on appeal from a confirmation order, Judge Stark remanded the case for the bankruptcy court in the first instance to rule on whether it has constitutional authority to enter a final order imposing third-party releases. If the bankruptcy court decides it does not have final adjudicatory authority, Judge Stark instructed the bankruptcy court to submit proposed findings and conclusions.

The Millennium Plan

The appeal arose from the reorganization of Millennium Lab Holdings II LLC, a provider of laboratory-based diagnostic testing services.

While being investigated by Medicare and Medicaid for fraudulent billing, the company obtained a $1.825 billion senior secured credit facility and used $1.3 billion of the proceeds to pay a special dividend to shareholders.

Thirteen months after the loan, the company agreed to settle with Medicare and Medicaid by paying $250 million. Unable to restructure its debt out of court, Millennium initiated a prepackaged chapter 11 reorganization six months later, in part to carry out the settlement.

The plan provided that the shareholders would contribute $325 million in return for releases of any claims that could be made by the lenders. The plan did not contain an opt-out provision allowing lenders to exempt themselves from the third-party releases given the shareholders.

The shareholders' $325 million contribution would be used to pay the government settlement. Some of the lenders would get $50 million in return for supporting the plan, while the remainder would be used for the reorganized company's working capital.

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

The bankruptcy court confirmed the plan and approved the third-party releases. The dissenting lenders appealed, but the bankruptcy court denied a stay pending appeal. The lenders did not seek a stay from higher courts.

Having consummated the plan, Millennium filed a motion to dismiss the appeal on the ground of equitable mootness. The parties also briefed the merits of the appeal, in which the dissenting lenders alleged that no court in Delaware had ever approved such a broad third-party, non-debtor injunction.

Judge Stark's Opinion

In connection with the contested confirmation hearing, Judge Stark said the bankruptcy court ruled that it had "related to" jurisdiction to impose third-party releases. He said the bankruptcy judge also ruled that third-party releases were appropriate under Third Circuit authority.

Significantly, Judge Stark reviewed the proceedings in the lower court and concluded that the bankruptcy court had not decided whether it had power under *Stern* to enter a final order granting the releases.

Judge Stark conceded that the company made a "persuasive" argument that the appeal should be dismissed as equitably moot. Nonetheless, he sided with the dissenting lenders by saying he could not consider equitable mootness "without first determining whether a constitutional defect in the bankruptcy court's decision deprived that court of the power to issue that decision."

Turing to the jurisdictional and constitutional issues, Judge Stark agreed that the bankruptcy court had "related to" jurisdiction to issue non-consensual releases. However, he said it was not clear that the bankruptcy court "ever had the opportunity to hear and rule on the adjudicatory authority issue."

On the *Stern* question, Judge Stark said that the lenders' common law fraud and RICO claims involved public rights that were "not closely intertwined with a federal regulatory program." Consequently, he said, the dissenting lenders "appear entitled to Article III adjudication of these claims."

Judge Stark said he was "further persuaded" by the lenders' "argument that the Plan's release, which permanently extinguished [the lenders'] claims, is tantamount to resolution of those claims on the merits against" the lenders. He rejected the company's contention that the releases in the plan "did not run afoul of *Stern* because it was not a final adjudication of the claims."

Next, Judge Stark said that a *de novo* review by him would not "resolve the constitutional concerns set forth in *Stern*."

Despite what he called the "seeming merits" of the dissenting lenders' arguments, Judge Stark said he "will not rule on an issue that the bankruptcy court itself may not have ruled upon."

He therefore remanded the case for the bankruptcy court to consider whether it had "constitutional adjudicatory authority" to approve non-consensual releases of the dissenting lenders' "direct-bankruptcy common law and RICO claims." If the bankruptcy court decides it does not have final adjudicatory authority, Judge Stark said the lower court should submit proposed findings and conclusions. Alternatively, Judge Stark said, the bankruptcy court could strike the releases from the confirmation order.

Judge Stark denied the equitable mootness motion without prejudice.

Assuming she feels compelled to issue proposed findings and conclusions, the bankruptcy judge on remand will presumably reach the same factual conclusions and again approve the releases, thus setting up the company to argue once again that the appeal is equitably moot. It is not clear that Judge Stark, the next time around, would dismiss the appeal as equitably moot if he were to differ with the bankruptcy court about the propriety of the releases, because he said that the bankruptcy judge on remand could strike the releases.

Confirmation Becomes Two-Step Process

Assuming Judge Stark is correct and plan releases are not core issues, plans like Millennium's will require two-step confirmation, first in the bankruptcy court, followed by *de novo* review in district court of non-consensual releases. Consequently, a plan could not be consummated until after district court review of proposed findings and conclusions about the releases. Presumably, the district court would review the merits of the appeal at the same time.

Given the lack of finality with regard to releases, a dissenter in effect gets an automatic stay of the confirmation order pending appeal to the district court.

The opinion is *Opt-Out Lenders v. Millennium Lab Holdings II LLC (In re Millennium Lab Holdings II LLC)*, 16-110, 2017 BL 84332 (D. Del. March 17, 2017).

Rochelle's Daily Wire

Refinancing & Tender Offers

Third Circuit says that New York bankruptcy court's* MPM *decision was wrong.

Third Circuit Splits with New York by Allowing Make-Whole Premiums in Chapter 11

Parting company with decisions from New York, the Third Circuit in Philadelphia reversed the lower courts in Delaware and ruled that so-called make-whole premiums must be paid to bondholders, at least when prepayment is voluntary in chapter 11 and the language of the indenture is not to the contrary.

In a Nov. 17 decision in the wake of the reorganization of electric energy giant Energy Future Holdings Corp., the Third Circuit distinguished a Second Circuit decision and eviscerated a New York bankruptcy court opinion that favored large corporate debtors by holding that make-whole premiums are not owing if the debt was automatically accelerated by a bankruptcy filing. The Third Circuit opinion is important because that court makes law governing Delaware, where many of the country's largest reorganizations are filed.

Litigation in the Lower Courts

Energy Future needed bankruptcy relief but also had designs on using chapter 11 to refinance secured bonds bearing interest rates well above the current market. However, more than $400 million in make-whole premiums on first and second lien bonds would be due in refinancings outside of bankruptcy.

A make-whole premium is a payment required in some indentures to compensate lenders for being forced to reinvest at lower interest rates when bonds are paid before maturity.

Immediately after the chapter 11 filing in Delaware, Energy Future refinanced the debt with court approval, leaving open the question of whether make-whole premiums were owing. Later, the bankruptcy court ruled that the premiums were not owing. The decisions by the bankruptcy court were upheld this year by a district judge in Delaware.

Reversal in the Third Circuit

Writing for the appeals court, Circuit Judge Thomas Ambro reversed the lower courts and reinstated the liability to pay the make-whole premiums. According to Judge Ambro, the result turned on the language of the indentures. His decision cannot be understood as a blanket ruling on make-whole premiums generally in bankruptcy, except to the extent that indentures have the same language.

For the first lien bondholders, pivotal Section 3.07 of the indenture, entitled "Optional Redemption," said that the company could "redeem" the notes by paying the principal and accrued interest "plus the Applicable Premium."

The bankruptcy court disallowed the make-whole premium, focusing on another provision in the indenture, Section 6.02, which automatically accelerated the notes in the event of bankruptcy. The bankruptcy judge reasoned that no premium was due in bankruptcy because the acceleration clause made no mention of the premium.

Judge Ambro said that Section 3.07 raised three questions: (1) was there a redemption; (2) was it optional; and (3) did it occur before the specified date? He answered all three questions in the affirmative.

First, Judge Ambro cited governing New York law for the proposition that a redemption includes "both pre- and post-maturity repayments." Next, he said the "redemption was very much optional" because the debtor could have reinstated the debt in a chapter 11 plan, even though the acceleration was automatic.

Judge Ambro therefore concluded that Section 3.07, "on its face," required paying the premium.

In opposition, the debtor relied on a 2013 Second Circuit decision in the American Airlines reorganization. Judge Ambro made short shrift of that argument by pointing to language in the indenture in the American Airlines case explicitly saying that no premium was due in an acceleration resulting from bankruptcy.

Rebutting the bankruptcy court's reliance on Section 6.02, Judge Ambro said "it surpasses strange to hold that silence in Section 6.02 supersedes Section 3.07's simple script."

Judge Ambro Rejects *MPM Silicones*

The second lien indenture was similar but not identical. In it, Section 6.02 said that bankruptcy automatically accelerated all principal "and premium, if any."

To escape the seemingly explicit requirement to pay the premium in bankruptcy, the Delaware bankruptcy court followed a 2014 New York bankruptcy court decision called *MPM Silicones*, which involved a similar indenture. There, the judge in Manhattan said that the reference to "premium" was not adequately specific to invoke the "Applicable Premium," which was the defined term for a make-whole premium.

With respect to the second lien bonds, Judge Ambro reversed the bankruptcy court because the words "premium, if any" left "no doubt" that a make-whole was required.

Rochelle's Daily Wire

Further undercutting *MPM Silicones* and cases that adopted its reasoning, Judge Ambro used the remainder of his opinion to explain why the New York bankruptcy court misinterpreted New York law, which governed the indentures. He said that the Manhattan court stretched a New York Court of Appeals decision "beyond its language." The Delaware bankruptcy court, he said, adopted the same misinterpretation of New York law.

Judge Ambro said the New York Court of Appeals decision, called *Northwestern*, reflected a "policy concern that lenders should not be permitted 'to recover prepayment premiums after default and acceleration'" outside of bankruptcy. In the *Energy Future* case, he said the noteholders "did not seek immediate payment." Indeed, the noteholders attempted to deaccelerate and reinstate the debt.

By refusing to enforce Section 3.07 after acceleration, Judge Ambro said that the bankruptcy court "ran afoul of New York authority by failing to enforce a contract provision" that was "not affected by acceleration."

Judge Ambro was a bankruptcy lawyer before ascending to the circuit bench in 2000.

The opinion is *Delaware Trust Co. v. Energy Future Intermediate Holding Co. LLC (In re Energy Future Holdings Corp.)*, 842 F.3d 247 (3d Cir. Nov. 17, 2016).

Appeals court focuses on the methods, not the result, in looking for a TIA violation.

Second Circuit Blesses a Nonconsensual Out-of-Court Restructuring

The Second Circuit handed down an opinion on the Trust Indenture Act that puts a cudgel in the hands of senior creditors to prevent a holdup by junior creditors. So long as the junior lenders' right to sue is not impaired, senior lenders can use the threat of friendly foreclosure to force lower-ranked creditors into accepting something or receiving nothing at all from a company that otherwise would be in bankruptcy.

In a 2/1 opinion, the majority justified its conclusion by an exhaustive analysis of legislative history in an environment where using legislative history is no longer in vogue. The net effect of the Jan. 17 opinion is to make bankruptcy less often necessary for companies that can restructure without impairing general unsecured creditors.

The opinion is important and beneficial for companies in financial distress because forum selection clauses in trust indentures often require litigation in New York, where the Second Circuit sits.

Education Management's Debt Structure

The appeal involved Education Management Inc., an operator of for-profit educational institutions. It was insolvent, with an enterprise value worth less than its $1.5 billion in debt.

The capital structure included $1.3 billion in senior secured debt with liens on all assets. Technically speaking, the debt was issued by a finance subsidiary and guaranteed by the parent.

The company had some $200 million in unsecured notes also issued by the finance subsidiary and guaranteed by the parent. The indenture provided that the parent's guarantee would be released if senior secured lenders ever released their guarantees against the parent. Offering materials explicitly said that unsecured noteholders should not put any value on the parent's guarantee.

As Education Management Inc. needed to reduce its debt, a chapter 11 reorganization was unpalatable because bankruptcy would make the company's students ineligible to receive government guaranteed loans.

To recapitalize out of court without consent from all unsecured noteholders, the senior lenders foreclosed all the assets under the Uniform Commercial Code and released the parent's guarantee, which had the effect of automatically releasing the guarantee held by the unsecured noteholders.

Next, the senior lenders "sold" the assets to a newly formed subsidiary of the parent. The newly formed subsidiary issued (1) new secured debt and most of the new stock to "old" secured lenders, and (2) a sliver of the new stock to unsecured noteholders who consented.

The nonconsenting unsecured noteholder, a hedge fund, got nothing, although its debt was not extinguished and it retained its right to sue, but could only sue the finance subsidiary, which had no assets, because the guarantee against the parent had been released.

The Decision in District Court

The hedge fund sued, claiming a violation of Section 316(b) of Trust Indenture Act of 1939, known as the TIA. The district judge declined to issue a preliminary injunction, although she did say the dissenting hedge fund might win after trial on the merits.

Following a bench trial, the district judge found a violation of the TIA and declared that the restructured company should be liable for the debt owing to the dissenter. The company and the senior lenders appealed and won, in an opinion for the majority written by Circuit Judge Raymond J. Lohier.

TIA § 316(b)

The appeal turned on Section 316(b) of the TIA, which provides, in relevant part, that the right of any security holder "to receive payment of the principal and interest . . . shall not be impaired or affected without the consent of such holder."

District Judge Katherine Polk Failla held, in substance, that the language of the statute prohibits more than cutting off the right to payment or the right to sue. She said it bars an "involuntary debt restructuring."

On appeal, the dissenting noteholder argued that the TIA bans nonconsensual transactions that result in the practical inability to collect.

The Majority Opinion

For himself and Circuit Judge José A. Cabranes, Circuit Judge Lohier held that the statute is ambiguous, thus justifying an extensive analysis of legislative history going back to the 1930s.

Judge Lohier said that the interpretation sought by the dissenting hedge fund would have "improbable results and interpretive problems." He said the conclusion sought by the dissenter would turn a right to sue, guaranteed by the TIA, into a right to receive payment.

Judge Lohier rejected the notion that the result depends on "the subjective intent of the issuer or majority bondholders, not the transactional techniques used." Were the dissenting bondholder to prevail, Judge Lohier said, in substance, that every friendly foreclosure would turn into a TIA violation.

At the end of his majority opinion, Judge Lohier pointed out potential flaws in the out-of-court restructuring as compared with a chapter 11 reorganization. Dissenting creditors could sue in state court to block the foreclosure and might try to hold the newly formed company liable on theories of successor liability or fraudulent transfer.

Judge Lohier said that the dissenting noteholder, a "sophisticated creditor," had the best protection of all, ensuring that the indenture could not allow a transaction of this type in the first place. Logically also, an investor could decline to purchase debt in the secondary market where the governing agreements might obviate the ability to hold up a transaction promulgated by senior creditors.

In short, Judge Lohier said there was no violation of the TIA because the transaction did not amend any terms of the indenture, nor did it preclude the dissenter from suing.

The Dissent

Circuit Judge Chester J. Straub dissented. He said that the "plain language" of the TIA barred the transaction. Focusing on the words "right," "impair" and "affect," he said that an offer violates the TIA when it gives a bondholder the choice between accepting something or receiving nothing at all.

Judge Straub's dissent goes to the heart of how a court ought to interpret a statute. Should a court focus on the mechanisms used by smart lawyers and investment bankers, or should the court focus on the result?

Judge Straub said that the "methodology used to accomplish an annihilation is of little interest when the end result is squarely at odds with the plain intent of Section 316(b)."

The split decision may be the end of road because the Second Circuit is disinclined toward rehearings *en banc*.

The opinion is *Marblegate Asset Management LLC v. Education Management Finance Corp.*, 846 F.3d 1 (2d Cir. Jan. 17, 2017); rehearing *en banc* denied March 21, 2017.

ROCHELLE'S DAILY WIRE

Plans & Confirmation

En banc, the Ninth Circuit reverses a panel opinion from last year on cramdown valuation.

Cramdown Value Is *Not* the Higher of Foreclosure or Replacement Value, Ninth Circuit Says

Reversing the three-judge panel, Ninth Circuit sat *en banc* and held that a secured creditor in a cramdown is only entitled to the replacement value of the collateral, not the price that would be realized after foreclosure in those rare cases where foreclosure value is higher than replacement value.

The majority in the three-judge panel opinion from April 2016 believed that valuation, governed by Section 506(a), is not measured by the income an owner could generate by operating the property as affordable housing. In the 2/1 decision a year ago, the majority believed that the bankruptcy court could not shortchange a secured creditor if foreclosure would generate a higher value by freeing the property from the strictures of affordable housing.

Reversing *en banc*, the 8/3 majority in the Ninth Circuit's May 26 opinion decided that *Associates Commercial Corp. v. Rash*, 520 U.S. 953 (1997) requires using the "replacement value standard" rather than the value from a foreclosure sale that will not take place.

Valuation of an Affordable Housing Project

Valuation in the context of a chapter 11 cramdown was complicated because the debtor owned an affordable housing complex. The property had an $8.5 million, government-guaranteed first mortgage and two subordinate mortgages. After default on the first mortgage, the government paid off the first lien lender and sold the mortgage to a third party for about $5 million. The new owner of the mortgage had arranged to sell the property after foreclosure for about $7.7 million. To halt foreclosure, the owner filed a chapter 11 petition.

The three mortgages and agreements related to affordable housing all provided that the restrictions related to affordable housing would terminate in the event of foreclosure. The project had not been foreclosed when the three-judge panel issued its opinion last year.

The owner financed the reorganization with $1.2 million in new equity provided by a new investor who in substance took over ownership when the plan was confirmed and consummated. As confirmed by the bankruptcy court, the plan valued the first lien at $3.9 million. The lender had exercised a Section 1111(b) election. As confirmed, the plan gave the lender a new secured note for $3.9 million, with interest at 4.4% and a balloon payment when the loan matured in 40 years.

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

The lender appealed and was denied stays in the bankruptcy and district courts. The district court later upheld the confirmation order, leading to a reversal in the majority opinion last year written by Circuit Judge Richard R. Clifton. Dissenting last year, Circuit Judge Richard A. Paez said that the majority had misread *Rash* by basing valuation on the creditor's perspective. Judge Paez also pointed out that the majority's approach to valuation under Section 506(a) was at odds with the *Collier* bankruptcy treatise.

The Ninth Circuit granted the debtor's petition for rehearing *en banc*. The 8/3 majority opinion on May 26 was written by Circuit Judge Andrew D. Hurwitz.

Rash and Cramdown Valuation

Because the lender objected to the plan, the debtor was required to employ cramdown under Sections 1129(a)(7)(B) and 1111(b)(2). In turn, those sections invoke the provision in Section 506(a)(1) that the lender's debt is deemed secured "to the extent of the value of such debtor's interest in" the collateral.

Since foreclosure would shed the requirement that the property be used as affordable housing, the lender argued that the proper value should be the higher value realized after foreclosure. The debtor contended that the value must represent the price the project would fetch as an affordable housing project, the use contemplated by the plan. Judge Hurwitz agreed with the debtor.

Judge Hurwitz said that *Rash* requires using the "replacement value standard," not foreclosure value, even in an "atypical case" where foreclosure value would be higher. He said that the "essential inquiry" was to determine the price the debtor "would pay to obtain an asset like the collateral for the particular use proposed in the plan." He said that *Rash* adopted replacement value even though the Supreme Court "implicitly acknowledged" that foreclosure on occasion might yield a higher value.

Judge Hurwitz said that "*Rash* did not adopt a rule requiring that the bankruptcy court value the collateral at the higher of its foreclosure value or replacement value."

Because the lender did not contest the $3.9 million valuation as an affordable housing complex, Judge Hurwitz turned to other issues, such as the proper interest rate on cramdown.

The Proper Interest Rate on Cramdown

The lender argued that the plan was not "fair and equitable" under Section 1129(b) because the 4.4% interest rate on the new note was too low.

Judge Hurwitz began with *Till v. SCS Credit Corp.*, 541 U.S. 465, 469 (2004), where the Supreme Court adopted a "formula approach" that adjusts the prime rate up or down according to risk.

The lender complained that 4.4% was lower than the rate on the original loan.

With a prime rate of 3.25% at confirmation, the bankruptcy court adjusted the rate up to account for risk. The bankruptcy court also had evidence that 4.18% would be the market rate for a loan on similar property.

Judge Hurwitz said that interest rates had declined "significantly" since the loan was originally made. In addition, there was more risk at the outset because the project had not been built.

Therefore, Judge Hurwitz said the bankruptcy court "did not clearly err" in fixing the rate on the new loan at 4.4%.

No Second 1111(b) Election

During the confirmation process, the lender attempted to vacate the so-called 1111(b) election it had made. Most likely, the lender wanted to have both a secured and unsecured claim, believing that its unsecured claim would vote down the plan by that class too. The bankruptcy judge did not permit the lender to revoke its election.

Judge Hurwitz said that the bankruptcy court did not commit error by refusing to amend "its scheduling order to allow the creditor a second bite at the apple." Without deciding, he assumed that a court should allow a change in the election if there were a material modification to the plan.

The only change was an increase in the value of the collateral. Judge Hurwitz said that was "not material to the election decision."

When the 1111(b) "gambit failed," Judge Hurwitz said the "bankruptcy court did not err when it rejected [the lender's] attempt to turn back the clock and torpedo the plan of reorganization."

The Dissent

Three judges dissented in an opinion written by former Chief Circuit Judge Alex Kozinski, who was in the majority in the panel opinion last year. He said the majority engaged in "cramped formalism" that produced a "strange result." He believes that *Rash* is "more flexible" and agreed with the rationale by the majority in the panel opinion last year. To read ABI's discussion of last year's opinion published before the court corrected citations to the wrong section of the Bankruptcy Code, click here.

Practical and Curious Aspects of the Opinions

The opinion last year would have made reorganization virtually impossible for owners of affordable housing in the Ninth Circuit where the lender is bent on taking title. The result from the panel opinion would have taken affordable housing units out of the inventory in populous states like California.

Last year, the majority repeatedly and erroneously cited Section 1325 as the governing cramdown statute, when the appeals court should have been referring to Section 1129. Although the court corrected its mistake 13 days later, the question remains whether the court and its clerks had adequately researched cramdown cases in chapter 11. The mistake presumably resulted from the fact that *Rash* was a chapter 13 case citing Section 1325.

The *en banc* majority opinion made the same mistake by saying in one instance that the debtor was invoking cramdown under Section 1325(a)(5)(B).

One wonders whether the lender's decision to buy the defaulted loan for more than value related to affordable housing was based on an opinion of counsel guessing how the Ninth Circuit might rule.

A petition for *certiorari* to the Supreme Court won't be a surprise.

The opinion is *First Southern National Bank v. Sunnyslope Housing LP (In re Sunnyslope Housing LP)*, 859 F.3d 637 (9th Cir. May 26, 2017).

***Divided panel holds that Section 1123(d) overruled* Entz-White.**

Ninth Circuit Now Requires Paying Default Interest to Cure a Default

In a split decision, the Ninth Circuit held that the addition of Section 1123(d) to the Bankruptcy Code in 1994 legislatively overruled the appeals court's 1988 decision in *Entz-White*. Unless the November 4 opinion is set aside on *en banc* review, debtors in the Ninth Circuit henceforth must pay interest at the default rate to cure a default.

Interpreting a statute designed to lower a debtor's interest burden, the majority increased interest cost, although in line with the underlying mortgage.

In dissent, Circuit Judge Marsha S. Berzon argued that neither the text nor the legislative history accompanying Section 1123(d) showed a clear congressional intent to overrule *Entz-White*.

The Facts of the Case

The case involved a corporate debtor that had defaulted on a mortgage calling for the interest rate to increase five percentage points after default. The bankruptcy judge confirmed the chapter 11 plan allowing the debtor to sell the property and pay off the mortgage at the lower non-default interest rate.

The bankruptcy judge required the debtor to escrow almost $800,000 to protect the lender in case an appellate court were to require paying the default rate.

At the request of both parties, the Ninth Circuit allowed a direct appeal, overstepping an intermediate appeal to the district court or the Bankruptcy Appellate Panel.

Entz-White, *Rake* and the Addition of Section 1123(d)

Although Section 1123(a)(5)(G) allows a plan to cure a default on secured debt, the Ninth Circuit noted in *Entz-White* that nothing in the Bankruptcy Code defines what it means to cure a default. In that case, the appeals court held that curing entitles a debtor to "avoid all the consequences of the default including the higher post-default interest rate." *Entz-White* therefore allowed a debtor to cure a default by paying arrears at the lower non-default rate.

Five years later, in *Rake v. Wade*, the Supreme Court held in 1993 that curing a default required a chapter 13 debtor to pay interest on arrears even if the underlying documents did not. For the stated purpose of overruling *Rake v. Wade*, Congress adopted Section 1123(d) in 1994 to bar creditors from collecting interest on interest. The House Report said that the new section would "limit the secured creditor to the benefit of the initial bargain with no court contrived windfall."

Thus, Section 1123(d) was intended by Congress to give debtors a lighter burden in curing defaults. To achieve the intended result, Section 1123(d) says that the "amount necessary to cure the default shall be determined in accordance with the underlying agreement and applicable nonbankruptcy law" when a plan proposes to cure a default.

The appeal decided on Friday called on the Ninth Circuit to apply the statute to a situation Congress may not have had in mind when it adopted Section 1123(d).

The Majority Opinion

In the majority opinion for herself and Circuit Judge Susan P. Graber, Circuit Judge Mary H. Murguia held that Congress legislatively overruled *Entz-White* by adopting Section 1123(d).

Judge Murguia observed that state law permitted the mortgage to impose higher interest after default. Therefore, she said, the plain language of the statute "cannot nullify a preexisting obligation in a loan agreement to pay post-default interest solely by proposing a cure."

Even if the statute were ambiguous, the result would be the same, Judge Murguia said, because the intent of the amendment was to hold "the parties to the benefit of their bargain." She added that the "fact that Congress had a particular purpose in mind when enacting a statute does not limit the effect of the statute's text."

The Dissent

Dissenting, Judge Berzon said that neither the statutory text nor the legislative history shows a congressional intent to overrule *Entz-White*. She cited the Supreme Court's decision in *Hamilton v. Lanning* for the proposition that the Bankruptcy Code should not be read to "erode past bankruptcy practice absent a clear indication that Congress intended such a departure."

Judge Berzon said that the text and legislative history both "support the continuing validity of *Entz-White*." She said that Section 1123(d) prescribes "which materials the parties may consult in determining how to cure a default."

The amendment, Judge Berzon said, was designed to address "an entirely separate matter" and was not intended to "impose a severe penalty" on a debtor. She said the amendment was designed to prevent secured creditors from receiving a "windfall."

Since Congress still has not defined what it means to cure a default, Judge Berzon said that *stare decisis* should have obligated the panel to follow *Entz-White* absent an en banc decision overturning the 1988 decision.

The opinion is *Pacifica L 51 LLC v. New Investments Inc. (In re New Investments Inc.),* 840 F.3d 1137 (9th Cir. Nov. 4, 2016).

ROCHELLE'S DAILY WIRE

Established practice governing distributions is upheld in Delaware district court.

To Establish Record Dates, the Plan Applies, Not Securities Regulations

District Judge Sue L. Robinson of Delaware upheld the bankruptcy court by ruling that the record date pursuant to a plan exclusively determines which shareholders are entitled to receive distributions, even if U.S. securities regulations might call for distributions to holders who purchased securities after the record date.

The opinion is important, because a decision to the contrary would have complicated distributions in chapter 11 cases and likely would have ended up requiring different and less clearly defined record dates for equity holders than for creditors.

The case, however, did not involve chapter 11. Instead, a Canadian company filed a petition in Canada for arrangement under the Companies' Creditors Arrangement Act. Simultaneously, the company filed a chapter 15 petition in Delaware.

The Canadian court approved the company's plan, which was recognized by the Delaware bankruptcy court in an order that gave the plan full force and effect in the U.S. The plan provided for distributions to unit holders once all creditors were paid in full. The company's units, effectively equity securities, were traded in the over-the-counter market in the U.S., thus invoking the regulatory regime under the Financial Industry Regulatory Authority, or FINRA.

As usual, the plan bound all creditors and equity holders, along with successors and assigns. The plan provided for distributions to unit holders as of a record date to be established under the plan.

After notices published in newspapers, along with a press release on Dec. 15, 2014, the company established Dec. 18, 2014, as the unit holders' record date. Beginning Dec. 16 and continuing through Jan. 22, 2015, when the distribution was actually made and trading in the units halted, the plaintiffs purchased units. The purchasers therefore did not receive any of the distributions, because they would have had to have bought the securities before Dec. 15 on account of the three-day settlement process before the transactions became effective.

The purchasers sued in bankruptcy court, contending that the company violated FINRA regulations. Bankruptcy Judge Kevin Gross granted the company's motion to dismiss and was upheld by Judge Robinson in her June 14 opinion.

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The plaintiffs conceded that the company had made the distribution in accordance with the plan. Had the FINRA regulations been employed, the plaintiffs contended that they would have been entitled to receive the distribution, not the sellers from whom they acquired the units.

Judge Robinson held that the company "had a duty to comply with the plan – not the FINRA Rules." She rejected the argument that the company had a "concurrent and additional" obligation, not contained in the plan, to follow FINRA.

Invoking *res judicata*, she said that the "plan sets forth an exclusive procedure for distributions to unit holders . . . and it is a final order on the merits." She added that the "plan imposed no obligations . . . to comply with FINRA Rules or any authority outside of" Canadian law and orders of the U.S. and Canadian courts.

Judge Robinson said there was no way to harmonize the plan and the FINRA rules. If the rules also applied, the company would have been required to make the same distribution twice: the first payment to the holders on the record date and another in the same amount to those who purchased the units later.

Although the *res judicata* ruling was enough to affirm the lower court, Judge Robinson also upheld dismissal because the plan gave releases to the defendants.

The opinion is *Zardinovsky v. Arctic Glacier Income Fund (In re Arctic Glacier International Inc.)*, 16-617, 2017 BL 203116 (D. Del. June 14, 2017).

Judge Carey distinguishes between administrative and priority claims for severance.

Fired Worker's Entire Severance Claim Given Priority in Delaware by Judge Carey

On an issue dividing the bankruptcy courts, Delaware Bankruptcy Judge Kevin J. Carey ruled that severance is earned in full as a fourth priority claim on the day an employee is fired, under Section 507(a)(4).

The employed had worked for the company for about five years and was entitled to 15 weeks of severance, to be paid each week after he was let go. Paid nine weeks of severance before the company filed a chapter 11 petition, the employee filed a priority severance claim for the remaining six weeks, or some $8,700.

Section 507(a)(4) provides a fourth priority claim up to $12,850 for "wages" and "severance" that are "earned within 180 days before" the filing date. The debtor objected to giving the claim priority status, contending that the former employee only had a severance claim based on six months of work before bankruptcy. In his Oct. 19 opinion, Judge Carey disagreed and allowed the employee his entire fourth priority claim of $8,700.

Judge Carey listed bankruptcy courts around the country that take the contrary view, allowing a priority claim only for the portion of total severance pay attributable to the 180-day period.

Judge Carey had already decided almost the same issue in his 2006 *Garden Ridge* decision. For him, the contingencies for a severance claim are satisfied and the compensation is "earned" when the employee is fired.

Judge Carey's most difficult task was distinguishing *Roth American*, where the Third Circuit held in 1992 that an administrative expense claim for severance under Section 503(b)(1)(A) is based on the length of time an employee works after a chapter 11 filing. Judge Carey declined to follow *Roth American*, saying it dealt with a "different issue."

Judge Carey approvingly cited *Matson v. Alarcon*, where the Fourth Circuit held in 2011 that severance is earned in full on the day an employee becomes entitled to the compensation.

If the issue goes up on appeal and the Third Circuit reverses, Judge Carey's decision will have given rise to an interesting split of circuits eligible for Supreme Court review, because the Fourth Circuit in *Matson* distinguished *Roth American*.

The opinion is *In re ADI Liquidation Inc.*, 560 B.R. 105 (Bankr. D. Del. Oct. 19, 2016).

ROCHELLE'S DAILY WIRE

Committees

ROCHELLE'S DAILY WIRE

Priority skipping permitted as part of final approval of DIP financing.

Delaware Judge Narrows *Jevic* to Prohibit Only End-of-Case Priority Skipping

Bankruptcy Judge Kevin Gross of Delaware read *Jevic* narrowly and approved final financing in chapter 11 with a payment for general unsecured creditors but none for unsecured creditors with unpaid administrative or priority claims.

Short Bark Industries Inc., a provider of body armor and apparel for the military, filed a chapter 11 petition in July, aiming for a quick sale of the assets. The company had about $17 million in secured debt, with almost $10 million owing to the senior secured lender.

After filing, the debtor landed a so-called stalking horse bid to sell the business for $3.2 million. The official creditors' committee objected to the proposed chapter 11 financing provided by the senior secured lender.

Subject to the court's approval, the lender and the committee settled their disputes over financing. The agreement called for the lender to hold a minimum of $110,000 in sale proceeds in escrow for payment to holders of general unsecured claims but not for holders of unpaid priority or administrative claims.

The U.S. Trustee and a creditor with a disputed priority claim objected to the settlement, based on *Czyzewski v. Jevic Holding Corp.*, 15-649, 2017 BL 89680, 85 U.S.L.W. 4115 (Sup. Ct. March 22, 2017), the Supreme Court decision barring structured dismissals that "deviate from the basic priority rules."

Ruling on the objection in an opinion delivered from the bench on Sept. 11, Judge Gross said he was initially inclined to disapprove the settlement, saying that the U.S. Trustee lodged a "very strong objection." The judge said he then reread *Jevic*, noting how "it was all about a structured settlement." He quoted Justice Stephen G. Breyer's opinion proscribing "end-of-case distributions" that "would be flatly impermissible in a chapter 7 liquidation."

Judge Gross characterized Justice Breyer as disapproving *Jevic*'s priority-skipping distribution because there was no "significant, offsetting, bankruptcy-related justification."

In contrast, Judge Gross said the settlement in *Short Bark* "enables the debtors to continue with their businesses . . . and the employment of 500 plus people, while preserving the committee's right to bring actions against insiders."

ROCHELLE'S DAILY WIRE

Judge Gross had been told that administrative claims would be paid by using the chapter 11 financing. He said there was "little, if any, assurance" that the creditor with the disputed priority claim "would receive any distribution, were the settlement to be denied."

The decision by Judge Gross appears to limit *Jevic* to a prohibition against priority-skipping distributions occurring at the end of the case, when it is clear that priority and administrative claims will not be paid. If his rationale holds up, settlements could avoid *Jevic*'s fate by being accelerated to an earlier time in the chapter 11 case.

If Judge Gross is reversed and priority-skipping settlements are barred at all stages of reorganization, chapter 11 may devolve into an exercise only for the benefit of secured creditors.

On the other hand, bankruptcy judges could largely, but not entirely, ensure compliance with the rules of priority by using early-stage, priority-skipping settlements combined with financing orders that guarantee payment of administrative claims, leaving only priority creditors with no assured recovery. For those overlooked creditors, perhaps estate claims could be carved out in a settlement for their benefit, but the effect would look much like a chapter 11 plan having less than full compliance with Section 1129.

In *Short Bark*, estate claims were not extinguished by the financing but were preserved, leaving the possibility that priority claimants could receive proceeds from successful suits either in a chapter 11 plan or a distribution in a subsequent chapter 7 case.

If there is a flaw in *Short Bark's* logic in relation to *Jevic*, perhaps it's because the proposed financing assured the ability to continue the business and the committee's objection to financing wouldn't necessarily be fatal were there no settlement.

Justice Breyer explicitly allowed first day orders departing from the rules of priority, such as authorizations to pay prepetition wages and claims of so-called critical vendors that are designed to continue the business as a going concern. If there is an appeal, *Short Bark* will raise the question of whether priority skipping somewhat later in the case is permissible if structures are already in place assuring continuation of the business long enough to sell the assets.

For bankruptcy judges, the choice is difficult. Should they impose the Bankruptcy Code priority rules stringently, or allow an outcome that benefits the largest numbers of creditors?

In *Short Bark*, the creditors' committee was represented by Lowenstein Sandler LLP.

The opinion is *In re Short Bark Industries Inc.*, 17-11502 (Bankr. D. Del. Sept. 11, 2017).

Dissent proclaims a split of circuits and says the debtor and DIP are distinct entities.

Split Sixth Circuit Bars Litigation Trustees from Suing on D&O Policies

Over a blistering dissent, a divided panel of the Sixth Circuit held that a liquidating trust and a corporate debtor are functionally the same for insurance purposes, absolving a provider of directors and officers' liability insurance from responsibility for covering a breach of fiduciary duty suit as the result of a so-called insured vs. insured exception in the policy.

The dissent says that the majority has waded into a split of circuits and contravened the circuit's own authority holding that a debtor and chapter 11 debtor in possession are distinct entities. The dissent says the majority opinion will prove costly for creditors by forcing them to abjure consensual plans forming litigation trusts and instead force them to pursue appointment of a chapter 11 trustee or propose a plan of their own.

The Liquidation Trust and the Policy

After negotiations with creditors, the corporate debtor confirmed a chapter 11 plan creating a liquidating trust specifically charged with suing officers and directors for breach of fiduciary duty. The creditors agreed to collect only from insurance, not from officers and directors personally.

After the trust sued, the provider of D&O coverage initiated a declaratory judgment action contending that the insured vs. insured provision in the policy gave it no obligation to cover damages in the trust's suit.

The pivotal provision in the policy excluded coverage for "any claim . . . made by, or on behalf of, or in the name or right of, the Company." The policy did provide coverage for derivative suits.

The district court decided that the insurance company had no liability because the exclusion applied. The trust appealed.

The Majority Opinion

The majority opinion on June 20 written by Circuit Judge Jeffrey S. Sutton said that the Bankruptcy Code does not support the notion that the prebankruptcy debtor and debtor in possession are "necessarily distinct legal entitles – at least for purposes of the insurance contract."

Judge Sutton's majority opinion barring the trust from recovery on the policy relies in significant part on the trust's status as a "voluntary assignee of the company." Because the company could not sue its own officers, the "outcome remains the same" when the company turned the right to sue over to the litigation trust, Judge Sutton said.

Because the company voluntarily transferred the claim, Judge Sutton said it was therefore filed "on behalf of" or "in . . . the right of" the company.

Although much of Judge Sutton's opinion intimates that a suit by a chapter 11 trustee would be exempt from the exclusion, he said "it's not even clear that a court-appointed trustee or creditors' committee could collect on the policy." Not taking "sides on this debate today," he "only" held "that a voluntary assignee like the trust, which stands in [the company's] shoes," was precluded from collecting under the policy because it was filing suit "'by, on behalf of, or in the name or right of' the debtor in possession."

The Noisy Dissent

Not mincing words, Circuit Judge Bernice B. Donald dissented. She said, "Many cases cited by the majority have held that court-appointed trustees are exempt from the insured-versus-insured exclusion because there is no risk of collusion."

She accused the majority of concluding, without citing authority, that "an assignee trustee is different than a court-appointed trustee." Judge Donald said she had found no case law supporting the distinction.

"In fact," she said, there is a split among the circuits on whether suits by a debtor in possession, creditors' committee or liquidating trustee trigger the exception. She relied heavily on a Delaware district court decision finding the exclusion inapplicable and holding that the debtor's estate and the debtor are separate entities.

In addition, Judge Donald argued that the "plain meaning" of the policy itself recognized a distinction between the company and the "debtor in possession or other estate representative."

Judge Donald contended that the majority ignored the circuit's own authority holding that "a bankruptcy estate and a debtor are separate legal entities."

By Judge Donald's reckoning, the weight of authority holds that a court-appointed trustee is exempt from the exclusion. Because they are "similarly situated," she believes that an independent liquidation trustee or liquidation committee "should likewise be exempt."

If the "majority's decision becomes settled precedent," she said the "cost in terms of professional fees and judicial resources cannot be overstated" because creditors with valuable

claims against management will be compelled to seek appointment of a trustee or propose their own plan.

The majority opinion is surprising in view of the Sixth Circuit's decision less than a year ago in *Bash v. Textron Financial Corp. (In re Fair Finance Co.)*, 834 F.3d 651 (6th Cir. Aug. 23, 2016), where the appeals court removed some of the barriers to a suit when a trustee is met with the *in pari delicto* defense. In *Bash*, the Sixth Circuit declined to follow the Second Circuit's 1991 decision in *Shearson Lehman Hutton, Inc. v. Wagoner*.

Although *Bash* and the new case involve different principles, they both deal with barriers that creditors encounter when filing suit based on management misconduct. To read ABI's discussion of *Bash*, click here.

The opinion is *Zucker v. Indian Harbor Insurance Co.*, 860 F.3d 373 (6th Cir. June 20, 2017).

The statute is tolled only if the creditors' committee is denied standing to sue.

Existence of a Committee Precludes Tolling the Statute for Adverse Domination

The mere existence of a creditors' committee will prevent a later trustee from invoking the doctrine of adverse domination to toll the statute of limitations, according to the Seventh Circuit.

A committee must seek and be denied the right to sue in the name of the debtor before a statute of limitations will be tolled, Circuit Judge Michael S. Kanne said in his Aug. 11 opinion.

A casino began reorganizing in 2001 when the state was in the process of revoking its gaming license. The case converted to chapter 7 in 2007, and a trustee was appointed, when revocation of the license became final. The trustee then sued officers and directors for breach of fiduciary duty and breach of contract for alleged misconduct that prompted the state to terminate the gaming license.

Relying on the state's five-year statute of limitations, the district court dismissed the fiduciary duty claims. The trustee appealed, unsuccessfully.

The trustee argued that the Illinois doctrine of adverse domination tolled the statute of limitations because the debtor in possession was not motivated to sue its own officers and directors. The existence of the chapter 11 creditors' committee doomed the argument.

The trustee noted that the committee could not sue without permission from the bankruptcy court. Judge Kanne rejected the notion that the committee was unable to sue. Although the ability to sue was "circumscribed by several requirements" such as court approval, he said "those limitations didn't render the Creditors' Committee unable to sue." In other words, "the mere existence of a potential barrier to suing did not negate the Creditors' Committee's ability 'to enforce a corporate cause of action against officers, directors, and third parties.'"

Judge Kanne said the committee would be seen as "unable to bring the claim" only "[i]f the Creditors' Committee had petitioned the bankruptcy court, and if the court had denied leave."

In a last attempt at invoking adverse domination, the trustee contended that the committee was not motivated to sue because the prospect of reorganizing in chapter 11 was more promising than suing officers and directors. Judge Kanne responded by saying that the committee "made a strategic decision not to sue." Potential plaintiffs, he said, "must live with their choice. A plaintiff

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did not lack motivation to sue just because its chosen course of action proved to be unsuccessful in the end."

However, the trustee did not emerge empty-handed from the Seventh Circuit. The appeals court not only upheld a $272 million breach of contract claim against the officers and directors, but the court also ruled that the defendants should have been jointly and severally liable, not merely severally liable. In addition, the trustee had already settled with a pair of defendants for $45 million.

The opinion is *Gecker v. Estate of Flynn (In re Emerald Casino Inc.)*, 16-1075, 2017 BL 281129 (7th Cir. Aug. 11, 2017).

Ninth Circuit lays down rules governing derivative judicial immunity for official committee members.

Ninth Circuit Extends *Barton* to Protect Creditors' Committee Members

The Ninth Circuit became the first appeals court to hold that the Supreme Court's *Barton* doctrine, barring suits against receivers and trustees without permission from the appointing court, also protects creditors' committee members from claims based on actions taken within the scope of authority.

The appeal involved Timothy Blixseth, former owner of the bankrupt Yellowstone Mountain Club LLC, who used some proceeds from a loan to the club to pay personal debts. The same lawyer who advised Blixseth about the loan was also his divorce lawyer before the club's bankruptcy.

The lawyer emerged as chairman of the club's creditors' committee. Long after the club was sold and a chapter 11 plan confirmed, Blixseth sued the lawyer in district court for malpractice and fraud, covering actions taken both before and after the club's bankruptcy. The district judge dismissed the suit, finding no jurisdiction for a suit against the creditors' committee chairman as a result of the *Barton* doctrine. Because it was not taken from a final order, the Ninth Circuit dismissed Blixseth's first appeal.

Blixseth then sought permission from the bankruptcy court to sue the lawyer in district court. The bankruptcy judge denied permission to sue and dismissed the claims on the merits. Blixseth appealed again, this time with some success.

In his Nov. 28 opinion, Circuit Judge Alex Kozinski noted that no court of appeals has granted *Barton* protection to creditors' committee members. He said that the Sixth and Eleventh Circuits had extended *Barton* to cover counsel for a trustee and individuals authorized to sell estate property, respectively.

Because "creditors have interests that are closely aligned with those of a bankruptcy trustee," Judge Kozinski extended *Barton* to protect creditors' committee members "who are sued for acts performed in their official capacities." He approvingly cited the ABI Commission report on chapter 11, which recommended expanding *Barton* to protect "statutory committees and their members."

Because some pre-bankruptcy claims had nothing to do with the lawyer's position on the committee, Judge Kozinski held that Blixseth did not need permission from the bankruptcy court to sue in district court on those claims.

Blixseth contended that the bankruptcy court lacked jurisdiction under *Stern v. Marshall* to rule on the merits of his claims. Judge Kozinski disagreed, saying that *Stern* deprives the bankruptcy court of power to render final judgment on common law claims with no connection to the bankruptcy estate "other than that they happened to be assets of the estate." *Barton* claims, he said, are different because "they concern actions taken in a trustee's or officer's official capacity" and would not "exist independently of a bankruptcy case."

The bankruptcy court had dismissed Blixseth's claims on the merits, finding that the lawyer was entitled to derivative judicial immunity. The Ninth Circuit remanded the case to the bankruptcy court because the lawyer would not be entitled to immunity for all actions taken as the committee's chairman, only those within the scope of his authority where the debtor "had notice of his proposed acts" and the bankruptcy court "approved these acts."

The opinion is *Blixseth v. Brown (In re Yellowstone Mountain Club LLC)*, 841 F.3d 1090 (9th Cir. Nov. 28, 2016).

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Evidence must show that hedge fund investors' identities are 'commercial information.'

New York Judge Requires Hedge Funds to Disclose Their Investors

The holders of 10% or more of the equity of a party in an adversary proceeding must be disclosed publicly absent *evidence* that the identity of the owners is "commercial information," according to a decision by Manhattan Bankruptcy Judge Martin Glenn, interpreting Bankruptcy Rule 7007.1 and Section 107(b)(1) of the Bankruptcy Code.

In his Dec. 9 opinion, Judge Glenn required disclosure of the investors in hedge funds even though no one aside from the U.S. Trustee objected to sealing the lists of the larger owners.

The issue arose in a lawsuit stemming from the bankruptcy of General Motors Corp. and one of the biggest legal blunders in history that may have caused the inadvertent termination of a $1.5 billion security interest. This year, hedge funds involved in the litigation asked Judge Glenn to permit them to seal the identities of their larger investors. He refused.

The pivotal authority is Bankruptcy Rule 7007.1 which requires a party in an adversary proceeding to file a statement disclosing the identities of holders of 10% or more of its equity. Although the rule itself requires disclosure by "corporations," the Southern District of New York by local rule expanded the disclosure requirement to cover other types of ownership such as partnerships and joint ventures.

The hedge funds argued that the identities of their larger investors was "confidential commercial information" protected from disclosure by Section 107(b) of the Bankruptcy Code. That section requires the court to allow redaction of "a trade secret or confidential research, development or commercial information."

Citing Second Circuit authority, Judge Glenn said that invoking Section 107(b) entails a "heavy" burden of proof "requiring an 'extraordinary circumstance or compelling need.'" He quoted the *Collier* treatise for the proposition that embarrassment or harm to reputation is insufficient. He went on to cite another New York bankruptcy judge for the notion that the commercial information exception "'is not intended to offer a safe harbor for those who crave privacy or secrecy for its own sake.'"

To justify sealing, the information must be "'so critical to the operations'" that disclosure "'will unfairly benefit the entity's competitors.'"

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Judge Glenn said it was "far from clear" that the identities of the larger equity owners "can ever be confidential information." He did not decide that question because the hedge funds "failed to establish that the required high standard ha[d] been met."

The hedge funds came up short because they submitted only argument of counsel, not evidence showing that the investors' identities was commercial information. Just because the information was "'confidential' does not mean it is 'commercial information' entitled to the extraordinary procedure of sealing," Judge Glenn said.

Hedge funds have a glimmer of hope that they can justify redaction of the identities of larger owners in future cases, though, because Judge Glenn said the record before him had "no evidentiary basis" to permit sealing because the investors had not met "their evidentiary burden to show why this information is 'commercial information.'"

By virtue of Bankruptcy Rule 9014, the disclosure requirement in Rule 7007.1 does not apply in contested matters, although bankruptcy judges could make the rule applicable.

To read an ABI story about recent developments in the litigation over the $1.5 billion security interest, click here.

The opinion is *Motors Liquidation Co. Avoidance Trust v. JPMorgan Chase Bank NA (In re Motors Liquidation Co.)*, 561 B.R. 36 (Bankr. S.D.N.Y. Dec. 9, 2016).

Stays & Injunctions

Tenth Circuit joins the minority by holding that passive retention of collateral is no stay violation.

Circuit Split Widens on Stay Violation for Failure to Turn Over Repossessed Collateral

The Tenth Circuit widened an existing split among the courts of appeals by ruling that passively holding an asset of the estate, in the face of a demand for turnover, does not violate the automatic stay in Section 362(a)(3) as an act to "exercise control over property of the estate."

The Tenth Circuit allied itself with the District of Columbia Circuit. The Seventh, Second, Ninth and Eighth Circuits are arrayed on the other side and hold that retention of estate property after demand for turnover does violate the automatic stay.

Taking the minority position, the Feb. 27 opinion authored by Circuit Judge Monroe G. McKay was based on the plain meaning of the statute, not on "policy considerations."

Before bankruptcy, a lender repossessed the debtor's truck. After filing a chapter 13 petition, the debtor requested the return of the truck. The creditor refused, claiming he had sold the truck before the bankruptcy filing.

A month later, the debtor moved to hold the creditor in contempt for willful violation of the automatic stay. The bankruptcy court granted the motion and directed the creditor to turn the truck over immediately, coupled with a warning that failure to do so could result in imposition of monetary damages for willful violation of the stay under Section 362(k)(1).

When the creditor did not comply, the debtor initiated an adversary proceeding. At trial, the creditor contended there was no stay violation because the debtor's ownership interest was terminated by the sale before bankruptcy.

The bankruptcy judge ruled that documents showing a sale of the truck were "likely forged." The judge also said that the creditor "gave perjured testimony." Even if the testimony were correct, the bankruptcy judge held that the debtor's ownership had not been terminated properly under Colorado law.

The bankruptcy judge concluded that the creditor violated Section 362(a)(3) and imposed actual and punitive damages under Section 362(k)(1). On appeal, the district court set aside the calculation of damages but otherwise upheld the bankruptcy court.

The creditor came out on top in the Tenth Circuit in terms of statutory interpretation, but it might not escape sanctions.

Judge McKay described the "majority rule" as saying that "'the act of passively holding onto an asset constitutes "exercising control" over it, and such action violates Section 362(a)(3),'" quoting the Seventh Circuit in *Thompson v. General Motors Acceptance Corp.*, 566 F.3d 699, 703 (7th Cir. 2009). He described the majority as "driven more" by "practical" and "policy considerations" than by "faithful adherence to the text."

Concluding that the language of the statute is "plain," Judge McKay aligned the Tenth Circuit with the D.C. Circuit's *U.S. v. Inslaw*, 932 F.2d 1467 (D.C. Cir. 1991).

Observing that the statute bars "any act to exercise control over property," Judge McKay said that "act" means "to 'take action' or 'do something.'" Because the stay enjoins "doing something," he said, "It does not cover 'the act of passively holding onto an asset.'"

Significantly also, Judge McKay said that Section 362(a)(3) does not "impose an affirmative obligation to turnover property."

Judge McKay conceded that the majority's "best argument" is for reading Section 362(a)(3) in tandem with Section 542, which provides that someone in "control" of estate property "shall deliver" it to the trustee. Arguably, Section 542 provides a right to return, while Section 362 imposes a sanction for failure to do so.

Judge McKay said that the majority's "policy argument" in combining the two sections "is simply not supported by the statute's text or its legislative history," in part because there is "no textual link between Section 542 and Section 362."

The opinion adopted "the minority rule: only affirmative acts to gain possession of, or to exercise control over, property of the estate violate Section 362(a)(3)."

Judge McKay said that his statutory interpretation may not absolve the creditor of liability for damages. On remand, he instructed the bankruptcy court to employ Sections 362(a)(3) and 105(a), which give power to "'sanction conduct abusive of the judicial process.'"

He said that the bankruptcy court's finding that the creditor likely forged documents and gave perjured testimony "would qualify as post-petition acts to exercise control over the debtor's property in violation of the automatic stay."

The Tenth Circuit does not seem to undercut the notion that the debtor retains the right to recover possession of repossessed property if title has not transferred. The opinion could be

interpreted to mean that a creditor need not heed a demand for turnover but may await entry of a turnover order.

Consequently, debtors who lose possession of their cars before filing may now be obliged in the Tenth Circuit to initiate legal proceedings to recover possession. In other circuits, bankruptcy has the virtue of enabling debtors to recover repossessed autos immediately because lenders know they face contempt sanctions if they do not cooperate.

The opinion has a beneficial feature: It removes the need for courts to explain why a bank's "administrative freeze" does not violate the automatic stay.

The opinion includes a holding favorable to debtors. In the case at hand, the bankruptcy court dismissed the chapter 13 petition because loss of the truck bereft the debtor of ability to generate regular income.

Judge McKay held that jurisdiction to impose damages under Section 362(k) continues after dismissal because a "'court must have the power to compensate victims of violations of the automatic stay and punish violators, even after the conclusion of the underlying bankruptcy case,'" citing *Johnson v. Smith (In re Johnson)*, 575 F.3d 1079, 1083 (10th Cir. 2009).

The opinion is *WD Equipment v. Cowen (In re Cowen)*, 849 F.3d 943 (10th Cir. Feb. 27, 2017).

Bankruptcy courts can enter final orders voiding mechanic's liens, Third Circuit says.

State Law Determines Whether Post-Filing Mechanic's Liens Are Voidable

A mechanic's lien filed by a supplier after the contractor filed a chapter 11 petition was void for violating the automatic stay, according to the Third Circuit's interpretation of New Jersey law.

The result would be different, and the lien would be valid, if state law provided for the lien to relate back to the beginning of the work, the circuit said.

A supplier provided goods to an electrical contractor on a construction job. Two weeks after the contactor filed a chapter 11 petition, the supplier filed a mechanic's lien, now called a construction lien under New Jersey law.

The contractor filed a motion to declare that the lien was invalid as a consequence of violating the automatic stay under Section 362. The supplier contended that the lien was an encumbrance on the owner's property and thus did not violate the stay.

The bankruptcy court found a stay violation and voided the lien. In the absence of a stay pending appeal, the owner paid the contractor what it was owed. The district court upheld the bankruptcy court.

In an opinion on March 30 written by Circuit Judge Jane R. Roth, the appeals court agreed that the lien was invalid.

The pivotal factor was Judge Roth's interpretation of New Jersey lien law. She concluded that the lien would allow the supplier to recover against the account receivable owing to the contractor from the owner and, thus, was a lien against the debtor's property. The conclusion therefore followed that the filing of the lien was void as a violation of the automatic stay.

Judge Roth said that *In re Yobe Electric Inc.*, 728 F.2d 207 (3d Cir. 1984), was not to the contrary. There, the case turned on Pennsylvania law, where the filing of a mechanic's lien relates back to the date when the work began. Consequently, there was no stay violation in *Yobe* because the work began before the contractor's bankruptcy.

In short, Judge Roth said that "Pennsylvania liens relate back, and New Jersey liens do not."

Invalidating the lien, Judge Roth said, was consistent with "numerous cases from other courts," including the Ninth Circuit.

Judge Roth rejected the supplier's argument that the bankruptcy court, an Article I tribunal, did not have constitutional power to rule on the validity of a lien arising under state law. She said that the debtor's motion was based on federal bankruptcy law and thus entailed issues of public rights where the bankruptcy court has adjudicatory power.

The opinion is *In re Linear Electric Co.*, 852 F.3d 313 (3d Cir. March 30, 2017).

First Circuit declines to take sides in circuit split over jurisdiction in Medicare disputes.

Cutting Off Medicare Funding Is Exempt from the Automatic Stay, First Circuit Says

The First Circuit declined to take sides in a circuit split about a bankruptcy court's ability to compel the federal government to continue Medicare and Medicaid funding. Instead, the appeals court exercised "hypothetical jurisdiction" by reaching the merits and deciding that cutting off Medicare reimbursement was "plainly" an exercise of "police and regulatory power" exempt from the automatic stay under Section 362(b)(4).

Given the Nov. 29 opinion from the First Circuit and the Eleventh Circuit's *Bayou Shores* decision in July, a hospital cannot fight Medicare in chapter 11 and survive.

A hospital in Maine had a strategy for closing down inpatient services in chapter 11 while continuing to provide outpatient care. Just before filing the petition, the hospital told Medicare authorities that it would halt inpatient admission after filing in chapter 11 and would immediately transfer patients to another acute-care hospital. The hospital intended to continue offering outpatient services.

The hospital was evidently too forthright, because the government announced that it was immediately terminating the provider agreement and cutting off Medicare funding because the facility no longer qualified as a "hospital" following the cessation of inpatient services.

The hospital's strategy required continued Medicare funding to finance the transition of the facility in chapter 11. Consequently, the hospital sued Medicare authorities while in chapter 11, asking the judge to compel continuation of government funding. The bankruptcy judge declined to enjoin federal authorities, and the decision was upheld in district court. Both lower courts held there was no jurisdiction and that the government did not violate the automatic stay by terminating the hospital's Medicare provider agreement.

The hospital lost again in the Nov. 29 opinion by Circuit Judge Sandra L. Lynch.

According to Judge Lynch, the "majority of circuits" hold, as in *Bayou Shores*, that bankruptcy courts have no jurisdiction over a Medicare or Medicaid dispute by virtue of Section 405(h) of Title 42 of the U.S. Code. The Ninth Circuit takes the contrary view that Section 405(h) does not preclude bankruptcy jurisdiction.

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Rather than leap into the circuit split, Judge Lynch upheld the decisions below “on narrower grounds evident from the record.”

Although jurisdiction is typically a threshold issue on appeal, Judge Lynch exercised “hypothetical jurisdiction” because “only statutory jurisdiction is at stake,” not “Article III jurisdiction.”

Turning to the merits, Judge Lynch said that the police and regulatory exception to the automatic stay in Section 362(b)(4) is “designed primarily to protect the public safety and welfare.” The exception does not apply if the government is trying to “recover property” or has a “pecuniary purpose.”

Judge Lynch said it was “true, but largely irrelevant,” that termination of the provider agreement did not result from a “threat to the health or safety of patients.” Concerns for health and safety alone, she said, are “too circumscribed a view of the public interest.” Precedents distinguish between governmental actions that govern behavior and those that “enforce contractual rights against debtors.”

There is a “strong public policy interest,” Judge Lynch said, in ensuring that Medicare dollars “are not spent on institutions that fail to meet qualification standards.” Because the hospital itself “had taken actions to disqualify itself from the Medicare program,” she said it was “plainly the exercise of a regulatory power” to prevent the “waste of public monies.”

To read ABI’s discussion of *Bayou Shores*, click here.

The opinion is *Parkview Adventist Medical Center v. U.S.*, 842 F.3d 757 (1st Cir. Nov. 29, 2016).

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Executory Contracts & Leases

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Ninth Circuit refuses to apply Section 506(b)(6) to all damages related to lease claims.

Lease Rejection Cap Doesn't Apply to Past-Due Rent Accrued Before Rejection

Having handed down an opaque, unpublished, non-precedential memorandum in October on an issue where the courts disagree, the Ninth Circuit responded to a request by one of the parties and issued a new opinion on Dec. 29, roughly four times longer than the original decision, holding that the cap on a lease claim under Section 506(b)(6) only applies to damages for future rent and related expenses, but nothing else.

The case involved a tenant that stopped paying rent before vacating the premises. Arbitrators awarded the landlord $1.3 million, representing unpaid past rent and future rent discounted to present value. The lease allowed the prevailing party to recover attorneys' fees. The arbitrators therefore also awarded the landlord about $200,000 for attorneys' fees and costs of the arbitration.

The tenant later filed a chapter 11 petition and objected to the landlord's claim, relying on Section 506(b)(6), which caps "damages resulting from termination of a lease of real property." The bankruptcy court applied the cap to limit the landlord's claim for past and future rent but did not cap the claim for attorneys' fees and arbitration fees. The district court affirmed on the first appeal.

In the Dec. 29 opinion on the second appeal, Circuit Judge Susan P. Graber reversed the lower courts, holding that Section 506(b)(6) "does not cap damages arising from every breach of contract." Judge Graber said that the cap should not have been applied to past rent. On remand, she also told the lower courts to apportion attorneys' fees and arbitration costs between claims that were covered by the cap and those that were not.

Judge Graber was bound by the Ninth Circuit's 2007 *El Toro* opinion, which held that "damages other than those based on loss of future rental income are not subject to the cap." *El Toro* did not address the question of capping claims for associated attorneys' fees.

In her Dec. 29 opinion that is to be published, Judge Graber conceded that courts are divided on the applicability of the cap. "On one end of the spectrum," she said, there are courts that interpret the cap "expansively, like a kind of subject matter cap on all lease-related claims." The Ninth Circuit Bankruptcy Appellate Panel was in that camp until reversed by *El Toro*.

"At the other end of the spectrum," Judge Graber cited a Virginia bankruptcy court as "narrowly" interpreting Section 506(b)(6) "to cap claims for future rent, but to exclude all other damages, thereby permitting collateral claims to be asserted in full."

Taking what she called "the middle ground," Judge Graber said that *El Toro* adopted a "simple test" asking whether the landlord would "'have the same claim against the tenant if the tenant were to assume the lease rather than rejecting it.'"

In the context of pre-bankruptcy termination, Judge Graber followed the approach taken by the Eighth Circuit Bankruptcy Appellate Panel in its 2015 *Wigley* opinion, holding that unpaid past rent, common area maintenance, and late fees accruing prior to lease termination do not result from termination of the lease and are therefore not subject to the cap. The Eighth Circuit BAP applied the same test to apportioning attorneys' fees.

Applying the *Wigley* test, Judge Graber held that attorneys' fees attributable to the landlord's claim for future rent would be capped, while fees related to past rent would not be capped because the landlord could assert a claim "independent of termination."

The opinion is *Kupfer v. Salma (In re Kupfer)*, 852 F.3d 853 (9th Cir. Dec. 29, 2016).

Boston BAP sides with Seventh Circuit, holding that trademark licenses survive rejection.

First Circuit BAP Rejects *Lubrizol* on Rejection of Trademark Licenses

The First Circuit Bankruptcy Appellate Panel aligned itself with the Seventh Circuit by holding that rejection of a trademark license does not strip the licensee of the right to use the mark, contrary to the controversial 1985 holding by the Fourth Circuit in *Lubrizol Enterprises v. Richmond Metal Finishers Inc.*

The BAP's Nov. 18 opinion by Bankruptcy Judge Melvin S. Hoffman adopted the reasoning employed by Seventh Circuit Judge Frank Easterbrook, who said in *Sunbeam Products Inc. v. Chicago American Manufacturing LLC* in 2012 that nothing in Section 365 forces the non-bankrupt party to stop using trademarks when the license is rejected.

The controversy has persisted because Congress has been flummoxed by *Lubrizol* when it comes to trademarks.

In *Lubrizol*, the Fourth Circuit ruled that rejection of an executory contract licensing intellectual property halted the non-bankrupt's right to use patents, trademarks and copyrights. Three years later, Congress responded by adding Section 365(n), which, in conjunction with the definition of "intellectual property" in Section 101(35A), provides that the non-debtor can elect to continue using patents, copyrights and trade secrets despite rejection of a license.

The amendment conspicuously omitted reference to trademarks. The Senate Report said that the amendment did not deal with trademarks because the issue "could not be addressed without more extensive study." According to the report, Congress decided to postpone action "to allow the development of equitable treatment of this situation by bankruptcy courts."

Since then, courts split into two camps. One group takes a negative inference from the omission of trademarks from Section 365(n) by holding that rejection terminates the right to use a trademark, although the licensee could elect to continue using patents covered by the same agreement.

The opposing camp is exemplified by the Seventh Circuit, where the appeals court acknowledged that Section 365(n) does not preserve the right to use trademarks, but at the same time does not prescribe the consequences of rejection. Instead, Circuit Judge Easterbrook relied on Section 365(g), which teaches that rejection "constitutes a breach" of contract.

Judge Easterbrook reasoned that a licensor's breach outside of bankruptcy would not preclude the licensee from continuing to use a trademark. He ruled that rejection converted the debtor's unfulfilled obligations into damages. He said that "nothing about this process implies than any other rights of the other contracting party have been vaporized." He added that *Lubrizol* has been "uniformly criticized" by scholars and commentators.

Adopting the approach in *Sunbeam* and reversing the bankruptcy court, Judge Hoffman called *Lubrizol* "draconian" and said that rejection does not "vaporize" trademark rights. He also noted that *Lubrizol* is not binding on courts in the First Circuit and mentioned that the bankruptcy court had not cited *Sunbeam* in ruling that the licensee could not use trademarks after rejection.

Judge Hoffman's decision upheld the bankruptcy court's ruling that the license agreement did not confer distribution rights that would survive rejection. Intellectual property lawyers should consult the decision for hints about how to draft licenses so that distribution rights might survive rejection.

The opinion is *Mission Product Holdings Inc. v. Tempnology LLC (In re Tempnology LLC)*, 559 B.R. 809 (B.A.P. 1st Cir. Nov. 18, 2016).

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Compensation

Standard carveout only limits committee counsel fees if no chapter 11 plan is confirmed.

Delaware Judge Disregards Committee Fee Cap if a Chapter 11 Plan Is Confirmed

In an opinion sure to rankle secured lenders, Delaware Bankruptcy Judge Christopher S. Sontchi ruled that the typical cap in a financing order on attorneys' fees for the official creditors' committee does not limit professional compensation once a chapter 11 plan is confirmed. He said that the cap, contained in what he called a "standard carveout provision," applies only if reorganization aborts and no plan is confirmed.

Should a lender try to close the loophole by imposing a cap on fees effective even after confirmation, Judge Sontchi hinted in a footnote that he might not approve a financing order imposing an absolute cap on professional fees.

"What this opinion may mean is that the parties have to be even more clear in terms of their intent to enforce a cap and that any ambiguity will be construed in favor of the professionals seeking to override a cap," Prof. Nancy Rapoport told ABI in an email. Prof. Rapoport is the Garman Turner Gordon Professor of Law at the Univ. of Nevada at Las Vegas William S. Boyd School of Law, where she is an expert on legal ethics.

The opinion handed down by Judge Sontchi on Jan. 5 followed confirmation of the Molycorp Inc. chapter 11. Soon after the reorganization began in June 2015, he approved financing where the lender agreed to make loans and allow the use of its collateral. The financing order provided that up to $250,000 from advances and the lender's collateral could be used to pay the committee's professionals "in connection with investigating (but not prosecuting any challenge to)" claims by or against the lender, including challenges to the validity of the lender's security interests.

The creditors' committee conducted an investigation regarding the lender and later obtained authorization to initiate suit. Mediation ensued, ultimately resulting in a global settlement among the debtor, the committee and the lender, laying the foundation for a chapter 11 plan.

Judge Sontchi confirmed the plan in April 2016.

For the time period covering the investigation, lawsuit and settlement, the committee filed an application after confirmation for approval of about $8,715,000 in fees and expenses. The lender objected, contending, among other things, that $250,000 was an absolute cap on fees related to the investigation and a prohibition against any allowance of fees in connection with litigation.

Judge Sontchi said he was being called on to decide whether the limitation in the financing order was an "absolute limit" or "absolute cap" on the allowance of fees related to the lender investigation and litigation.

Before addressing the issue directly, he said that a lender's interest in its collateral is a property right "which may not be substantially impaired when bankruptcy intervenes." Therefore, he said, administrative creditors run the risk of nonpayment if there are insufficient unencumbered assets.

To attenuate the risk, Judge Sontchi described how professionals negotiate so-called carveouts, which he characterized as "essentially an agreement by the secured creditor to subordinate its liens and claims to certain allowed administrative expenses."

When no plan is confirmed and there are insufficient unencumbered assets, Judge Sontchi said the carveout is the "professionals' only recourse." Had Molycorp not confirmed a plan, the opinion says that the committee's lawyers would not have been compensated for all their work.

As a consequence of Section 1129(a)(9), the analysis changes when the debtor confirms a plan, Judge Sontchi said. At confirmation, the Bankruptcy Code "elevates allowed administrative claims to a dominant priority" conferring a right to payment in full unless the particular administrative claimant has agreed otherwise. Citing authorities, he said that if secured creditors desire confirmation, "'administrative claims must be paid in full in cash at confirmation even if it means invading their collateral.'"

The parties disagreed about whether the DIP financing order represented a waiver of the right to full compensation permitted by Section 1129(a)(9). Although the parties disagreed about the interpretation of the financing order, Judge Sontchi said the provision capping fees was not ambiguous.

The limitation in the financing order, according to Judge Sontchi, "does not connote in any way that the dollar-amount cap would operate as a complete bar against the allowance of administrative expense claims following plan confirmation." Although it would limit fees were there no plan, he said "it was not intended to come into play if a chapter 11 plan was confirmed."

Judge Sontchi ended his 23-page opinion by allowing the application but reducing the fees by about $31,000, as recommended by the fee examiner.

The opinion is *In re Molycorp Inc.*, 562 B.R. 67 (Bankr. D. Del. Jan. 5, 2017).

Florida judge allows fees for supplementing application with more detail.

Baker Botts Read Narrowly on Compensation for Defending Fee Application

A bankruptcy court in Florida narrowly interpreted *Baker Botts v. ASARCO* by allowing compensation for supplying more detail after an objection to a fee application that was initially in compliance with local rules.

In chapter 7, the trustee's counsel recovered $6.5 million in settlement of a fraudulent transfer suit. In compensation for the litigation and general services to the trustee, the lawyer filed a fee application for about $750,000.

In his opinion on Oct. 26, Chief Bankruptcy Judge Michael G. Williamson in Tampa, Fla., said that the fee application, as originally filed, complied with the local rules for chapter 7 cases. Nonetheless, the U.S. Trustee objected to the application, asking for additional detail akin to that which would be required under local rules were the case in chapter 11.

The lawyer decided to comply with the U.S. Trustee's request. Once additional information was provided, the U.S. Trustee in substance withdrew the objection, and the fee application was allowed in full.

On a second fee application, the lawyer sought almost $34,000 for preparation of the first fee application, including some $27,500 spent in responding to the U.S. Trustee's request for more information.

The U.S. Trustee objected to allowance of the $27,500, contending the money spent in defense of the fee application did not benefit the estate, and thus was not allowable under the Supreme Court's 2015 decision in *Baker Botts*.

Judge Williamson disagreed and allowed the entire $34,000 for fee application preparation, latching onto an analogy that Justice Thomas included in his *Baker Botts* opinion.

Justice Thomas said that preparation of an itemized bill by an auto mechanic would be "part of his 'services' to the customer." Therefore, Judge Williamson said, the "touchstone" is not whether the services were performed before or after objection.

Judge Williamson said that supplying additional information "was akin to the mechanic's preparation of an itemized bill as part of his 'services' to the customer." Here, he said, "the parties were not fighting over the amount of the bill but whether it was detailed enough."

The result might have been different, Judge Williamson said, had the U.S. Trustee's objection complained about duplication of services.

It is not entirely clear from the opinion, but services for providing additional detail might also have been allowed were the case in chapter 11. Because incurring the expense after an objection is not pivotal, response to an objection requesting more detail might also be allowable in chapter 11, since providing detail would be compensable where the expense is incurred in the initial preparation of the application.

Judge Williamson in substance wanted a rule of law that would not prompt counsel to overdo their fee applications routinely, since providing detail is compensable.

The opinion is *In re Stanton*, 11-22675, 2016 BL 356911 (Bankr. M.D. Fla. Oct. 26, 2016).

Fraudulent Transfers

Ninth Circuit criticizes the Seventh for making the sovereign immunity waiver meaningless for Section 544(b)(1) suits.

Ninth Circuit Splits with Seventh on Sovereign Immunity and Derivative Suits by a Trustee

The Ninth Circuit created a split of circuits with the Seventh by holding that the waiver of sovereign immunity under Section 106(a)(1) enables a trustee to file a derivative suit against the Internal Revenue Service for receipt of a fraudulent transfer under Section 544(b)(1).

The issue is important because the outcome determines whether a trustee can ever mount a fraudulent transfer action under state law against governmental units, in this case the IRS.

"Before the Seventh Circuit's opinion, the bankruptcy courts were unanimous in their conclusion that 106 fully waives sovereign immunity under 544(b) — hopefully the Ninth Circuit will reassure them that was the right result," Prof. Stephen J. Lubben of Seton Hall University School of Law told ABI in an email. In support of the trustee, Prof. Lubben submitted an *amicus* brief for the National Association of Bankruptcy Trustees.

The Facts

Operated as a Ponzi scheme, the debtor was a so-called subchapter S corporation that paid the IRS about $17 million on account of taxes owing by its shareholders. Under a confirmed chapter 11 plan, the trustee for a creditors' trust sued the IRS to recover the payments.

The IRS conceded that it was liable under Section 548(a)(1)(B) for receipt of fraudulent transfers amounting to about $56,000 made within two years of bankruptcy. The government acknowledged that the waiver of sovereign immunity made the IRS subject to suit for fraudulent transfer within the ambit of the Bankruptcy Code.

To recover the remainder of the $17 million, the trustee also sued under Idaho's version of the Uniform Fraudulent Transfer Act, invoking Section 544(b)(1), which requires the existence of an actual, unsecured creditor who could have sued under state law. The trustee relied on Section 544(b) because Idaho law has a four-year statute of limitations, compared with only two years under the Bankruptcy Code.

The government filed a motion for summary judgment on the Section 544(b)(1) claim, because any creditor would have been barred by sovereign immunity from suing the government for receipt of a fraudulent transfer. The district court granted the trustee's cross motion for summary judgment, holding that Section 106(a)(1) waived sovereign immunity for derivative fraudulent transfer claims brought under Section 544(b)(1).

Section 106(a)(1) provides that "sovereign immunity is abrogated as to a governmental unit . . . with respect to" Section 544, among others.

The Ninth and Seventh Circuits Split

Upholding the district court in an Aug. 31 opinion by Circuit Judge Richard Z. Paez, the Ninth Circuit held that the Section 106 waiver permits suits under Section 544(b)(1), in the process creating a split of circuits with the Seventh Circuit in *In re Equipment Acquisition Resources Inc.*, 742 F.3d 743 (7th Cir. 2014).

In *EAR*, the Chicago-based court held 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. Judge Paez said he could find no other circuit decisions on the question.

Plain Language, Logic and Equity

Judge Paez relied on logic and the language of the statute, in particular the phrases in Section 544(b)(1) that allow a trustee to "avoid any transfer" that is "voidable under applicable law." He said that Section 544(b)(1) "does not exist in a vacuum; rather, it must be read in concert with other sections of the Bankruptcy Code," such as Section 106(a)(1), which "unambiguously abrogates the federal government's sovereign immunity 'with respect to Section 544.'"

Reading the two sections together, Judge Paez said that the abrogation of sovereign immunity is "absolute" and "thus necessarily includes the derivative state law claim on which a Section 544(b)(1) claim is based."

In terms of logic, Judge Paez said that the government's argument "would essentially nullify Section 106(a)(1)'s effect on Section 544(b)(1), an interpretation we should avoid." He also said, "It would defy logic to waive sovereign immunity as to a claim which could not be brought against the government."

Differing with the Seventh Circuit, Judge Paez appealed to a sense of equity. The Bankruptcy Code, he said, was drafted to put the IRS "on an equal footing with all other creditors." He said "it would be unfair for the governmental unit to participate in the distributions in a bankruptcy case while at the same time shielding itself from liability," quoting the Tenth Circuit from *In re Franklin Savings Corp.*, 385 F.3d 1279, 1290 (10th Cir. 2004).

Rochelle's Daily Wire

Saying that the waiver of immunity applies, Judge Paez held that "a trustee need only identify an unsecured creditor, who, but for sovereign immunity, could bring an avoidance action against the IRS."

The Second Issue

The case involved another issue. In a separate, nonprecedential opinion, the Ninth Circuit remanded that facet of the case to the district court.

From the $17 million found to be avoidable, the district court had held that the trustee could not recover $3.6 million that the IRS had refunded to shareholders before bankruptcy as overpayment of taxes.

In the separate *per curiam* opinion, the appeals court said that the trustee's appeal from that feature of the lower court's decision turned on whether the IRS was an initial transferee under Section 550(a)(1). The circuit remanded because the district court had employed the "control test" rather than the Ninth Circuit's "more restrictive dominion test."

The opinions are *Zazzali v. U.S. (In re DBSI Inc.)*, 16-35597 and 16-35598, 2017 BL 308010 and 2017 BL 306947 (9th Cir. Aug. 31, 2017).

Eleventh Circuit goes 'objective' while Fifth Circuit remains 'subjective' on value for constructive fraudulent transfers.

Circuits Split on Objective vs. Subjective Value for Fraudulent Transfer Consideration

The Eleventh Circuit waded into the controversy that embroiled the Fifth Circuit and Texas Supreme Court in *Janvey v. Golf Channel Inc*., 834 F.3d 570 (5th Cir. Aug. 22, 2016).

Unlike its New Orleans-based cousin, the Court of Appeals in Atlanta came down on the side of suppliers by protecting them from fraudulent transfer suits even when the goods or services they supplied did not give subjective value to the debtor.

The precedential value of the Eleventh Circuit's June 22 decision is questionable because the opinion is not to be published officially. Nonetheless, there is a conflict of circuits on the definition of "value" for a constructively fraudulent transfer.

In the Eleventh Circuit case, a company and its owner together leased a large home for $8,500 a month. The lease allowed using the premises only as a residence. Nonetheless, the business paid about 25% of the rent, with the owner claiming that he used a portion of the master bedroom as a home office. The company had a separate office where it conducted the bulk of its business.

The company went bankrupt, and the chapter 7 trustee sued the landlord for receipt of about $74,000 in constructively fraudulent transfers, representing the portion of the rent paid by the business. Upheld in district court, the bankruptcy court ruled in favor of the trustee, finding that the company did not receive reasonably equivalent "value" under Section 548(d)(2)(A), thereby making the transfers constructively fraudulent under Section 548(a)(1)(B) because the company was insolvent.

In a *per curiam* opinion, the Eleventh Circuit reversed, saying there was "no evidence" to support the finding of inadequate value. The panel was composed of Circuit Judges Adalberto Jordan, Robin S. Rosenbaum and Jill A. Pryor.

Here's the circuit split: The Fifth Circuit insists on using a subjective test under Section 548, evaluating subjectively whether the estate realized value, regardless of the objective value of the goods or services in the market generally. The Eleventh Circuit looks only to the objective value of the services, not the value realized by the debtor.

The Eleventh Circuit said the outcome was governed by *In re Financial Federated Title & Trust, Inc.*, 309 F.3d 1325, 1331–33 (11th Cir. 2002), where, according to the panel, "we explicitly

answered the question" by holding that "value under Section 548 is measured by the objective value of the property received by the debtor."

For the Eleventh Circuit, "the question is not whether the debtor subjectively benefitted from the property it received; the operative question is whether the property, goods, or services provided had objective value."

Because the trustee conceded that the home was worth $8,500 a month in rent, the appeals court reversed the lower courts, saying it was error to focus on the subjective benefit to the estate.

The Fifth Circuit's *Janvey* decision was an even more appealing case from the supplier's perspective. There, the defendant provided television advertising that was concededly worth $5.9 million in the market. Unbeknownst to the supplier, the advertiser-debtor was a Ponzi scheme. In its initial opinion, the Fifth Circuit employed a subjective test and found a fraudulent transfer because creditors of the Ponzi scheme received no benefit from advertising that only sustained the fraud.

On a motion for rehearing, the Fifth Circuit certified a question to the Texas Supreme Court, because the case turned on the Texas Uniform Fraudulent Transfer Act, not Section 548. The Fifth Circuit asked the Texas high court to opine on whether proof of "reasonably equivalent value" is determined from the perspective of creditors, or whether the defendant can defeat a fraudulent transfer claim by showing it provided goods or services at market value.

In sum, the Texas Supreme Court answered by saying that state law looks at "objective value," among other things. The Fifth Circuit was therefore compelled to set aside its prior opinion and let the supplier off the hook for receipt of a constructively fraudulent transfer.

Nonetheless, the Fifth Circuit served notice that it was not changing its prior interpretation of "value" under the Bankruptcy Code. The New Orleans court said the "primary consideration" is "the degree to which the transferor's net worth is preserved." The question, the court said, is not whether the consideration had "objective value," but whether the exchange "conferred a tangible economic benefit on the debtor."

To read ABI's discussion of the *Janvey* decision, click here.

The Eleventh Circuit opinion is *McHenry v. Dillworth (In re Caribbean Fuels America Inc.)*, 688 Fed. Appx. 890 (11th Cir. June 22, 2017).

Reversed by one district judge, Bankruptcy Judge Gerber was lauded by another on the same issue.

New York District Judges Are Split on Drawing Inferences of Fraud from Executives

Until the Second Circuit steps in to clear up confusion, lower courts in New York are in disarray about the standards to apply when deciding whether a corporation had the requisite intent to set aside a leveraged buyout as a fraudulent transfer with actual intent to hinder, delay or defraud.

The latest installment in the dispute is a Jan. 6 opinion involving Tribune Co. where District Judge Richard J. Sullivan pointedly disagreed with a *Lyondell Chemical Co.* opinion handed down in July by District Judge Denise Cote.

In the middle is former New York Bankruptcy Judge Robert E. Gerber, whose *Lyondell* opinion was reversed by Judge Cote. Noting that Judge Cote's decision was not binding on him but finding Judge Gerber's "thoughtful" opinion to be "highly compelling," Judge Sullivan decided to "apply Judge Gerber's analysis as persuasive."

The Tribune LBO and Bankruptcy

Tribune – the owner of the *Chicago Tribune*, *Los Angeles Times*, six other newspapers and 23 television stations – plunged into chapter 11 in 2008 not long after an LBO where the company took on billions in new debt, in large part to pay off selling shareholders. Tribune implemented a reorganization plan in late 2012, creating litigation trusts to pursue claims on behalf of unsecured creditors.

Broadly interpreting the safe harbor for "settlement payments" provided by Section 546(e) of the Bankruptcy Code, the Second Circuit held in March that the Bankruptcy Code superseded state fraudulent transfer law and barred pre-LBO unsecured creditors from asserting their own constructive fraudulent transfer claims against selling shareholders in the LBO.

The March decision precluded virtually any argument allowing creditors individually or collectively to sue shareholders on constructive fraudulent transfer theories seeking recovery of money received for stock in an LBO that rendered the company insolvent.

In *Tribune*, the creditors filed a petition for *certiorari* in September from the Second Circuit's dismissal, but the Supreme Court has yet to schedule a conference for the justices to consider allowing a final appeal. To read ABI's discussion of the March *Tribune* decision, click here.

The Second Circuit decision left the open the possibility of suits for actual fraud against selling Tribune shareholders under Section 548(a)(1)(A). Actual fraud lawsuits were pending in Judge Sullivan's court, but his Jan. 6 decision slammed the door on those too, for reasons we shall discuss after a quick look at *Lyondell*.

Lyondell

Filing chapter 11 in 2009, Lyondell Chemical Co. confirmed a chapter 11 plan the next year creating several litigation trusts. One suit alleged that Lyondell's pre-bankruptcy leveraged buyout was a fraudulent transfer with "actual intent" under Section 548(a)(1)(A). Bankruptcy Judge Gerber dismissed the suit for failing to satisfy the requisite pleading standards. He held that the chief executive's alleged knowledge of fraud could not be imputed to the company since Lyondell had a "functioning board" and the plaintiffs did not allege that the CEO controlled the board. He was reversed by District Judge Cote on July 27.

Judge Cote reinstated the suit, holding that the CEO's knowledge and intent could be imputed to the company, because requiring control of the board does "not appear to have any basis in Delaware agency law." She then went on to hold that the complaint alleged several "badges of fraud" justifying reinstatement of the suit. To read ABI's discussion of *Lyondell*, click here.

Judge Sullivan Takes on Judge Cote

In dismissing the Tribune actual fraud suit for failure to state a claim, Judge Sullivan momentarily sided with creditors by saying there was no need to show fraudulent intent on the part of selling shareholders. Rather, he said, the corporation's fraudulent intent mattered.

Next, he analyzed whether the creditors had to show fraudulent intent by the board, or just fraudulent intent on the part of company executives. That's where Judge Sullivan parted company with Judge Cote and sided with Judge Gerber.

The decision to consummate the LBO was delegated to an independent committee of the Tribune board. At the board level, Judge Sullivan said that the creditors therefore needed to show that the independent directors harbored actual intent to hinder, delay or defraud. If they did, then their intent could be imputed to the company.

It was another matter, Judge Sullivan said, to impute fraudulent intent to the company based on the intent of company executives. Disagreeing with Judge Cote and following Judge Gerber, Judge Sullivan said that the intent of executives mattered only if they were in a position to "control" decision making by the board. In other words, executives must have "formidable voting and managerial power" that rises to the level of "majority voting control."

Having established the pleading standard based on the executives' knowledge and intent, Judge Sullivan analyzed the complaint and said that the creditors failed to allege the requisite level of control by management over the board.

The creditors also alleged that management controlled the board by "manipulating the information" provided to the special LBO committee. The complaint failed, Judge Sullivan said, because it did not allege facts showing that the independent committee was "'supine'" or "'under the sway of an overweening CEO.'"

Therefore, the sufficiency of the creditors' complaint turned on the knowledge and intent of the special committee, because Judge Sullivan had held that the role of the executives was irrelevant given their lack of control.

Judge Sullivan then analyzed the badges of fraud alleged in the creditors' complaint and concluded that they "were insufficient to raise a strong inference" of intent to hinder, delay or defraud Tribune's creditors. He said the complaint was also deficient if the lower standard in securities law was applicable in deciding whether there was fraudulent intent.

A major chunk of the opinion is a close analysis of factual allegations in the complaint where the creditors were attempting to raise inferences of fraudulent intent. To some readers, the opinion might seem more like a ruling after a bench trial, where the judge draws inferences one way or the other from ambiguous facts. On appeal, Tribune's creditors might contend that Judge Sullivan was engaged in fact finding rather than making inferences in favor of the non-moving party.

Surely, there will be an appeal. Because Judge Cote denied a motion for an interlocutory appeal of her *Lyondell* decision, Judge Sullivan's *Tribune* decision will reach the Second Circuit first.

The *Tribune* decision is *Kirschner v. Fitzsimons (In re Tribune Co. Fraudulent Conveyance Ligitation)*; 11-md-2296, 2017 BL 5202 (S.D.N.Y. Jan. 6, 2017).

Madoff and Sixth Circuit have differing formulations about the 'good faith' defense for a recipient of a fraudulent transfer.

Sixth Circuit Pens Major Decision on Duty to Investigate Suspicions of Fraud

The Sixth Circuit handed down a fraudulent transfer opinion in a Ponzi scheme case that lays down rules for those murky situations when the recipient of a transfer should have suspicions but is short of knowing that fraud was afoot. Without citing the wealth of decisions emanating from the district and bankruptcy courts in New York, the appeals court in Cincinnati is establishing a principle similar to the "willful blindness" test adopted in the wake of the Bernard Madoff Ponzi scheme.

The case entailed a classic Ponzi scheme where the perpetrator ran two companies claiming to be in the computer services business. They created phony invoices showing they were purchasing computer equipment and defrauded equipment finance companies that had made loans to one of the fraudster's companies to enable the purchases.

Needless to say, the fraud was exposed, and the chief perpetrator committed suicide, having been in jail once before for bank fraud. Both companies ended up in bankruptcy.

The trustee sued the bank that had made loans and provided a bank account for about two years. Alleging that the bank was the recipient of transfers from an actual fraud under Section 548(a)(1)(A), the trustee sought to recover all payments the bank received to pay off the loans, along with all deposits into the bank account.

The bankruptcy court issued proposed findings and conclusions that were adopted in full by the district court. The bankruptcy court said there were two critical dates. By one date in 2004, the bank in substance knew there was fraud, thus precluding the bank from raising a good faith defense. At an earlier date in 2003, the bank was on "inquiry notice" about fraud.

The lower courts also held the bank liable for all loan repayments back to the date in 2003, ruling that "inquiry notice" destroyed the bank's good faith defense as being a transferee. The lower courts also held the bank liable for all deposits into the account, even those not used to repay the loans.

In significant part, Circuit Judge John M. Rogers reversed and remanded in an opinion on Feb. 8, holding that mere deposits into a bank account are not transfers and that inquiry notice by itself is not enough to eradicate the good faith defense.

The Deposits

Judge Rogers first addressed what he called "excess deposits," or deposits that were not used to repay loans from the bank. To establish liability for receipt of a fraudulent transfer under Section 548, there must be a transfer. Judge Rogers therefore had to decide whether mere deposits are considered to be transfers.

He held that they were not, reversing the lower courts and absolving the bank of liability for any deposits not used to repay the loans.

Following the Seventh, Ninth and Eleventh Circuits, and the *Collier* treatise, Judge Rogers held that the deposits were not transfers because the bank did not have "dominion and control," since the company was contractually entitled to withdraw the funds at any time. He said it was "not sufficient" that the bank could have used the deposited cash as it wished until the time came to honor a draw on the account.

The bank's security interest in the deposit account did not change the result, because the lien did not give the bank dominion and control since the depositor could withdraw funds unless the bank had declared a default and frozen the account.

The Loan Repayments

The liability for disgorging loan repayments turned on the bank's good faith defenses. With respect to loan repayments that were made directly, the bank would have no liability under Section 548(c) if it took "in good faith" and gave "value in exchange."

In some instances, the bank's loans were repaid indirectly, making the bank a subsequent transferee. In those situations, the bank would have no liability under Section 550(b)(1) for transfers for "value" made "in good faith" and "without knowledge of the voidability of the transfer."

To determine when the bank lost its good faith defense, the lower courts settled on two critical dates. At the later date, the bank in substance would have known there was fraud had bank employees communicated with one another. Judge Rogers upheld the finding of liability for all loan repayments after a later date when the bank could have put the pieces together from its files and known there was fraud.

The lower courts went wrong, Judge Rogers said, about liability after the earlier date, when the bank only had "inquiry notice."

Although Judge Rogers does not cite them, courts in New York in *Madoff* cases have held that recipients of actually fraudulent transfers from a Ponzi scheme will not have more liability for

having suspicions and conducting investigations to determine whether there was fraud. If there is not actual knowledge of fraud, the *Madoff* courts have held that recipients lack "subjective good faith" and become liable if they have "turned a blind eye to facts that suggested a high probability of fraud." For ABI's discussion of a recent *Madoff* decision, click here.

Judge Rogers used a different formulation. He asked whether "a reasonable person, given the available information, would have been alerted to a transfer's voidability." Notably, the *Madoff* test is subjective whereas Judge Rogers' test appears to be objective. Beyond that, the tests may end up in the same place.

Inquiry notice is not enough, Judge Rogers said, because "a reasonable person may not be alerted to a transfer's voidability even if there was inquiry notice." To find liability, the facts must "place a reasonable person on notice that the transfer was illegitimate" given the "investigative avenues that existed, the reasonableness of pursuing those investigations, and the findings that those reasonable investigations would have yielded."

In that respect, the test laid down by Judge Rogers seems to turn on subjective factors, more like the *Madoff* cases.

Consequently, the "holistic review of the facts" required by Judge Rogers' opinion seems to include both subjective and objective elements: The test is objective in deciding whether the recipient should investigate, and it is subjective in deciding how the recipient could have investigated and what it could have learned.

Whatever the nomenclature, Judge Rogers remanded the case for the lower courts to make factual determinations about the extent of the bank's knowledge on the earlier date when previously they had found only "inquiry notice."

Circuit Judge Karen Nelson Moore concurred in most of the opinion, but she wrote separately to clarify what "knowledge" means. If there is no actual knowledge, she said the recipient must "also show it lacks knowledge of facts that would lead a reasonable person to investigate further and learn that the transfer was voidable."

She also said "there is no daylight" between "inquiry notice and facts that would alert a reasonable person to voidability."

Judge Moore agreed with the majority that liability depends in part on available investigative avenues and what they would have uncovered. Significantly, she said that recipients "are not required to undertake unduly onerous investigations, and that whether an investigation is unduly onerous depends on the circumstances of the case."

The opinion is *Meoli v. Huntington National Bank*, 848 F.3d 716 (6th Cir. Feb. 8, 2017).

Innocent suppliers to Ponzi schemes are given protection from fraudulent transfer claims.

Judge Bonapfel Sides with Fifth Circuit on 'Equivalent Value' in Ponzi Schemes

Delving into a controversy where the Fifth Circuit and the Texas Supreme Court disagree, Bankruptcy Judge Paul W. Bonapfel of Atlanta scribed the outer limits of the so-called Ponzi scheme presumption in fraudulent transfer law.

In the bankruptcy of a Ponzi scheme, most courts presume that the fraudster had the requisite actual intent to hinder, delay or defraud creditors, as required by Section 548(a)(1)(A) and similar state laws. The presumption simplifies litigation and hastens the inevitable result when the trustee is suing to recover payments to investors who profited from the Ponzi scheme by taking out more cash than they invested and had no defenses apart from claimed innocence.

Were there no limits to the presumption, a trustee could recover any payments by a Ponzi schemer because the law only requires fraudulent intent on the part of the transferor, not the transferee. Therefore, the presumption becomes problematic when the trustee is suing an ordinary trade supplier, landlord or employee who gave equivalent value.

Janvey in the Fifth Circuit

In *Janvey v. Golf Channel Inc.*, the trustee had sued a cable television channel to recover $5.8 million paid for advertising the business that was later shown to be a Ponzi scheme. The trustee contended that the payments were fraudulent transfers with "actual intent" under Texas' non-uniform version of the Uniform Fraudulent Transfer Act, or TUFTA. The district court ruled against the trustee, saying that Golf Channel was an innocent supplier entitled to the good faith defense under state law by providing equivalent value and in good faith.

In March 2015, the Fifth Circuit reversed, holding that Golf Channel had not given reasonably equivalent value because the advertising did not benefit creditors. On motion for rehearing, the panel certified the state law question to the Texas Supreme Court.

The Texas court answered the certified question by ruling that "reasonably equivalent value" is provided under TUFTA when (1) services were fully provided under an arms'-length contract for "fair market value," (2) the consideration had "objective value" and (3) the exchange occurred in the ordinary course of the defendant's business.

Compelled by the Texas court's interpretation of state law, the Fifth Circuit reversed its prior conclusion in August and upheld the district court's granting of summary judgment absolving Golf Channel of fraudulent transfer liability.

Because Texas has a non-uniform definition of value, the Fifth Circuit panel said that its prior decisions continue to have binding effect with respect to Section 548 and the laws of other states. To read ABI's discussion of the Fifth Circuit's August opinion, click here.

Judge Bonapfel's Case

In Judge Bonapfel's case, the Ponzi scheme appeared to be an advisor providing investments to customers in hedge funds and limited partnerships. To park investors' money and provide the outward appearance of a legitimate business, the mastermind maintained an account with a legitimate stock brokerage firm that did not know it was dealing with a Ponzi scheme.

Relying on the Ponzi scheme presumption that focuses only on the transferor's intent, the trustee sued the broker under Section 548(a)(1)(A) to recover about $6 million paid within the year before bankruptcy in connection with ordinary, non-fraudulent brokerage transactions.

Because the transfers were within a year of bankruptcy, the broker had no safe harbor defense under Section 546(e). The broker nonetheless contended that the presumption should not apply. Judge Bonapfel agreed.

Judge Bonapfel's Critique of the Presumption

Judge Bonapfel's Jan. 10 opinion is a scholarly analysis of the history and logic (or lack of it) behind the Ponzi scheme presumption. He said that the Fifth, Sixth, Ninth, Tenth and Eleventh Circuits adopted the presumption, although "uncritically and without analysis of the fact that fraudulent inducement . . . differs from the fraudulent removal of assets beyond the reach of creditors." He said that the Ninth and Tenth Circuits "present no analysis of the presumption" and that the Fifth Circuit relied on a Seventh Circuit case "which did not address" the presumption.

Judge Bonapfel conceded that the Eleventh Circuit adopted the presumption in one sentence in a 2011 decision called *Perkins* but said it was "quite clearly" dictum.

On the other hand, he pointed out how the Eighth Circuit "left the issue open," while the Minnesota Supreme Court said there is no presumption under that state's law.

Nonetheless bound by the presumption, Judge Bonapfel explored its outer limits, otherwise anyone who innocently supplies goods, services or labor could be liable for receipt of a fraudulent transfer. He noted that lower courts in the Eleventh Circuit and elsewhere apply the presumption

only to transactions "in furtherance of" the Ponzi scheme. He said the Eleventh Circuit had not addressed when a transfer is considered "in furtherance of."

Finding some courts' formulations of "in furtherance of" to be unsatisfactory, Judge Bonapfel said the presumption applies only to a transfer that is "an inherent and integral part of the fraudulent inducement scheme, and the continuation of the fraudulent inducement must depend on the transfers." In other words, a "transfer that does not induce future investors is not an inherent and integral part" of the fraud.

In addition, there must be a "direct and material" causal connection "between the transfer and the inducement of future investors."

Applying the standards, Judge Bonapfel held that the broker had no liability because the presumption did not apply and there was no evidence that the transfers removed assets or concealed them from creditors.

Innocent Supplier's Other Defenses

Although the inapplicability of the presumption was enough to award judgment in favor of the broker, Judge Bonapfel went ahead and decided that the broker had a valid "good faith" defense under Section 548(c).

To counter the broker's asserted good faith defense, the trustee contended there were "red flags" that should have impelled the broker to investigate. Judge Bonapfel said that an objective standard would impose liability for negligent failure to recognize "red flags." He therefore declined to apply an objective standard to ordinary course, arms'-length transactions for equivalent value.

In the broker's context, the good faith test is subjective, he said. To flunk the good faith test, the transferee must be "willfully blind."

On that issue, the trustee presented evidence to show the broker violated regulatory requirements and compliance rules. Judge Bonapfel said the broker was not in a position to lose money on the account. Subjectively speaking, he therefore concluded that the broker acted "honestly and with integrity" in response to "compliance exception reports." Overall, the "red flags" were not sufficient for a reasonable jury to conclude that the broker willfully ignored the possibility of fraud.

Applicability to *Janvey*

Judge Bonapfel's standards support the Fifth Circuit's conclusions in *Janvey*. There, television advertising was directly soliciting new investors to prolong the Ponzi scheme. Since the

advertising was "in furtherance of" the Ponzi scheme, Judge Bonapfel presumably would have made the presumption applicable because there was no value from the perspective of creditors.

Whether Judge Bonapfel would have found good faith is a question we leave to the reader.

The opinion is *Perkins v. Lehman Brothers Inc. (In re International Management Associates LLC)*, 563 B.R. 393 (Bankr. N.D. Ga. Jan. 10, 2017).

ROCHELLE'S DAILY WIRE

Preferences & Claims

Third Circuit aids suppliers because 'receipt' can occur after 'delivery.'

Receipt under Section 503(b)(9) Occurs on Physical Possession, Third Circuit Holds

In determining whether a seller has an administrative expense claim under Section 503(b)(9), goods are "received" when the debtor takes "physical possession," the Third Circuit held in reversing two lower courts.

Under Section 503(b)(9), a seller of goods has an administrative claim if the goods were "received" within "20 days before the date of commencement" of bankruptcy. Questions arise when the dates of "delivery" and "receipt" are not the same.

By holding that receipt occurs on the sometimes later date of physical possession, the Third Circuit's decision is beneficial for sellers because delivery can occur before physical receipt, thus giving a supplier a better shot at having a valid reclamation or administrative claim for goods received before bankruptcy.

Two Chinese furniture manufacturers sold goods to a U.S. buyer. The goods were loaded on a cargo vessel and shipped free on board, or FOB. Although the goods were loaded more than 20 days before the buyer's chapter 11 filing, the buyer received physical possession within the 20-day period.

Upheld in district court, the bankruptcy court ruled that because the goods were shipped FOB, they were received when the risk of loss or damage passed to the debtor at the port in China. The sellers appealed and won, in a July 10 opinion by Circuit Judge Thomas M. Hardiman.

Although "received" is not defined in the Bankruptcy Code, Judge Hardiman said that Black's Law Dictionary and the Oxford English Dictionary both define the word as requiring physical possession. The legal and dictionary definitions agree with Section 2-103(1)(c) of the Uniform Commercial Code, which "defines 'receipt' of goods as 'taking physical possession of them.'"

For purposes of Section 546(c) and the right of reclamation, the Third Circuit had previously defined "receipt" in *In re Marin Oil Inc.*, 740 F.2d 220, 224–25 (3d Cir. 1984), to mean "taking physical possession." *Marin* "explicitly stated that delivery and receipt of goods can occur at different times," Judge Hardiman said.

"Receipt" means the same thing in Sections 546(c) and 503(b)(9), Judge Hardiman said. Therefore, "regardless of FOB status, under the UCC and chapter 11, receipt does not occur until after the seller's ability to stop delivery ends – namely, upon the buyer's physical possession."

Consequently, the sellers were entitled to administrative expense claims because the debtor received the goods within 20 days of filing.

Judge Hardiman qualified the holding by saying that receipt occurs on physical possession by the buyer "or his agent." However, he said the shipper was not the buyer's agent.

The opinion is *In re World Imports Ltd.*, 862 F.3d 338 (3d Cir. July 10, 2017).

`Ninth Circuit majority goes for a difficult issue when an easier answer was available.

Preference Analysis Permits 'Hypothetical-Within-a-Hypothetical' on Chapter 7 Recovery

The majority on a Ninth Circuit panel held that a bank has potentially large preference liability because the bankruptcy court should have decided whether there was another hypothetically avoidable preference. The majority's opinion relies entirely on the elements of a preference under Section 547(b), and subsection (b)(5) in particular.

Sitting by designation, District Judge Edward R. Korman, from the Eastern District of New York, employed Section 553(b) to arrive at a substantially smaller recoverable preference. Judge Korman used the arguably better approach.

The opinions do not contain sufficient facts to know for sure whether the bank, at the end of the day, will have any preference liability at all. Both opinions may have analyzed questions that were not necessary to answer because the bank may have another complete defense to preference liability.

The analysis of the case is muddled because the plaintiff-trustee did not make an argument under Section 553(b), perhaps because a recovery under that section would have been substantially smaller than by reliance on Section 547 alone. The bank-defendant did not argue that its liability should be measured by Section 553(b), likely because it won a complete victory in the lower courts on a different theory.

The Facts

According to the March 7 majority opinion by Circuit Judge Milan D. Smith, Jr., the debtor sold its real property for about $1.3 million well outside of the preference period. The proceeds were held in escrow.

Ninety days before bankruptcy, the debtor's deposit account at the bank held $173,000. The sale proceeds were released from escrow about five weeks before bankruptcy, within the preference period.

When the proceeds were released from escrow, the debtor paid off the $190,000 loan it owed to the bank. The debtor deposited the remainder, about $526,000, into its deposit account at the same bank.

The $173,000 that had been in the deposit account at the outset of the preference period declined to about $53,000 on the day the bank was paid off and the $526,000 went into the bank account.

The debtor paid some bills following release of the sale proceeds from escrow, leaving $564,000 in the bank account on the filing date.

Subtracting the disputed $526,000 deposit from the ending balance theoretically would have left about $38,000 in the account on the filing date, Judge Smith said.

Judge Smith said that the bank had a lien on personal property, including deposit accounts. His opinion also could be read to mean that neither the bank nor any other creditor had a security interest in the real estate that was sold.

Judge Korman, in contrast, said that that the bank's personal property lien included general intangibles, including the contractual right to be paid the proceeds held in escrow. He also said that the bank's security interest would have remained in the funds even if they had never been released from escrow.

If Judge Korman is correct, and if the bank had a lien on the escrow established at the time of the sale, then the bank's lien would have attached to the sale proceeds outside of the preference period, making the bank a fully secured creditor not subject to a preference claim. However, that issue is not discussed in either opinion because it was not the basis for the decisions in the lower courts.

The Lower Court Holdings

On summary judgment, the bankruptcy court found that the bank had a right of setoff and that the $564,000 in the account on the filing date would have fully repaid the $190,000 bank loan. Since the bank did not recover more from the prepetition payoff than it would have received from a chapter 7 liquidation, the bankruptcy court held there was no preference because the trustee did not satisfy Section 547(b)(5).

The district court upheld the decision in the bankruptcy court, finding no preference. The trustee appealed.

The Majority's Analysis

In the circuit, the trustee argued that the hypothetical chapter 7 liquidation analysis conducted in a preference suit under Section 547(b)(5) obliges the court, hypothetically, to unwind any other transfers that also would have been preferential, even if they were never actually avoided.

Reversing the lower courts, ruling for the trustee, and finding a preference, the majority held that the court "may account for hypothetical preference actions within a hypothetical chapter 7 liquidation analysis when such an inquiry is factually warranted, is supported by appropriate evidence, and the action would not contravene an independent statutory provision."

In deciding whether the $190,000 loan payoff was preferential, the majority concluded that the $526,000 deposit also would have been preferential. Backing out the $526,000 from the deposit account on the filing date would have left the account with $38,000 on the petition date, "a sum far less than the [$190,000 that the bank] received."

The majority remanded the case, evidently implying that the bank should be liable for receiving a preference of about $152,000 if there are no other defenses.

The majority said that its hypothetical-within-a hypothetical was supported by the statutory text, legislative history, and "current practice in bankruptcy courts." More particularly, Judge Smith said that the statutory "test clearly does not directly forbid courts from considering hypothetical preference actions within a hypothetical chapter 7 liquidation."

Judge Smith alluded to the best interests tests in confirming chapter 11 and 13 plans, where courts examine hypothetical avoidance actions in deciding whether the plans give creditors more than chapter 7 liquidations.

The majority then went on to decide that the $526,000 deposit also would have been preferential and thus should be deducted from the account balance on the filing date, leaving the account with insufficient funds to pay off the bank's loan in full.

Judge Korman's Dissent

Although technically a concurrence, Judge Korman's opinion reads like a dissent.

He concurred in the decision to reverse. Significantly also, he concurred with the proposition that a hypothetical preference should be taken into the equation in deciding whether another transfer was a preference because the creditor's recovery was larger than it would have been in chapter 7.

However, Judge Korman did not agree that the entire $526,000 deposit was preferential.

Instead, Judge Korman would have decided how much of the $526,000 would be preferential under Section 553(b). That section allows recovery of a setoff to the extent that the creditor has improved its position during the preference period.

Judge Korman saw the Section 553(b) analysis as "straightforward." At all times, he said, the debt to the bank totaled $190,000. On the 90th day before bankruptcy, the account balance was

$173,000, leaving an insufficiency of about $17,000, and allowing the bank "to recover at most [$173,000] in a hypothetical post-petition transfer."

Judge Korman concluded that the trustee "made out a prima facie case" that $17,000 "is voidable as a preference."

The majority did not conduct a Section 553 analysis because the trustee did not make the argument. Judge Korman said in a footnote that he nonetheless raised the issue given the importance of laying down the proper legal standards for courts to apply.

Assuming Judge Korman was correct and the bank's lien attached to the sale proceeds when they were held in escrow outside of the preference period, there would be no preference. That issue is not addressed in either opinion. On remand, the bank might be able to raise the defense if it was not waived, and if Judge Korman was correct that the lien attached to the escrow account.

The opinion is *Schoenmann v. Bank of the West (In re Tenderloin Health)*, 849 F.3d 1231 (9th Cir. March 7, 2017).

Judge adheres to plain language of agency commentary as though it were a statute.

Allowing WARN Claims in Liquidating Chapter 11s, Chicago Judge Splits with 3d Circuit

Disagreeing with the Third Circuit, Chicago Bankruptcy Judge Timothy A. Barnes ruled in substance that the so-called liquidating fiduciary exception to the federal Worker Adjustment and Retraining Notification Act, or WARN Act, does not apply if a chapter 11 debtor makes representations about attempting to reorganize, as opposed to liquidating.

The decision may end up giving $4 million in administrative expense claims to fired workers. Judge Barnes admitted that his approach would "detrimentally affect liquidating chapter 11 cases" by giving large claims to workers that must be paid in full ahead of unsecured claims.

The case involved a corporate debtor that fired its workers immediately after filing a chapter 11 petition. The WARN Act makes an employer liable for 60 days' wages if workers were not given advance notice of mass layoffs. Assuming there was a valid WARN Act claim, Judge Barnes concluded that it would be entitled to administrative expense priority under Section 503(b)(1)(A)(ii).

The difficult question for Judge Barnes was deciding whether there was a valid claim under the WARN Act, 29 U.S.C. § 2101-2109.

The statute itself contains several provisions absolving employers of liability even if they did not give 60 days' notice. There is no liability if the company was seeking capital or if the shutdown was caused by a "natural disaster" or "business circumstances that were not reasonably foreseeable."

In commentary issued in connection with the statute, the U.S. Department of Labor created what's known as the "liquidating fiduciary exception," which says that WARN Act liability does not attach to a "fiduciary whose sole function in the bankruptcy process is to liquidate." The commentary goes on to say, "In other situations, where the fiduciary may continue to operate the business for the benefit of creditors, the fiduciary would succeed to the WARN obligations of the employer precisely because the fiduciary continues the business in operation."

Judge Barnes said that the validity of the liquidating fiduciary exception was a case of first impression in the Seventh Circuit because it "exists nowhere in the statute itself." Since the Seventh Circuit has said in other contexts that the Labor Department's commentaries should be given "significant weight," Judge Barnes had "little hesitation" in following other courts that have "uniformly concluded" that the exception does exist.

Applying the exception, Judge Barnes looked to the plain language of the commentary just as he would analyze the words of a statute. He focused on the requirement that the fiduciary's "sole function" must be to liquidate. Chapter 7 trustees, he said, automatically qualify.

In chapter 11, the sole function of a trustee or debtor in possession is not to liquidate. Unless the bankruptcy court has limited the trustee's ability to operate the business under Section 1108, Judge Barnes said that the liquidating fiduciary exception would not apply in chapter 11.

To depart from the "plain words" of the commentary "would be to legislate from the bench," Judge Barnes said.

However, the Third Circuit upheld use of the exception in *Official Comm. of Unsecured Creditors of United Healthcare Sys., Inc. v. United Healthcare Sys., Inc. (In re United Healthcare Sys., Inc.),* 200 F.3d 170 (3d Cir. 1999). A bankruptcy court in New York did the same in the liquidation of MF Global Holdings Ltd.

In his Feb. 24 opinion, Judge Barnes said that the Third Circuit focused on the debtor's intent to liquidate rather than on the debtor's powers. He said that the appeals court and the court in New York did not constrain themselves "to the plain language" of the Department's commentary. Instead, he said, those courts used "hindsight" to "create a new, court-made liquidating fiduciary exception that is not in line with the specific language of the commentary itself."

Even were he to follow the Third Circuit, Judge Barnes ruled that the debtor was not eligible for the exception in view of the record in the bankruptcy court. He rejected the argument that the debtor always intended to liquidate.

Although the debtor did liquidate, Judge Barnes said "it is not clear that was their intent or sole course." He pointed to the financing order, which said that credit was needed "to operate the business." Without cash collateral, the debtor said it could not "operate its business," eliminating the possibility of a "successful reorganization."

Likewise, the debtor got permission to pay prepetition wages because failing to do so would "jeopardize its ability to reorganize." In addition, the motion to sell assets "repeatedly" referred to a "going concern" sale.

Even using the Third Circuit's retrospective analysis, Judge Barnes concluded that the debtor would not qualify for the exception because the debtor "acted in a manner inconsistent with liquidation."

ROCHELLE'S DAILY WIRE

The opinion is *In re World Marketing Chicago LLC*, 564 B.R. 587 (Bankr. N.D. Ill. Feb. 24, 2017).

Judge relies on physics in ruling that electricity qualifies as 'goods.'

Courts Divided on Electric Service as 'Goods' Under Section 503(b)(9)

Since judges are more like philosophers than physicists, it's not surprising that courts disagree on whether electricity qualifies as "goods" entitled to administrative priority when provided within 20 days of filing under Section 503(b)(9).

Finding no ambiguity in the term "goods" and surveying dozens of bankruptcy and non-bankruptcy cases involving electricity, Bankruptcy Judge Thomas B. McNamara of Denver concluded that electricity qualifies as goods under Section 503(b)(9).

In his 40-page, single-spaced opinion on Feb. 10, Judge McNamara was persuaded in large part by expert testimony from a physicist who described electric energy as electrons moving along transmission lines from the generating source to the consumer. Electrons, the expert said, are a "fundamental particle of nature." The judge also adopted the expert's nomenclature by using the term "electric energy" rather than "electricity" or "electric service."

As part of the 2005 amendments, Congress gave administrative priority status to "goods" provided within 20 days of filing. The term "goods," however, is not defined in the Bankruptcy Code. Although the Uniform Commercial Code defines "goods," Judge McNamara said that the definition of goods in the bankruptcy context is a question of federal law, not state law emanating from the UCC.

In the first major decision on Section 503(b)(9), *In re Pilgrim's Pride*, 421 B.R. 231, 236 (Bankr. N.D. Tex. 2009), now-retired Bankruptcy Judge Michael Lynn of Fort Worth concluded that natural gas and water were goods while electricity, trucking services and sewage disposal services were not. Although state law provides some guidance, Judge Lynn believed that the need for uniformity in bankruptcy law allowed federal courts to make their own rules. With regard to water and natural gas, Judge Lynn ruled that the creditors were entitled to an administrative claim only for the cost of the goods, but not for the cost of transporting them to the debtor's place of business.

After *Pilgrim's Pride*, Judge McNamara said that bankruptcy courts are evenly split on the status of electric energy as goods under Section 503(b)(9).

Before analyzing state law and the UCC, Judge McNamara searched for a federal law definition of "goods" by turning to the dictionary, which defines goods to mean things with value, whether tangible or not, that are produced for sale, including commodities. Since Congress decided

to use "an extremely broad word" when it wrote the statute, Judge McNamara found no linguistic basis for limiting goods to substances that can be "packaged and handled," a formulation employed in *Pilgrim's Pride*.

Judge McNamara said that electric energy is "most definitely a 'thing'" that can be seen, heard, touched, felt and quantified. Given those tangible, physical attributes, he concluded that a claim for electric energy supplied before filing easily qualifies for administrative priority.

Because every court to rule on Section 503(b)(9) has turned to the UCC for guidance, Judge McNamara did too.

Outside of bankruptcy, Judge McNamara said the majority of cases hold that electric energy is goods under UCC § 2-105. Most of the decisions holding otherwise are tort cases, where the issue turns on whether energy is considered goods or services.

New York, he said, is the state where the courts most starkly hold that electricity is not goods. Judge McNamara said that *dicta* from an intermediate state appellate court had been unthinkingly and incorrectly adopted by other state and federal courts. Pointing out the flaws in cases deciding that electric energy is not goods, Judge McNamara concluded that electric energy qualifies as goods under UCC § 2-105.

Moving beyond the UCC, Judge McNamara surveyed dozens of cases where electric energy is defined as goods in antitrust law, labor law, energy regulatory law, tort law and international treaties.

Judge McNamara also addressed Section 366, which deals with the discontinuation of "utility service." He rejected the notion that "use of the phrase 'utility service' in Section 366 means that electrical energy is not a 'good' under Section 503(b)(9)." He said that "every court" to consider the question "has determined that Section 366 is irrelevant."

Because "services" do not qualify for administrative status under Section 503(b)(9), debtors in the future might contend, following *Pilgrim's Pride*, that priority status should be given only to the cost of energy, but not the cost of transmission, if local utility tariffs support the argument.

The opinion is *In re Escalera Resources Co*., 563 B.R. 336 (Bankr. D. Colo. Feb. 10, 2017).

ROCHELLE'S DAILY WIRE

Subordination & Dismissal

ROCHELLE'S DAILY WIRE

Sympathy for the creditor arguably drove appeals court not to invoke subordination.

No Subordination in Ninth Circuit for a Stock Conversion Claim

A split decision from the Ninth Circuit on automatic subordination of a securities claim under Section 510(b) shows once again how hard cases can make bad law. The majority's sympathy for a defrauded investor may have influenced the appeals court to elevate a claim related to securities to the status of an unsecured claim.

A man was given 6 million shares in a small company in 2001 in return for unreimbursed expenses and compensation. After he left the company in 2009 as the result of a stroke, two other founders caused the company to cancel the stock. Raising claims for conversion and fraud, the man sued the two co-founders and won a judgment in state court that he should recover damages and that his stock should be reinstated.

Following more hearings, the state court concluded that reinstating the stock would lead to further, endless litigation. Deciding that the plaintiff should instead receive the value of the stock, the state court awarded him damages of almost $4 million for conversion, based on the value of the stock in 2009.

The two co-founders filed chapter 13 petitions and moved to subordinate the $4 million claim under Section 510(b). The bankruptcy court ruled that the claim was not subject to subordination and was upheld by the Bankruptcy Appellate Panel, but on different grounds: The BAP held that Section 510(b) did not apply in an individual's debtor case.

The two debtors appealed and lost again 2/1 in the Ninth Circuit, with the majority's opinion written by Circuit Judge Ferdinand F. Fernandez.

Judge Fernandez held that the claim was not the type for applying automatic subordination. He could not affirm on the ground relied upon by the BAP because the Ninth Circuit, in the meantime, had handed down *Liquidating Trust Committee of the Del Baggio Liquidating Trust v. Freeman (In re Del Baggio)*, holding that Section 510(b) does apply in individuals' cases. To read ABI's discussion of *Del Baggio*, click here.

Section 510(b) automatically subordinates "a claim arising from rescission of a purchase or sale of a security of the debtor or of an affiliate of the debtor [or] for damages arising from the purchase of such a security."

Assuming that the two debtors were "affiliates" of the company they each partially owned, Judge Fernandez said that Section 510(b) did not apply because the "claims did not arise out of a purchase or sale of securities," but from the debtors' "actions many years later (2009) when they fraudulently converted" the stock.

The damages, Judge Fernandez said, "were not remotely related to the purchase; they were simply a judgment measured by the value of the converted property when the conversion took place."

Although the Ninth Circuit had subordinated claims in other cases where there was "no actual purchase or sale," Judge Fernandez said that those cases "arose from a purchase or sale transaction." While "arising from" calls for a "broad interpretation," he said that Section 510(b) "stops short of encompassing every transaction that touches on or involves stock."

Judge Fernandez best explained the result when he said that the claim "did not arise out of the purchase of the securities and the risks that the purchase might entail. It arose out of the Debtors' conversion of the securities many years later."

Circuit Judge Johnnie B. Rawlinson dissented, saying that the "claim did arise from the purchase or sale of a security under Section 510(b)." She said that the later conversion of the stock "did not erase the fact" that the claim "arose from his previous purchase of securities."

Quoting from *Del Baggio*, she said subordination is proper "'where there exists some nexus or causal relationship between the claim and the purchase of the securities."

For both the majority and the dissent, the bulk of the opinions are devoted to justifying the result in comparison with prior Ninth Circuit decisions on Section 510(b). The opinions show that Section 510(b) would profit from having a bright-line test. Someone should write a definitive law review article.

The opinion is *Khan v. Barton (In re Khan)*, 846 F.3d 1058 (9th Cir. Jan. 23, 2017).

Circuits split on whether Section 510(b) killed off the exception to the Rule of Explicitness.

Judge Punts on How the Rule of Explicitness Survived Adoption of the Code

Resolving a distribution dispute between four layers of senior lenders, District Judge Deborah A. Batts of Manhattan sidestepped a conflict of circuits on the so-called Rule of Explicitness but nonetheless applied the doctrine to direct payment of interest on bondholders' claims, even though post-petition interest would not have been an allowable claim under Section 506(b).

Judge Batts' Jan. 27 opinion is a handy primer on the Rule of Explicitness and how courts around the country disagree over its interpretation and application.

In the case before Judge Batts, the trustee for a chapter 7 corporate debtor handed over about $25 million to the collateral agent for holders of five bond issues. The intercreditor agreement called for paying interest *pro rata* to all of the tranches simultaneously before beginning to pay principal. Once interest was paid, the agreement provided for principal until the senior-most tranche was paid in full, and then to the second in line until it was fully paid, and on down the line.

If interest were to be paid *pro rata*, the junior-most lender would get 38% of the $25 million. If Section 506(b) barred paying any interest at all, the first in line would get everything and the junior-most lender would get nothing. Under Section 506(b), interest is an allowable claim only if the collateral is worth more than the secured debt.

Judge Batts decided that the exception to the Rule of Explicitness was applicable in this case, meaning that all tranches were entitled to *pro rata* payment from the $25 million.

In her opinion, Judge Batts recounts the pre-Code derivation of the Rule of Explicitness. Created by federal courts before the adoption of Section 506, it decreed that interest ceases to accrue at the initiation of bankruptcy. It was codified by Section 506(b), with the exception that interest is a valid claim if the collateral is worth more than the debt.

Also before the adoption of the Code, courts created an exception to the Rule of Explicitness by suspending the doctrine between creditors if their agreement "clearly" showed "an intent to suspend the rule."

Usually, disputes about the Rule arise between senior and subordinated creditors. Judge Batts held that it also applies in disputes among tranches of senior lenders.

Adoption of the Bankruptcy Code arguably modified or eradicated the Rule in its original form because Section 510 makes subordination agreements enforceable in bankruptcy to the extent they are "enforceable under state law."

Answering a question certified from the Eleventh Circuit, the New York Court of Appeals, the highest court in the New York State court system, said that the Rule is a substantive principle of New York contract law.

The First Circuit, on the other hand, held that New York's highest court improperly intruded into federal law by making a bankruptcy specific rule declaring that the Rule is applicable in bankruptcy. The Second Circuit has yet to address the dispute.

In the most dubious part of her opinion, Judge Batts avoided deciding whether the New York Court of Appeals improperly intruded into federal bankruptcy law because she said that the case before her did not involve bankruptcy since none of the parties before her were in bankruptcy, nor was she dealing with property of a bankrupt estate.

Thus free to apply the unvarnished New York version of the Rule of Explicitness, Judge Batts said that the parties' agreements gave "clear notice" that principal payments were subordinated to prior payment of post-petition interest. To reach her conclusion, she pointed to a provision providing for the payment of interest "regardless of whether such interest and fees are allowed in such [bankruptcy] proceeding." Another said that interest is due and payable "regardless of whether" the debtor is in bankruptcy.

Judge Batts buttressed her decision to allow interest payments by noting that the documents in the case before her incorporated language similar to the American Bar Association's model indenture designed for use when the parties intend to override the Rule.

The opinion is *U.S. Bank NA v. T.D. Bank NA*, 569 B.R. 12 (S.D.N.Y. Jan. 27, 2017).

Consumer Bankruptcy

ROCHELLE'S DAILY WIRE

Fair Debt Collection Practices Act

The Eighth Circuit bars clever litigation tactics designed to evade the FDCPA on suits to collect time-barred claims.

Eighth Circuit Broadly Interprets the FDCPA to Protect Consumers

The Eighth Circuit set up a test case where the Supreme Court could decide, in the wake of *Spokeo Inc. v. Robins*, 136 S. Ct. 1540, 194 L. Ed. 2d 635, 84 U.S.L.W. 4263 (Sup. Ct. 2016), whether damages under the federal Fair Debt Collection Practices Act, or FDCPA, are sufficiently “concrete” to pass constitutional muster.

The Eighth Circuit’s opinion also pushes back against the tendency of some courts to read the FDCPA so narrowly that it fails its mission as a consumer protection statute.

The case centered around the practice of suing on debts where collection is barred by the statute of limitations. Intending to avoid liability under state laws or the FDCPA, the creditor will dismiss suits when consumers appear for trial. Otherwise, the creditor would obtain judgments against those not appearing or defending.

In the case that went to the Eighth Circuit, the debtor appeared, ready to try the case, but the creditor dismissed the suit. A month later, the creditor sued, alleging violations of the FDCPA. The district judge dismissed the suit, saying, among other things, that the creditor had only engaged in “permissible litigation tactics and not actionable false assertions.”

In an opinion on Aug. 29, Circuit Judge Duane Benton reinstated the suit, reversing all the grounds for dismissal.

Relying on *Spokeo*, the creditor contended in the Eighth Circuit that the consumer-plaintiffs lacked constitutional standing because they were only alleging *de facto* damages created by statute, not the required “concrete” injury.

Broadly holding that violations of the FDCPA meet constitutional requirements when stale debts are involved, Judge Benton said that “Congress created a statutory right to be free from attempts to collect debts not owed, helping to guard against identified harms,” such as the “risk of mental distress” and marital discord that can accompany the “harm of being subjected to baseless legal claims.”

The creditor contended that serving discovery requests on the consumers’ attorney was not an FDCPA violation because it was not served on the consumers themselves. Since papers served on an attorney "routinely" come to clients' attention, Judge Benton held that the service of discovery requests caused "concrete injury in fact."

For those engaged in practice under the FDCPA, we recommend reading the opinion in full, because Judge Benton handed down many holdings regarding consumers' rights.

For instance, the district court dismissed claims because the suit was not commenced within the one-year statute of limitations under the FDCPA. More particularly, the district judge said that the communications relied on in the complaint all related back to the filing of the creditor's original complaint, which was beyond the FDCPA's one-year window.

Judge Benton rejected the relation-back theory, holding that the limitations clock begins ticking with each alleged violation of the FDCPA.

Characterizing the creditor's pleadings and other actions as "permissible litigation tactics," the district court dismissed under 28 U.S.C. § 1692(e), which prohibits "any false, deceptive, or misleading representation or means in connection with the collection of any debt."

Judge Benton said that "the fact that it used an ordinarily 'permissible litigation tactic' does not insulate it from FDCPA liability" when the consumer plausibly alleges that the creditor threatened to go to trial.

Without mentioning all of Judge Benton's holdings, his analysis of Section 1692(f) is also significant. The creditor contended that the discovery requests did not violate that section, which prohibits debt collectors from using "unfair or unconscionable means to collect or attempt to collect any debt."

The district court dismissed, saying that the consumers were unlikely to be deceived by court papers served on the consumers' attorney.

Judge Benton countered by saying that Section 1692(f) contains no "misled, deceived, or duped" requirement. That section only proscribes "unfair or unconscionable" means to collect debts. He said that cases interpreting that section "do not impose a 'misled, deceived, or duped' requirement."

The FDCPA, the judge said, does not merely prohibit activities "that mislead consumers into paying debts not owed." The statute, "by its terms, guards against many other harms — the mental distress that can cause 'marital instability' and 'the loss of jobs,' as well as 'invasions of individual privacy.'"

Reversing the district court for having dismissed the consumer's suit, Judge Benton said, "The attempted collection of debts not owed harms consumers not just by inducing the payment of false claims. It also forces consumers to spend time and money addressing the false claims — even if they know they do not actually owe the claimed debt."

Judge Benton was appointed to the circuit bench in 2004 by President George W. Bush.

If the debt-collection bar is looking for a case worthy of the Supreme Court, the original *Spokeo* suit may be first in line. After remand from the Supreme Court, the Ninth Circuit ruled on Aug. 15 that the plaintiff had alleged constitutionally necessary "concrete" damages. To read ABI's discussion of *Spokeo* after remand, click here. For ABI's report on the Supreme Court's *Spokeo* decision, click here.

Whether the high court grants *certiorari* is uncertain because there still does not seem to be a circuit split. Nonetheless, the justices originally granted *certiorari* in *Spokeo* although there was no split at the time.

The opinion is *Demarais v. Gurstel Chargo PA*, 16-3173, 2017 BL 302806 (8th Cir. Aug. 29, 2017).

There is no litigation privilege in the FDCPA for inaccurate allegations in bankruptcy court.

Lawyers Violate FDCPA with Factually Inaccurate Allegations in Bankruptcy Pleadings

A law firm representing a creditor in a consumer bankruptcy can violate the federal Fair Debt Collection Practices Act simply by making an erroneous factual allegation in a motion to modify the automatic stay, according to Chicago's Chief District Judge Rubén Castillo.

Assuming Judge Castillo's opinion is correct, making a factual mistake in court papers could more than take the profit out of a creditor representation in a consumer bankruptcy because violating the FDCPA automatically entitles the debtor up to $1,000 in damages plus attorneys' fees.

Judge Castillo's case involved a law firm that filed a motion to modify the automatic stay on behalf of a condominium association. The motion alleged that the debtors had not paid condominium assessments after being in chapter 13 for a year. The motion also alleged that the unpaid post-petition assessments were about $750.

Three months later, the debtors filed suit in district court alleging violations of the FDCPA. They contended the motion was factually incorrect because they had only been in chapter 13 for six months, not a year, when the firm filed the lift-stay motion. To show that the arrears at the time were only $550, they attached a letter from the law firm alleging arrears in the lower amount.

The parties disagreed on the standard to be applied to the factual inaccuracies. The debtors pushed for the "unsophisticated consumer standard," while the firm argued it should be the "competent attorney" standard since the motion was directed to the lawyer for the chapter 13 debtors.

When a complaint alleges that a communication was false but not deceptive, Judge Castillo said in his Dec. 12 opinion that the "unsophisticated consumer" standard applies "'no matter the targeted recipient.'" Citing Seventh Circuit authority, the judge said the more stringent standard applies to false statements because even a lawyer may be unable to discern the falsehood except by conducting an investigation that may not be possible.

Applying the standard, Judge Castillo said that the incorrect allegation about defaulting for a year in chapter 13 did not violate the FDCPA because even an unsophisticated consumer would know the bankruptcy was only six months old, not a year old, given that the motion itself said

when the petition was filed. Therefore, the error was "readily apparent on the face of the filings," the judge said.

On the other hand, inflating the arrears by $200 did state an FDCPA claim that could withstand a motion to dismiss. The $200 overstatement was material, Judge Castillo said, and was likely to mislead an unsophisticated consumer.

Judge Castillo ended his opinion by directing the parties to "reevaluate their settlement positions" and "exhaust all settlement possibilities."

The opinion is *Mehling v. Fullett Rosenlund Anderson PC*, 16-5921, 2016 BL 413232 (N.D. Ill. Dec. 12, 2016).

The Code or rules must change to bar debt collectors from filing stale claims, Judge Dow says.

Courts Can't Sanction Debt Collectors for Filing Stale Claims after *Midland Funding*

Now that the Supreme Court has allowed debt collectors to file stale claims, the statute or the Bankruptcy Rules must be amended before courts can halt the practice, according to Bankruptcy Judge Dennis R. Dow of Kansas City, Mo.

In *Midland Funding LLC v. Johnson*, 137 S. Ct. 1407, 197 L. Ed. 2d 790, 85 U.S.L.W. 4239 (Sup. Ct. May 15, 2017), the Supreme Court held that a debt collector who files a claim that is "obviously" barred by the statute of limitations has not engaged in false, deceptive, misleading, unconscionable, or unfair conduct and thus does not violate the federal Fair Debt Collection Practices Act.

The U.S. Trustee mounted a frontal attack on a debt collector engaged in the business of filing proofs of claim where collection would be barred by the statute of limitations. In an adversary proceeding begun eight months before the high court decided *Midland Funding*, the U.S. Trustee alleged that regularly filing claims based on stale debts was a "systemic abuse of the bankruptcy process."

The U.S. Trustee sought a nationwide injunction, a monitor, unspecified monetary damages, and sanctions for routinely filing stale claims. Despite finding the creditor's "behavior disturbing," Judge Dow dismissed the complaint while allowing the U.S. Trustee to proceed with objections to two stale claims.

Although critical of the creditor's practices and procedures, the bulk of Judge Dow's Sept. 1 opinion leads to the conclusion that the current state of the law and rules cannot be employed to outlaw so-called robo-signing or the filing of stale claims.

For example, Judge Dow found that the creditor's "alleged process for preparing and reviewing claims fell short of the requirement of Official Form 10 and Bankruptcy Rule 9011." Despite the fact that the creditor used "questionable practices," the judge concluded that the facts did not lend to the imposition of sanctions, in part because the form was not amended until 2016 "to require that the individual signing the proof of claim personally review it."

Judge Dow faulted the creditor's elaborate robo-signing procedures because there was "no indication" that the person who signed the claims "knew if, or to what extent, that process was followed." He also said it was "inconceivable that an individual could comply with the instructions

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for Official Form 10 without ever examining the claim." Evidently, the same person's signature appeared on about 54,000 claims.

Ultimately, the complaint failed to state a claim for sanctions, Judge Dow said, because the U.S. Trustee did not allege "bad faith in connection with its 'robo signing' practice," because the propriety of the practice was at least debatable.

The U.S. Trustee was barred from seeking sanctions under Bankruptcy Rule 9011 for filing stale claims because he had "failed to abide by the safe harbor provisions of that rule." Sanctions were similarly unavailable under Section 105 because the statutes of limitations in most states do not extinguish these types of claims. Also on the question of whether the filing of stale claims violates the Bankruptcy Code, Judge Dow said that the definition of "claim" is "extremely broad."

Therefore, "considering applicable state law and the provisions of the Code," Judge Dow decided that "creditors have the right to file such claims and that doing so is not sanctionable." There is no violation of Rule 9011, he said, unless the creditor continues asserting the claim "after the statute of limitations has been raised."

Locking the door after slamming it shut, Judge Dow said the U.S. Trustee would not be entitled to sanctions even if the creditor had been filing claims that did not comply with Rule 3001(c). The remedy for failure to file a claim in proper form, he said, is to strip the claim of its *prima facie* validity, "besides those enumerated in Rule 3001(c)."

The "other appropriate relief" allowed under the rule "does not include the disallowance of a claim." Likewise, there is no independent cause of action for a violation of Rule 3001.

Putting his finger on the nub of the issue, Judge Dow held that the creditor's behavior was "not sanctionable and may not be treated as such until changes are made either by Congress or the Rules Committee," even though the creditor's "conduct is unsettling and perhaps even distasteful or unseemly in some respects." In addition, Judge Dow said he had "no power to grant relief which would purport to be binding as to claims filed and conduct occurring in cases other than ones before this Court." Even if there were nationwide power, Judge Dow said he "would decline to exercise it."

The opinion is *Casamatta v. Resurgent Capital Services LP (In re Freeman-Clay)*, 16-4102, 2017 BL 314777 (Bankr. W.D. Mo. Sept. 1, 2017).

ROCHELLE'S DAILY WIRE

Discharge/Dischargeability

Scheduling the amount of an asset isn't enough. The name must be shown, too.

Discharge Denied for Omitting Name of a Retirement Account

Disclosing the amount of an exempt asset wasn't enough. A debtor properly lost his discharge, the First Circuit said, because he only disclosed the name of one retirement account, not both.

Although the mistake possibly resulted from sloppy work by the debtor's lawyer or the lawyer's paralegal, the debtor lost his discharge nonetheless.

A man had two retirement accounts with the same bank. One was a 401(k) and the other was a cash balance plan.

Each bank statement covered both accounts. Headings on the statements read, "401(k) Plan and Cash Balance Plan." The two accounts were listed separately on the bank statements, with the cumulative balance was shown under the heading, "Total Retirement Accounts."

On his schedule of assets, under the line for "Interests in IRA, ERISA, Keogh, or other pension or profit sharing plans," he listed $148,000 as the amount of a "401(k) with Wells Fargo." Although the schedule did not include the name of the cash balance plan, $148,000 was the total amount of both retirement accounts together.

Following an objection to discharge by a creditor, the bankruptcy judge denied discharge under Section 727(a)(4) for making a false oath. The district court affirmed, and so did the First Circuit in an Oct. 25 opinion by Rhode Island District Judge John J. McConnell, Jr., sitting by designation.

For Judge McConnell, the question was whether the debtor "knowingly and fraudulently made a false oath" that related to "a material fact." Swearing to the schedules was a false oath, he said, because the debtor failed to include the name of the cash balance account.

Like other courts he cited, Judge McConnell said that failure to show the name of the account was material because "we have rejected the notion that valuation determines materiality." He added that "knowledge of an asset's value alone does little to forewarn creditors and the court of unscrupulous dealings." Creditors "have a right to investigate the history of a debtor's asset," he said.

The appeals court saw "no perverse result" in denying discharge even though "[b]ankruptcy disclosures are not meant to create a trap for the unwary."

It is unclear from the opinion whether the omission was intentional on the debtor's part or resulted from a mistake in his lawyer's office, because he testified that the schedules were prepared from information that he provided to his former attorney. Whoever caused the omission, the debtor contributed to his own problems because the bankruptcy judge, according to the First Circuit, "'found him less than credible' based on numerous misrepresentations conflated with evasive answers."

The debtor's trial lawyer may have committed a second error as well.

The pleadings did not raise the issue regarding the missing account name, because the mistake evidently surfaced for the first time during trial.

Judge McConnell's opinion implies that debtor's counsel could have barred consideration of the "unpleaded claim" by raising an objection at trial. Since counsel did not object, Judge McConnell said that the debtor impliedly consented to the trial of the unpleaded claim under Fed. R. Civ. P. 15(b)(2).

The opinion is *Crawford v. Premier Capital LLC (In re Crawford)*, 841 F.3d 1 (1st Cir. Oct. 25, 2016).

A 'no harm, no foul' stay violation is harmless error.

Co-Conspirator's Intent Is Enough for Nondischargeability, Fifth Circuit Holds

A co-conspirator's intent to commit larceny is enough render a debt nondischargeable even if the debtor did not show the requisite intent, the Fifth Circuit held in a case that also made important law about harmless violations of the automatic stay.

Appealing a judgment that a debt for larceny was nondischargeable under Section 523(a)(4), the debtor argued that the creditor failed to show that he possessed the requisite larcenous intent. However, the debtor admitted that his co-conspirators had shown the necessary intent.

Based on the language of the statute, Circuit Judge Stephen A. Higginson held in a July 18 opinion that a "debtor cannot discharge a debt that arises from larceny so long as the debtor is liable to the creditor for the larceny." He went on to say, "It is the character of the debt rather than the character of the debtor that determines whether the debt is nondischargeable under Section 523(a)(4)," which bars discharge of "any debt" for "fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny."

Judge Higginson rested his decision in large part on *Deodati v. M.M. Winkler & Assocs. (In re M.M. Winkler & Assocs.)*, 239 F.3d 746 (5th Cir. 2001), where the state court had held a partnership liable for the fraud of one partner. Reversing the bankruptcy court under Section 523(a)(2) in the ensuing bankruptcy of a partner, the Fifth Circuit held that the plain meaning of the statute barred the partners from discharging the debt "so long as they are liable to the creditor for fraud." *Id.* at 748. The court said that the "statute focuses on the character of the debt, not the culpability of the debtor." *Id.* at 751-52.

Importing the *Deodati* decision under subsection (a)(2) to (a)(4), Judge Higginson said that (a)(4) similarly bars discharge of "any debt . . . for . . . larceny." The text, he said, "adds no further criteria or qualifications."

Therefore, Judge Higginson said that "the intent and actions of [the debtor's] co-conspirators is sufficient to support nondischargeability under Section 523(a)(4)."

Judge Higginson stopped short of saying the result would be the same under Section 523(a)(6), because that subsection refers to "willful and malicious injury by the debtor . . . ." The additional words "by the debtor," he said, have led "several courts" to "require that the debtor have acted personally" to inflict the injury.

The appeal also presented an issue of first impression regarding the automatic stay.

The dischargeability litigation arose in the debtor's prior chapter 11 case. Although the bankruptcy court had dismissed the chapter 11 case, the parties agreed that the bankruptcy court could retain jurisdiction to complete the adversary proceeding.

After the bankruptcy court issued its opinion but before the entry of the judgment of nondischargeability, the debtor filed a chapter 7 petition in the same bankruptcy court. Although the debtor filed a suggestion of bankruptcy, the bankruptcy judge went ahead and entered the judgment of nondischargeability.

In the Fifth Circuit, the debtor argued that entry of judgment violated the automatic stay in his newly commenced chapter 7 case.

Without holding, Judge Higginson intimated there was no stay violation because the "automatic stay does not bar actions that are expressly allowed under the Bankruptcy Code." He also said, again without holding, that the stay does not bar actions in the same bankruptcy court.

Even if there were a stay violation, it was harmless error, Judge Higginson held. He examined "everything in the record" to conclude that the bankruptcy judge would have modified the automatic stay to allow the entry of judgment.

If the bankruptcy court had modified the stay, "the outcome would have been the same." Any error was harmless because the debtor would be "in the same position as he is in now."

The opinion is *Cowin v. Countrywide Home Loans Inc. (In re Cowin)*, 864 F.3d 344 (5th Cir. July 18, 2017).

Eleventh Circuit panel divided on reaching alternative holding under Section 523(a)(19).

Circuits Now Split on Dischargeability for Third Party's Violation of Securities Laws

The Eleventh Circuit created a conflict of circuits by holding that an individual cannot discharge a debt even if someone else was responsible for conduct that led to a judgment for violation of securities laws.

Circuit Judge Robin S. Rosenbaum concurred with the judgment on another ground while criticizing the majority's opinion for being internally inconsistent and creating confusion about an individual's nondischargeable liability for someone else's conduct.

The case turned on Section 523(a)(19)(A)-(B), which provides that a debt of an individual is nondischargeable if it "is for . . . violation of any" state or federal securities law and "results . . . from . . . any judgment" by a state or federal court.

The debtor was an executive in a company that sold securities to a plaintiff who later sued the company and the executive in state court to rescind the sale. The state court ordered arbitration, but the arbitration was initially stayed when the executive filed bankruptcy.

After the bankruptcy court allowed the arbitration to proceed, the arbitrator awarded the plaintiff more than $600,000. The state court confirmed the award and entered judgment jointly and severally against the company and the executive.

In bankruptcy court, the plaintiff prevailed in an adversary proceeding declaring that the judgment against the executive was nondischargeable under Section 523(a)(19). The executive appealed, lost in district court, and lost a second time in the Feb. 15 majority opinion by Circuit Judge William Pryor.

Judge Pryor upheld the conclusion about nondischargeability because the bankruptcy judge properly interpreted the arbitrator's award as finding that the executive himself violated state securities laws.

Even if the arbitrator had not found a securities law violation by the executive himself, Judge Pryor went on to rule that the debt was nondischargeable even if the conduct was attributable to a third party.

Violations committed by a third party are sufficient, Judge Pryor said, because the text of the statute "applies irrespective of debtor conduct." "Unambiguously," he said, the section precludes discharge of debts "for violation of" securities laws. The Supreme Court, he said, has interpreted "debt for" to mean "debt as a result of."

Judge Prior mentioned other subsections in Section 523 that require events "caused" by the debtor. "Because Congress rendered discharge in some subsections dependent on debtor conduct but never did so for Section 523(a)(19)(A), we infer that the limit does not extend to Section 523(a)(19)(A)."

Judge Pryor said that opinions to the contrary from the Ninth and Tenth Circuits were unpersuasive.

Judge Rosenbaum concurred with respect to the finding that the debtor himself violated securities laws but said she would not have reached the alternative ground: making the debt nondischargeable based on someone else's conduct. "Sometimes one reason is enough," she said.

"That alternative holding," based on the conduct of a third party, "may or may not prove to be correct," she said. "[B]ut by reaching it in this case, where we do not need to do so, we have needlessly created confusion." She went on to say that "internal inconsistency in the panel's reasoning will no doubt create confusion."

Judge Rosenbaum would have left "the issue addressed by the alternative holding to a case where it is better developed" from "advocacy on these issues by parties with an actual interest in them. We don't have that here."

The opinion is *Lunsford v. Process Technologies Services LLC (In re Lunsford)*, 848 F.3d 963 (11th Cir. Feb. 15, 2017).

Eleventh Circuit takes sides with the majority in circuit split over Section 523(a)(2).

Falsely Misrepresenting One Asset Isn't Grounds for Nondischargeability, Circuit Holds

Facing a split among the circuits, the Eleventh Circuit came down on the side of the majority by holding that a false oral statement about one asset is a statement of "financial condition" that must be in writing to be grounds for denial of discharge of a debt under Section 523(a)(2).

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

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

The bankruptcy judge held that the claim for legal fees was not discharged. The ruling in bankruptcy court was upheld in district court, but the Eleventh Circuit reversed in a Feb. 15 opinion authored by Circuit Judge William Pryor.

Section 523(a)(2)(A) makes a debt nondischargeable if obtained by "a false representation . . . other than a statement respecting the debtor's or an insider's financial condition."

In Section 523(a)(2)(B), there are additional requirements for the denial of discharge of a debt resulting from reliance on a materially false written statement about the debtor's financial condition.

Taking sides with the Fourth Circuit, the district court reasoned that a false statement about one asset was "not a statement of financial condition" and could therefore form the basis for nondischargeability, even though it was not made in writing.

Judge Pryor disagreed and followed the Fifth, Eighth and Tenth Circuits in making the debt dischargeable because a false oral statement about one asset "'says nothing about the overall financial condition of the person . . . or the ability to repay the debt.'"

The phrase "financial condition," Judge Pryor said, "likely means one's overall financial status." He went on to say that "knowledge of one asset or liability is a partial step toward knowing whether the debtor is solvent or insolvent."

"If the statute applied only to statements that expressed a debtor's overall financial condition, Congress would have said so," the opinion says.

Making the debt nondischargeable given a false oral statement about one asset "is based on policy, not statutory structure." Judge Pryor concluded that the statute was not ambiguous.

The opinion is *Appling v. Lamar, Archer Cofrin LLP (In re Appling)*, 848 F.3d 953 (11th Cir. Feb. 15, 2017).

Financial professional was held to a higher standard in valuing estate assets.

Undervaluing One Asset Can Result in Denial of Discharge, Fourth Circuit Holds

Lowballing the value of an estate's only significant, non-exempt asset can result in denial of discharge if the debtor is a financial professional, the Fourth Circuit held in affirming the bankruptcy court.

The debtor had an undergraduate degree in finance and an MBA. He worked 10 years at a brokerage, but ended up in chapter 7 when personal investments went sour.

His assets included a $65,000 minority investment in woodland and farmland that generated minimal income. The objective was to sell the property eventually for development.

The debtor filed his petition as a "no asset" case. In the schedules, he listed the minority investment as worth $2,500. To arrive at this value, he testified that he used the income capitalization method, multiplying his largest annual distribution, $500, by five.

For making a false oath or account, the bankruptcy court denied the debtor's discharge under Section 727(a)(4), deciding that the asset was worth at least $13,200. The district court affirmed, as did the Fourth Circuit in a Feb. 28 opinion by Circuit Judge J. Harvie Wilkinson, III.

Judge Wilkinson rejected the debtor's argument that undervaluation of a single asset is insufficient for denial of discharge. The circuit court found no "clear error" in the bankruptcy court's decision that the debtor made a false oath because conclusions "often boil down to an assessment of a debtor's credibility."

The capitalization method, Judge Wilkinson said, can be proper in valuing income-producing property. Using an income-based valuation for property that has only incidental income "was bound to assign a paltry figure to the property," Judge Wilkinson said.

There was abundant evidence that the value was considerably higher than $2,500. In addition to his $65,000 investment, the debtor's K-1 showed his capital account at $67,555. Evidence also showed that he valued the investment without consulting his co-investors or the property manager, who were unable to arrive at a precise amount but testified that the value was higher than $2,500.

Judge Wilkinson said that the bankruptcy judge "reasonably inferred fraudulent intent from [the debtor's] background, course of conduct, and absence of credibility." Filing the petition as a "no asset" case suggested "an effort to persuade the trustee and creditors to abandon the property."

Since the investment was the debtor's "only significant, non-exempt asset," Judge Wilkinson said that "lowballing" the value "sent a message" to the trustee "that there was no reason to conduct any further investigation."

Judge Wilkinson explained that the "advice of counsel" defense did not apply because there was no evidence that the debtor told his lawyer about his $65,000 investment or his $67,555 capital account.

The opinion is *Worley v. Robinson (In re Worley)*, 849 F.3d 577 (4th Cir. Feb. 28, 2017).

First Circuit requires attempt to collect to prove a discharge injunction violation.

Subjective Feeling of Coercion Doesn't State a Claim for Discharge Violation

A First Circuit opinion vividly shows why damages are far more difficult to obtain in bankruptcy court for violating the discharge injunction than through a lawsuit alleging transgression of the federal Fair Debt Collection Practices Act.

Establishing a claim for violation of Section 524 alone invokes an objective test in the First Circuit, were an FDCPA claim implicates the unsophisticated consumer test. When a Section 524 claim stands alone without being raised in an FDCPA suit, the Boston-based appeals court says there is no liability if the creditor does not explicitly demand payment, even if the debtor subjectively feels coerced into paying a discharged debt.

The case involved a couple who got a chapter 7 discharge of their personal liability on a home mortgage. To keep the home, they signed a mortgage modification agreement after bankruptcy allowing them to retain the home if they continued making payments. The modification agreement did not rekindle personal liability on the mortgage.

Later, they stopped making payments, surrendered the home, and allowed the lender to foreclose.

The lender sent the couple the required IRS Form 1099A telling them they "may have reportable income or loss" resulting from foreclosure. The form incorrectly checked a box saying the couple were personally liable on the debt.

The debtor's lawyer contacted the lender and demanded revocation or correction of the form. The Dec. 14 opinion by Circuit Judge O. Rogeriee Thompson says that the lender "did not revoke the form and claims they are accurate."

Contending that the IRS form and other actions by the lender made them feel coerced into paying discharged debt to avoid tax liability, the debtors reopened their bankruptcy. They sued the lender for violating the Section 524(a) discharge injunction, emphasizing the false information in the form about their personal liability for the mortgage debt.

The bankruptcy court dismissed on motion for summary judgment. The district court affirmed, as did the First Circuit.

For the circuit court, Judge Thompson said that a claim for violation of Section 524(a) must show that the creditor improperly coerced or harassed the debtor. The test is objective, so the "debtor's subjective feeling of coercion is not enough," her opinion says.

Despite the debtors' subjective feelings, sending the form was not in violation of Section 524(a) because it was "not a collection attempt" and did not indicate that the debtors owed "any money to anyone," Judge Thompson said.

Checking the box on the form saying that the debtors had personal liability did not change the result. Judge Thompson said that the form was informational, made no demand for payment, and threatened no action.

Unlike the failure to correct a credit report, which can be actionable, the opinion says that the incorrect statement about the debtor's personal liability did not give rise to liability because "there were no consequences and no attempt to collect a debt."

Although the appeals court said that the form doubtless caused the debtors "stress and concern" and necessitated retaining a lawyer who told them they had no tax liability, the opinion says that their "subjective feeling of coercion [was] not enough" because they did not present "evidence that the forms were objectively coercive."

Depending on how the Supreme Court decides *Midland Funding LLC v. Johnson*, to be argued Jan. 17, the debtors might have had more success suing under the FDCPA. Although some courts have held that the Bankruptcy Code precludes FDCPA claims, the Second Circuit, for example, allows debtors to make FDCPA claims for discharge violations even though a debtor before discharge cannot sue for an automatic stay violation under the FDCPA. To read an ABI discussion of *Midland Funding*, click here.

The opinion is *Bates v. CitiMortgage Inc.*, 844 F.3d 300 (1st Cir. Dec. 14, 2016).

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Eighth Circuit says orders reducing nondischargeable claims may not be binding on the creditor.

No Contempt on Discharge Violation of Nondischargeable Debt, Circuit Says

The Eighth Circuit arguably narrowed a June 2016 opinion from its Bankruptcy Appellate Panel that could have been interpreted to mean that a decision in bankruptcy court reducing the amount of a nondischargeable debt is not enforceable outside of bankruptcy, the rules of *res judicata* or collateral estoppel to the contrary notwithstanding.

In chapter 13, a man listed his former wife as the holder of a priority unsecured domestic support obligation. The Missouri Division of Child Support Enforcement initially filed an unsecured priority claim for about $36,000. Believing it had incorrectly calculated the claim, the Division later filed an amended claim for over $88,000.

The debtor objected to the amended claim. The bankruptcy court disallowed the $88,000 claim and allowed the $36,000 claim, having concluded that the Department waived the excess under Missouri law by acquiescing to lower payments after the children were emancipated.

The debtor completed his five-year plan and got a discharge. The Department never appealed the disallowance order or the plan confirmation order.

After discharge, the Department began garnishing the debtor's salary to collect the disallowed $52,000. The bankruptcy court held the Department in contempt of the discharge injunction.

The BAP reversed, holding that the "discharge injunction does not apply to a nondischargeable domestic support obligation, even the disallowed portion." The debtor appealed and lost once more in an Aug. 22 opinion for the Eighth Circuit authored by Circuit Judge James B. Loken.

Judge Loken ducked the more significant issue regarding the preclusive effect of the bankruptcy court's ruling that the Department had waived the $52,000 claim under state law, because, he said, it was an appeal only from the contempt order, not the disallowance order.

With regard to contempt, Judge Loken said that the bankruptcy court could not use Section 105(a) to impose sanctions in contravention of specific statutory provisions, citing *Law v. Siegel*, 134 S. Ct. 188 (2014). He referred to Sections 523(a)(5) and 1328(c)(2) for the proposition that domestic support obligations "are not dischargeable under any circumstances," citing *United Student Aid Funds Inc. v. Espinosa*, 559 U.S. 260 (2010).

Together, those principles “eliminated the basis for the bankruptcy court’s sanctions order,” Judge Loken said.

In simple terms, the Eighth Circuit seems to say there is no contempt power available to enforce a bankruptcy court order reducing a nondischargeable claim.

Judge Lokens sidestepped the larger issue by refusing to “render an advisory opinion” on the preclusive effect of the bankruptcy court’s order disallowing the additional claim for $52,000. Consequently, the circuit court expressed “no view on the merits of whether [the debtor] remains personally liable for the disallowed portion of [the Department’s] bankruptcy claim.” “These are not easy issues,” he added.

With regard to whether the bankruptcy court even had jurisdiction to enforce its prior claim disallowance order, Judge Lokens said that *Local Loan v. Hunt*, 292 U.S. 234 (1934), “might give the bankruptcy court ancillary jurisdiction to enforce” that order. On the other hand, he said, the fact that domestic support claims are not dischargeable under any circumstances “puts a very different gloss on the issue,” citing *Siegel*.

In substance, Judge Lokens might be saying that provisions of the Bankruptcy Code making some types of debt automatically nondischargeable may somehow divest the bankruptcy court of jurisdiction. Or, perhaps, the power of the bankruptcy court regarding nondischargeable claims does not extend beyond the bankruptcy case itself.

Although it is cold comfort for the debtor, Judge Lokens said that the state court was “fully competent” to rule on the preclusive effect of the bankruptcy court’s disallowance order.

The opinion lends itself to a petition for rehearing *en banc*.

To read ABI’s discussion of the BAP opinion and the dissent, click here.

The opinion is *Spencer v. State of Missouri Department of Social Services*, 16-3182, 2017 BL 293263 (8th Cir. Aug. 22, 2017).

Wages & Dismissal

ROCHELLE'S DAILY WIRE

***Test case on preferences deepens a circuit split and lays the groundwork for* certiorari.**

Wages Garnished Before Bankruptcy Are Voidable Preferences, Circuit Rules

The Fifth Circuit handed down an important garnishment decision on March 13 following the *Collier* treatise and saying that opinions from three other circuit courts were either wrongly decided or did not survive *Barnhill v. Johnson*, 503 U.S. 393 (1992).

The case involved a judgment creditor who served a garnishment order on a debtor's employer before the debtor filed bankruptcy. The bankruptcy court awarded a preference judgment to the trustee for recovery of wages garnished within 90 days of bankruptcy.

The district court affirmed, and so did the Fifth Circuit in an opinion by Circuit Judge James L. Dennis.

Do not be surprised if there is a petition for *certiorari*. The appeal was a test case because it entailed the recovery of a $1,750 preference.

Judge Dennis explained that a preference resulting from garnishment is governed by two subsections in Section 547.

First, Section 547(e)(2)(B) provides that a transfer is "perfected" when a creditor on a simple contract could not obtain a lien superior to the interest of the transferee. Because the garnishment order was served on the employer before bankruptcy, the creditor argued that no other creditor could acquire a judicial lien superior to the garnishor's interest.

Judge Dennis said that would be true, except for the fact that it ignores the second relevant subjection, Section 547(e)(3), which says that the debtor must have an interest in the property before a transfer can occur.

On that topic, the Supreme Court ruled in *Barnhill* that the time of a transfer is governed by federal law, not state law.

The Supreme Court had ruled earlier in *Local Loan v. Hunt*, 292 U.S. 234 (1934), that the earning power of an individual is not "translated into property" until the earnings come into "existence."

Thus, Judge Dennis said that the Sixth Circuit was correct when it said in *In re Morehead*, 249 F.3d 445 (6th Cir. 2001), that a debtor cannot obtain rights in future wages until the services have been performed. Therefore, the Sixth Circuit held that garnished wages earned during the preference period are recoverable preferences.

Judge Dennis agreed with the Sixth Circuit. He went on to say that contrary decisions from the Eleventh, Seventh and Second Circuits were all decided before *Barnhill* and are therefore no longer good law. He noted that the Seventh Circuit has disavowed its pre-*Barnhill* case, which had held that wages garnished before bankruptcy are not preferential.

Those three cases, Judge Dennis said, have been "roundly criticized" by the Sixth Circuit in *Morehead* and by lower courts. He noted that the *Collier* treatise says those three circuit cases are "wrong."

In short, Judge Dennis said, there is no property a creditor can garnish or that a debtor can transfer until wages are earned. Therefore, the "creditor's collection of garnished wages earned during the preference period is an avoidable transfer made during the preference period even if the garnishment was served prior to that period."

The opinion is *Tower Credit Inc. v. Schott (In re Jackson)*, 850 F.3d 816 (5th Cir. March 13, 2017).

Deadlines for direct appeal to the circuit are procedural, not jurisdictional.

On the Means Test, Fourth Circuit Allows Chapter 7 Debtors the Best of Both Worlds

The Fourth Circuit answered a question the Supreme Court left open in *Ransom* by holding that chapter 7 debtors can pass the means test by using the National and Local Standards even if their actual expenses are less than the standard amounts.

In computing the means test, the husband and wife debtors filled out Form 122A-2 using the National and Local Standards for their mortgage and auto expenses rather than their actual expenses, which were substantially less.

The bankruptcy administrator filed a motion to dismiss for presumptive abuse, contending that the debtors would fail the means test if their actual expenses were used. Bankruptcy Judge Stephani W. Humrickhouse of Raleigh, N.C., denied the motion to dismiss.

The Fourth Circuit granted the parties' motion for a direct appeal because the bankruptcy courts in North Carolina have been divided on this issue.

In a Jan. 4 opinion, the appeals court affirmed the bankruptcy court and held that the plain language of Section 707(b) allows the debtors "to deduct the full National and Local Standard amounts even if they have actual expenses below the standard amounts."

The opinion by Circuit Judge Stephanie D. Thacker said that requiring a debtor to use the lower of the two amounts "would create an absurd result: punishing frugal debtors."

In *Ransom*, the Supreme Court held in 2011 that an expense is "applicable" under Section 707(b)(2)(A)(ii)(I) only if the debtor will incur "that kind of expense" during the life of the plan. Judge Thacker said that the high court expressly declined to decide the proper deduction for a debtor with expenses lower than the Local Standards.

In deciding the issue left open by the Supreme Court, Judge Thacker said that the statutory language is "quite clear," because the subsection says that the amount "shall be the debtor's applicable monthly expense amounts specified under the National and Local Standards," so long as that type of expense has been incurred.

Judge Thacker noted how the statute uses the words "applicable" and "actual." She said that the "words must mean something different" because "Congress chose to use the two different words in the same sentence." She therefore concluded that "applicable monthly expenses" allows a debtor to take the full standard amounts while "actual monthly expenses" only permits using "expenses incurred."

The opinion contains a second holding of note.

The parties missed the deadlines for applying to certify an appeal directly to the circuit court under Bankruptcy Rule 8006. Judge Thacker held that the deadlines were procedural, not jurisdictional. She therefore allowed the direct appeal because the delay "resulted from the complexity and confusing nature of the Bankruptcy Code and not an act of bad faith by the parties."

The opinion is *Lynch v. Jackson*, 845 F.3d 147 (4th Cir. Jan. 4, 2017).

Judge follows statutory language that didn't achieve the result Congress intended.

Courts Split on Allowing Credit Counseling on the Same Day but After Filing

A consumer can complete credit counseling after filing a petition, so long as counseling takes place later on the day of filing, according to Bankruptcy Judge Laura T. Beyer of Charlotte, N.C., who sided with the minority on the issue.

The case raises a fundamental question about statutory interpretation: Should the court follow the plain language of the statute even if it does not accomplish the result that Congress likely intended?

Congress adopted Section 109(h)(1) as part of the BAPCPA amendments in 2005. Originally, the subsection required a consumer to complete credit counseling "preceding" the date of filing. Some courts dismissed petitions unless counseling was finished the day before filing. That reading of the statute prevented some consumers from filing in time to prevent eviction or home foreclosure.

Congress amended the statute in 2010 so that it now requires counseling "during the 180-day period ending on the date of filing of the petition."

In the case before Judge Beyer, the debtor completed counseling after she filed her petition, but on the same day. The bankruptcy administrator filed a motion to dismiss the petition but lost in Judge Beyer's March 8 opinion.

Although the courts are split, the leading authorities on both sides of the question are from Chicago.

In 2013, Bankruptcy Judge Timothy A. Barnes concluded that the plain language of the statute allows counseling later on the day of filing. *In re Walker*, 502 B.R. 324 (Bankr. N.D. Ill. 2013).

Two years later, District Judge Sara T. Ellis, also of Chicago, disagreed with *Walker* and required completion of counseling before the moment of filing. *In re Arkuszewski*, 550 B.R. 374 (N.D. Ill. 2015). Judge Ellis was persuaded in part by legislative history suggesting that Congress wanted counseling in advance of filing, thus preventing some bankruptcies.

Judge Beyer declined to follow *Arkuszewski* "without more explicit guidance in the statute." She said that the plain language of the amended subsection "unambiguously allows a debtor to

satisfy the credit counseling requirement on the same day the case commences," even if the class takes place later that day.

Even though Congress may have intended for counseling to occur before filing, Judge Beyer felt compelled to enforce the statute as written as long as the plain language is "unambiguous and not absurd."

The *Collier* treatise agrees with Judge Beyer.

Even if the statute required counseling in advance, Judge Beyer said she still would deny the dismissal motion because the debtor had "substantially complied with the credit counseling requirement."

The opinion is *In re Tillman*, 17-30037, 2017 BL 73259 (Bankr. W.D.N.C. March 8, 2017).

BAPCPA amendments on student loans modified the definition of 'educational benefit.'

A 'Loan' Is Not an 'Educational Benefit,' Ninth Circuit BAP Holds

The Ninth Circuit Bankruptcy Appellate Panel delved into some of the changes that Congress made in 2005, intentionally or not, when it amended Section 523(a)(8) dealing with the nondischargeability of student loans.

The case involved a woman who took on more than $70,000 in non-governmental loans to attend a medical school in the Caribbean that did not qualify as an "eligible educational institution." She received a standard discharge in chapter 7 and subsequently filed a complaint to declare that the loans were dischargeable under Section 523(a)(8).

The lender paid the funds directly to the medical school. The debtor therefore contended that loans were not "funds received as an educational benefit" under Section 523(a)(8)(A)(ii).

The bankruptcy court held that the loans were not dischargeable. In an opinion on April 28 by Bankruptcy Judge Robert J. Faris, the BAP reversed and remanded.

On the "funds received" prong, the BAP held that the loan proceeds were "funds received" even though the money went directly from the lender to school. The BAP said there is no requirement of an "actual transfer of money" to the debtor.

The BAP distinguished its *Christoff* decision from 2015, where the panel held that an obligation to repay financial aid from a university was not "funds received." In that case, the BAP said that neither the university nor the debtor received any funds. Rather, the BAP said, "the university just agreed to be paid at a later date."

The more significant feature of the opinion deals with the aspect of Section 523(a)(8)(A)(ii) barring discharge of "an obligation to repay funds received as an educational benefit . . . ."

The lender contended that the loan was an "educational benefit" thus excepted from discharge. The BAP disagreed.

Where subsection (A)(i) refers to a "loan," subsection (A)(ii) does not. Instead, subsection (A)(ii) uses the term "educational benefit."

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In *Christoff*, the panel presumed that the amendments in 2005 gave each subsection "a distinct function" and targeted "different kinds of debts." The BAP therefore held that "a 'loan' is not an 'educational benefit' within Section 523(a)(8)(A)(ii)" because the BAPCPA amendments delinked the two terms. As a result, the loan was not nondischargeable under subsection (A)(ii).

In the case at hand, the record did not indicate whether the loan was made by a nonprofit organization. It was therefore unclear whether the loan might fall under subsection (8)(A)(i) and be nondischargeable.

Since a student loan will be nondischargeable if it falls into any of the categories in subsection 8, the panel was obliged to remand the case to the bankruptcy court to determine if the loan was from a nonprofit organization.

The opinion is *Kashikar v. Turnstile Capital Management LLC (In re Kashikar)*, 567 B.R. 160 (B.A.P. 9th Cir. April 28, 2017).

Difficult to discharge, student loans are more easily classified as non-consumer for the presumptive abuse test.

Student Loans to Advance a Career Are Classified as Non-Consumer

Student loans incurred to earn a Ph.D. qualified as non-consumer debt because the debtor had a profit motive as demonstrated by his desire to own and run a business of his own, a Colorado district judge said during the course of reversing the bankruptcy court.

The debtor filed a chapter 7 petition with more than $90,000 in student loans taken out while he was employed. The U.S. Trustee filed a motion to dismiss under Section 707(b)(2), alleging there was a presumption of abuse because the debts were primarily consumer.

The parties stipulated that the motion to dismiss would be governed by deciding whether the student loans were consumer or non-consumer in nature. Based on testimony from the debtor, the bankruptcy judge dismissed the petition after deciding that the student loans were consumer debts.

District Judge Raymond P. Moore of Denver reversed and set aside dismissal in his Nov. 15 opinion.

Judge Moore said he was bound by the Tenth Circuit's 1999 decision in *Stewart III*, which says that non-consumer debts are distinguished by a "profit motive." In that case, the appeals court said that loans taken to invest in the stock market were "clearly" motivated by profit. Otherwise, Judge Moore said that the Tenth Circuit has given little guidance on how to characterize educational expenses, leaving the case before him to fall "nicely into the void left unresolved by *Stewart III*."

Judge Moore said that student loans can be non-consumer if they are "incurred primarily as a business investment in oneself." In the process, Judge Moore rejected several tests employed by the bankruptcy court.

Judge Moore said that a debtor is not required to show a tangible benefit to an existing business or a current employer and is not required to undertake further education to comply with an employer's mandate. He also said there is no requirement to show advancement or higher income from a current job.

Judge Moore even said there is no requirement for the student to have been employed when borrowing for education. Otherwise, he said, college loans taken by full-time students never could classify as non-consumer.

The judge even implied that the same bankruptcy judge came down the wrong way in an Oct. 26 decision in a case not before him. That case involved a nurse who took loans to attain degrees qualifying her for higher-ranking jobs in nursing. In that case, the bankruptcy judge ruled that the educational loans were consumer debt.

Judge Moore said that if a nurse's striving for professional advancement and higher income "are not business investments in oneself, the court cannot imagine what would be."

Significantly, Judge Moore said a debtor is not required to have achieved his or her objectives before a loan is classified as non-consumer. On the other hand, he said that a student must show an attempt at using the education to realize profit. If a former student, for example, takes out loans but only aims for a job requiring no education, the loans would be consumer in nature, he said.

For ABI's discussion of a Ninth Circuit Bankruptcy Appellate Panel opinion called *Bushkin* also focusing on profit motive, click here.

The opinion is *Palmer v. Laying*, 559 B.R. 746 (D. Colo. Nov. 15, 2016).

Plans

'Value' doesn't mean 'present value' in Section 1325(b)(1)(A).

Interest on Unsecured Claims Not Required in 100% Chapter 13 Plan

On an issue dividing the lower courts, Bankruptcy Judge Thomas L. Perkins of Peoria, Ill., ruled that a chapter 13 debtor, not devoting all his disposable income to the plan, can confirm the plan by paying unsecured creditors in full, *without interest*.

The above-median debtor had more than $2,000 in monthly disposable income. The 60-month plan called for him to pay about $1,300 a month, in the process paying his unsecured debts in full without interest.

The trustee objected to the plan, thus invoking Section 1325(b), because the debtor was not paying interest on unsecured claims when monthly payments were less than disposable income. The case turned on Section 1325(b)(1)(A) and (B).

The debtor conceded that he could not confirm the plan under subsection (b)(1)(B) because he was not devoting all his "projected disposable income" to plan payments. He contended, however, that he was entitled to confirm under subsection (b)(1)(A) because the "value of the property to be distributed under the plan" was more than the amount of the claims.

In opposition, the trustee argued that the statutory language in subsection (b)(1), "as of the effective date of the plan," modifies the word "value" to mean that the plan must pay the present value of the claims and therefore interest.

In his May 19 opinion, Judge Perkins noted that the *Norton* and *Collier* treatises differ on the outcome. Other than what he called the "exceptional right to interest under Section 1325(a)(4)," the judge said that "unsecured creditors in a chapter 13 case have no right to an immediate payment in full at the front end of the case." Instead, he said that unsecured creditors "get paid from the debtor's future income." There is "no entitlement to interest" where "there is no forced deferral of any pre-existing payment right."

Judge Perkins found a "policy decision" in subsection (b)(1)(A). If Congress intended for debtors to pay interest, he said that "Congress would have maintained statutory consistency by placing the phrase 'as of the effective date of the plan' immediately after the word 'value.'" In his view, "different placement is best construed as conveying a different meaning."

As a matter of statutory interpretation, Judge Perkins therefore held that a chapter 13 debtor can confirm a plan by paying 100% to unsecured creditors, without interest.

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The opinion is *In re Gillen*, 568 B.R. 74 (Bankr. C.D. Ill. May 19, 2017).

Two circuits allow discretion for non-culpable debtor to make payment after five years.

Third Circuit Permits Last Chapter 13 Plan Payment Beyond 60 Months

The Third and Seventh Circuits, the only courts of appeals to consider the issue, conclude that a chapter 13 debtor under proper circumstances can complete plan payments and receive a discharge even if the final payment is made after 60 months.

The Third Circuit's June 1 opinion by Circuit Judge Cheryl Ann Krause lays down flexible rules governing the bankruptcy court's discretion in allowing a final payment after 60 months.

The debtors confirmed a chapter 13 plan calling for monthly payments of about $3,000, totaling almost $175,000 over five years. After paying about $50 more than the plan required, the trustee notified the debtors in the 61st month that their payments were about $1,100 short because the trustee's fees were higher than anticipated.

Judge Krause said that the underpayment was not the debtors' fault because the trustee did not make the calculation and bring the shortfall to the debtors' attention until after the end of the plan term.

The trustee filed a motion to dismiss but said she would withdraw the motion if the debtors made up the shortfall. Within 16 days of being notified, but after 60 months, the debtors paid the shortfall.

The trustee withdrew her motion to dismiss, but by that time a creditor had joined the motion to dismiss. The bankruptcy judge denied the motion to dismiss, granted a discharge, and was upheld in district court, prompting the creditor's appeal to the Third Circuit.

The creditor argued that the plain language of the statute required dismissal. The creditor pointed to Section 1322(d) which provides that the court "may not" approve a plan with payments extending beyond five years and to Section 1329(c) which prohibits plan modifications that extend payments beyond five years.

Judge Krause said the creditor was relying on the wrong sections. The relevant provisions, she said, were Sections 1307 and 1328 which govern dismissal and completion discharge. Section 1307 says a court "may" — not "must" — dismiss a case, and Section 1328 requires the court to issue a discharge when all plan payments have been completed, "without an express requirement that such payments were made within five years."

Only the Seventh Circuit has touched the issue, in *Germeraad v. Powers*, 826 F.3d 692 (7th Cir. June 23, 2016), according to Judge Krause. She said the Chicago court's discussion of the issue was *dicta* and that the circuit assumed, without deciding, that a bankruptcy court has discretion to allow a final payment beyond five years. To read ABI's discussion of *Germeraad*, click here.

Judge Krause concluded that the unambiguous language of Sections 1307 and 1328 invest the bankruptcy court with discretion. She bolstered her conclusion by reference to legislative history where Congress said that the Bankruptcy Reform Act's chapter 13 was intended to remedy similar provisions in the Bankruptcy Act that were "overly stringent and formalized."

Judge Krause said that chapter 13 was intended to cap plans at five years, where payments might have continued up to 10 years under prior law. The cap, she said, was a "shield" for debtors, not a "sword" for creditors.

To deny discharge, Judge Krause said, "would also produce an absurd result" when the debtors had acted in good faith by making the final payment promptly and had substantially complied with the plan. She said it "would hardly make sense to deny them the benefit of chapter 13 bankruptcy by dismissing the entire proceeding."

Judge Krause then turned to the question of standards to govern the bankruptcy court's exercise of discretion in permitting a payment beyond five years. Building on case law from lower and from the circuit's case law on setting aside default judgments, she laid down a "nonexclusive list" of five factors to guide the court's exercise of discretion: (1) whether the debtor substantially complied with the plan, (2) the feasibility and time required to complete payments, (3) whether any creditors would be prejudiced, (4) whether the "debtor's conduct is excusable or culpable," and (5) the "availability and relative equities of other remedies."

Judge Krause had "no trouble concluding" that the bankruptcy court properly exercised discretion in denying the dismissal motion and granting a discharge. She said that conversion to chapter 7 or a "hardship discharge would be nonsensical in this situation."

The opinion is *Shovlin v. Klass (In re Klass)*, 858 F.3d 820 (3d Cir. June 1, 2017).

Dissenter argues that suing in bankruptcy court was sufficient disclosure to avoid judicial estoppel.

Ninth Circuit Demands Amended Schedules to Avoid Judicial Estoppel

In a nonprecedential opinion, the majority on a Ninth Circuit panel held that disclosure to a bankruptcy judge is not enough. A lawsuit by a chapter 13 debtor against a third party must be disclosed in amended schedules to avoid invocation of the doctrine of judicial estoppel.

The dissenter would have held that disclosure to the bankruptcy judge made judicial estoppel inapplicable. She said that the "majority elevates form over substance."

A couple filed a chapter 13 petition in 2010 and got their discharges in 2016. In 2012, they sued in bankruptcy court, contending that a nonjudicial foreclosure violated state laws. After a bench trial, the bankruptcy judge gave judgment to the debtors.

The district court reversed and was upheld by the majority in an unsigned Ninth Circuit opinion on Aug. 29.

In a two-page opinion, the majority said that a debtor's inadvertence or mistake can be remedied by amending schedules and thereby avoiding judicial estoppel.

Saying that "bankruptcy is a form-driven process," the majority upheld dismissal on the basis of judicial estoppel because the debtors "'deceived the bankruptcy court,' which confirmed a plan that did not account for those assets." The majority do not say whether the plan was confirmed before or after the debtors sued in bankruptcy court.

Circuit Judge Jacqueline Nguyen dissented, even though the majority said its opinion was "not precedent" and "not appropriate for publication."

Once "their claims became cognizable," Judge Nguyen said, in her dissenting opinion of slightly more than two pages, that the debtors "disclosed them in the most conspicuous way possible — by actually litigating the claims in a bench trial before the bankruptcy court." She went on to say, "No one suggests that the bankruptcy court was misled."

Judge Nguyen said that the "only winner" was the "alleged bad actor in the estopped lawsuit."

By saying that the debtors should have amended their schedules, Judge Nguyen said that "the majority literally elevates form over substance. Yet, bankruptcy law is driven not by forms but by equitable principles."

Given the elevation of amended schedules to such importance in the pantheon of judicial estoppel, the case should be reheard *en banc* or before the panel.

Doubtless, the chapter 13 trustee was aware of the suit and was therefore in a position to require amending the plan, if relief was of a type that might help general creditors. In contrast, amending the schedules would have been a formalistic gesture since the two most important players, the judge and the chapter 13 trustee, were aware of the suit and its implications for the chapter 13 plan, if any.

The opinion is *Meyer v. Northwest Trustee Services Inc.*, 2017 BL 303335 (9th Cir. Aug. 29, 2017).

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

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

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

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

The Facts

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

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

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

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

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

'Mockery' No Longer Automatic

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

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

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

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

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

Is a *Cert* Petition Next?

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

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

Judge Pryor may have overstated the circuit split.

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

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

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

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

The *Amicus* in the Eleventh

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

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

Remand to the Panel

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

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

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

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

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

Chapter 13 debtor permitted to surrender collateral and reclassify deficiency as unsecured.

Judge Reverses Course and Allows Reclassification of Deficiency Claim

Clifton R. Jessup, Jr. is a bankruptcy judge willing to change his mind. In an opinion on Nov. 2, he reversed course and held that a chapter 13 debtor may surrender collateral, modify the plan, and reclassify the resulting deficiency claim as unsecured.

In a prior opinion in June 2015, Judge Jessup, of Decatur, Ala., had precluded a chapter 13 debtor from surrendering collateral and reclassifying the deficiency claim as unsecured.

Judge Jessup said that the courts have been split on the issue for 25 years. The minority, he said, follow the 2000 Sixth Circuit decision in Nolan, which barred the debtor from modifying a plan to surrender collateral and reclassify the deficiency claim as unsecured.

Outside of the Sixth Circuit, the majority of courts find no bar to surrender, modification and reclassification, according to Judge Jessup. Those courts rely on the plain language of the statute, which says that a deficiency claim is unsecured, because the lender lost secured status when the collateral was surrendered and liquidated. With the claim no longer secured, treating the claim as unsecured and reducing plan payments is permissible.

In the case before him, the husband and wife debtors had reason for surrendering their car. One of them was no longer employed, significantly reducing family income and preventing them from paying the auto loan and required plan payments. They had previously surrendered their home and modified their plan to reduce plan payments.

The lender claimed there would be prejudice by allowing reclassification. Judge Jessup said that the good faith requirement for amending the plan under Sections 1329(b)(1) and 1325(a)(3) would “moderate” the risk to the secured creditor.

Judge Jessup called for a hearing to determine whether the amended plan, surrender, and classification were sought in good faith. There might be a lack of good faith, he said, if the debtor had abused the collateral, failed to maintain insurance, or “intentionally caused a substantial decrease in the value of the collateral.”

Judge Jessup adopted the logic by Chief Bankruptcy Judge William R. Sawyer of Montgomery, Ala., whose *Scarver* opinion this year permitted surrender, plan modification, and reclassification.

The opinion is *In re Rodgers,* 14-83452, 2016 BL 366329 (Bankr. N.D. Ala. Nov. 2, 2016).

'Deemed Allowed' Claims

Res judicata ***does not apply to 'deemed allowed' claims.***

Chapter 13 Plan Confirmation Doesn't Bar Later Claim Objections, Circuit Holds

The Fourth Circuit held definitively that *res judicata* does not bar a debtor from objecting to allowance of unsecured claims after confirmation of a chapter 13 plan.

The litigation was brought by LVNV Funding LLC, a company that buys stale claims where collection is barred by the statute of limitations.

In consolidated appeals directly to the Fourth Circuit from the bankruptcy court, LVNV had filed its claims before confirmation. LVNV did not object to confirmation, nor did the debtors object to the claims before confirmation. The claims were therefore "deemed allowed" at the time of confirmation under Section 502(a).

After confirmation, but before the completion of payments under the plans, the debtors objected to allowance of the claims based on the statute of limitations. Relying on the principle of *res judicata*, the creditor contended that the confirmation orders were final judgments on the allowance of the claims, barring later objections.

The bankruptcy court did not buy the argument, nor did the Fourth Circuit in a March 30 opinion by Circuit Judge G. Steven Agee. He said that LVNV's theory "does not satisfy the requirements for the application of *res judicata* and contradicts the plain language of the Bankruptcy Code."

Judge Agee pointed out that plan confirmation and the filing of claims are on different schedules. Under Section 1324, plan confirmation is 20 to 45 days after the Section 341 meeting. The claims bar date, on the other hand, is 90 days after the first meeting, under Bankruptcy Rule 3002(c). Consequently, the bar date is usually after confirmation in a typical chapter 13 case.

Turning to the law, Judge Agee said that *res judicata* bars relitigation of matters that were actually and necessarily litigated previously. In confirming a chapter 13 plan, he said the bankruptcy court need only determine under Section 1325(a)(4) whether the funds available for unsecured creditors under the plan exceed what the class would receive in chapter 7.

"No provision of the Bankruptcy Code," he said, "provides for the determination of the merits of an individual unsecured claim." Since confirmation does not entail ruling on the validity of an individual unsecured claim, *res judicata* does not bar a claim objection after confirmation.

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Section 502(a) does not change the result, just because a claim is deemed allowed. Judge Agee said there was nothing for "the bankruptcy court to adjudicate at plan confirmation" because there is "no deadline for the initiation of" a claim objection under the "plain text of the relevant rules and statute." He went on to say, "Nothing in the Bankruptcy Code ties contested matters for unsecured claims to a timeline related to plan confirmation."

Res judicata does not bar a claim objection after confirmation, Judge Agee said, because a confirmation order is not a "'prior judgment,' final or otherwise, 'on the merits' as to any individual unsecured creditor's claim."

On March 24, the Fifth Circuit held in *Kipp Flores Architects LLC v. Mid-Continent Casualty Co.* that an uncontested proof of claim in a "no asset" chapter 7 case cannot be grounds for invocation of *res judicata* against a third party. In that case, the Fifth Circuit rested its decision on Section 502, evidently assuming that *res judicata* applied.

Using the Fourth Circuit's analysis, the Fifth Circuit could have reached the same result with an analysis of the elements of *res judicata*. To read ABI's discussion of *Kipp Flores*, click here.

The opinion is *LVNV Funding LLC v. Harling*, 852 F.3d 367 (4th Cir. March 17, 2017).

Do 'deemed allowed' claims have **res judicata** *effect in 'asset' cases?*

No *Res Judicata* Effect for 'Deemed Allowed' Claims in 'No Asset' Cases

The Fifth Circuit concluded that an uncontested proof of claim in a "no asset" chapter 7 case cannot be grounds for invocation of *res judicata* against a third party.

In addition to Section 502, there may be other grounds for reaching the same result, as discussed at the end of this analysis.

The Facts

A company filed a chapter 7 petition after being sued for architectural copyright infringement. Initially, the trustee believed there would be no assets and notified creditors that it was unnecessary to file proofs of claim. The trustee later decided there might be distributable assets and notified creditors that they should file claims within 90 days.

The plaintiff in the copyright suit filed a proof of claim for $83 million. Later, however, the trustee filed a "no asset report" and notified creditors accordingly. No one ever filed an objection to the copyright claim.

The copyright plaintiff demanded that the debtor's insurer pay the face value of a $6 million insurance policy. When the insurance company refused, the plaintiff filed suit in district court for breach of contract, claiming to be a beneficiary of the insurance policy. The plaintiff contended that the debtor's liability on the policy was *res judicata* because the proof of claim was deemed allowed under Section 502(a), which provides that a proof of claim is "deemed allowed, unless a party in interest . . . objects."

The district court granted summary judgment for the insurance company dismissing the complaint and was upheld in the Fifth Circuit's March 24 opinion by Circuit Judge Edith H. Jones. She said the case presented "an intriguing question of statutory interpretation."

Judge Jones' *Ratio Decidendi*

Judge Jones said that "the necessity for creditors to file and the courts to adjudicate claims depends on the existence of assets in the debtor's estate." She also said the "Bankruptcy Rules plainly contemplate pretermitting claims allowance and objection procedures when there are no distributable assets."

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Beyond the statute, Judge Jones said the official forms and accompanying instructions "explain that proofs of claim need only be filed in asset-holding bankruptcy cases."

Because objections to claims are not mandatory under Bankruptcy Rule 3007(a), Judge Jones concluded that no "party in interest," including the insurance company, "had any reason to ascertain that [the plaintiff] had filed a proof of claim, much less object to the superfluous claim."

"Section 502 would be significantly transformed," Judge Jones said, if it required that parties in interest "monitor, object to, and litigate proofs of claim that need not even be filed." Were that true, "sureties, guarantors, general partners, and other entities that might share liability for claims against debtors would risk suffering adverse judgments in the form of 'deemed allowed' claims."

Judge Jones distinguished a Ninth Circuit opinion that gave preclusive effect to a "deemed allowed" claim because it did not involve a no-asset case.

Judge Jones held that a "deemed allowed" claim does not have *res judicata* effect in a no-asset case when creditors were not told to object to claims and "no bankruptcy purpose would have been served by the bankruptcy court's adjudicating" the claim.

The opinion had another holding of note. The insurance company argued that the bankruptcy court lacked jurisdiction to adjudicate the claim because it would have had no conceivable impact on the nonexistent estate.

Judge Jones held that the bankruptcy court had subject matter jurisdiction, although the Bankruptcy Code gave the court discretion over the claim-allowance process since it was a no-asset case.

What About Asset Cases?

Judge Jones' opinion might be interpreted to imply that a deemed allowed claim does have *res judicata* effect whenever there are assets for distribution. However, the opinion does not say that explicitly.

When there are minimal assets, mounting claim objections might not be justifiable economically from the trustee's vantage point. Further, third parties may lack notice of potential *res judicata* effects. Indeed, a third party like an insurance company might not even know that a potentially insured claim was filed. Although an insurance company might have a defense under the policy for lack of notice of the claim, other potentially liable third parties might not have similar rights.

If deemed allowed claims have *res judicata* effect in asset cases, Section 502 would become a trap for the unwary third party liable on a claim against a debtor.

In asset or no-asset cases, another court presented with the same facts might explore whether *res judicata* is even applicable to deemed allowed claims, since claim preclusion requires a final order. It is at least questionable whether the absence of an objection is equivalent to a final order, given that there was no judicial action affirming the validity of the claim.

Finality is another issue. In chapter 7 cases, there may be no deadline for claim objections. Indeed, a closed case conceivably could be reopened to permit a claim objection.

Therefore, it might be said that a deemed allowed claim is neither an order nor is it final, thus precluding the invocation of *res judicata*.

Judge Jones' opinion does not discuss the elements of *res judicata*, but she appears to assume that the doctrine applies. Another court might explore whether *res judicata* is applicable when the party allegedly in privity with the debtor lacks notice or an opportunity to defend.

The opinion is *Kipp Flores Architects LLC v. Mid-Continent Casualty Co.*, 852 F.3d 405 (5th Cir. March 24, 2017).

Rochelle's Daily Wire

Surrender & Forced Vesting

Debtors may face sanctions for continuing to occupy property they intend to surrender.

Election to 'Surrender' Property Bars Opposition to Foreclosure, Eleventh Circuit Holds

The Eleventh Circuit resolved a split among the Florida bankruptcy judges by ruling that a debtor who elects to "surrender" real property cannot oppose foreclosure. The opinion also implies that a debtor must give up possession and not force the lender to initiate eviction proceedings.

A husband and wife filed a "no asset" chapter 7 petition where they listed the mortgage on their home as valid, with mortgage debt exceeding the value of the home. They filed a statement of intention under Section 521(a)(2) to surrender the home. Since there was no equity, the trustee abandoned the home to the debtors.

The debtors opposed the lender's foreclosure. Rather than litigate in the foreclosure court, the lender persuaded the bankruptcy judge to enjoin the debtors from opposing foreclosure. The bankruptcy judge also threatened to revoke the debtors' discharges were they to persist. The district court affirmed.

The Eleventh Circuit affirmed in an opinion on Oct. 4 by Circuit Judge William Pryor.

Section 521(a)(2)(A) requires debtors to state their intention to retain, surrender or redeem property, or reaffirm the debt. Subsection (a)(2)(B) requires a debtor to "perform his intention" within 30 days.

Interpreting the "text and the context of the statute," Judge Pryor said the debtors must surrender the property to both the trustee and to the lender. If the trustee abandons the property, the debtor, he said, retains a duty to surrender the home to the lender.

Next, Judge Pryor decided what "surrender" means. It does not mean deliver possession, he said, because the Bankruptcy Code says "deliver" not "surrender" when the statute compels turning over possession.

The "context" of Section 521(a) shows that "surrender" means to give up a right or claim, according to Judge Pryor. The statutory language therefore means that debtors cannot oppose foreclosure.

Since the debtors conceded in their filings that the mortgage was valid and the lender had the right to foreclose, Judge Pryor said that enjoining them from opposing foreclosure was proper because they must "honor that declaration."

The debtors also contended that the lender's only remedy in bankruptcy court was to lift the stay and litigate in the foreclosure court.

Again, Judge Pryor agreed with the lender. He said the bankruptcy court has "broad powers" under Section 105(a) to remedy a violation of a debtor's duties under Section 521(a).

The very first paragraph of the opinion says that an election to surrender means that "debtors relinquish their rights to possess the property." The statement could be read to mean that debtors face sanctions if they force the lender to initiate eviction proceedings, even if they do not oppose foreclosure.

It remains to be seen whether the result will be the same if the facts are altered.

Suppose that the debtor states an intention to surrender, but *only to the trustee*, while listing the mortgage debt as disputed and scheduling a claim against the lender for an alleged defect in the loan or mortgage. Assuming the trustee abandons both the home itself and the claim against the lender, the debtor would not face the estoppel argument that underlay part of Judge Pryor's opinion.

On the other hand, Judge Pryor interpreted "surrender" not to mean "deliver possession." However, Judge Pryor's affirmation of the powers of the bankruptcy court implies an ability to impose sanctions on debtors who do not voluntary surrender possession.

In Florida, Bankruptcy Judges Paul G. Hyman Jr., Eric P. Kimball and Michael G. Williamson held that a statement of intention to surrender a home bars a debtor from opposing foreclosure. District Judge Kenneth A. Marra in West Palm Beach upheld Judge Hyman in *Failla.* In February, Bankruptcy Judge Laurel M. Isicoff of Miami ruled in *In re Elkouby* that a statement of intention to surrender a home does not compel a chapter 7 debtor to withdraw defenses to foreclosure.

To read ABI's write-up of the *Failla* decision in district court, click here. To read about *Elkouby*, click here.

The opinion is *Failla v. Citibank NA (In re Failla)*, 838 F.3d 1170 (11th Cir. Oct. 4, 2016).

Less than a month after* Failla*, a circuit split is brewing on the effect of intention to surrender.

Judge Farris Disagrees with 11th Circuit on 'Surrender' as Waiver of Foreclosure Defenses

Bankruptcy Judge Robert J. Farris in Honolulu disagreed with the Eleventh Circuit and held that a chapter 7 debtor's election to "surrender" real property does not preclude the debtor from defending against a foreclosure action or asserting claims for allegedly improper foreclosure.

In *Failla*, the Atlanta-based circuit court resolved a split among Florida bankruptcy judges by holding on Oct. 4 that a debtor who elects to "surrender" real property under Section 521(a)(2) cannot oppose foreclosure. To read ABI's discussion of *Failla*, click here.

Judge Farris faced the same issue in his Oct. 19 opinion, although in a procedurally different posture.

In the Hawaii case, the debtors stated their intention under Section 521(a)(2) to surrender their residence, and the lender sought and obtained a modification of the automatic stay. After the debtors received their discharges and the court closed the case, the lender completed nonjudicial foreclosure.

One week after foreclosure, the debtors initiated a wrongful foreclosure suit in state court. The lender filed a motion to dismiss, arguing that the intention to surrender, coupled with discharge, precluded the debtors from suing for wrongful foreclosure.

To prevent the state court from ruling on the implications flowing from the statement of intention, the debtors reopened their bankruptcy case and filed a motion asking Judge Farris to declare that their intention to surrender did "not deprive them of any substantive right to litigate their wrongful foreclosure action."

Finding that the Eleventh Circuit's reasoning was "flawed," Judge Farris disagreed with *Failla*'s holding that a stated intention to surrender requires "'debtors to drop their opposition to a foreclosure action.'"

Reading the word "surrender" in "its immediate statutory context," Judge Farris said he agreed with courts that have held that an intention to surrender waives only the right to redeem the collateral, reaffirm the secured debt, or exempt the property. He found nothing in Section 521 to suggest "that the debtor is required to give a broader waiver."

A narrow reading of "surrender," he said, is consistent with the *Collier* treatise and a Ninth Circuit Bankruptcy Appellate Panel opinion holding that Section 521(a)(2) is a notice provision that does not affect a debtor's substantive rights.

Fairly read, Judge Farris said "there is no reason to read" the so-called hanging paragraph in Section 521(a)(2) "to give secured creditors a free pass to violate foreclosure laws."

Judge Farris also ruled on several other issues that were not unimportant. He found jurisdiction, held that the debtors were not asking him to issue an advisory opinion, and saw insufficient reason to abstain.

In addition, he held that neither receipt of discharges nor closing the case precluded the debtors from reopening their bankruptcy and importuning the court to rule on the implications of an election to surrender.

The opinion is *In re Ryan*, 560 B.R. 339 (Bankr. D. Haw. Oct. 19, 2016).

District judge hopes novel theories of equity will permit forced vesting.

Massachusetts District Judge Nixes Notion of Forced Vesting in Chapter 13

Bankruptcy judges in Massachusetts have been split on whether a chapter 13 plan can force a mortgage lender to take title to property. In an appeal from a confirmation order upholding forced vesting, District Judge Mark G. Mastroianni of Springfield, Mass., reversed the bankruptcy court and held that the plain language of Sections 1322(b)(9) and 1325(a)(5)(C) does not empower a debtor to convey title to a secured lender over the lender's objection.

Remanding the case to bankruptcy court, Judge Mastroianni left the door open for the bankruptcy judge to search for equitable powers that might permit forced vesting.

Forced vesting arose as a remedy for situations where the secured lender either delays foreclosing or will not foreclose, thus leaving the debtor stuck with title and with nondischarged post-petition costs for maintaining and insuring the property until the lender forecloses. The problem can be acute for debtors who own condominiums and thus remain liable for post-petition common area fees.

The appeal involved a man who owned several parcels of real property. One was property worth about $90,000 that was encumbered with one mortgage for about $60,000. The plan, confirmed by Bankruptcy Judge Melvin S. Hoffman, required the mortgage lender to take title in full satisfaction of the debt. The lender appealed and won in Judge Mastroianni's Jan. 23 opinion.

The opinion revolved around Section 1322(b)(9), which provides that a plan may "provide for the vesting of property," and Section 1325(a)(5)(C), which requires confirmation if, among other things, the debtor "surrenders" collateral to the lender.

Judge Mastroianni held that the terms "vest" and "surrender" have well established meanings. In the First Circuit, "surrender" means to make collateral "available" to the lender. "In contrast," he said, "vest" is generally defined to mean conferring ownership. In other words, "Vesting refers instead to the acceptance of surrender by the grantee, which consummates the legal act of transfer."

The bankruptcy court was wrong, because the two words are not interchangeable. Consequently, a debtor cannot use Section 1325(a)(5)(C) to convey title forcibly on a lender.

Judge Mastroianni held that "the plain language of Section 1322(b)(9), considered alone or in combination with Sections 1322(b)(8) and/or Section 1325(a)(5)(C), does not allow forced vesting of collateral property in an objecting creditor."

ROCHELLE'S DAILY WIRE

The opinion by Judge Mastroianni includes a comprehensive summary of arguments on both sides of the issue.

Judge Mastroianni ended his opinion by saying that he "ultimately doubts" whether the bankruptcy court is "wholly lacking in authority and ability to balance the equities in a situation that includes forced vesting in chapter 13." Citing the Supreme Court, he said that forced vesting would be consistent with the concept of the bankruptcy court being a court of equity with broad authority to modify the debtor/creditor relationship.

For property that is not a principal residence, he said that a debtor might use Section 1322(b)(2), which allows modification of the rights of a secured creditor. In the case of a principal residence, the debtor might try using Section 1322(c), he said.

The opinion is *Wells Fargo Bank NA v. Sagendorph (In re Sagendorph)*, 562 B.R. 545 (D. Mass. Jan. 23, 2017).

ROCHELLE'S DAILY WIRE

Exemptions

After rehearing, the Fifth Circuit rediscovers the snapshot rule by giving finality to exemptions in chapter 7.

Reversing Itself, Fifth Circuit Panel Reinstates Finality to Exemptions in Chapter 7

In a remarkably short time, a panel of the Fifth Circuit saw the error in its ways, vacated an opinion handed down on July 19, and held that exempt property on the filing date does not lose its exempt status even if it is converted to nonexempt property after the filing of a chapter 7 petition.

The *per curiam* opinion on Sept. 5 removes a cloud of perpetual uncertainty that had been hanging over chapter 7 debtors in the Fifth Circuit. For seven weeks, when the July opinion was good law, a chapter 7 debtor who liquidated exempt property was in peril even if the case had been closed and the time for objecting to exemptions had long since passed.

The new opinion establishes two principles in the Fifth Circuit. As we will discuss later, the holding in *In re Frost*, 744 F.3d 384 (5th Cir. 2014), is now limited to chapter 13 cases, and *In re Zibman*, 268 F.3d 298 (5th Cir. 2001), does not apply to cases where the time for objecting to exemptions has elapsed.

The Facts

The case involved a couple who filed a chapter 7 petition with about $130,000 in an individual retirement account, or IRA. They scheduled the IRA as exempt under Texas law. There were no objections to the claimed exemption, and the trustee eventually issued a no-asset report.

Starting a few days before filing and continuing for seven months, the couple withdrew all the money from the IRA, spent most of it on living expenses, and did not reinvest any proceeds in another IRA.

Learning that the IRA had been liquidated and not reinvested, the trustee demanded that the couple turn over the IRA proceeds, because Texas law provides that withdrawals from an IRA must be reinvested in another IRA within 60 days to retain their exempt character. When the trustee made her demand, the debtors still held about $30,000 in proceeds from the IRA.

The bankruptcy judge ruled in favor of the trustee and required the couple to turn over the $130,000. The district court affirmed.

The Original Panel Opinion

The original panel opinion from July was based largely on *Frost*, where 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 *Zibman*, discussed below.

Lower courts were divided on whether *Frost* also applied to chapter 7 cases. Some courts believed that *Frost* should apply only in chapter 13 cases because Section 1306(a)(1) brings after-acquired property into the estate. Since there is no counterpart in chapter 7, those courts would not invoke *Frost* in chapter 7 cases.

The original panel opinion in July, written by Circuit Judge Edward C. Prado, resolved the issue by holding that *Frost* applied equally in chapter 7. The appeals courts developed the notion of conditionally and unconditionally exempt property.

Unconditionally exempt property, like an IRA or a homestead, could become conditionally exempt on being sold or liquidated. If proceeds were not reinvested in exempt property within the time permitted by state law, the conditionally exempt money would lose its exempt character.

Arguably splitting with every other circuit and seemingly abandoning the snapshot rule, the original panel opinion in effect held that exemptions never become final even if the time for objection has run out.

The original opinion was important because it meant that debtors in Texas and perhaps elsewhere could not take money from an IRA until after the chapter 7 case was closed. It also meant that a chapter 7 debtor in Texas could not sell an exempt homestead after filing because it would lose the exemption if the proceeds were not reinvested in a new homestead within six months.

Even after the chapter 7 case had been closed, a trustee could reopen the case and demand turnover. Following the July decision, it was unclear how long debtors were required to hold exempt property even after a chapter 7 case was closed.

The Motion for Rehearing

On August 2, the husband moved for panel rehearing and rehearing *en banc*, supported by an *amicus* brief filed by Prof. Christopher G. Bradley of the Univ. of Kentucky College of Law, retired Bankruptcy Judge Leif M. Clark, and attorneys Stephen W. Sather and Michael Baumer, both of Austin.

The last brief on the rehearing petitions was filed on Aug. 21. Without holding oral argument, the panel issued its 14-page *per curiam* opinion on Sept. 5, withdrawing the prior opinion, reversing the bankruptcy court, remanding the case, and denying the petition for rehearing *en banc*. In effect, the panel reversed its prior opinion and allowed the debtors to retain all proceeds from the liquidated IRA.

The Rationale after Rehearing

Originally mandated by the Supreme Court in *White v. Stump*, 266 U.S. 310 (1924), and largely ignored in the prior opinion, the new opinion reaffirmed the snapshot rule, which in substance provides that exemptions are fixed on the filing date. The appeals court then examined *Frost* and *Zibman*, ultimately limiting the holdings of both.

Zibman, which predated *Frost*, concerned debtors who sold their exempt homestead two months before filing a chapter 7 petition but did not reinvest the proceeds in another home. The appeals court held that the proceeds lost their exempt status because the Texas statute protects only a homestead, not proceeds of a homestead.

The new opinion then did what *Frost* did not do: It limited the holding to chapter 13 because after-acquired property is not brought into a chapter 7 estate. The new opinion characterized the IRA proceeds as a newly acquired property interest.

Since the time for objecting to exemptions had expired, the new opinion said "there was no means by which the [debtors'] newly acquired property interest [in the IRA proceeds] could become part of the chapter 7 estate."

The new opinion emphasized how *Zibman* dealt with debtors who had sold their home before filing, giving them only a conditional exemption on the filing date. The new opinion thus limits *Zibman* to situations where an exempt asset is sold before bankruptcy but not reinvested in another exempt asset within the time allowed by state law.

Finality of Exemptions Emphasized

The new opinion helps debtors generally because the appeals court emphasized the finality resulting from the lack of objections to exemptions.

The debtors had liquidated some of the IRA before filing, thus giving the trustee an opening to demand turnover of those moneys, based on *Zibman*. Nonetheless, the new opinion allowed the debtors to retain even those proceeds. Because the trustee "did not timely object to the claimed exemption," she "could not contest the exemption's validity after the time for objection passed," the opinion says.

Consequently, the new opinion also limits *Zibman* to cases where the time for objection to exemptions has not elapsed.

The new opinion emphasizes the differences between chapters 7 and 13. The *per curiam* opinion says the two chapters "are not meant to always yield the same results."

With regard to after-acquired property, the opinion holds that "a new property interest the debtor acquires after filing for bankruptcy becomes part of the estate in a chapter 13 case but does not become part of the estate in a chapter 7 case, even if the debtor acquires the new property by transforming a previously exempted asset into a nonexempt one."

The debtor was represented by William P. Haddock from Pendergraft & Simon LLP in Houston.

To read ABI's coverage of the July opinion and the motion for rehearing, click here and here.

The opinion is *Hawk v. Engelhart (In re Hawk)*, 16-20641, 2017 BL 312031 (5th Cir. Sept. 5, 2017).

Even if an exemption is lost after filing, a Code provision must bring property into the estate, Fourth Circuit holds.

Fourth Circuit Conflicts with the Fifth on Loss of Chapter 7 Exemptions after Filing

Unlike the Fifth Circuit, an exemption that the Fourth Circuit takes away with one hand, it gives back with the other, as District Judge James K. Bredar of Baltimore explained in his Aug. 29 opinion.

A man filed a chapter 7 petition owning a home as tenants by the entireties with his wife, who did not file. The husband claimed an exemption in the home under Section 533(b)(3)(B), which applies to an interest in entireties property that is exempt from process under state law.

After bankruptcy, the wife died, and the trustee claimed that her death brought the home into the estate since there was no longer entireties ownership. The bankruptcy judge ruled against the trustee, and Judge Bredar affirmed, albeit on a somewhat different theory.

Using the so-called snapshot test, Judge Bredar said that most courts hold that a postpetition change in the character of exempt property does not change the status of the property. The Fourth Circuit, however, holds otherwise.

In *Birney v. Smith (In re Birney)*, 200 F.3d 225 (4th Cir. 1999), the appeals court held that an exemption in entireties property lapses after bankruptcy as a consequence of divorce or death of the spouse. But that "does not end the inquiry," the Fourth Circuit said. *Id.* at 228.

Even if an exemption lapses after bankruptcy, the *Birney* court said, there still must be a provision in the Bankruptcy Code to "bring the property into the estate." *Id.*

Like the circuit court in *Birney*, Judge Bredar found no Code provision that would bring previously exempt entireties property into a chapter 7 estate based on an event after filing. "Although the Bankruptcy Code provides several mechanisms by which a debtor's interest in property acquired postpetition becomes part of the bankruptcy estate, none apply here," he said.

Unlike chapters 11, 12 and 13, nothing generally brings property into a chapter 7 estate that is acquired after filing. Significantly, *Birney* held that a survivor does not "inherit" entireties property on the death of a spouse, thus making Section 541(a)(5)(A) inapplicable. That section brings property into the estate if the inheritance was within 180 days of filing.

Upon his wife's death, the debtor became the sole owner of the home in fee simple. However, Judge Bredar, like in *Birney*, said that the fee simple interest was not estate property because Section 541(a)(1) only reaches property interests "as of the commencement of the case."

Although the debtor lost his entireties exemption on his wife's death, Judge Bredar upheld the result in bankruptcy court by ruling that the home was not brought into the chapter 7 estate.

The opinion is *Bellinger v. Buckley*, 17-068, 2017 BL 303887 (D. Md. Aug. 29, 2017).

Community property homestead rights
are lost if only one spouse files bankruptcy.

Fifth Circuit Denies Exemption to Nonfiling Spouse for Home Owned Under 1,215 Days

In a case where prebankruptcy exemption planning backfired disastrously, the Fifth Circuit held that a nonfiling spouse had no homestead exemption rights because the husband's bankruptcy trustee sold the home the couple owned for fewer than 1,215 days.

In substance, the wife was worse off financially because she did not file a petition herself, although she had no debt to discharge.

The Feb. 14 opinion by Circuit Judge Leslie Southwick stands for the proposition that the bankrupt husband's estate included all community property, leaving the wife with no rights under Section 363(j) or otherwise to receive any proceeds from the sale of the couple's home, despite her homestead exemption rights under Texas law.

Unless the opinion is set aside on rehearing *en banc*, couples in Texas who are subject to the Section 522(p) limitation on a homestead exemption must both file petitions to receive the double exemption, which is now about $320,000. The Fifth Circuit's interpretation of the statute would appear to apply to any state with community property.

Gerrit M. Pronske told ABI in a phone interview that he will file a petition for rehearing *en banc*. Pronske, of Dallas, is counsel for the wife who lost in the Fifth Circuit.

The Facts

A husband and wife purchased an expensive Texas home they improved and intended to flip for a profit, living there in the meantime as their homestead. Attempting to maximize their profit on the home despite the husband's impending bankruptcy on account of his business debt, the couple recorded a partition agreement where they recharacterized their community property interest in the home into separate property, with each owning half. The husband alone filed a chapter 7 petition hours after recording the partition agreement, which had been executed on the advice of counsel.

Without objection from the couple, the trustee sold the home, generating almost $570,000 after payment of liens.

Because the couple had owned the home for fewer than 1,215 days, Section 522(p) limited the homestead exemption to $155,675, which became $160,375 in April 2016. The husband agreed to limit his homestead exemption to about $130,000.

The Fraudulent Transfer

After payment of the liens, expenses and the husband's homestead exemption, the wife claimed $450,000 of the remaining sale proceeds as her separate property under the partition agreement. In response, the trustee sued to set aside the partition agreement as a fraudulent transfer.

The bankruptcy judge set aside the agreement as a fraudulent transfer with actual intent to hinder or delay creditors. The lower court also held that the wife was entitled to no compensation under Section 363(j). The Fifth Circuit granted a direct appeal and affirmed.

Judge Southwick upheld the ruling that the partition agreement was a fraudulent transfer. Even so, the wife argued on appeal that she was entitled to some or all of the remaining net sale proceeds in view of her Texas homestead exemption rights.

Judge Southwick didn't buy her arguments under either the Bankruptcy Code or the Constitution.

The Statute

In addition to Section 522(p), several other provisions in the Bankruptcy Code were pivotal.

Section 541, defining property of the estate, provides in subsection (a)(2) that the estate includes "all interest of the debtor and the debtor's spouse in community property."

Section 363(h) allows a trustee to sell both the interest of the debtor and "any co-owner in property in which the debtor had . . . an undivided interest as a tenant in common, joint tenant, or tenant by the entirety."

Following a sale under Section 363(h), Section 363(j) requires the trustee to distribute net proceeds "to the debtor's spouse or co-owners" and to the estate according to "the interests of such spouse or co-owners, and of the estate."

In a sale under Section 363(h), Section 363(i) gives the debtor's spouse a right of first refusal with regard to "property of the estate what was community property."

Notwithstanding avoidance of the partition agreement, the wife asserted her homestead exemption rights and claimed $450,000 under Section 363(j).

The Circuit Court's Analysis

Citing Texas cases, Judge Southwick said that the Texas exemption grants only a possessory interest, not an economic interest. He posed the question as to whether the wife was entitled to any compensation for her homestead interest "beyond the [$130,000] her husband elected" under Section 522(p). He answered the question in the negative.

Judge Southwick held that Section 363(h) did not apply because the community property became property of the bankrupt estate under Section 541(a)(2) when the husband filed bankruptcy, even though the wife was not bankrupt.

Judge Southwick concluded that Section 363(h) gave the wife no protection because it did not refer to "community property," as did Section 363(i). He said that if Congress intended to protect community property in Section 363(h), it would have said so.

Because "the entire homestead property is brought in[to]" the bankrupt estate, the judge said that the "voluntary sale of a homestead" did not give the wife a right to compensation.

Judge Southwick rejected several constitutional attacks to his interpretation of the Code. Although homestead rights are constitutionally protected, he said that the Supremacy Clause allowed Congress to limit the dollar amount of the exemption.

Implications of the Decision

In similar circumstances, a husband and wife should both file bankruptcy, even if only one has debt to be discharged. Judge Southwick so much as said so himself when he observed that the couple would have enjoyed a $311,500 exemption had both filed.

Pronske said the result is "worse in divorce": If a couple separate and one files bankruptcy, the nonfiling spouse could end up with no distribution from the sale of a home owned for fewer than 1,215 days. Consequently, one spouse could use the threat of bankruptcy as leverage in matrimonial negotiations.

Thankfully, the untoward results do not befall a couple who have owned a homestead for more than 1,215 days. In those situations, the bankrupt spouse could exempt the entire property in Texas.

In other words, the Fifth Circuit's interpretation of Section 541(a)(2) results in giving a nonfiling spouse no exemption at all, not even the $160,375 perhaps intended by Section 522(p).

Residents of states without community property laws but in an identical circumstance would not realize the same loss of homestead rights, because the Fifth Circuit's opinion is based on the notion that the community property rights of both spouses are brought into the bankrupt estate under Section 541(a)(2) even though only one spouse has filed.

In short, Texas is great place to live if you've owned your expensive home for more than 1,215 days. Otherwise, watch out!

The opinion is *Wiggains v. Reed (In re Wiggains)*, 848 F.3d 655 (5th Cir. Feb. 14, 2017); petition for rehearing *en banc* denied June 21, 2017.

Debtors have standing for a motion compelling a trustee to abandon.

Trustee Can't Evict Debtors in Advance of Selling Their Home, Sixth Circuit Rules

The Sixth Circuit established an important precedent protecting individual debtors by declaring they can't be evicted from their home simply because the trustee tenders a check representing the full value of the homestead exemption.

The circuit's decision on July 14 made law on seemingly obvious questions about the debtors' standing and the right to occupy a home before sale. Like here, there will sometimes be no direct precedent because no one previously will have had the temerity to raise questions with obvious answers.

A couple filed a chapter 7 petition, listing their home as worth $108,000, encumbered by a $91,500 mortgage. Alleging that the property was really worth about $200,000, the trustee filed a motion asking the bankruptcy judge to evict the couple, saying that he could not sell the property while they were living there.

The debtors cross moved for an order compelling the trustee to abandon the home on the theory that the home had inconsequential value for creditors. At the hearing on the dueling motions, the trustee tendered the debtors a check for $7,500, representing the full amount of their Tennessee homestead exemption.

Bankruptcy Judge Nicholas W. Whittenburg of Chattanooga, Tenn., held an evidentiary hearing and took appraisal testimony from both sides. He vouched for the debtors' appraisal, concluding that the property was worth only $108,000. He also said that the trustee had six months to find a buyer and that properties are often sold with tenants in residence. Judge Whittenburg therefore granted the debtors' motion to compel abandonment and denied the motion to evict.

The trustee appealed and lost again in district court. The trustee lost a third time in the Sixth Circuit, in an opinion authored by Circuit Judge Ronald Lee Gilman.

The trustee contended that the debtors lacked standing to compel abandonment. Using a result-oriented approach, Judge Gilman said that being allowed to keep their home gave them a "practical stake" in the outcome, thus conferring standing. He also said that their homestead exemption was not the debtors' only remedy in the face of a motion to evict, thus countering the trustee's argument that tendering the $7,500 check was the only relief to which they were entitled. The debtors' alternate remedy, he said, was to seek abandonment.

Judge Gilman said that the debtors also had Article III standing because evicting them "would surely constitute injury-in-fact."

Turning to the merits, Judge Gilman found "no authority for the proposition that the trustee can tender the debtors the homestead exemption and cause them to 'skedaddle.'" There was, he said, "no basis in precedent or in the Bankruptcy Code."

On the question of value to support the conclusion of inconsequential value, Judge Gilman invoked the "clear error" standard and said the record was "replete with evidence" supporting the debtors' valuation.

W. Thomas Bible, Jr. represented the debtors, while Tara A. Twomey of the National Consumer Bankruptcy Rights Center filed an *amicus* brief on behalf of the debtors.

The opinion is *Jahn v. Burke (In re Burke)*, 863 F.3d 521 (6th Cir. July 14, 2017); rehearing *en banc* denied Aug. 17, 2017.

***Adhering to traditional bankruptcy concepts, Utah judge gives reasons for reversing* Jevic.**

Debtor Has Valid Homestead Exemptions Even Without Equity in the Property

Addressing the same question now before the Sixth Circuit, Chief Bankruptcy Judge R. Kimball Mosier of Salt Lake City wrote an encyclopedic opinion concluding that a trustee cannot sell an individual debtor's home without paying the homestead exemption in full, in cash.

Judge Mosier's opinion explains why the Bankruptcy Code prevents collusion between a trustee and a secured creditor from stripping away a debtor of a homestead exemption even when the encumbrances exceed the value of the property.

The Sixth Circuit Case

In *Brown v. Ellmann (In re Brown)*, 16-1967 (6th Cir.), the Sixth Circuit is reviewing a decision by a district judge in Detroit who held in May that a debtor can have a homestead exemption only if there is equity in the property. Even though the debtor got nothing, the decision allowed the trustee and unsecured creditors to obtain a recovery from the sale of the debtor's home, although the homestead exemption was otherwise valid.

In the Sixth Circuit case, a woman filed a chapter 7 petition while owning a home worth $170,000 that was encumbered with mortgages totaling almost $220,000. With consent from the lenders, the trustee sold the home for $160,000.

The holder of the first mortgage agreed to take about $148,000 in full satisfaction of the debt and allowed the trustee to distribute $6,000 to the holder of the second mortgage. After paying the brokerage fee and closing costs, the trustee would have money left over for distribution to unsecured creditors.

The debtor objected, raising her homestead exemption as reason for not selling the home. The bankruptcy court ruled against her, and the district court affirmed, holding there is no homestead exemption without equity in the property for the debtor.

The briefs having been filed, *Brown* awaits oral argument. Because the underlying principles are the same, the Cincinnati-based appeals court might withhold ruling until the Supreme Court decides *Czyzewski v. Jevic Holding Corp.*, on which oral argument took place on Dec. 7. *Jevic* will decide whether a settlement can distribute proceeds in violation of statutory priorities. To read ABI's discussion of the implications of *Jevic* on the outcome of *Brown*, click here.

The Salt Lake City Case

In Judge Mosier's case, a couple filed a chapter 7 petition while owning a home they scheduled as being worth $351,000. The home was encumbered with $300,000 in mortgage debt and an IRS tax lien for about $115,000. The couple claimed a $51,000 homestead exemption under Utah law.

After Judge Mosier overruled the trustee's objection to the homestead exemption, the trustee responded by locating a purchaser willing to pay $425,000 for the property, or enough to pay off the liens and cover expenses of sale, generating about $7,500 of equity. The proposed sale was not that simple, because the trustee intended for the debtors to get nothing.

As part of the sale, the IRS agreed to subordinate its secured claim by enough to generate $10,000 for the estate. The deal would also allow the trustee to pay his fees and costs from the sale proceeds.

Faced with the possible loss of their home, the couple converted the case to chapter 13 and removed their claim of a homestead exemption. After conversion, the trustee and his counsel filed fee applications for about $31,000.

Ruling on the fee applications in his Dec. 14 opinion enabled Judge Mosier to explain in detail why the chapter 7 trustee could not have sold the home without paying the debtors' homestead exemption in full.

Reasons for Denying the Fee Application

Citing Section 330(a)(4)(A), Judge Mosier denied the fee applications because the trustee's services were not necessary, did not benefit the estate, and "could work a substantial harm on the debtors if they were approved." In effect, his opinion explained why he would not have approved the sale had the debtors not converted the case to chapter 13.

Judge Mosier said that allowing the sale would have had "devastating consequences for the debtors." He explained that the debtors "would lose their home without any funds in return with which to acquire a new place to live, and proceeds from the sale of the home would go to the trustee and his counsel instead of toward the IRS's claim."

But that was not all. By paying the trustee, the IRS would have a smaller recovery, saddling the debtors with a larger nondischargeable tax claim even though the debtors would have no sale proceeds to apply toward tax debts.

And there's more. Judge Mosier said the debtors in effect would have been paying the costs of administration from an increase in their nondischargeable tax debt.

"This is hardly the fresh start that the Code contemplates," Judge Mosier said.

Why the Code Bars Selling a Homestead with No Equity

The bulk of Judge Mosier's opinion is a dissection of several provisions of the Bankruptcy Code, all leading to the conclusion that a trustee cannot sell someone's homestead without paying the homestead exemption in full. He also discusses concepts raised in *Jevic* without addressing that case by name.

The judge began with the proposition that Section 554 was included in the Bankruptcy Code to prevent trustees from selling fully encumbered property and "bringing no value to the estate." He cited the *U.S. Trustee's Handbook* as saying that "'a trustee should not sell property subject to a security interest unless the sale generates funds for the benefit of unsecured creditors,'" nor should a trustee sell an asset where the proceeds "'will primarily benefit the trustee or the professionals.'"

The *Handbook*, according to Judge Mosier, explains why trustees are not "to act as liquidating agents for secured creditors," a concept in bankruptcy law dating from the former Bankruptcy Act.

To show that the trustee's services would not have benefitted the estate, Judge Mosier first cited the Supreme Court's 1991 *Owen* decision for the proposition that exemptions are not limited by liens. At the time of filing, he said, the liens presumptively exceeded the value of the home. Consequently, the debtors were basing their homestead exemption on legal title, which he said *Owen* permits.

Even though it turned out that the property was worth more than the liens, a sale was still not permissible, for reasons Judge Mosier explained.

Under Utah law, the judge said that the debtors were entitled to an exemption even if the property were worth less than the encumbrances, contrary to the trustee's contention. Since it turned out that there indeed was equity for the debtors, he said the trustee could not contest the validity of the homestead exemption.

Judge Mosier said that Utah law does not allow a forced sale of a homestead unless the proceeds would pay the exemption in full, in cash. He then went on to explain why the purported carveout for the trustee was nonetheless exempt proceeds that the debtors were entitled to receive.

Even if the trustee could have sold the property, Judge Mosier would have paid the carveout to the debtors on account of their homestead exemption before distribution to unsecured creditors.

In a comment reminiscent of the issues in *Jevic*, Judge Mosier said that the trustee and the IRS cannot by agreement "defeat junior lien interests or the debtors' homestead exemption." He then went on to explain why he disagreed with cases where a secured creditor uses debt to purchase property and leaves a "tip" for unsecured creditors, bypassing junior liendholders or holders of priority claims. He explained why he disagreed with the notion that a "tip" or carveout is not proceeds of estate property.

Judge Mosier went on to explain in depth why neither Sections 724 nor 506(c) provide a basis for carveouts that disregard statutory priorities.

The extent to which the result stemmed from Utah law is not immediately apparent. Arguably also, much of the opinion is *dicta* and may have different or no application in chapter 11 cases where exemptions are not in play. Nonetheless, the thrust of the opinion arguably stands for the proposition that Section 507's priorities cannot be ignored in a sale, the very question at issue in *Jevic*.

To read ABI's discussion of *Jevic*'s oral argument in the Supreme Court, click here.

The opinion is *In re Christensen*, 561 B.R. 195 (Bankr. D. Utah Dec. 14, 2016).

ROCHELLE'S DAILY WIRE

Late-Filed Tax Returns

Circit split widens on an issue the Supreme Court has been ducking.

Third Circuit Joins the Majority in the Split Over Late-Filed Tax Returns

The split widens on the one-day-late rule, where the First, Fifth and Tenth Circuits hold that a tax debt never can be discharged under Section 523(a)(1)(B)(i) if the underlying tax return was filed even one day late.

The Fourth, Sixth, Seventh, Eighth and Eleventh Circuits, on the other hand, employ the four-part test resulting from a 1984 Tax Court decision known as *Beard*. Addressing the question, the Third Circuit joined the majority in a May 5 opinion by adopting the *Beard* test.

Deepening the controversy over late-filed tax returns, the Third Circuit weighed in on a subordinate split by differing with the Eighth Circuit and considering the timing of the late-filed return as relevant to the question of dischargeability.

The Supreme Court has been ducking the split. Columbia University Law Professor Ronald J. Mann attempted to take a one-day-late case to the Supreme Court in 2015 in *In re Mallo*. The high court denied *certiorari*.

In February, the justices denied *certiorari* in *Smith v. IRS*, where the petitioner's counsel raising the same issue was Prof. John A.E. Pottow from the University of Michigan Law School.

The Third Circuit Case

The Third Circuit dealt with a case where the debtor did not file three years' worth of tax returns until after the Internal Revenue Service made assessments. The bankruptcy court held that the tax debt was not dischargeable and was upheld in district court.

On appeal to the Third Circuit, the debtor argued that his late-filed returns nonetheless qualified as "returns," making the tax debt dischargeable under Section 523(a)(1)(B)(i). That section excepts a debt from discharge "for a tax . . . with respect to which a return . . . was not filed . . . ."

Added to Section 523(a) along with the amendments in 2005, the so-called hanging paragraph defines "return" to mean "a return that satisfies the requirements of applicable nonbankruptcy law (including applicable filing requirements)."

The opinion by Third Circuit Judge Jane R. Roth declined to employ the one-day-late rule followed by three circuits and instead adopted the *Beard* test used by five others. She tersely alluded to the fact that the IRS does not endorse the one-day-late rule.

Among the four parts to the *Beard* test, only the fourth element was at issue: whether the debtor's late-filed return "represent[ed] an honest and reasonable effort to comply with the tax law."

Citing other circuits, Judge Roth said that a return filed after an IRS assessment will "rarely, if ever, qualify as an honest or reasonable attempt to satisfy the tax law."

The debtor relied on the Eighth Circuit's *Colsen* decision focusing "on the content of the form, not the circumstances of its filing." Judge Roth declined to follow the sister circuit but instead agreed "with the weight of authority that the timing of the filing of a tax form is relevant" in deciding whether the late-filed return was an "honest and reasonable attempt to comply with tax law."

Judge Roth therefore ruled that tax debts were not dischargeable under the *Beard* test because they did not qualify as "returns."

The opinion is *Giacchi v. U.S. (In re Giacchi)*, 856 F.3d 244 (3d Cir. May 5, 2017).

Automatic Stay

ROCHELLE'S DAILY WIRE

For an 'egregious' stay violation,
medical evidence of emotional distress is
not required.

Willful Stay Violation Can Justify Damages for Emotional Distress, Third Circuit Says

The Third Circuit joined a growing number of courts that allow damages for emotional distress resulting from a willful violation of the automatic stay under Section 362(k)(1).

In his April 10 opinion, Circuit Judge Michael J. Melloy did not need to decide whether "financial injury is a necessary predicate to recovery for emotional distress" because the debtors incurred $2,600 in attorneys' fees as a result of the stay violation. Judge Melloy was sitting by designation from the Eighth Circuit.

The 'Egregious' Stay Violation

The individual debtors' landlord had locked them out of the premises, where they operated a daycare business. He also physically threatened the wife and threatened to sue the debtors' new landlord unless he terminated their lease and they renewed a lease with him.

According to Bankruptcy Judge Thomas P. Agresti of Erie, Pa., the stay violation was the "most egregious" he had seen during his tenure on the bench. He said the debtors' testimony about having nightmares and becoming depressed was "compelling."

In addition to $2,600 in attorneys' fees, Judge Agresti awarded $7,500 for emotional distress and $40,000 in punitive damages against the debtors' landlord. Judge Agresti was upheld in district court and again in the Third Circuit, where the appeals court said the stay violations were "patently egregious."

Emotional Distress Damages Are 'Actual'

The landlord contended in the Third Circuit that damages for emotional distress are not "actual damages" and are thus not permitted under Section 362(k)(1). That section provides that "an individual injured by any willful violation of [the automatic stay] shall recover actual damages, including costs and attorneys' fees, and, in appropriate circumstances, may recover punitive damages."

Judge Melloy said that the Third Circuit had not yet decided whether "actual damages" includes damages for emotional distress. He said that the First, Ninth and Eleventh Circuits permit emotional distress damages for willful stay violations.

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The Seventh Circuit, he said, was "skeptical" about emotional distress damages but "might" permit an award "where the plaintiff is already seeking damages for financial injury." A district court in Ohio ruled in 2005 that emotional distress damages do not qualify as "actual damages."

Although Section 362(k)(1) is "indisputably ambiguous," Judge Melloy concluded that "Congress intended the automatic stay to protect both financial and non-financial interests." He therefore joined "the growing number of circuits" by concluding that "actual damages" includes damages resulting from emotional distress.

Judge Melloy did not decide "whether financial injury is a necessary predicate" to damages for emotional distress because the debtors incurred $2,600 in attorneys' fees.

Since debtors will invariably incur some attorneys' fees after a stay violation, the Third Circuit opinion seems to mean that emotional distress damages will be available, at least where the stay violation was egregious.

The Sufficiency of the Evidence

The landlord contended that the debtors had not proven that the stay violation caused the debtors' emotional distress because they introduced neither medical documentation nor expert medical testimony.

Judge Melloy declined to "adopt a bright-line rule requiring" corroborating medical evidence, "at least where a stay violation is patently egregious." In those circumstances, he said that "a claimant's credible testimony alone can be sufficient to support an award of emotional-distress damages."

Likewise, the debtors were not required to show causation with "absolute precision" when the stay violation was "so egregious that a reasonable person could be expected to suffer some emotional harm."

Since the bankruptcy court awarded "a comparatively modest $7,500" for emotional distress, Judge Melloy said the damages were not unduly speculative."

Punitive Damages

Judge Melloy said that the $40,000 punitive damage award "comports with due process," given that the "repeated stay violations" were "sufficiently reprehensible."

Since actual damages were about $10,000, the 4-1 ratio between punitive and actual damages was "in line with awards previously deemed acceptable by the Supreme Court" and was not so excessive as to be unconstitutional.

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The opinion is *Zokaites v. Lansaw (In re Lansaw),* 853 F.3d 657 (3d. Cir. April 10, 2017).

Section 105(a) was utilized because Section 1301 is silent on sanctions.

Monetary Sanctions Are Available to Remedy Violations of the Co-Debtor Stay

Courts are split on whether there is power to impose sanctions for violations of the co-debtor stay under Section 1301. Chief Bankruptcy Judge Thad J. Collins of Cedar Rapids, Iowa, decided there is power and imposed sanctions under Section 105(a).

A wife filed a chapter 13 petition, but the husband did not. After the wife's bankruptcy, the power company got a judgment in small claims court against the non-bankrupt husband for about $2,500 and began garnishing his salary for the debt that both of them owed.

After the order for relief, Section 1301 enjoins any action "to collect all or any part of a consumer debt of the debtor from any individual that is liable on such debt with the debtor," except in situations not applicable to the case at bar.

Despite being notified twice about the co-debtor stay, the power company continued garnishing. Garnishment only halted when the debtor initiated contempt proceedings in bankruptcy court. In total, the power company garnished almost $900.

The debtor said she missed plan and mortgage payments as a result of the garnishment. Eventually, the power company agreed that the garnishment had been improper and gave the money back.

The debtor nonetheless sought recovery of damages and attorneys' fees. The power company argued that damages and fees are not recoverable because there is no statutory basis under Section 1301, unlike Section 362.

In his June 26 decision, Judge Collins said the courts are split. Some disallow damages because there is no enabling provision in Section 1301. Other courts award damages under Section 1301, relying on the notion that the co-debtor stay is intended to protect the debtor.

Judge Collins followed courts in a third category that employ Section 105(a) to impose sanctions, finding it "appropriate to carry out and give meaning to Section 1301." He relied on Section 105 because Section 1301 itself does not authorize damages and Section 362 is inapplicable.

Judge Collins awarded $1,500 for “emotional upset and needless stress” incurred by the husband and wife for being forced to miss mortgage and plan payments. He also awarded $1,400 in attorneys’ fees.

The opinion is *In re Tucker*, 16-1127, 2017 BL 219854 (Bankr. N.D. Iowa June 26, 2017).

Using a different approach, Judge Grossman agrees with the minority on Section 362(c)(3)(A).

New York Judge Takes Different Approach to Repeat-Filer Automatic Stay Termination

Wading into the disagreement among courts about the scope of the automatic termination of the stay with respect to repeat filers, Bankruptcy Judge Robert E. Grossman of Central Islip, N.Y., decided there is "an inherent flaw in both the majority and minority reasoning." His interpretation of Section 362(c)(3)(A), focusing on different parts of the statute, terminates the stay as to the debtor, property of the debtor, and property of the estate.

If a debtor's case was dismissed within a year, the automatic stay terminates 30 days after the new filing "with respect to any action taken with respect to a debt or property securing such debt or with respect to any lease...."

The majority interpret the statute narrowly to mean that the stay does not terminate with regard to property of the estate, only as to the debtor or property of the debtor. The minority read the same words differently to conclude that the stay evaporates 30 days after the subsequent filing as to the debtor, the debtor's property and property of the estate.

In his Dec. 6 opinion, Judge Grossman correctly pointed out that the majority view represents a "hollow victory" for secured creditors since most of a debtor's property will become property of the estate in chapter 7, aside from exempt property and wages earned after filing. In chapter 13, the automatic termination of the stay is even more limited because after-acquired property comes into the estate.

Judge Grossman said that both the majority and minority focus only on the phrases "property of the debtor" and "property of the estate." Instead, Judge Grossman believes the important phrase is "the stay under subsection (a)" of Section 362. Emphasizing that phrase, he concludes that the "wholesale reference to subsection (a)," rather than to any of the eight subparts of subsection (a), means that the stay automatically ends as to the debtor, the debtor's property, and property of the estate.

Judge Grossman admits that his interpretation makes some language in the statute superfluous, but, citing authorities, he said that while "language surplus is not favored, it is permissible."

We recommend reading Judge Grossman's opinion in full to understand his analysis. For ABI's discussion of recent opinions reflecting the majority and minority views, click here and here, respectively.

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The opinion is *In re Bender*, 562 B.R. 578 (Bankr. E.D.N.Y. Dec. 6, 2016).

Arbitration

Delaware's Judge Shannon protects workers' rights, disagreeing with some circuit courts.

Arbitration Agreements Held Unenforceable in WARN Act Litigation

Bankruptcy Judge Brendan L. Shannon wrote a decision on the cutting edge of issues where courts are split on the ability of workers to sue collectively for improper early termination under the National Labor Relations Act, or NLRA.

The Oct. 11 opinion also explores the so-called *Chevron* deference doctrine in a difficult case where the NLRA seemingly conflicts with the Federal Arbitration Act, or FAA.

The Arbitration Agreement

Two years before a retailer filed a chapter 11 petition in Delaware, an employee signed an agreement requiring arbitration of any employment disputes. The agreement also barred the employee from bringing class claims in arbitration.

The arbitration agreement gave the employee a 30-day window to opt out of the arbitration agreement. The employee did not opt out.

The employee was among those who were fired when the retailer terminated all operations in chapter 11, before selling the assets. On behalf of a class of workers, the employee initiated an adversary proceeding in bankruptcy court, alleging that the debtor violated the federal Worker Adjustment and Retraining Notification Act and a comparable California law requiring employers to give 60 days' notice of mass firings.

The debtor filed a motion asking Judge Shannon to compel arbitration and provide that the arbitrator could only rule on the named plaintiff's individual claim.

The motion to compel arbitration raised complex issues given the seeming conflict between two federal statutes. On one hand, there is the FAA, with its strong federal policy favoring arbitration. On the other, the NLRA arguably bars employers from requiring workers to arbitrate and waive their right to file class actions.

Issue One: 'Concerted Activities' Protected

For Judge Shannon, the first question was deciding whether the NLRA protects workers' rights to file class suits. He interpreted Section 7 of the NLRA, which protects workers' ability to "engage in other concerted activities" for their "mutual aid or protection."

He followed courts that have held that the statutory reference to "concerted activities" gives workers the right to "collective adjudications," or class suits. He went on to say that allowing class suits "furthers the policies underlying the NLRA."

Consequently, Judge Shannon held that Congress has "spoken directly" in the NLRA and created a "substantive right" for employees to "proceed collectively" to vindicate their rights under Section 7.

Issue Two: *Chevron* Deference

Recently, the National Labor Relations Board, or NLRB, interpreted Section 7 to mean that workers have a substantive right to bring class or collective suits. The debtor argued that the NLRB's interpretation was not entitled to *Chevron* deference because the FAA was beyond the labor board's purview.

Judge Shannon disagreed, finding that *Chevron* requires the court to give the Board's interpretation "considerable deference." To reach his conclusion, Judge Shannon saw the NLRB as interpreting only the NLRA, not also the FAA, contrary to the holding of some courts, including the Fifth Circuit.

Even if he were wrong in having previously held that NLRA Section 7 on its face ensures workers' rights to bring collective suits, Judge Shannon said that invocation of the *Chevron* deference doctrine requires the same result, because the NLRB's decisions were "rational and consistent" with Section 7. He therefore declined to follow courts holding that collective suits are not protected by Section 7.

Issue Three: Substantive Rights

The debtor contended that protection of a class suit is merely procedural and thus not protected by Section 7.

Although the ability to mount a class action is usually a procedural right, Judge Shannon followed the Seventh Circuit, holding that the right to collective action is an "independent substantive right" granted by NLRA Section 7.

Issue Four: Class Waiver Unenforceable

The debtor argued that the waiver of the right to mount a class arbitration is unenforceable because the FAA mandates enforcement of arbitration agreements as written.

Again, Judge Shannon disagreed, citing Section 2 of the FAA, which provides that arbitration agreements are enforceable except "upon such grounds as exist at law or in equity."

Although the Fifth Circuit found conflict between the FAA and the NLRB, Judge Shannon followed the Seventh Circuit, finding no conflict because, he said, FAA Section 2 does not require enforcement of class waivers. He said the "FAA's savings clause prevents a conflict between the statutes."

Judge Shannon therefore concluded that the class wavier was unenforceable because Section 7 of the NLRB is a law falling within the exception contained in Section 2 of the FAA.

Issue Five: No Waiver Via 'Opt Out'

The debtor relied on a 2014 Ninth Circuit decision holding that an arbitration agreement is enforceable if the employee could have opted out. Judge Shannon said that the appeals court did not refer to any NRLB decisions nor did it discuss *Chevron* deference.

While no other circuits have directly addressed the issue, Judge Shannon concluded that the ability to opt out does not eradicate rights under NLRA Section 7. In that regard, he interpreted the Seventh Circuit's *Lewis* decision as intimating disagreement with the Fifth Circuit.

To bolster his conclusion, Judge Shannon cited a recent decision by the NLRB holding that requiring an employee to opt out of an arbitration agreement interferes with workers' rights under the NLRA.

Even though the Fifth Circuit summarily reversed the NLRB, Judge Shannon felt compelled by *Chevron* deference to follow the Board.

Judge Shannon did not reach the question of certifying a class or rule on the validity or invalidity of WARN Act claims. In a footnote, Judge Shannon said that the issues were "core." If an appellate court decides that the issues were non-core, he said that that his opinion should be taken as proposed findings and conclusions.

By concluding that the NLRA renders the arbitration agreement unenforceable, Judge Shannon was not called upon to utilize judge-made law for overriding an arbitration agreement in the bankruptcy context. In a *Lehman* case decided on Oct. 6 by the Second Circuit, the appeals court reiterated the two-part test that Judge Shannon would have been obliged to employ were it not for Section 7 of the NLRA.

The two-part test first requires that the dispute be "core." Second, the court must conclude that arbitration "would severely conflict" with a purpose of the Bankruptcy Code. Courts have tended to enforce arbitration agreements in the non-NLRA context when debtors attempt to mount class actions in bankruptcy.

To read ABI's discussion of the *Lehman* decision, click here. For an example of a non-employment case where arbitration was enforced in bankruptcy, click here.

The opinion is *Chan v. Fresh & Easy LLC (In re Fresh & Easy LLC)*, 15-51897, 2016 BL 340239 (Bankr. D. Del. Oct. 11, 2016).

Debtor must arbitrate a violation of the discharge injunction.

Florida Judge Plunges into the Split on Enforcing Arbitration Agreements

The Second Circuit is primed to resolve a split among the districts courts in the Southern District of New York by deciding whether an arbitration agreement is enforceable when a bankrupt mounts a class action claiming that a creditor violated the discharge injunction.

In *Credit One Financial v. Anderson (In re Anderson),* 16-2496 (2d Cir.), the last brief was filed this month, but oral argument has not been set. In *Anderson*, District Judge Nelson S. Román upheld Bankruptcy Judge Robert Drain, refused to enforce an arbitration agreement, and allowed the class action to proceed in bankruptcy court.

In an opinion on March 3, Bankruptcy Judge Erik P. Kimball of West Palm Beach, Fla., disagreed with *Anderson*, while concluding that *Belton v. GE Capital Consumer Lending Inc.,* 15-cv-1934, 2016 BL 8541 (S.D.N.Y. Jan. 12, 2016), "is better aligned with the federal policy favoring arbitration."

Handing down his opinion six months before *Anderson,* District Judge Vincent L. Briccetti in New York enforced an arbitration agreement in *Belton* and halted a class action alleging violation of the discharge injunction. In *Belton*, the district judge did not allow an interlocutory appeal, forcing the parties to arbitrate.

Notably, Bankruptcy Judge Robert Drain was also the author of the lower court opinion that Judge Briccetti reversed in *Belton*. In other words, Bankruptcy Judge Drain was reversed by one district judge and upheld by another on precisely the same issue.

The facts in Judge Kimball's new case were little different.

The debtor got her chapter 7 discharge, only to face collection efforts on a student loan. The debtor contended that her so-called bar study loan was not a "qualified education loan" and was therefore not excepted from discharge under Section 523(a)(8). Because study loans are designed to pay recent graduates' living expenses while they prepare for the bar examination, debtors have achieved some success on similar theories.

The debtor reopened her bankruptcy and filed a class action on behalf of similarly situated debtors in Florida. The lender responded with a motion to dismiss and compel individual arbitration of the debtor's discharge violation claim.

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The lender won. Judge Kimball granted the arbitration motion, compelled individual arbitration of the discharge violation claim, closed the adversary proceeding, and reclosed the chapter 7 case.

Judge Kimball stated the governing law in the same terms as the courts in New York: The court must enforce an arbitration agreement if the issues are "core." He determined that interpretation of a chapter 7 discharge and enforcement of a discharge injunction are both core.

For core proceedings, the court can override an arbitration agreement if arbitration inherently conflicts with the underlying purposes of the affected provisions in the Bankruptcy Code.

Siding with District Judge Briccetti, Judge Kimball found no inherent conflict because the debtor's bankruptcy case had been closed, thus precluding any interference with distribution of the estate or an ongoing reorganization. He also said that the "putative class action case weighs in favor of compelling arbitration."

In addition, Judge Kimball was swayed by the fact that the bankruptcy court does not have exclusive jurisdiction to determine whether claims of that type are excepted from discharge.

Like *Belton*, Judge Kimball did not indicate whether he would have been more inclined to override the arbitration agreement if the debtor were only suing on her own behalf.

To read ABI's discussion of Anderson, click here. For the story on Belton, click here.

The opinion is *Williams v. Navient Solutions LLC (In re Williams)*, 564 B.R. 770 (Bankr. S.D. Fla. March 3, 2017).

ROCHELLE'S DAILY WIRE

Municipal Debt Adjustment & Puerto Rico

On stay modification, secured creditors shoulder the entire burden.

PROMESA Is No Clone of the Bankruptcy Code, First Circuit Says

PROMESA, the federal law to alleviate Puerto Rico's financial crisis, will not always be governed by principles established under the Bankruptcy Code, according to a First Circuit decision dealing with the automatic stay.

In a departure from the Bankruptcy Code, Chief Circuit Judge Jeffrey R. Howard found "policy reasons" in his Jan. 11 opinion to put the burden on the secured creditor to show cause for modifying the stay, including the lack of adequate protection.

PROMESA

After the Supreme Court ruled in June that Puerto Rico's instrumentalities are ineligible for municipal debt adjustment under chapter 9 of the Bankruptcy Code and that the island commonwealth cannot adopt local laws dealing with the insolvencies of its units, Congress adopted the Puerto Rico Oversight, Management, and Economic Stability Act, or PROMESA.

As part of the program to address what Judge Howard called Puerto Rico's "financial crisis," Section 405(m)(4) of PROMESA includes an automatic stay that lasts until Feb. 17 and can be extended to May 1. It automatically halts any proceedings against the Puerto Rico government "to recover a Liability Claim," defined to mean "financial indebtedness for borrowed money, including rights, entitlements, or obligations whether" they arise from "contract, statute or any other source of law."

Bondholders with liens on toll road revenue and employer contributions to a retirement fund filed motions to modify the automatic stay, contending they lacked adequate protection because Puerto Rico had cut off income streams from their collateral.

Without holding a hearing, District Judge Francisco A. Besosa of San Juan handed down a decision on Nov. 2 denying the motions, saying that their collateral was "constantly replaced." He said they were not entitled to adequate protection because they only faced "a delay in recouping such funds, not a permanent loss of them." To read ABI's discussion of Judge Besosa's decision, click here.

The bondholders took expedited appeals argued in the First Circuit on Jan. 4. Judge Howard concluded that the toll road bondholders were not even entitled to a hearing because they failed to allege facts showing a lack of adequate protection.

Without ruling on the merits, Judge Howard sent the motion by the retirement fund bondholders back to the district court because they were entitled to a hearing given the sufficiency of their pleadings.

PROMESA and Adequate Protection

Section 362(d) of the Bankruptcy Code says that "cause" for modifying the automatic stay includes lack of adequate protection. PROMESA, however, does not define "cause." By the omission of a reference to adequate protection, Puerto Rico argued that deprivation of collateral is not grounds for modifying the stay under PROMESA.

Because it allows impairment of secured creditors' property rights, Judge Howard characterized PROMESA as a "statute of questionable constitutional validity." He therefore interpreted the statute to avoid constitutional infirmities and held that lack of adequate protection "constitutes cause to lift the PROMESA stay."

PROMESA and the Burden of Proof

The disposition of the appeal depended in part on who had the burden of proof on adequate protection.

In bankruptcy, Section 362(g) altered prior law by putting the burden of proof on the creditor regarding the debtor's equity in the property while it put the burden of everything else on the debtor. Because Congress did "not transplant the Bankruptcy Code's express alteration of the pre-Code regime" into PROMESA, Judge Howard put the entire burden on the creditor to show "cause," including lack of adequate protection.

In deciding to depart from the Code, Judge Howard cautioned courts not to infer "too readily" that silence in PROMESA represents congressional rejection of a concept from bankruptcy law. On the other hand, he said that silence in PROMESA may represent congressional intent "precisely."

Judge Howard also found "sound policy reasons" to depart from the Code on burden of proof. He said that PROMESA addresses a "truly unique situation" dealing with an "'immediate financial crisis.'" Moreover, the PROMESA stay endures for a maximum of 10 months, compared with the Bankruptcy Code, where the stay could be in place for years.

The Definition of 'Cause'

To carry the burden justifying stay modification, Judge Howard said a creditor must prove that the lack of an equity cushion is "more likely than not." He said the toll road bondholders' motion

did not contain facts showing the absence of an equity cushion, thereby justifying dismissal of their motion without a hearing.

In contrast, the retirement fund bondholders did make allegations about the insufficiency of future revenue to cover their claims. Consequently, Judge Howard remanded to the district court because they were entitled to a hearing.

Right of the 'Board' to Intervene

PROMESA created the Financial Management & Oversight Board. The district judge denied the Board's motion to intervene in the lift-stay motions under Federal Rule 24, because the Board had not submitted a proposed answer to a complaint that the bondholders were yet to file. However, the Board did file a proposed pleading opposing modification of the stay.

Judge Howard reversed, finding an abuse of discretion in barring intervention. He said the circuits have "eschewed overly technical readings of Rule 24(c)." While he did not definitively rule on the right to intervene, Judge Howard did say that "PROMESA appears to grant the Board such a right."

The opinion is *Peaje Investments LLC v. Garcia-Padilla*, 845 F.3d 505 (1st Cir. Jan. 11, 2017).

ROCHELLE'S DAILY WIRE

Circuit court bars lawsuit by one Puerto Rico bondholder group against another.

First Circuit Interprets PROMESA's Automatic Stay Broadly, Reverses District Court

The First Circuit mended a gaping hole torn in the side of the automatic stay by reversing a decision in February by a district judge in Puerto Rico interpreting PROMESA, the federal law to alleviate Puerto Rico's financial crisis.

In an 11-page *per curiam* opinion concluding an expedited appeal, the First Circuit adopted an expansive reading of the word "control" to hold that a lawsuit by bondholders was enjoined by PROMESA's automatic stay. The appeals court handed down its decision on April 4, the same day it held oral argument.

The First Circuit's decision is the latest in a series of back-and-forth opinions exploring the similarities between the automatic stays in PROMESA and the Bankruptcy Code.

The Dispute Between Bondholder Groups

Within days after the Supreme Court held in June that Puerto Rico is precluded from adopting local laws to ameliorate the insolvencies of its units, the President signed the Puerto Rico Oversight, Management, and Economic Stability Act, or PROMESA. The high court also held that the commonwealth's instrumentalities are ineligible for municipal debt adjustment under chapter 9 of the Bankruptcy Code.

PROMESA contains a broad automatic stay modeled after Section 362 of the Bankruptcy Code. Both statutes bar actions to "control" property of the debtor, not just those that attempt to gain possession of estate property.

Immediately after the adoption of PROMESA, the commonwealth defaulted on $817 million in general obligation bonds but continued to pay so-called COFINA bonds, which are secured by revenue from sales and use taxes.

Holders of general obligation bonds filed suit in July in federal district court in San Juan under PROMESA, referring to their bonds as "constitutional debt" backed by the island's full faith, credit and taxing powers. Relying on Puerto Rico's Constitution, they argued that their debt must be paid from all revenue sources before COFINA bonds.

The general obligation bondholders sought a declaration and injunction that would bar Puerto Rico from using sales and use taxes to pay COFINA bonds.

Puerto Rico and the COFINA bondholders filed motions contending that the lawsuit was automatically enjoined by Section 405, the automatic stay under PROMESA that expires on May 1.

Because he believed that the general obligation bondholders were not attempting to collect on a claim and were only seeking a declaration and injunction, District Judge Francisco A. Besosa ruled on Feb. 17 that the automatic stay did not preclude the suit from proceeding.

Established under PROMESA, the Financial Oversight & Management Board appealed, along with COFINA bondholders. Indicating that a reversal was possible, if not likely, the First Circuit expedited the appeal on March 17 and invited the appellants to file a motion for a stay pending appeal. The circuit court entered a stay three days later.

The First Circuit's Opinion

Contrary to the conclusion by the district court, the circuit court said that the general obligation bondholders were seeking an injunction that would compel Puerto Rico to default on the COFINA bonds by barring the commonwealth from using sales and use taxes to pay those bonds. The *per curiam* opinion said that Congress "could hardly have envisioned" that one group of bondholders, "during the stay period" to end on May 1, would "dispossess the other by driving its bonds into default."

Next, the panel construed the word "control," as used in PROMESA's automatic stay, and said it mimics the same word in Section 362. Like the term in the Bankruptcy Code, "control" is interpreted "quite broadly."

"From this expansive understanding of 'control,'" the circuit court reversed the district court, imposed the stay on the general obligation bondholders' suit, and held that "the stay applies to litigation seeking declaratory and injunctive relief at least where, as here, the express purpose of the lawsuit is to preclude the Commonwealth from using its own funds as it sees fit."

What Does It Mean?

The April 4 opinion is the second time the First Circuit has addressed the breadth of PROMESA's automatic stay. The first decision was in January in *Peaje Investments LLC v. Garcia-Padilla*, 845 F.3d 505 (1st Cir. Jan. 11, 2017). There, the appeals court equated the two statutes when it concluded that lack of adequate protection is reason for vacating the automatic stay, although the lack of adequate protection is not among the enumerated grounds in PROMESA like it is in Section 362(d)(1).

On the other hand, the First Circuit ruled that PROMESA is different from the Bankruptcy Code because PROMESA has no provision like Section 362(g) that puts the burden of proof on the debtor for everything except the debtor's equity in the property. Consequently, the appeals court put the entire burden on the creditor to show "cause," including lack of adequate protection.

Therefore, *Peaje* seems to mean that the two automatic stays are similar, although not identical. Subtle differences in language may or may not lead to different results.

A month later, District Judge Besosa appeared to construe PROMESA's automatic stay more narrowly. If nothing more, the circuit's reversal precludes litigants from arguing that Judge Besosa's decision is authority for a narrow construction of the automatic stay under Section 362.

The First Circuit's newest decision may have been driven by PROMESA's avowed objective of fostering consensual restructurings. Notably, the appeals court appeared repulsed at the notion that one group could force a default on other bondholders.

Prior to May 1, the contending creditor groups are intended by PROMESA to negotiate among themselves and with Puerto Rico on consensual restructurings. If voluntary negotiations fail, Puerto Rico can then initiate a court-supervised debt adjustment similar to chapter 9 municipal bankruptcy.

The April 4 decision might be an effort to keep the parties focused on negotiations by precluding any creditor group from attempting to gain the upper hand through litigation. Perhaps the main takeaway from the April 4 opinion is the notion that PROMESA, like cases in chapters 9 and 11, should focus primarily on negotiations rather than litigation to achieve a global debt adjustment.

In the final analysis, the April 4 decision was a relatively terse, hurriedly issued, *per curiam* opinion. Perhaps it's best not to read too much into the opinion aside from the direct holding about "control."

To read ABI's discussion of the First Circuit's PROMESA decision in January, click here. For District Judge Besosa's February opinion, click here.

The opinion is *Financial Oversight and Management Board v. Lex Claims LLC*, 853 F.3d 548 (1st Cir. April 4, 2017).

Barring a city in chapter 9 from turning off the water violates Section 904, Sixth Circuit rules.

Sixth Circuit Bars Bankruptcy Courts from Enforcing Constitutional Rights in Chapter 9

In the wake of Detroit's municipal bankruptcy, the Sixth Circuit ruled that the court cannot exercise jurisdiction in a chapter 9 case, even though the same claims might be viable in an ordinary district court suit for violation of state law or the federal Constitution when the plaintiffs want the court to rule on how the city should provide governmental services.

A group of Detroit residents sued in bankruptcy court following the city's filing for municipal debt adjustment in 2013. They alleged that the city was violating state law as well as their constitutional rights in turning off water for nonpayment and in imposing requirements for the resumption of service. They sought declaratory and injunctive relief.

The pivotal statute is Section 904, which provides that the court may not "interfere with" a municipality's "political or governmental power" or the city's "use or enjoyment of any income-producing property."

Although the citizens sought the same declaratory and injunctive relief on their state law and constitutional claims, the bankruptcy court ruled that Section 904 only barred consideration of the state law claims, not the constitutional claims. In a Nov. 14 opinion by Circuit Judge Richard Allen Griffin, the Sixth Circuit went a step further by holding that the bankruptcy court does not have "judicial power to enjoin" a violation of citizens' constitutional rights.

The opinion is a synopsis of the limitations imposed by the Tenth Amendment on municipal bankruptcy law. Chapter 9 was crafted "'to give courts only enough jurisdiction to provide meaningful assistance to municipalities that require it, not to address the policy matters that such municipalities control,'" Judge Griffin said in quoting a bankruptcy court decision from Stockton, Calif.'s chapter 9 case.

Judge Griffin said that an injunction to stop terminations and provide water service "necessarily" interferes with the city's "governmental powers" and its "use [and] enjoyment" of income-producing property.

The appeals court disagreed with the bankruptcy court's conclusion that Section 904 does not bar consideration of claims under the federal Constitution. Although governments do not have power to violate citizens' constitutional rights, Judge Griffin said it "does not follow that the bankruptcy court has judicial power to enjoin such violations."

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Explaining that Section 904 "limits remedies," he added that the "massive scale of a municipal bankruptcy simply provides more opportunities for excessive federal court interference." While constitutional rights are "inviolable," Judge Griffin said "the remedies available to [plaintiffs] in the chapter 9 setting are not."

Tellingly, the opinion includes a footnote speculating that the plaintiffs might have achieved more success by seeking a modification of the automatic stay "to pursue their claims outside of bankruptcy court."

The opinion includes discussions of interest to constitutional scholars, including analysis of substantive due process and other features of the complaint where the plaintiffs failed to state viable claims. There is also an analysis of mootness in the context of recurring constitutional claims.

The opinion is *Lyda v. City of Detroit, Michigan (In re City of Detroit, Michigan)*, 15-2236, 2016 BL 378016 (6th Cir. Nov. 14, 2016).

Third-party injunctions in chapter 9 must be a financial necessity, judge says.

Ninth Circuit Prohibition on Third-Party Injunctions Is Inapplicable in Chapter 9

The Ninth Circuit is among the three circuits that categorically prohibit so-called third-party releases in chapter 11 plans.

So, how did the City of San Bernardino, Calif., manage to include a third-party injunction in its chapter 9 municipal debt-adjustment plan?

As Bankruptcy Judge Meredith A. Jury explained in her March 7 opinion, the answer is simple. Section 524(e) is not applicable in chapter 9 cases under Section 901.

Third-Party Releases in Chapter 11

A third-party release is a provision in a chapter 11 plan that bars creditors from suing non-debtors, typically officers, directors, and professionals involved in the reorganization.

Six circuits permit third-party releases, although not willy-nilly. For ABI's discussion of recent cases where courts in those circuits erect a high barrier, click here, here, and here.

Third-party releases have been prohibited in the Ninth Circuit since *American Hardwoods Inc. v. Deutsche Credit Corp. (In re American Hardwoods Inc.),* 885 F.2d 621 (9th Cir. 1989), when the appeals courts held there was no jurisdiction to impose the injunction. Six years later, the Ninth Circuit dropped the other shoe in *Resorts International Inc. v. Lowenschuss (In re Lowenschuss),* 67 F.3d 1394 (9th Cir. 1995), by holding that third-party releases are inconsistent with Section 524(e).

With an exception not applicable, Section 524(e) says that the "discharge of a debt of the debtor does not affect the liability of any other entity" for "such debt."

The San Bernardino Bankruptcy

San Bernardino was one of three California cities to undergo municipal debt adjustment in chapter 9. The city confirmed a plan on Feb. 7, 2017. In her March 7 opinion, Judge Jury explained why she allowed the city to include the third-party injunction in the plan.

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San Bernardino had an estimated $200 million of claims in class 13, covering general unsecured creditors. Many of those claims were held by litigation plaintiffs, including people claiming civil rights violations committed by police officers.

Although the plan paid only 1% of claims in that class, litigation claimants could pursue their suits against individual police officers unless the plan cut off their rights to sue.

A California statute compounded the problem for San Bernardino, because state law requires municipalities to indemnify and defend their workers. To obviate the possibility that San Bernardino's discharged debt to lawsuit plaintiffs would come in through the back door via the indemnification obligation, the city included the third-party injunction in the plan.

Judge Jury's Rationale

Judge Jury easily found jurisdiction to issue the injunction. The California indemnification statute, she said, gives rise to "related to" jurisdiction because a judgment against a police officer would end up being a claim on the city's treasury.

She found authority for the injunction in Section 105(a), the so-called All Writs Act, because Section 109(a) does not make Section 524(e) applicable in chapter 9 cases.

However, Judge Jury was not willing to allow a city to scatter third-party injunctions like beads at a Mardi Gras parade. The standards for deciding when a third-party, chapter 9 injunction can be issued is a question of first impression in the Ninth Circuit, she said. The other two notable chapter 9 cases in California – for Vallejo and Stockton – did not have the injunctions in their plans.

To pass muster, Judge Jury said the injunction must be express in the plan; it must be an integral part of the reorganization, and it must be "supported by specific factual findings regarding the necessity of the injunction."

San Bernardino passed the test in spades. Among other things, Judge Jury recited pages of fact findings to show that the city could not provide municipal services were it liable to indemnify police officers in civil rights suits.

Although Judge Jury had given her reasons for the injunction orally at the confirmation hearing in December, she wrote the opinion because creditors are appealing. The appeal will be heard by a district judge, not by the Ninth Circuit Bankruptcy Appellate Panel.

The opinion is *In re City of San Bernardino*, 12-28006, 2017 BL 71152 (Bankr. C.D. Cal. March 7, 2017).

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Cross-Border

Chapter 15 isn't the exclusive means for enforcing foreign bankruptcy court judgments.

Second Circuit Discusses Role of Chapter 15 in Cross-Border Litigation

Chapter 15 of the Bankruptcy Code, the U.S. version of the United Nations Model Law on Cross-Border Insolvency, is not the exclusive method for giving preclusive effect to a decision from a foreign bankruptcy court, at least when the party seeking enforcement is not the foreign representative.

In a Jan. 18 opinion, the Second Circuit relegated chapter 15 to its designed purpose: assisting foreign bankruptcy tribunals. The appeals court said chapter 15 was not intended to inhibit private parties when they are enforcing foreign bankruptcy judgments in the U.S.

The case arose from disputes between two men who together had owned an investment advisory firm. One initiated a winding up proceeding in the Cayman Islands against the advisory firm. The foreign court eventually granted the petition to liquidate the firm, and the decision was affirmed all the way up to the Privy Council in London.

Meanwhile, the other owner filed a lawsuit in federal district court against his former partner, alleging breach of fiduciary duty and other claims related to the advisory firm.

The district court ultimately granted summary judgment in favor of the defendant and dismissed the suit by giving collateral estoppel effect to findings by the Caymans court made in the course of granting the winding up petition.

In the Second Circuit, the defeated plaintiff argued that the judgment from the foreign court could not have preclusive effect because there was no chapter 15 recognition given to the Cayman Islands liquidation. Writing for the appeals court, Circuit Judge John M. Walker, Jr. rejected the argument, saying that "the requirements of chapter 15 do not apply here."

Judge Walker based his decision on the purposes of chapter 15. He said it was designed to consolidate "multinational bankruptcies into one single proceeding" and address a "persistent problem" where some creditors attempt to recover more than their fair share by suing a debtor in several countries.

When called upon to give preclusive effect to the findings of the foreign court, Judge Walker said that the U.S. court was not assisting a foreign liquidation nor was a foreign court assisting a bankruptcy in the U.S. He also said that neither of the parties in the federal district court was the foreign representative and neither was seeking the U.S. court's assistance in enforcing a foreign judgment.

In addition, Judge Walker said that the U.S. suit was a non-bankruptcy action that was "unconnected to any foreign or U.S. bankruptcy proceeding." Consequently, he narrowly held that "chapter 15 does not apply when a court in the U.S. simply gives preclusive effect to factual findings from an otherwise unrelated foreign liquidation proceeding."

Judge Walker also held that chapter 15 was neither an express nor an implied federal preemption of state law of comity, which underlaid the district court's decision to invoke collateral estoppel in dismissing the suit.

Although the holding is narrow, some language in the opinion might be taken out of context to mean that chapter 15 must be invoked before directly enforcing a foreign judgment in the U.S. In a footnote, Judge Walker said that a Connecticut state court ruling to that effect may not have been correctly decided.

In the Connecticut case, one of the parties to the foreign liquidation, not the foreign representative, sought to enforce an award of attorneys' fees in the U.S. Judge Walker said that directly seeking enforcement of a foreign bankruptcy court order "arguably falls within the scope of chapter 15."

However, Section 1509(a) says that a chapter 15 case is initiated by the filing of a petition for recognition by a "foreign representative," not by a private party in a foreign bankruptcy. Thus, it is doubtful that a private party could employ chapter 15 for direct enforcement of a foreign judgment when the foreign representative sees no reason for incurring the expense.

In addition, Section 1509(f) provides that the lack of a chapter 15 case "does not affect any right the foreign representative may have to sue in a court in the U.S. to collect or recover a claim which is property of the debtor." Thus, the statute implies that even foreign representatives are not required to obtain chapter 15 recognition before suing in the U.S.

The opinion is *Trikona Advisers Ltd. v. Chugh*, 846 F.3d 22 (2d Cir. Jan. 18, 2017).