2022 Winter Leadership Conference

Supersized Eye on Bankruptcy with Bill Rochelle

William J. Rochelle, III, Moderator
American Bankruptcy Institute; Alexandria, Va.

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Bill Rochelle • Editor-at-Large
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bill@abi.org • 703. 894.5909
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66 Canal Center Plaza, Suite 600 • Alexandria, VA 22014 • www.abi.org

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Supreme Court

Decisions This Term

The Supreme Court's unanimous opinion avoids saying whether the dual system of U.S. Trustees and Bankruptcy Administrators is itself unconstitutional.

2018 Increase in U.S. Trustee Fees Held Unconstitutional by the Supreme Court

The Supreme Court ruled unanimously on June 6 that the increase in fees payable to the U.S. Trustee system in 2018 violated the uniformity aspect of the Bankruptcy Clause of the Constitution because it was not immediately applicable in the two states with Bankruptcy Administrators rather than U.S. Trustees.

The opinion for the Court by Justice Sonia Sotomayor said that the Uniformity Clause "is not a straightjacket: Congress retains flexibility to craft legislation that responds to different regional circumstances that arise in the bankruptcy system." She remanded for lower courts to determine the proper remedy.

Although Justice Sotomayor pointedly said that her opinion "does not today address the constitutionality of the dual scheme of the bankruptcy system itself," some of her language could be read to imply that the dual system is constitutionally questionable.

The Fee Structure's History

Justice Sotomayor recounted how U.S. Trustees were originally a pilot program after the adoption of the Bankruptcy Code in 1978. In 1986, Congress expanded the program nationwide, but not in North Carolina and Alabama, where she said there was "resistance from stakeholders." Courts in those states retained their Bankruptcy Administrators.

The U.S. Trustee system was designed to be self-funding, with fees paid by chapter 11 debtors in 48 states. Originally, Congress did not require user fees in the two exempted states. After the Ninth Circuit held in 1995 that the dual system was unconstitutional in view of the disparate fees, Congress rewrote the law to say that the Judicial Conference "may" requires fees in Bankruptcy Administrator districts to be equal to those in the other 48 states.

Fees in all states were the same until Congress raised the fees in January 2018 for the U.S. Trustee system. Justice Sotomayor said the increase was "significant."

The Judicial Conference did raise the fees in the two other states effective in October 2018. There were two differences, Justice Sotomayor said.

First, the increase was not effective in the two states until October 2018, while the U.S. Trustee fees had risen everywhere else in January 2018. Second, the increase in the two states only applied to newly filed cases. In U.S. Trustee districts, the increase applied to pending cases, not only new cases.

Procedural History

Circuit City Stores Inc., the debtor that brought the case to the Supreme Court, had confirmed a chapter 11 plan in 2010. Until the increase went into effect, the debtor had been paying $30,000 a quarter, the maximum.

In the period after the increase, the debtor paid $632,500 in fees. Had there been no increase, Justice Sotomayor said the fees during the period would have been only $56,400.

The debtor mounted an objection to the increase on constitutional grounds and won. Bankruptcy Judge Kevin R. Huennekens of Richmond, Va., held that the increased fees violated the Uniformity Clause, if the fee is seen as a tax, and violated the Bankruptcy Clause, if the fee is considered a user fee. *In re Circuit City Stores Inc.*, 606 B.R. 260 (Bankr. E.D. Va. July 15, 2019). To read ABI's report, click here.

However, the bankruptcy court did not rule on whether the debtor was entitled to a refund, Justice Sotomayor said.

The Fourth Circuit agreed to hear an interlocutory appeal and reversed in a 2/1 decision. The majority on the Richmond, Va.-based appeals court did not believe that the increase was arbitrary. The dissenter would have held the increase to be unconstitutional. *In re Circuit City Stores, Inc.*, 996 F.3d 156 (4th Cir. April 29, 2021). To read ABI's report, click here.

Like the Fourth Circuit, the Fifth Circuit saw no constitutional infirmity. There were dissenters in both opinions. In unanimous opinions, the Second and Tenth Circuits found constitutional transgressions. The Supreme Court granted *certiorari* to resolve the circuit split and heard oral argument on April 18.

Applicability of the Bankruptcy Clause

The Bankruptcy Clause empowers Congress to "establish . . . uniform Laws on the subject of Bankruptcies throughout the United States."

Defending the disparate fee structure, the U.S. Solicitor General argued that the fees were not covered by the Bankruptcy Clause because the fee statutes were not substantive law.

The language of the clause is "broad," Justice Sotomayor said, and "[n]othing in the language of the Bankruptcy Clause itself, however, suggests a distinction between substantive and administrative laws." Furthermore, she said that the Court has never "distinguished between substantive and administrative bankruptcy laws or suggested that the uniformity requirement would not apply to both."

"Not surprisingly," Justice Sotomayor said, all courts to consider the question have concluded that the fees were subject to the Bankruptcy Clause, including those courts that found no constitutional violation.

"Moreover," Justice Sotomayor said, the fees were substantive because they affected the debtor/creditor relationship by making less money available for creditors in 48 states. She said that Congress exempted debtors from the higher fees in two states "without identifying any material difference between debtors across those States."

Precedent Foretells the Outcome

Having decided that the fee structure was subject to the Bankruptcy Clause, Justice Sotomayor addressed the question of whether the disparate fees were "a permissible exercise of that Clause." She discussed the three Supreme Court cases that have confronted the meaning of the clause. "Taken together," she said, "they stand for the proposition that the Bankruptcy Clause offers Congress flexibility, but does not permit arbitrary geographically disparate treatment of debtors."

In 1908 under the former Bankruptcy Act, Justice Sotomayor said that the Supreme Court upheld the constitutionality of state homestead and exemption laws, because the general operation of the law was uniform, although the results might be different in some states. *Hanover Nat. Bank v. Moyses*, 186 U.S. 181, 187 (1902).

In 1974, the Court upheld a railroad reorganization law that only applied to railroads in the Northeast and Midwest. Based on the "flexibility" in the Bankruptcy Clause, the Court upheld the law that addressed "geographically isolated problems." *Regional Rail Reorganization Act Cases*, 419 U.S. 102, 159 (1974)."

Justice Sotomayor read *Regional Rail Reorganization Act Cases* to mean that "Congress may enact geographically limited bankruptcy laws consistent with the uniformity requirement if it is responding to a geographically limited problem."

In *Railway Labor Executives' Assn. v. Gibbons*, 455 U.S. 457 (1982), the Court struck down a railroad reorganization law than changed the priority scheme, but only for one railroad.

From the three cases, Justice Sotomayor said that the Bankruptcy Clause "does not give Congress free rein to subject similarly situated debtors in different States to different fees because it chooses to pay the costs for some, but not others."

In other words, the clause permits "flexibility, but does not permit arbitrary geographically disparate treatment of debtors," Justice Sotomayor said.

Impermissible Lack of Uniformity

For Justice Sotomayor, the "only remaining question" was "whether Congress permissibly imposed nonuniform fees because it was responding to a funding deficit limited to the Trustee Program districts."

In the case in the Supreme Court, the geographical discrepancy cost Circuit City more than $500,000, Justice Sotomayor said. She said that the budgetary shortfall in the U.S. Trustee districts:

> existed only because Congress itself had arbitrarily separated the districts into two different systems with different cost funding mechanisms, requiring Trustee Program districts to fund the Program through user fees while enabling Administrator Program districts to draw on taxpayer funds by way of the Judiciary's general budget.

The reasons for the different fees, Justice Sotomayor said, "stem not from an external and geographically isolated need, but from Congress' own decision to create a dual bankruptcy system funded through different mechanisms in which only districts in two States could opt into the more favorable fee system for debtors."

Consequently, Justice Sotomayor held that "the Clause does not permit Congress to treat identical debtors differently based on an artificial funding distinction that Congress itself created."

Final Comments by Justice Sotomayor

The debtor took the position in the Supreme Court that the dual system itself is unconstitutional. Justice Sotomayor said that the Court was not addressing "the constitutionality of the dual scheme of the bankruptcy system itself."

Indicating that the Court was not overruling the *Regional Rail Reorganization Act Cases*, Justice Sotomayor said the opinion "should not be understood to impair Congress' authority to structure relief differently for different classes of debtors or to respond to geographically isolated problems." Rather, she said that the court was only prohibiting "Congress from arbitrarily burdening only one set of debtors with a more onerous funding mechanism than that which applies to debtors in other States."

Justice Sotomayor ended her opinion by noting how the government and the debtor disagreed about the remedy in the event of reversal. Because the Fourth Circuit had not considered remedy, she reversed and remanded for the Fourth Circuit to consider remedy "in the first instance."

Is the Dual System Constitutionally Sound?

In the context of disparate fees, Justice Sotomayor noted how the Ninth Circuit said that the dual system of U.S. Trustees and Bankruptcy Administrators was unconstitutional. *St. Angelo v. Victoria Farms, Inc.*, 38 F.3d 1525 (1994), *amended*, 46 F.3d 969 (1995). The question never went to the Supreme Court because Congress quickly brought the fees in line.

Litigants may have difficulty attacking the dual system on appeal given the requirement of showing actual pecuniary harm. Furthermore, does the Constitution mandate that all debtors have the same adversary? And if all debtors must have the same adversary, are court-appointed trustees constitutional in chapters 7 and 13? In other words, overturning the dual system would have wide ramifications.

Several statements by Justice Sotomayor might bear on the constitutionality of the dual system. Early in the opinion, she said that "Congress itself had arbitrarily separated the districts into two different systems." She also said that Congress may "enact geographically limited bankruptcy laws consistent with the uniformity requirement in response to a geographically limited problem."

Is the dual system unconstitutional simply because it is arbitrary? Is the dual system unconstitutional just because there was no geographical mandate? Laws are not unconstitutional just because they are arbitrary.

Although the constitutionality of the dual system is unclear, this writer believes that the system is subject to scrutiny under the Bankruptcy Clause, because Justice Sotomayor several times said the clause must be brought to bear whether the law is substantive or "administrative."

Although the disparate fees are ancient history, the last chapter has not been written. Absent settlement, the lower courts in the *Circuit City* case can decide on remand whether the debtor is entitled to a refund.

The same issue is alive in a now-revived class action that could end up giving refunds to chapter 11 debtors throughout the country that paid higher fees.

The Federal Court of Claims dismissed a class action on ruling that the disparate fees did not violate the Bankruptcy Clause. *See Acadiana Management Group LLC v. U.S.*, 19-496, 151 Fed. Cl. 121 (Ct. Cl. Nov. 30, 2020).

The debtor-plaintiff appealed and is asking the Federal Circuit to reinstate the class action. Oral argument in the Federal Circuit was postponed pending the outcome in *Circuit City*. For ABI's report on *Acadiana*, click here.

The opinion is *Siegel v. Fitzgerald*, 21-441 (Sup. Ct. June 6, 2022).

The Tenth Circuit is the first appeals court to rule on remedy after the Supreme Court said that the 2018 increase in U.S. Trustee fees was unconstitutional.

After *Siegel*, Tenth Circuit Mandates Refunds for Overpayment of U.S. Trustee Fees

In *Siegel* this term, the Supreme Court did not decide whether chapter 11 debtors are entitled to refunds for overpayments of quarterly fees paid to the U.S. Trustee system. *Siegel v. Fitzgerald*, 142 S. Ct. 1770 (June 6, 2022).

The first appeals court to speak following *Siegel*, the Tenth Circuit adhered to its original decision in *John Q. Hammons Fall 2006 LLC v. U.S. Trustee (In re John Q. Hammons Fall 2006 LLC)*, 15 F.4th 1011 (10th Cir. Oct. 5, 2021), by holding on Aug. 15 that the government must pay a refund to a chapter 11 debtor based on what the debtor would have paid over the same time were the case in a Bankruptcy Administrator district. To read ABI's report on the circuit's original decision in *John Q. Hammons Fall*, click here.

The Tenth Circuit decision is important for former chapter 11 debtors throughout the country because a class action is pending in the Court of Federal Claims in Washington, D.C. *See Acadiana Management Group LLC v. U.S.*, 19-496 (Ct. Cl.). If the class action holds up and the Court of Claims and the Federal Circuit follow the Tenth Circuit, chapter 11 debtors countrywide could see refunds.

Refunds, however, were not a foregone conclusion.

Background on *Siegel*

The fees paid by chapter 11 debtors to the U.S. Trustee program increased in 2018, but the increase did not become effective for 10 months in the two states that have Bankruptcy Administrators rather than U.S. Trustees. In U.S. Trustee districts, the increase applied to pending cases. The increase did not apply to pending cases in Bankruptcy Administrator districts. The circuits were split 2/2 on whether the increase offended the uniformity aspect of the Bankruptcy Clause of the U.S. Constitution.

The Supreme Court resolved the split in *Siegel* by holding unanimously that the increase violated the Bankruptcy Clause because it was not immediately applicable in the two states with Bankruptcy Administrators rather than U.S. Trustees.

In *Siegel*, the Fourth Circuit had not reached the question of remedy because the appeals court saw no constitutional violation. At oral argument in the Supreme Court, Justice Sotomayor said that the "parties raise[d] a host of legal and administrative concerns with each of the remedies proposed, including the practicality, feasibility, and equities of each proposal; their costs; and potential waivers by nonobjecting debtors." *Siegel, supra,* 142 S. Ct. at 1783.

Because the appeals court "has not yet had an opportunity to address . . . the proper remedy," Justice Sotomayor remanded "for the Fourth Circuit to consider these questions in the first instance." *Id*. To read ABI's report on *Siegel*, click here.

The Fourth Circuit remanded *Siegel* to the bankruptcy court, which has yet to rule on remedy.

Hammons Fall on Remand

The Tenth Circuit ruled last year that the disparate fee increase was unconstitutional. Having lost in the circuit, the government had filed a petition for *certiorari* in *Hammons Fall*. On June 13, the Supreme Court granted the *certiorari* petition, vacated the judgment and "remanded for further consideration in light of *Siegel*." Vacating the judgment was appropriate because the Supreme Court had not ruled on remedy.

Back in the Court of Appeals after remand, the Tenth Circuit directed the parties in *Hammons Fall* "to file supplemental briefs addressing the impact of *Siegel* on this appeal." In other words, the parties were free once again to joust over remedy.

On remand, the government strenuously argued in the Tenth Circuit that the debtor was not entitled to a refund, saying that "retrospective monetary relief is rarely available at all." In the government's view, "prospective relief alone is the appropriate remedy for systemic equal-treatment violations where, as here, appellants had an adequate opportunity to challenge the fees before payment had they wished to do so."

The government went on to say that Congress had already supplied prospective relief given a technical amendment in 2020 that mandates fee uniformity going forward in U.S. Trustee and Bankruptcy Administrator districts.

If there were to be retrospective relief, the government contended that the proper remedy would be "a good-faith effort to collect higher payments in the six [Bankruptcy Administrator] districts rather than to issue refunds in the 88 [U.S. Trustee] districts, thereby potentially resurrecting the very funding problem that Congress was explicitly trying to solve" by raising the fees in 2018.

In its August 15 order and judgment, the Tenth Circuit "reinstate[d] our original opinion," which required the government to pay a refund based on what the debtor would have paid were it in a Bankruptcy Administrator district. In the first opinion, the Tenth Circuit mandated a refund in

part because the appeals court had no jurisdiction over the two states with Bankruptcy Administrators and thus could not require debtors in those states to pay the higher fees.

The circuit's August 15 order and judgment was nonprecedential. However, the original opinion last year was precedential and therefore may be cited by other courts in their rulings on remedy.

The opinion is *John Q. Hammons Fall 2006 LLC v. U.S. Trustee (In re John Q. Hammons Fall 2006 LLC)*, 20-3203 (10th Cir. Aug. 15, 2022).

Cutting back on knee-jerk invocation of arbitration, the Supreme Court says that agreements to arbitrate are no more enforceable than ordinary contracts.

Supreme Court on Arbitration (Again): Perhaps Bankruptcy Is Exempt from Arbitration?

For the bankruptcy community, arbitration cases in the Supreme Court are important because the justices have never granted *certiorari* to decide whether arbitration agreements are generally enforceable in bankruptcy.

For example, would the high court require a debtor to arbitrate the allowance of a claim or the rejection of a contract or the question of whether a plan impairs a creditor's claim?

This term, the Supreme Court has ruled on two arbitration cases. Both times, the Court has taken a less expansive approach, finding no special rules impelling federal courts to enforce arbitration agreements.

On March 31, Justice Elena Kagan wrote for the 8/1 majority that there must be an independent basis of federal jurisdiction to mount an action in federal court to confirm (or to attack confirmation of) an arbitration award. *See Badgerow v. Walters*, 20-1143, 142 S. Ct. 1310, 212 L. Ed. 2d 355 (Sup. Ct. March 31, 2022). To read ABI's report, click here.

Writing for the unanimous Court on May 22, Justice Kagan overruled the majority of circuits, which had held that a "party can waive its arbitration right by litigating only when its conduct has prejudiced the other side."

Aligning the Supreme Court with the *minority* of circuits, Justice Kagan held that "the [Federal Arbitration Act's] 'policy favoring arbitration' does not authorize federal courts to invent special, arbitration-preferring procedural rules."

The Employer's Waiver of Arbitration

An hourly worker had signed an arbitration agreement when she accepted employment. She later brought a purported class action against the employer in district court in Iowa, alleging violations of the Fair Labor Standards Act.

The employer filed and lost a motion to dismiss. Answering the complaint, the employer raised 14 affirmative defenses, but not arbitration. Eight months into the lawsuit, the employer filed a motion to stay the litigation and compel arbitration.

The Eighth Circuit had previously held that a party could waive arbitration only if there were prejudice to the other party. The district court ruled that the prejudice requirement had been satisfied, but the Eighth Circuit reversed in a 2/1 opinion. The dissenter in the appeals court "raised doubts" about the prejudice requirement, Justice Kagan said.

The Supreme Court granted *certiorari* to resolve a circuit split. According to Justice Kagan, nine circuits "have invoked 'the strong federal policy favoring arbitration' in support of an arbitration-specific waiver rule demanding a showing of prejudice." The Seventh and the District of Columbia Circuits "have rejected that rule," Justice Kagan said.

Ruling Based on Principles of Contract Law

Without deciding, Justice Kagan assumed that federal courts properly invoke federal law on waiver in arbitration cases. She tackled the question of whether courts "may create arbitration-specific variants of federal procedural rules, like those concerning waiver, based on the FAA's 'policy favoring arbitration.'"

"Outside the arbitration context," Judge Kagan said, "a federal court assessing waiver does not generally ask about prejudice." Instead, she said, "the court focuses on the actions of the person who held the right; the court seldom considers the effects of those actions on the opposing party."

The Eighth Circuit had applied a "rule found nowhere else," Judge Kagan said.

Justice Kagan's opinion has the effect of putting limits on the policy favoring arbitration. She said that the "policy is to make 'arbitration agreements as enforceable as other contracts, but not more so.' *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395, 404, n. 12 (1967)."

Justice Kagan held that "a court must hold a party to its arbitration contract just as the court would to any other kind. But a court may not devise novel rules to favor arbitration over litigation." She explained that the policy "*is about treating arbitration contracts like all others, not about fostering arbitration*." [Emphasis added.]

Justice Kagan vacated the judgment of the Eighth Circuit and remanded for the lower court to "focus" on the employer's conduct. "Our sole holding today is that it may not make up a new procedural rule based on the FAA's 'policy favoring arbitration,'" she said.

Observations

The two arbitration opinions this term by Justice Kagan are the latest installments in the Supreme Court's recent push to limit or cut back on the adoption of federal common law.

In *Rodriguez v. F.D.I.C.*, 140 S. Ct. 713, 206 L. Ed. 2d 62 (Feb. 25, 2020), Justice Neil M. Gorsuch used a bankruptcy case to rule that federal courts may not employ federal common law to decide who owns a tax refund when a parent holding company files a tax return but a subsidiary generated the losses giving rise to the refund. To read ABI's report, click here.

To this writer's way of thinking, it is questionable whether there is any longer a federal policy favoring arbitration. Justice Kagan's opinion makes enforcement of an arbitration agreement nothing more than a question of contract interpretation.

Let us assume that a creditor has an otherwise enforceable arbitration agreement in a contract with a debtor in bankruptcy.

It goes without saying that the contract bends to the plethora of rights conferred by the Bankruptcy Code on debtors and trustees. That is to say, contracts are enforceable only to the extent permitted by the Bankruptcy Code, and the Code presumes that virtually all disputes are relegated to the district or bankruptcy courts, absent remand or modification of the automatic stay.

But here's the rub: The Supreme Court has long held that courts must compel arbitration unless a federal statute manifests a clear intention to override the FAA. Does the Bankruptcy Code manifest a clear intention to override an arbitration agreement?

Is "clear intention" still the standard, or has it been modified by focusing on contract interpretation?

The opinion is *Morgan v. Sundance Inc.*, 21-328 (Sup. Ct. May 23, 2022).

The Supreme Court is still giving no hints about whether arbitration agreements are enforceable in bankruptcy cases.

Supreme Court Rules Again on Arbitration, Saying Nothing Explicitly About Bankruptcy

We follow arbitration cases in the Supreme Court because the justices have never granted *certiorari* to decide whether arbitration agreements are generally enforceable in bankruptcy. For example, must a debtor arbitrate the allowance of a claim or rejection of an executory contract or even enforcement of a plan that impairs a creditor's claim?

Late last week, the justices ruled 8/1 in *Badgerow v. Walters*, 20-1143 (Sup. Ct. March 31, 2022), that there must be an independent basis of federal jurisdiction to mount an action in federal court to confirm (or to attack confirmation of) an arbitration award. The opinion means this: The federal court may have had subject matter jurisdiction to compel arbitration but may not have jurisdiction later to confirm or enforce the resulting award.

As expected, the opinion has no language that would apply expressly to bankruptcy. At best, the new opinion could be read to mean that federal courts do not champion arbitration in all circumstances.

Another arbitration case was argued in the Supreme Court on March 30: *Viking River Cruises Inc. v. Moriana*, 20-1573 (Sup. Ct.). The case deals with the ability of a state to curtail an arbitration agreement. We will not speculate on the outcome.

The Issue in *Badgerow*

An employee had an arbitration clause in her employment agreement. She launched an arbitration against her employer and lost.

Alleging that the arbitration proceedings has been infected with fraud, she sued her employer in state court to vacate the arbitration award. The employer removed the suit to federal district court. The district court decided that it had jurisdiction, denied the employee's motion to remand, and confirmed the award.

The Fifth Circuit affirmed. Like the district court, the New Orleans-based appeals court looked through the petition and found subject matter jurisdiction because the employee's underlying claims were based on federal law.

The Supreme Court granted *certiorari* to resolve a 4/2 circuit split, where the majority of circuits found jurisdiction if the underlying dispute was based on federal law.

Different Jurisdiction for Compelling and Confirming

Justice Elena Kagan reversed, writing the opinion for the majority. She based the outcome on differing provisions in the Federal Arbitration Act, or FAA.

Section 4 of the FAA deals with enforcing arbitration agreements. It provides that a party may petition to enforce an arbitration agreement in "any United States district court which, save for such agreement, would have jurisdiction . . . of the subject matter of a suit arising out of the controversy between the parties."

In *Vaden v. Discover Bank*, 556 U.S. 49 (2009), Justice Kagan said, the Supreme Court held that the court will "look through" to the underlying dispute to decide whether there is jurisdiction. If there is diversity or if a federal question will be arbitrated, then the district court has jurisdiction to compel arbitration.

Enforcement of an arbitration award does not fall under Section 4 of the FAA. Rather, enforcement is under Sections 9 and 10. Justice Kagan based her holding on the conclusion that "[t]hose sections lack Section 4's distinctive language directing a look-through, on which *Vaden* rested."

In other words, ordinary rules about subject matter jurisdiction apply to petitions for confirmation of an arbitration award because Sections 9 and 10 do not have their own special provisions governing jurisdiction. When the petition to the district court is for enforcement of an award, Justice Kagan said that the court must decide whether there is jurisdiction without relying on the subject matter of the underlying dispute.

In other words, if the parties are diverse, there is jurisdiction. Or, if enforcement itself raises a federal question, there would be jurisdiction to confirm an award.

In the case on *certiorari*, Justice Kagan said that the parties were not diverse and there was no federal question regarding confirmation of the award.

Rather, the issue regarding enforcement of the arbitration award was nothing "more than a contractual resolution of the parties' dispute . . . . And quarrels about legal settlements — even settlements of federal claim — typically involve only state law, like disagreements about other contracts."

There being no diversity and no federal question controlling confirmation of the award, Judge Kagan reversed and remanded, since enforcement would turn on state contract law. Presumably,

confirmation of the award will be vacated for lack of subject matter jurisdiction, and the employee will have her day in state court to attack the confirmation award.

Any Applicability to Bankruptcy?

On the surface, there is little or nothing on the face of the opinion regarding enforcement of arbitration agreements in bankruptcy. Furthermore, the decision deals with enforcement of arbitration awards, not enforcement of arbitration clauses.

In recent terms, the Supreme Court has been adamant about enforcing arbitration agreements. *See, e.g.*, *Epic Systems Corp. v. Lewis*, 200 L. Ed. 2d 889 (Sup. Ct. May 21, 2018). One might perhaps read *Badgerow* to mean that federal courts are not bound by the FAA to enforce arbitration clauses and awards in all circumstances. However, *Badgerow* is not based on policy. It's based strictly on statutory interpretation.

When it comes to enforcement of arbitration agreements, *Vaden* and *Badgerow* both suggest that the bankruptcy court has "related to" jurisdiction even if there is no diversity and no federal question.

Still, having jurisdiction does not automatically mean that the bankruptcy court must enforce an arbitration clause. In *Epic*, the Supreme Court said that courts must compel arbitration unless the federal statute manifests a clear intention to override the FAA. Does the Bankruptcy Code manifest a clear intention to override an arbitration agreement?

Although it was decided before *Epiq*, some circuits still interpret *Shearson/American Express Inc. v. McMahon*, 482 U.S. 220 (1987), liberally by overriding arbitration agreements in bankruptcy cases, even though the Bankruptcy Code contains no express language barring enforcement of the FAA. *See, e.g.*, *Credit One Bank NA v. Anderson (In re Anderson)*, 884 F.3d 382 (2d Cir. March 7, 2018), *cert. denied*, 139 S. Ct. 144 (2018). To read ABI's report, click here.

Centrality of administration is evident throughout the Bankruptcy Code, in provisions like the automatic stay, the requirement to file claims, and the encompassing nature of "core" jurisdiction. Perhaps those (less than explicit) provisions in bankruptcy law would persuade the Supreme Court to override arbitration agreements in most bankruptcy disputes.

The opinion is *Badgerow v. Walters*, 20-1143 (Sup. Ct. March 31, 2022)

'Cert' Granted for This Term

The circuits are split on whether an innocent debtor's liability is automatically nondischargeable when an agent or partner committed fraud.

Cert Granted to Decide: Is a Principal's Liability for an Agent's Fraud Nondischargeable?

The Supreme Court granted *certiorari* this week to resolve a split of circuits and decide whether a debtor is saddled with a nondischargeable debt for a false representation or actual fraud under Section 523(a)(2)(A) based entirely on the fraud of a partner or agent. In other words, does the imputation of liability for fraud also result automatically in nondischargeability, or must the debtor have some degree of scienter?

The decision in *Bartenwerfer v. Buckley*, 21-908 (Sup. Ct.), likely to be argued this fall, will say whether the debtor must have known or should have known about the agent's fraud before the debt is considered nondischargeable.

The circuits are split as follows: (1) The Second, Fourth, Seventh and Eighth Circuits hold that the debtor must have some degree of scienter before an imputed liability for fraud becomes nondischargeable, while (2) the Fifth, Sixth, Ninth and Eleventh Circuits hold that a debt is nondischargeable as to an entirely innocent debtor based on the fraud of a partner or agent.

The 'Innocent' Wife

A couple owned a home. They moved out to renovate and then sell the home. The husband oversaw the renovations. The wife had little to do with the renovations. After renovation, they sold the home.

The buyers sued in state court, alleging fraud in the disclosure statement for failure to disclose known defects in the home. A jury found the couple liable, resulting in a judgment against them for about $540,000, plus interest.

The couple filed a chapter 7 petition, and the bankruptcy court ruled that the debt was nondischargeable as to the husband.

Bankruptcy Judge Hannah L. Blumenstiel discharged the debt as to the wife, finding that she neither knew nor should have known that the disclosures were fraudulent. *See Buckley v. Bartenwerfer (In re Bartenwerfer)*, 596 B.R. 675 (Bankr. N.D. Cal. 2019). The Ninth Circuit Bankruptcy Appellate Panel affirmed in a nonprecedential opinion. *See Bartenwerfer v. Buckley*

(In re Bartenwerfer), 16-1277, 2017 BL 461730, 2017 Bankr. Lexis 4396, 2017 WL 6553392 (B.A.P. 9th Cir. Dec. 22, 2017).

The Ninth Circuit reversed in a nonprecedential opinion and directed the bankruptcy judge to enter judgment in favor of the creditor, declaring the debt to be nondischargeable. Raising the circuit split, the debtor-wife filed a petition for *certiorari* in December. The Supreme Court granted the petition on May 2.

The Supreme Court's order granting review did not describe the issue on appeal. The debtor's petition stated the question presented as follows:

> May an individual be subject to liability for the fraud of another that is barred from discharge in bankruptcy under 11 U.S.C. § 523(a)(2)(A), by imputation, without any act, omission, intent or knowledge of her own?

The (Outdated?) Supreme Court Precedent

The root of the circuit split is found in what the debtor calls a misinterpretation of an 1885 decision by the Supreme Court under the Bankruptcy Act of 1867, *Strang v. Bradner*, 114 U.S. 555 (1885). There, the Court was primarily concerned with whether a partner in a law firm was entitled to a discharge. The Court said the debt was not discharged, because the partner had himself committed fraud.

According to the debtor, the Court in 1885 "simply assumed — without authority or analysis — that the liability [of other partners] was nondischargeable."

The debtor went on to say,

> [T]he Court did not actually consider the particular issue, perhaps because it was not raised on appeal, the parties having elected to focus their arguments on the underlying liability for fraud, which occupies most of the opinion.

In other words, the debtor is arguing that the Court's pronouncement in 1885 about *per se* nondischargeability of one partner for another's fraud is *dicta*.

The Circuits' Opposing Camps

The circuits these days that find no *per se* liability are led by the Eighth Circuit in *Walker v. Citizens State Bank (In re Walker)*, 726 F.2d 452 (8th Cir. 1984). The St. Louis-based appeals court held that actual participation in the fraud is not required for the debt to be nondischargeable. However, the circuit said that the debt is nondischargeable if "the principal either knew or should have known of the agent's fraud." *Id*. at 454.

On the other side of the fence, *Deodati v. M.M. Winkler & Assocs. (In re M.M. Winkler & Assocs.)*, 239 F.3d. 746 (5th Cir. 2001), is the leading authority for a principal's strict liability. Writing for the Fifth Circuit, Circuit Judge Edith H. Jones held "that § 523(a)(2)(A) prevents an innocent debtor from discharging liability for the fraud of his partners, regardless of whether he receives a monetary benefit." *Id*. at 751.

Conclusion

Absent lengthy extensions, the briefs should be filed by summer, allowing for argument in the fall. As the debtor said in her *certiorari* petition, did the Ninth Circuit commit error when it "impose[d] nondischargeability upon an innocent debtor for the fraud of another without any act, omission, intent or knowledge of the debtor's own"?

It's a classic question that asks whether scienter is an implicit requirement before a debt is excepted from discharge under Section 523(a)(2)(A).

The face of the statute itself may or may not answer the question. The subsection renders a debt nondischargeable if it was obtained by "false pretenses, a false representation, or actual fraud."

The subsection does not say whether the debtor must have made the false representation or committed the fraud. Still, the statute could be read to mean that any liability for fraud or misrepresentation is nondischargeable, regardless of who committed the fraud.

The drafters of the Code did not explicitly overrule *Strang*, of which they surely were aware. Being vague on the issue now in the Supreme Court, did they mean for the courts to decide whether the debtor must be guilty of fraud?

We will have the answer about one year from now.

The case is *Bartenwerfer v. Buckley*, 21-908 (Sup. Ct.).

The Supreme Court now has two bankruptcy cases on the calendar for argument in the term to begin in October.

Supreme Court to Decide Whether Section 363(m) Is a Jurisdictional Bar to Appeal

The Supreme Court will hear two bankruptcy cases in the term to begin this coming October. Yesterday, the high court granted *certiorari* to decide whether the failure to obtain the stay of a sale approval order erects a jurisdictional bar to appeal under Section 363(m).

The courts of appeals are split 6-2. Led by the Second Circuit, the minority hold that Section 363(m) is jurisdictional and bars an appeal from any order that is "integral" to a sale order. The Fifth Circuit sides with the Second.

The majority – composed of the Third, Sixth, Seventh, Ninth and Tenth Circuits – hold that Section 363(m) only sets limits on the relief that a court may grant on appeal from a sale order and is not jurisdictional.

With the grant of *certiorari*, the Supreme Court will review *MOAC Mall Holdings LLC v. Transform Holdco LLC (In re Sears Holdings Corp.)*, 20-1846, 2021 BL 481940, 2021 US App Lexis 37358, 2021 WL 5986997 (2d Cir. Dec. 17, 2021). To read ABI's report on the Second Circuit opinion, click here.

The Sears Lease Sale

The facts and procedural history were complicated but boil down to this:

The landlord was the owner of the giant Mall of America. It was objecting to the assignment of a lease by Sears, a chapter 11 debtor. The landlord lost in bankruptcy court.

Initially, the district court reversed, holding that a provision in a lease cannot supplant the requirement in Section 365(b)(3)(A) mandating that the financial condition of an assignee of a lease must be "similar to the financial condition . . . of the debtor . . . as of the time the debtor became the lessee under the lease . . . ." *MOAC Mall Holdings LLC v. Transform Holdco LLC (In re Sears Holdings Corp.)*, 613 B.R. 51 (S.D.N.Y. May 11, 2020). ("*MOAC I*"). To read ABI's report on *MOAC I*, click here.

Almost immediately, the purchaser of the lease filed a motion for rehearing. Although having taken a contrary position consistently, the purchaser argued for the first time on rehearing that the

appeal should be dismissed under Section 363(m) because the landlord did not obtain a stay pending appeal. Previously, the purchaser had consistently contended that the transaction was not a sale.

The case (and the outcome in the Supreme Court) turned on Section 363(m), which says that reversal or modification "of an authorization under subsection (b) or (c) of this section of a sale or lease of property does not affect the validity of a sale or lease [to a purchaser in good faith] . . . unless such authorization and such sale or lease were stayed pending appeal."

On rehearing in *MOAC II*, *MOAC Mall Holdings LLC v. Transform Holdco LLC (In re Sears Holdings Corp.)*, 616 B.R. 615 (S.D.N.Y. 2020), the district judge said that the buyer now "seeks to benefit from a complete reversal of that representation." *MOAC II*, 616 B.R. at 626. Citing *In re WestPoint Stevens Inc.*, 600 F.3d 231, 248 (2d Cir. 2010), and *In re Gucci*, 105 F.3d 837, 838–840 (2d Cir. 1997), the district judge said that the Second Circuit had twice held that Section 363(m) is "a jurisdiction-depriving statute." *Id*. at 624.

In *MOAC II*, the district judge granted rehearing, concluded that she lacked appellate jurisdiction, vacated her earlier opinion, and dismissed the appeal. To read ABI's report on MOAC II, click here.

The Effect of 'Jurisdictional'

The Second Circuit affirmed in a nonprecedential, summary order on December 17.

The circuit panel said that Section 363(m) applied. Following its own precedent, the Second Circuit held that Section 363(m) is jurisdictional and that the section "also limits appellate review of any transaction that is integral to a sale authorized under § 363(b)."

Applying Section 363(m) was outcome determinative. If the appeal had only dealt with the appellate court's power, the buyer's failure to raise Section 363(m) earlier would have been waived, and the Second Circuit could have ruled in favor of the landlord on the merits.

Because the Second Circuit held that Section 363(m) was jurisdictional, the buyer was entitled to raise the jurisdiction issue for the first time on appeal.

The circuit panel held that a review of the merits was "foreclosed by our binding precedent in *In re WestPoint Stevens Inc.*, under which § 363(m) deprived the District Court of appellate jurisdiction." Earlier last year in another nonprecedential opinion citing *WestPoint Stevens*, a Second Circuit panel held that Section 363(m) is jurisdictional because it "creates a rule of statutory mootness." *Pursuit Holdings (NY) LLC v. Piazza (In re Pursuit Holdings (NY) LLC),* 845 Fed. App'x 60, 62 (2d Cir. 2021).

The Second Circuit affirmed the judgment of the district court dismissing the appeal for lack of jurisdiction. Dismissal of the appeal reinstated the bankruptcy court's decision in favor of the buyer and effectively overturned the district court's first decision to reverse the bankruptcy court in the landlord's favor.

The landlord prevailed on the Second Circuit to stay issuance of the mandate and filed a petition for *certiorari* in March. The respondent opposed in May. The justices of the Supreme Court held a conference on June 23 to consider the petition and granted *certiorari* in an order on June 27.

The Question Presented

The landlord is urging the Supreme Court to reverse the Second Circuit, based in large part on *Arbaugh v. Y & H Corp.*, 546 U.S. 500, 515 (2006), where the high court held that a statute is jurisdictional only if Congress has "clearly state[d]" that it is jurisdictional. Earlier, the Supreme Court held that federal courts have a "virtually unflagging obligation" to exercise jurisdiction. *Colorado River Water Conservation Dist. v. United States*, 424 U.S. 800, 817 (1976).

In the petition for *certiorari*, the landlord colloquially stated that the question on appeal was "whether Section 363(m) of the Bankruptcy Code deprives the appellate courts of jurisdiction or instead merely limits the remedies available on appeal from a sale order [that] has arisen in at least seventy appeals at the district and circuit court levels in the past five years."

Naturally, the petitioner said that the jurisdictional label "is not merely semantic, but carries immense practical consequences [because] [j]urisdictional issues are not subject to waiver or forfeiture."

The petitioner explained that the jurisdictional label prevents an appellate court from even considering "whether there are remedies available on appeal that do not affect the validity of the sale."

Assuming there are no inordinate delays in the filing of merits briefs, the case could be argued in the Supreme Court before the year's end, with a decision by March or April.

Both sides will be well represented by counsel who have argued multiple times in the Supreme Court on complex bankruptcy questions. The petitioner-landlord's counsel is Douglas Hallward-Driemeier from the Washington, D.C., office of Ropes & Gray LLP. The buyer-respondent's counsel is G. Eric Brunstad, Jr., from the Hartford, Conn., office of Dechert LLP.

To read the petition for *certiorari* and the brief in opposition, click here and here.

Previously, the Court granted *certiorari* in *Bartenwerfer v. Buckley*, 21-908 (Sup. Ct.), to resolve a split of circuits and decide whether a debtor is saddled with a nondischargeable debt for a false representation or actual fraud under Section 523(a)(2)(A) based entirely on the fraud of a partner or agent. To read ABI's report on *Bartenwerfer*, click here.

The appeal is *MOAC Holdings LLC v. Transform Holdco LLC*, 21-1270 (Sup. Ct.).

'Cert' Denied

The Supreme Court on June 13 declined to hear two bankruptcy cases in the term to begin next October.

Supreme Court Won't Rule on Remedies for Overpayments and Violation of Rule 3002.1

In the term to begin this coming October, the Supreme Court will not be hearing cases raising two bankruptcy questions.

The Court will not decide (1) whether a refund is the proper remedy for a chapter 11 debtor who paid higher U.S. Trustee fees that were held unconstitutional by the Court on June 6, and (2) whether bankruptcy courts may impose contempt sanctions for violations of Bankruptcy Rule 3002.1, the rule that requires lenders to give notice within 180 days of fees or expenses being charged to a chapter 13 debtor.

John Q. Hammons Fall

Reversing the majority opinion from the Fourth Circuit, the Supreme Court ruled unanimously on June 6 that the increase in fees payable to the U.S. Trustee system in 2018 violated the uniformity aspect of the Bankruptcy Clause of the U.S. Constitution because it was not immediately applicable in the two states with Bankruptcy Administrators rather than U.S. Trustees. *Siegel v. Fitzgerald*, 21-441, 2022 BL 194063, 2022 US Lexis 2681 (Sup. Ct. June 6, 2022). To read ABI's report, click here.

Although remedy had been a focus of questions from the justices during oral argument in *Siegel*, the Court pointedly remanded for the lower court to determine the proper remedy, because the Fourth Circuit had not been required to rule on remedy. The government has been contending in the lower courts and in the Supreme Court that chapter 11 debtors are not entitled to a refund of overpayments.

The *certiorari* petition in *Office of the U.S. Trustee v. John Q. Hammons Fall 2006 LLC*, 21-1078 (Sup. Ct.), raised the remedy question that the Supreme Court ducked in *Siegel*.

The Tenth Circuit had ruled in *John Q. Hammons Fall* that the U.S. Trustee fee increase was unconstitutional and that a refund was the proper remedy. *John Q. Hammons Fall 2006 LLC v. U.S. Trustee (In re John Q. Hammons Fall 2006 LLC)*, 15 F.4th 1011 (10th Cir. Oct. 5, 2021). To read ABI's report on the circuit's decision in *John Q. Hammons Fall*, click here.

In *John Q. Hammons Fall*, the Supreme Court could have denied *certiorari*, in which event the remedy of refund would have been binding precedent in the Tenth Circuit and influential elsewhere.

Instead, the Supreme Court granted *certiorari* in an order on June 13, vacated the judgment and "remanded to the United States Court of Appeals for the Tenth Circuit for further consideration in light of *Siegel v. Fitzgerald*, 596 U.S. ___ (2022)." For the Supreme Court's docket in *John Q. Hammons Fall*, click here.

The Tenth Circuit will surely cite *Siegel* and affirm its ruling that the fee increase was unconstitutional. It is not certain, however, that the Tenth Circuit will reflexively uphold its prior decision on remand. To read the tea leaves, the judges on the Tenth Circuit will likely read the transcript of oral argument in *Siegel*, in hopes of divining how the Supreme Court might rule on remedy.

Even if the Tenth Circuit again upholds refund as the remedy, it's unlikely that the Supreme Court will grant *certiorari* immediately to rule on remedy, in this writer's view. The issue of remedy is not well developed among the circuits, and a class action now pending in the Federal Circuit raises the issue starkly.

The Federal Court of Claims dismissed a class action, believing (incorrectly, as it turns out) that the disparate fees did not violate the Bankruptcy Clause. *Acadiana Management Group LLC v. U.S.*, 19-496, 151 Fed. Cl. 121 (Ct. Cl. Nov. 30, 2020). The debtor-plaintiff appealed and is asking the Federal Circuit to reinstate the complaint. Oral argument in the Federal Circuit was postponed pending the outcome in *Siegel*. *Acadiana Management Group LLC v. U.S.*, 21-1941 (Fed. Cir.). For ABI's report on *Acadiana*, click here.

The complaint in *Acadiana* will be reinstated, based on *Siegel*. Liability seems to be established by *Siegel*, but whether the Court of Claims certifies a class is another question. If a class is certified, the question of remedy will remain for the Court of Claims and the Federal Circuit to decide.

Rule 3002.1

Last year, the Second Circuit held in *PHH Mortgage Corp. v. Sensenich (In re Gravel)*, 6 F.4th 503 (2d Cir. Aug. 2, 2021), that bankruptcy courts may not impose contempt sanctions for violating Bankruptcy Rule 3002.1. Rather, the majority ruled over a vigorous dissent that a debtor may only recover compensatory damages, which often will be nominal. To read ABI's report on *Gravel*, click here.

One month later, a bankruptcy judge in Texas disagreed with the Second Circuit's majority and held that a debtor can mount a claim for sanctions and punitive damages under Bankruptcy

Rule 3002.1(i)(2) when a lender violates Rule 3002.1(b) and (c) by failing to give notice of changes in the payment, charges, fees and expenses claimed by a secured lender. *Blanco v. Bayview Loan Servicing LLC (In re Blanco)*, 633 B.R. 714 (Bankr. S.D. Tex. Sept. 14, 2021). To read ABI's report, click here.

The debtor filed a petition for *certiorari* in *Gravel*. *Sensenich v. PHH Mortgage Corp.,* 21-1322 (Sup. Ct.). A group of law professors and retired bankruptcy judges, along with the National Association of Chapter 13 Trustees, filed *amicus* briefs urging the Court to grant *certiorari* and reverse the Second Circuit.

In an unsigned order on June 13, the Supreme Court denied the *Sensenich certiorari* petition. Supreme Court review may not occur until there is a circuit split on the precise issue under Rule 3002.1. Otherwise, the Supreme Court would be wading into the murky area regarding a bankrupt court's inherent power and jurisdiction to impose punitive sanctions.

For the Supreme Court's docket in *Sensenich*, click here.

The *certiorari* petitions were *Office of the U.S. Trustee v. John Q. Hammons Fall 2006 LLC*, 21-1078 (Sup. Ct.); and *Sensenich v. PHH Mortgage Corp.,* 21-1322 (Sup. Ct.).

Reorganization

Fraudulent Transfers

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

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

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

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

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

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

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

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

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

Corporate Restructuring & Venue

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

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

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

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

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

J&J's Financial Distress

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

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

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

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

Applying the Facts to the Law

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

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

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

Valid Reorganization Purpose

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

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

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

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

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

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

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

Unfair Tactical Advantage

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

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

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

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

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

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

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

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

The Remedy

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

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

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

Executory Contracts & Leases

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

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

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

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

The Gas Pipeline Contract

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

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

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

Mirant and the Dueling Regulatory Schemes

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

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

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

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

Mirant Controls

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

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

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

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

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

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

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

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

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

The Fifth Circuit said in dicta that courts might apply the 'functional approach' rather than the Countryman test in deciding whether a triangular contract is executory.

Fifth Circuit Holds that Surety Bonds Are Not Executory Contracts

Holding that a surety bond is not an executory contract, the Fifth Circuit also said that a triangular contract might be an executory contract in some circumstances, even if the creditor owes no further performance to the debtor.

In addition, the Fifth Circuit opened the door for courts to employ the so-called functional approach in deciding whether multiparty contracts can be executory contracts susceptible to assumption.

The Surety Bonds

The debtor was a producer of oil and gas in chapter 11. Before bankruptcy, it acquired four irrevocable performance bonds securing the debtor's obligations for environmental liabilities and for plugging and abandoning wells. The bonds were accompanied by an indemnity agreement where the debtor agreed to indemnify the bonding company if it were called on the bonds.

The insurance company's obligations to the third party obligees were irrevocable. That is to say, even if the debtor were to fail to pay premiums or default on its obligations to the bonding company, the bonding company would remain liable to the obligees.

The insurer was liable for a maximum of about $10.6 million on the bonds, for which the insurer held some $3.2 million in cash to secure the bonding company's obligations were claims to be made on the bonds.

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

The Confirmed Plan

On motion of the debtor near the outset of reorganization, the bankruptcy court authorized the debtor to "continue and maintain" the surety bonds and to pay obligations under the bonds as they came due.

The plan said that executory contracts were deemed assumed unless they were listed for rejection, but the bonds were not on the list of rejected executory contracts.

After confirmation, the debtor failed to pay a premium on the bonds. The bonding company responded by demanding $7.3 million more in collateral. The debtor refused, accusing the bonding company of violating the discharge injunction.

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

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

The surety had an allowed secured claim for $3.2 million, but Judge Dodd disallowed the surety's unsecured claim for $7.3 million, because there had been no call on the bonds, and the claim was contingent.

The Appeal to District Court

The bonding company appealed to the district court and lost. *Argonaut Ins. Co. v. Falcon V LLC*, 20-00702, 2021 BL 374472 (M.D. La. Sept. 30, 2021). To read ABI's report, click here.

Like the bankruptcy judge, District Judge Brian A. Jackson held that the contract was not executory. Judge Jackson also held that the surety bonds could not "pass through" or "ride through" bankruptcy because riding through only applies to executory contracts that were neither assumed nor rejected, and the surety bonds were not executory.

Although not recited in the Fifth Circuit affirmance on October 11, several other facts from the record are of import.

The surety has not been called on the bonds because the debtor, both before and after bankruptcy, continued to perform its obligations regarding the plugging and abandonment of wells. Similarly, the debtor had assumed leases for the wells, thus taking on post-confirmation responsibilities for obligations that would be covered by the bonds.

A finding that the surety bonds had been assumed as executory contracts would have had consequences for the debtor. Requiring the debtor to post an additional $7.3 million in favor of the surety would have resulted in a breach of the debtor's post-confirmation financing arrangements.

The Circuit Affirms: No Executory Contract

Under the plan, the debtor would have assumed the surety bonds automatically if they indeed were executory contracts. To determine whether the bonds were executory, Circuit Judge Stephen A. Higginson said that the "vast majority of circuits have adopted" the definition of executory contracts developed by Prof. Vern Countryman of Harvard Law School.

The professor called a contract executory if it is "a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing performance of the other." *Executory Contracts in Bankruptcy: Part I*, 57 Minn. L. Rev. 439, 460 (1973).

The bankruptcy and district courts both had ruled that the bonds were not executory because the bonding company owed no further obligations to the debtor, only to the obligees. The bonding company countered by arguing that the Countryman definition should be modified to take into account the surety's unperformed obligations to the obligees.

Judge Higginson did not accept the invitation. He said:

> We decline to adopt [the surety's] proposed modification to the Countryman test. [The surety] offers no authority in support of the modification, and it makes no attempt to explain how the modification would further the test's goal of "facilitat[ing] the debtor's rehabilitation" by giving debtors discretion to assume or reject those contracts "where there can be uncertainty if the contract is a net asset or liability for the debtor." *In re Weinstein Co. Holdings*, 997 F.3d 497, 504–05 (3d Cir. 2021).

Judge Higginson added, "[The surety's] proposed test seems designed simply to elevate the rights of sureties above those of other creditors."

Then, Judge Higginson added a new wrinkle to Fifth Circuit law. He said that two circuits have adopted "the 'functional approach,' under which 'the question of whether a contract is executory is determined by the benefits that assumption or rejection would produce for the estate.'"

Agreeing with the surety, Judge Higginson said:

> [C]ourts should apply the Countryman test to multiparty contracts in a flexible manner that accounts for the various obligations owed to *all* of the parties, rather than focusing exclusively on the flow of obligations between the debtor and the creditor. [Emphasis in original.]

Judge Higginson said he could "imagine . . . a tripartite agreement under which [the debtor] owes performance to a creditor, the creditor owes performance to a third party, and the third party owes performance to the debtor." In such a case, he said, "we consider not just the obligations that [the debtor] and [the surety] owe to each other but also their respective obligations to the third-party obligees."

Still, the modification would not avail the surety, Judge Higginson said, because the surety owed no more obligations to the debtor, since the surety had posted irrevocable bonds. Rather, the surety's remaining obligations were to the obligees.

Even applying the Countryman test "in this flexible manner," Judge Higginson said that bonds would fail the text "because [the debtor's] failure to perform would not excuse [the surety] from performing."

Judge Higginson upheld the two lower courts by ruling that the bonds were not executory contracts under the Countryman test and thus were not assumed automatically under the plan. He listed one district court and three bankruptcy courts with decisions holding that surety bonds are not executory contracts.

No Ride-Through

In one paragraph, Judge Higginson dismissed the surety's argument that the bonds rode through bankruptcy.

Because the bonds were not executory contracts, he said they were not subject to assumption, rejection or ride-through.

Functional Approach to Triangular Agreements

Judge Higginson said that the "Countryman test, flexibly applied," in itself was sufficient to decide that the bonds were not executory contracts. He noted that neither the bonding company nor the debtor had asked the appeals court to apply a functional analysis.

In a footnote, Judge Higginson said that "future courts should not consider foreclosed the possibility that the functional approach should be adopted for multiparty contract cases."

The opinion is *Argonaut Ins. Co. v. Falcon V LLC (In re Falcon V LLC)*, 21-30668 (5th Cir. Aug. 11, 2022).

Adequate assurance of future performance may not be required if the debtor has already cured the breach of **lease, the Ninth Circuit says.**

A Cured Breach Still Invokes Section 365(b)(1)'s Landlord Protections, Circuit Says

If there has ever been a breach of a lease of real property — even if it was cured or was not material — the landlord is still entitled to "adequate protection" or one of the other assurances laid out in Section 365(b)(1), according to the Ninth Circuit.

However, "adequate assurance" may not be required if the breach has been cured or if the debtor has agreed to comply with the lease by having assumed the lease, Circuit Judge Danielle J. Forrest said.

The Monetary and Nonmonetary Breaches of Lease

The debtor leased several floors of an office building in a large city. In her September 23 opinion, Judge Forrest said the lease was below-market.

The landlord and the tenant were not on good terms. Before the tenant's bankruptcy, the landlord asked the tenant to sign an estoppel certificate to assist in refinancing. The tenant refused and instead said there were problems with the premises and that the tenant had claims against the landlord.

After the squabble about the estoppel certificate, and also before bankruptcy, the landlord notified the tenant about several alleged, non-monetary breaches of the lease. When the landlord threatened to terminate the lease, the tenant filed a chapter 11 petition.

In bankruptcy, the tenant paid a month's rent into an escrow account, claiming a right to a Covid rent moratorium under local law. The bankruptcy court concluded that the moratorium did not apply. The tenant-debtor paid the rent late and subsequently paid a late fee charged by the landlord.

Soon after filing, the tenant moved to assume the lease. After a year's discovery, the bankruptcy judge held a trial and allowed the tenant to assume the lease. Judge Forrest quoted the bankruptcy judge as finding that many of the alleged breaches "appeared manufactured, and minor, and made-up, sometimes."

The landlord nonetheless sought "adequate protection" under Section 365(b)(1) because there had been a breach of lease. The bankruptcy judge decided that the landlord was not entitled to "adequate protection" because the breaches were cured or were not material and would not result in forfeiture of the lease under California law.

The district court affirmed. The landlord appealed to the circuit and won a pyrrhic victory. Although the landlord was entitled to the protections of Section 365(b)(1), the error was harmless because any monetary breach had been cured, and the debtor's promise to abide by the lease covered everything else.

The Verb Tense in Section 365(b)(1) Is Pivotal

Judge Forrest paraphrased Section 365(b)(1) as saying that a debtor may assume an unexpired lease if (1) it cures or provides adequate assurance of curing a default, (2) provides compensation for actual pecuniary loss, and (3) provides "adequate assurance of future performance."

However, the prelude in Section 365(b)(1) requires the three protections "[i]f there has been a default." When there has been no default, "section 365(b)(1)'s requirements — cure, compensation and adequate assurance of future performance — are not triggered," Judge Forrest said.

The tenant-debtor contended that no protection under Section 365(b)(1) was required because the bankruptcy court had found "no ongoing default at the time of assumption and . . . that any default that had occurred was immaterial under California law."

Judge Forrest nixed the contention by reference to the "plain terms of the statute" and the use of the "present-perfect tense," *i.e.*, if "there has been a default." Citing the *Collier* treatise, she said that the "assertion that section 365(b)(1) can provide no relief for a landlord where a default already has been cured is simply incorrect both as a matter of interpretation and common sense."

Judge Forrest held that the absence of an "active default . . . did not render section 365(b)(1)'s curative requirements inapplicable."

Next, Judge Forrest dealt with the idea that the lack of a material default would render the section inapplicable. She found "no basis for this interpretation" and held that "the bankruptcy court erred in narrowly interpreting 'default' to refer only to defaults that are sufficiently material to warrant forfeiture of the lease under California law."

Judge Forrest concluded the opinion by addressing "whether the bankruptcy court's failure to analyze section 365(b)(1)'s curative requirements was reversible error" under F.R.C.P. 61, made applicable by Bankruptcy Rule 9005.

The only issue was the landlord's claimed right to "adequate protection of future performance" under Section 365(b)(1)(C), because any existing breaches had been cured or had been found by the bankruptcy judge to be "only minor deviations from the contract terms."

"Thus," Judge Forrest said, "any adequate assurance responsive to the alleged defaults would be little more than simple promises not to deviate from the contract terms again." She went on to say that the landlord "has not explained how any additional assurance of future performance would have substantively impacted its right to full performance of the lease terms."

Judge Forrest held that any error by the bankruptcy court was "harmless." Alluding to the below-market nature of the lease, she said that the landlord "made the deal" and "is not entitled to use section 365(b)(1) as a means to get out of a bad deal so that it can make a better one."

The opinion is *Smart Capital Investments I LLC v. Hawkeye Entertainment LLC (In re Hawkeye Entertainment LLC)*, 21-56264 (9th Cir. Sept. 23, 2022).

Venue, Jurisdiction & Power

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

Second Circuit Expands Standing to Ensure Integrity of the Bankruptcy Court

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

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

The Allegations

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

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

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

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

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

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

Special Standing Rules for Bankruptcy Integrity

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

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

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

Here's the important bankruptcy angle:

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

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

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

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

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

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

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

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

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

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

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

The Circuit Split

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

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

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

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

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

The Eleventh Circuit explained how prudential (or 'person aggrieved') standing is a higher standard more difficult to meet than constitutional (or 'Article III') standing.

Target of Lawsuit Doesn't Have Standing to Appeal a Litigation Funding Agreement

The target of a lawsuit financed by a litigation funding agreement has neither Article III standing nor prudential standing in the Eleventh Circuit to appeal the bankruptcy court's order authorizing the funding.

The corporate debtor's confirmed chapter 11 plan created a litigation trust, whose trustee sued the debtor's bank for aiding and abetting a breach of fiduciary duty and to recover an allegedly $3 million fraudulent transfer.

Lacking funds to prosecute the suit, the liquidating trustee negotiated a litigation funding agreement with the debtor's principal. Significantly, the trustee retained the power to settle or make settlement offers. However, the trustee was required to confer in good faith with the funder.

According to the Eleventh Circuit's *per curiam* opinion on March 31, there evidently was animus between the bank and the debtor's principal, who had threatened to sue the bank if it did not withdraw objections made to state insurance regulators.

The bank opposed approval of the funding agreement, arguing that the debtor's principal could improperly influence settlement. The circuit court characterized the bank as claiming to preserve the fairness of the bankruptcy proceedings.

The bankruptcy court approved the funding agreement. The district court dismissed the bank's appeal for lack of appellate standing. Reviewing the district court's standing decision *de novo*, the Eleventh Circuit affirmed.

The circuit court separately addressed the bank's dual hurdles: Article III (or "constitutional") standing, and prudential (or "person aggrieved") standing. Prudential standing is the higher standard that an appellant must meet.

To establish constitutional standing under Article III, the litigant must show injury in fact, causation and redressability, the circuit court said. Furthermore, the injury must be concrete and

particularized, not conjectural or hypothetical. In addition, the injury must be "certainly impending." Possible future injury won't cut the mustard.

The appeals court said that the appellant must "at least demonstrate that he is in immediate danger of sustaining a direct injury, meaning that the anticipated injury must occur within a fixed time period in the future."

Applying the standards to the case on appeal, the appeals court said that the bank's "alleged injury is not imminent, and is instead based on a speculative, highly attenuated, chain of possibilities."

The circuit court noted that no settlement offer had been made in the lawsuit. Indeed, discovery had not even begun. For there to be injury, there would need to be a settlement offer where the trustee, although having retained settlement authority, would have acquiesced improperly in the lender's exhortations.

Because injury to the bank was "clearly based on a highly attenuated chain of possibilities," the appeals court held that the bank lacked constitutional standing.

Turning to prudential standing to appeal, the circuit court said that the "person aggrieved" test "restricts a plaintiff's standing more than Article III." The appellant must be directly, pecuniarily and adversely affected by the bankruptcy court's order.

Hoping to avoid liability in a lawsuit, the appeals court said, does not make a party "aggrieved," because "orders allowing litigation to continue do not burden a party's ability to defend against liability."

Furthermore, the circuit court said that a party is not aggrieved unless "the interest he seeks to validate is not protected or regulated by the Bankruptcy Code." In the case on appeal, the court said that the bank's "interest in avoiding liability is 'antithetical to the goals' of the Bankruptcy Code."

"Finally," the appeals court said, the bank did "not meet the 'person aggrieved' doctrine simply by virtue of attacking the inherent fairness of the bankruptcy proceedings."

The Eleventh Circuit upheld dismissal of the appeal. Even if the bank had constitutional standing, it lacked "person aggrieved" standing.

The opinion is *Valley National Bank v. Warren (In re Westport Holdings Tampa Ltd.)*, 21-11767 (11th Cir. March 31, 2022).

The Third Circuit opinion by Thomas Ambro explained that the 'close nexus' test does not apply when a post-conformation dispute is 'core' or entails enforcing a court order.

Bankruptcy Courts Always Have Post-Confirmation Jurisdiction for 'Core' Matters

If a post-confirmation adversary proceeding is "core" or entails interpretation of an order made during the chapter 11 case, there is always jurisdiction. According to an August 25 opinion by Third Circuit Judge Thomas L. Ambro, the close nexus test does not apply to a post-confirmation dispute that is "core."

Under the debtor's chapter 11 plan, the company was being acquired by a third party. Before confirmation by the bankruptcy court in Delaware, the buyer had hired a financial advisor.

The day before the plan became effective, an executive of the buyer signed an agreement to give the advisor a success fee for arranging financing after the acquisition was completed. The agreement purported to make the reorganized debtor liable for the success fee, although the buyer was not yet in control of the debtor.

The reorganized debtor closed a financing six months after the plan became effective. Were it enforceable, the reorganized debtor would be liable to the advisor for a $16 million success fee. The debtor refused to pay the success fee.

The advisor filed a lawsuit in federal district court in Minnesota against the debtor. In response, the debtor initiated an adversary proceeding in the Delaware bankruptcy court to hold the advisor in contempt of the discharge injunction and for a declaration that any liability for a success fee had been discharged.

The advisor filed a motion to dismiss the adversary proceeding in bankruptcy court. The bankruptcy judge issued a bench opinion dismissing the adversary proceeding for lack of jurisdiction. The district court authorized a direct appeal that the circuit accepted.

Policy Still Matters (in the Third Circuit)

Judge Ambro began his analysis by laying out policies behind the Bankruptcy Code. "[W]e ground our discussion in the broader context of bankruptcy jurisdiction," he said. "The aim of the Bankruptcy Code . . . is to sort out, as much as possible, a debtor's financial affairs in one place."

Next, he said that the "scope" of bankruptcy jurisdiction "diminishes" after confirmation but does not disappear "entirely." The first step in discerning jurisdiction is to divine whether the dispute is core or non-core.

Urging the circuit to uphold dismissal, the advisor contended that the post-confirmation dispute lacked a "close nexus" to the chapter 11 case, as required by the Third Circuit.

Judge Ambro explained that the close nexus test derived from *In re Resorts International Inc.*, 372 F.3d 154 (3d Cir. 2004). There, the appeals court said there is a close nexus when a dispute after confirmation "affects the interpretation, implementation, consummation, execution, or administration of a confirmed plan . . . ."

In *Resorts*, the Third Circuit found no jurisdiction for a post-confirmation malpractice suit by a litigation trust against a professional retained during the course of the bankruptcy. The malpractice suit, Judge Ambro said, had no "close connection" to the plan, would not affect the estate and would only have an "incidental effect" on the reorganized debtor.

There being no close nexus, the Third Circuit held in *Resorts* that there was no "related to" jurisdiction.

Important though *Resorts* and the close nexus test may be, Judge Ambro said that test "does not extend to core proceedings."

The dispute over the advisor's fee was a core proceeding for several reasons. First, it was core because the bankruptcy court was being asked to decide whether the claim had been discharged. Second, purporting to bind the debtor a day before the acquisition could be seen as attempting "to circumvent the bankruptcy process" and bind the reorganized debtor, Judge Ambro said.

Third, the debtor was seeking to hold the advisor in contempt of the discharge injunction. Judge Ambro cited sister circuits for holding that civil contempt proceedings are core because they arise from the confirmation order.

Judge Ambro found a second ground for jurisdiction: The bankruptcy court was being asked to interpret its own prior orders, a principle for which he cited *Travelers Indem. Co. v. Bailey*, 557 U.S. 137 (2009).

Like *Travelers*, Judge Ambro said that the debtor was asking the bankruptcy court "to enforce the discharge and injunction provisions of its plan and confirmation order after the debtor emerged from bankruptcy."

Judge Ambro set aside dismissal of the adversary proceeding because the bankruptcy court "plainly" had jurisdiction to interpret and enforce the discharge injunction. He said that the "close nexus test is not in play" because "the action was a core proceeding."

Observation

Scholars will debate whether Judge Ambro's decision enlarges the net of post-confirmation jurisdiction in the Third Circuit. What do you think?

The opinion is *Mesabi Metallics Co. v. B. Riley FBR Inc. (In re Essar Steel Minnesota LLC)*, 20-3022 (3d Cir. Aug. 25, 2022).

Foreign creditors not subject to 'specific personal jurisdiction' in the U.S. can violate the automatic stay with impunity.

Seventh Circuit Limits a U.S. Court's Jurisdiction over Creditors Abroad

While U.S. bankruptcy courts are reorganizing large companies headquartered and operating chiefly abroad, the Seventh Circuit laid down rules barring U.S. bankruptcy courts from stopping foreign creditors from taking action against a debtor's assets abroad when the U.S. court has no general or specific personal jurisdiction over the creditors.

The debtor was a U.S. citizen who borrowed money from a bank in Ireland to purchase stock in an Irish company and real property in Ireland. The debtor gave the bank a lien on the stock and real property to secure the loan.

After the debtor defaulted on the loan, the bank sold the loan to an Irish purchaser, whom we shall call the creditor. The creditor began foreclosure proceedings in Ireland. After lengthy litigation, the Irish court appointed an Irish receiver to take possession and sell the stock and the real property.

Before the receiver sold the collateral, the debtor filed a chapter 11 petition in Chicago, notified the creditor and the receiver about the bankruptcy, and demanded that the receiver return possession of the property to the debtor. The creditor and the debtor declined.

So, the debtor filed an adversary proceeding in the Chicago bankruptcy court, contending that the creditor and the receiver were violating the automatic stay. The debtor wanted the bankruptcy court to return possession of the collateral to the debtor.

The receiver and the creditor filed a motion to dismiss for lack of personal jurisdiction. The bankruptcy court granted the motion, and the district court agreed that the bankruptcy court lacked personal jurisdiction over the receiver and the creditor. The debtor appealed to the circuit.

In an opinion on September 7, Circuit Judge Ilana Rovner affirmed.

The appeal was measured against the demands of due process that a defendant from elsewhere must have minimum contacts with the forum and that maintenance of the suit must not offend notions of fair play and substantial justice.

Neither the receiver nor the creditor had any connections with Illinois, but the debtor contended that the bankruptcy court's *in rem* jurisdiction over the collateral conferred personal jurisdiction over the defendants.

The debtor's argument went nowhere. Judge Rovner conceded that the U.S. court had jurisdiction over the property in Ireland, but she said that a U.S. bankruptcy court cannot enforce the stay abroad unless the court has personal jurisdiction over the party holding the property.

Next, the debtor tried a legal fiction: The debtor's property abroad is subject to the legal fiction of being located in Illinois. Based on the fiction, the debtor contended that the actions by the receiver and the creditor "must have occurred (fictionally) in Illinois," Judge Rovner said.

Judge Rovner saw no authority for the idea "linking personal jurisdiction to *in rem* jurisdiction." Instead, she said the court must have either general or specific personal jurisdiction over the party. The debtor admitted that there was no general jurisdiction over the defendants, who were Irish citizens and conducted business in Ireland.

So, Judge Rovner turned to specific personal jurisdiction. She said it requires that the defendants must have "purposefully directed their actions at the forum state" and that the alleged injury must have arisen from forum-state activities. In addition, the exercise of jurisdiction must comport with notions of fair play and substantial justice.

Granted, the defendants had contacts with the debtor, but "the defendants' minimum contacts must be with the forum itself and not merely with a person who resides there," Judge Rovner said. Similarly, she said, the "focus on a defendant's activities means that it is not enough that the defendant took some action that ultimately had an effect on the plaintiff in the forum."

Focusing on the facts, Judge Rovner said that the "Irish defendants directed their activity at Irish property located in Ireland and which served as collateral for a loan made by an Irish bank . . . . None of the defendants did anything to reach out to the United States and affiliate themselves with the United States or Illinois." She said that specific personal jurisdiction "cannot be based on the plaintiff's mere presence in the forum or on the 'unilateral activity' of a plaintiff."

Likewise, Judge Rovner said, "the fact that the defendants could have foreseen that their conduct would affect [the debtor] in Illinois was insufficient to establish personal jurisdiction."

Concluding that the creditor and the receiver had no minimum contacts with the U.S., Judge Rovner upheld dismissal and therefore had no reason to decide whether exercising personal jurisdiction would violate notions of fair play and substantial justice.

The opinion is *Sheehan v. Breccia Unlimited Co. (In re Sheehan)*, 21-2946 (7th Cir. Sept. 9, 2022).

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

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

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

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

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

Stay-Relief Motion Denied

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

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

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

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

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

Lift-Stay Denial Was Appealable

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

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

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

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

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

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

The Merits of Stay Relief

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

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

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

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

The Dissent

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Johnson & Johnson Venue Transferred from North Carolina to New Jersey

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

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

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

The Facts

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

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

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

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

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

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

The Venue Statute

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

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

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

Convenience of the Parties

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

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

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

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

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

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

The Interests of Justice

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

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

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

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

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

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

Epilogue

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

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

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

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

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

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

The Obstreperous Debtor

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

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

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

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

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

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

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

The Doctrine and Its Limitations

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

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

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

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

The New, Limited *Barton* Doctrine Applied

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

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

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

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

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

Observations

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

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

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

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

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

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

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

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

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

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

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

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

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

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

In a case that may be headed to the U.S. Supreme Court at least once more, the Fourth Circuit is subjecting 26 multinational oil companies to the tender mercies of the Maryland state courts.

Texaco Plan in 1988 Wasn't Grounds for Removal to Federal Court, Fourth Circuit Says

The Fourth Circuit employed colorful language in holding that the confirmation of the chapter 11 plan by Texaco Inc. 34 years ago provided no basis for removing an environmental lawsuit from state court to federal court.

The litigation has already been to the U.S. Supreme Court once and was back in the Fourth Circuit after remand. The plaintiff is the City of Baltimore, having brought suit in state court by asserting only state law claims against 26 multinational oil and gas companies.

The city alleged that the oil companies contributed to greenhouse gas pollution and deceived customers when they knew for almost 50 years about the link between fossil fuels and climate change. As Circuit Judge Henry F. Floyd said in his April 7 opinion for the Fourth Circuit, the city was seeking "to shift the costs of climate-change injuries onto" the oil companies.

The defendants removed the suit to federal district court based on eight theories of federal jurisdiction. Originally, the district court remanded the suit to state court, and the Fourth Circuit affirmed. The Supreme Court reversed and remanded, for reasons of little significance to bankruptcy nerds.

After remand, the district court remanded the suit a second time to state court, prompting the defendants' second appeal to the Fourth Circuit.

Although the "impacts of climate change undoubt[ed]ly have local, national, and international ramifications," Judge Floyd said, "those consequences do not necessarily confer jurisdiction upon federal courts *carte blanche*."

Judge Floyd knocked down all of the asserted grounds for federal jurisdiction, principally because the city's suit was based only on Maryland law and there is no governing federal common law. Among other things, he said that product liability has traditionally been in the realm of state law. He said that the oil companies "have failed to show that federal common law truly controls this dispute involving their fossil-fuel products and misinformation campaign."

Judge Floyd also rejected the idea of federal jurisdiction based on the federal Clean Air Act and the concept of "federal officer removal" under 28 U.S.C. § 1442.

For ABI members, the opinion is noteworthy for its treatment of the bankruptcy removal statute, 28 U.S.C. § 1452(a). It allows a party to

> remove any claim or cause of action in a civil action other than . . . a civil action brought by a governmental unit's police or regulatory power, to the district court where such civil action is pending, if such district court has jurisdiction of such claim or cause of action under section 1334 of this title.

In turn, Section 1334(b) confers federal jurisdiction over civil proceedings arising under title 11 or arising in or related to a case under title 11.

Once a chapter 11 case has been confirmed, Judge Floyd said that the Fourth Circuit limits bankruptcy jurisdiction to disputes having a "close nexus" to the implementation, consummation, execution or administration of the plan.

For the defendants, the jurisdictional hook was the chapter 11 plan confirmed in 1988 by Texaco Inc., a subsidiary of one of the defendants.

"First," Judge Floyd said, "we find it hard to fathom how Baltimore's suit, filed thirty years later, has any 'close nexus' to Texaco's confirmed plan because it is so far removed from the initial bankruptcy confirmation."

"Secondly," Judge Floyd said, "Baltimore's claims are completely independent and distinct from Texaco's bankruptcy plan, there is no indication that the bankruptcy plan involved climate change, and Defendants do not explain how a judgment more than thirty years later could impact Texaco's estate."

In short, Judge Floyd held that "Baltimore's suit is too far removed from Texaco's 1988 confirmed plan for us to find a 'close nexus' warranting bankruptcy jurisdiction."

But Judge Floyd found a second ground for remand under Section 1452(a). It disallows the removal of a governmental unit's enforcement of police or regulatory powers, and the defendants had sought to remove a suit exercising the city's police or regulatory powers.

Baltimore indisputably is a governmental unit, and Judge Floyd had "no doubt this suit is a valid exercise of Baltimore's police power" because the city was seeking "to protect its citizens, property, and resources by suing Defendants, all of whom are private parties, for the detrimental impacts of their fossil-fuel products."

Naturally, Judge Floyd took "no view" on whether the city would prevail on its claims under state law. However, he affirmed the district court and said, "These claims do not belong in federal court."

The opinion is *Mayor and City Council of Baltimore v. BP P.L.C.*, 19-1644 (4th Cir. April 7, 2022).

Two circuit have held this month that there is no 'related to' bankruptcy jurisdiction for climate-change lawsuits against energy companies.

Another Circuit Says: Old Bankruptcies Aren't Grounds for Removal to Federal Court

For a second time in 12 days, a circuit court has held that a chapter 11 plan confirmed by an energy company doesn't permit multinational oil companies to remove a climate-change lawsuit to federal court.

Like the Fourth Circuit's decision on April 7 in *Mayor and City Council of Baltimore v. BP P.L.C.*, 19-1644, 2022 BL 121937, 2022 US App Lexis 9409 (4th Cir. April 7, 2022), the Ninth Circuit ruled on April 19 that a confirmed chapter 11 plan did not bear a "close nexus" to a climate-change lawsuit. To read ABI's report on *Baltimore*, click here.

The facts and the procedural posture in the Fourth and Ninth Circuits were similar. In 2017, six California cities and counties sued dozens of oil and gas companies in California state court, asserting only state-law claims. The plaintiffs alleged that the energy companies wrongfully promoted fossil fuels and concealed their known hazards. The plaintiffs are seeking damages for the costs to be thrust on municipalities as a result of climate warming and rising sea levels.

The energy companies removed the suit to federal court, asserting there was federal jurisdiction on six grounds, including federal question, federal enclave, federal officer removal, and bankruptcy jurisdiction. The district court rejected all assertions of federal subject matter jurisdiction. The district court stayed its remand order pending appeal to the Ninth Circuit.

In 2020, the Ninth Circuit affirmed the district court's ruling regarding the federal officer removal statute. The appeals court dismissed the remainder of the appeal for lack of appellate jurisdiction.

Meanwhile, the energies companies appealed *Baltimore* to the Supreme Court, where the high court reversed and held that 28 U.S.C. § 1447(d) permitted appellate review of all of the defendants' asserted grounds for removal. In the California case, the Supreme Court reversed and remanded for consideration in light of *Baltimore*.

So, the question of remand was back in the Ninth Circuit's lap to consider whether remand was proper despite all of the defendants' theories about federal jurisdiction.

In her April 19 opinion, Circuit Judge Sandra S. Ikuta affirmed the district court's remand. Because our readers are bankruptcy nerds, we will only discuss her opinion regarding the bankruptcy removal statute, 28 U.S.C. § 1452(a). It allows a party to

> remove any claim or cause of action in a civil action other than . . . a civil action brought by a governmental unit's police or regulatory power, to the district court where such civil action is pending, if such district court has jurisdiction of such claim or cause of action under section 1334 of this title.

In turn, Section 1334(b) confers federal jurisdiction over civil proceedings arising under title 11 or arising in or related to a case under title 11.

The energy companies based removal on the chapter 11 plan of Texaco Inc., which was confirmed in 1988, and the plan confirmed in 2017 by Peabody Energy Corp., a coal company.

In deciding whether a lawsuit is "related to" a bankruptcy, Judge Ikuta said that the Ninth Circuit has "differentiated between bankruptcy cases that are pending before a plan has been confirmed and bankruptcy cases where the plan has been confirmed and the debtor discharged from bankruptcy."

Consequently, Judge Ikuta said, "the same term 'related to' has a more limited meaning after a plan has been confirmed." When a lawsuit arises after confirmation, she said there is "related to" bankruptcy jurisdiction "only if there is 'a close nexus to the bankruptcy plan or proceeding.'"

In turn, Judge Ikuta said there is a close nexus if the new case involves the interpretation, implementation, consummation, execution or administration of the confirmed plan.

The energy companies argued there was a close nexus to the Peabody bankruptcy because the confirmed plan would have discharged the municipalities' claims in California. In fact, by the time the district had ruled on the remand motion, the Peabody bankruptcy court had directed the plaintiffs to dismiss the suit against Peabody.

Where "the district court's review of a plan involves merely the application of the plan's plain or undisputed language, and does not require any resolution of disputes over the meaning of the plan's terms," Judge Ikuta said that "the review does not 'depend upon resolution of a substantial question of bankruptcy law.'"

Judge Ikuta said that the energy defendants did not contend that the district court would be interpreting "disputed language" in the Peabody plan. "Accordingly," she said, "the complaints before the district court were not 'related to' Peabody Energy's bankruptcy case for purposes of § 1334(b), and the district court did not have removal jurisdiction over the complaints under § 1452 on that basis."

The energy's company reliance on the Texaco bankruptcy met the same fate. The energy companies did not argue that the district court would be interpreting "disputed language" in the Texaco plan, Judge Ikuta said.

"Moreover," Judge Ikuta said, Texaco's relationship to the California lawsuit was "attenuated" because Texaco was not named as a defendant. The district court, she said, would not "look at" the Texaco plan unless Texaco was held to be "a proper defendant" and the court decided that the municipalities claim arose before Texaco's confirmation in 1988.

Seeing no "close nexus" to the Texaco plan, Judge Ikuta saw no bankruptcy removal jurisdiction under Section 1452.

The opinion is *County of San Mateo v. Chevron Corp.*, 18-15499 (9th Cir. April 19, 2022).

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

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

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

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

The Criminal Subpoena

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

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

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

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

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

Barton Applied

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

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

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

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

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

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

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

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

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

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

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

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

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

Plans & Confirmation

The Second Circuit adapts Rash to value the lender's collateral in chapter 11 where there was a going-concern sale.

Second Circuit Says Orderly Liquidation Value Is Proper for a Retailer in Chapter 11

When an orderly going-out-of-business sale is a "genuine possibility" for a retailer in chapter 11, the Second Circuit says that secured lenders' collateral can be valued as of the filing date at the orderly liquidation value, less expenses, not at the higher book value or replacement cost.

The Second Circuit's October 14 opinion is an extrapolation (or perhaps departure) from *Rash*, where the Supreme Court commanded in a chapter 13 case that the value of collateral retained by the debtor must be based on the "actual use" of the collateral. *Associates Commercial Corp. v. Rash*, 520 U.S. 953 (1997).

In the case on appeal, the "actual use" of the collateral actually turned out to be a going-concern asset sale that presumably realized more than a going-out-of-business sale. The Second Circuit nonetheless upheld a valuation for less than going-concern value.

The Second Circuit worked from the proposition that the valuation must be made as of the filing date. At that time, the appeals court believed it was reasonable to expect a going-out-of-business sale rather than a going-concern sale.

The opinion is a testament to the respect that the Second Circuit has for the findings of fact by a well-regarded bankruptcy judge, Robert D. Drain of White Plains, N.Y.

The Sears Going-Concern Sale

The opinion by Circuit Judge Richard J. Sullivan was 13 months in the making. It involves the chapter 11 reorganization of Sears, the retailer that operated almost 700 stores when the filing took place in 2018.

The debtor had first- and second-lien lenders with $2.7 billion in liens on inventory. Under Section 363, Bankruptcy Judge Drain gave them "adequate protection" for the use of their collateral in the form of replacement liens and a super-priority under Section 507(b) over all other creditors' claims if there were a decline in value of the collateral after filing.

Unable to reorganize on its own, the debtor sold the business as a going concern to its largest secured creditor for about $5.2 billion. The buyer paid for the assets largely with non-cash

consideration, including a $433.5 million credit bid. Under an intercreditor agreement, second-lien lenders were obliged to participate in the credit bid.

As Judge Sullivan said, the credit bid "for practical purposes forgave debt that the Debtors owed to [the first- and second-lien lenders] in exchange for a dollar-for-dollar reduction in the purchase price."

The second-lien lenders, however, contended that the $433.5 million credit bid fell "far short" of the value of the collateral on the petition date. Rather, they argued there had been a diminution in the value of their collateral, entitling them to a super-priority claim.

To resolve the controversy, Bankruptcy Judge Drain was called on to fix the filing-date value of the collateral and then subtract the obligations to the first-lien lenders as of the filing date. Judge Sullivan said that the second-lien holders would "have a viable section 507(b) super-priority claim only if this figure exceeds the $433.5 million credit bid [that the buyer] already recouped in the transaction."

Judge Sullivan described how the bankruptcy court had heard from expert witnesses whose collateral values "varied widely." He characterized Judge Drain as having considered the full retail price as the highest valuation and a going-out-of-business liquidation for the lowest value.

Instead, Judge Drain settled on the so-called NOLV, or net orderly liquidation value, which Judge Sullivan defined to mean "an orderly company-wide going out of business sale that would sell the Debtors' assets at more than their liquidation value, but less than their full retail price."

Judge Sullivan said that Judge Drain adopted the "NOLV because, on the Petition Date, a complete liquidation of the Debtors' assets was a genuine possibility." After deducting overhead and legal fees, Judge Drain found as a fact that the filing-date value of the inventory was 87.4% of book value, or about $2.15 billion.

From the $2.15 billion, Judge Drain subtracted first-lien claims totaling almost $2 billion, yielding a net of $187 million for second-lien creditors. Since the second-lien holders "had already realized more than this from the $433.5 million credit bid, the bankruptcy court held that they were not entitled to any further recovery in the form of section 507(b) super-priority claims," Judge Sullivan said.

The junior lenders appealed, but the district court affirmed, and so did Circuit Judge Sullivan.

The Law on Chapter 11 Valuations, According to the Second Circuit

The junior lenders argued on appeal that the bankruptcy court should have valued the inventory at book value or replacement value. Judge Sullivan measured the argument against *Rash* and

Section 506(a)(1). The section says that the value of collateral "shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property . . . ."

Rash was a chapter 13 case involving a truck. The Supreme Court held that the bankruptcy court was required to use "replacement value" because the debtor retained and continued to use the truck. Judge Sullivan characterized *Rash* as respecting "the debtor's 'actual use' of the collateral, 'rather than' taking cues from 'a foreclosure sale that will not take place.'" *Rash, supra*, at 963.

The Sears valuation intimately involved Section 506, which requires consideration of the "disposition or use" of collateral. Judge Sullivan said that *Rash* "had no need to address" Section 506. He also said that *Rash* did not involve the valuation of retail inventory.

Still, Judge Sullivan said that *Rash* was "instructive" because the debtor had elected to use the truck to generate income. Thus, he said, "actual use" was the proper guide for valuation.

Judge Sullivan inferred that "*Rash* contemplated that one *particular* use or disposition must be proposed, and that this proposal must guide the valuation exercise." [Emphasis in original.] Deferring to the bankruptcy court's findings, he said that Judge Drain "reasonably decided" on using NOLV because it assessed "what the Debtors would likely be able to recoup from the collateral." He characterized NOLV as "somewhere between a forced liquidation and . . . full retail price."

"Far from being erroneous," Judge Sullivan said that NOLV "was, by any measure, a sensible one."

No to Retail Value

Because the debtor did not liquidate immediately, the junior lenders argued that the court should have used retail value, given that the stores continued operating after filing.

"But," Judge Sullivan said, valuation "turned on the value of the collateral on the Petition Date, without inquiring into how the collateral was *ultimately* used." [Emphasis in original.] In a footnote, he noted how the lenders proffered no authority for the idea that the court must make the filing-date valuation "in light of subsequent developments."

Again deferring to the bankruptcy court's findings, Judge Sullivan said that Judge Drain's "decision to settle on an orderly liquidation value was therefore not an unreasonable conclusion."

Judge Sullivan ended his review of inventory valuation by focusing on whether 87.4% of book value was "clear error." He found "no error of fact or law."

The last few pages of Judge Sullivan's opinion dealt with two other types of collateral. One was inventory in transit on the filing date, to which Judge Drain gave no value. The other was almost $400 million in letters of credit that were undrawn on the filing date and were the lenders' collateral.

As to both, the lenders suffered from a failure of proof. Judge Sullivan said that Judge Drain "reasonably rejected" the only valuation proffered by the lenders for in-transit inventory. With regard to the letters of credit, he said that the lenders made "little effort to defend a valuation other than 'zero.'"

Affirming the lower courts, Judge Sullivan ruled that "the bankruptcy court did not commit clear error by denying the second-lien holders' section 507(b) claims."

The opinion is *ESL Investments Inc. v. Sears Holding Corp. (In re Sears Holding Corp.)*, 20-3343 (2d Cir. Oct. 14, 2022).

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

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

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

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

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

Prof. Ralph Brubaker agrees. He told ABI:

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

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

The Decision Is Limited

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

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

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

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

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

The Executive Summary

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

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

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

In her summary, Judge McMahon summed up her holding:

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

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

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

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

The Facts

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

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

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

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

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

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

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

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

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

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

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

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

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

The Chapter 11 Plan

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

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

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

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

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

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

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

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

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

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

Stern v. Marshall

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

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

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

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

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

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

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

Subject Matter Jurisdiction

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

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

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

Statutory Authority for Non-Debtor Releases

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

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

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

The Primacy of Section 524(g)

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

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

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

The Split Among the Circuits

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

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

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

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

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

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

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

The Debtor's Other Arguments

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

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

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

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

Scholarly Commentary

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

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

To read the forthcoming article, click here.

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

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

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

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

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

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

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

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

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

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

Takeaways

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

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

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

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

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

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

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

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

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

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

The Facts

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

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

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

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

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

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

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

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

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

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

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

Standing to Appeal

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

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

The Constitution and Third-Party Releases

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

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

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

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

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

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

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

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

Consequences of a *Stern* Violation

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

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

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

The Circuit Split on Third-Party Releases

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

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

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

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

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

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

Severability

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

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

Equitable Mootness

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

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

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

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

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

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

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

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

The Exculpation Provisions

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

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

Remand

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

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

Another Appeal?

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

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

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

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

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

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

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

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

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

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

The Plan and the Release

The debtor signed a three-year commercial lease. The debtor's corporate parent issued an unconditional guarantee in favor of the landlord.

The pandemic intervened, and the debtor was never able to open a store in the leased premises. Eventually, the debtor filed a chapter 11 petition, rejected the lease and confirmed a plan.

The plan contained a release reading in pertinent part as follows:

> [A]ll Persons who . . . hold Claims . . . that are subject to . . . the Plan . . . are deemed to have released the Debtor, Reorganized Debtor, the Estate and each of their affiliates, current and former officers, directors, principals, members, professionals, advisors, accountants, attorneys, investment bankers, consultants, employees, agents, and other representatives (collectively, the "Released Parties"), from any and all claims . . . , *including any direct claims held by any such Person against each Released Party* . . . whether known or unknown, . . . that each such Person would have been legally entitled to assert, . . . based on or relating to . . . the Debtor or its affiliates. [Emphasis added.]

After the plan was confirmed and consummated, the landlord sued the parent on the guarantee in district court in New York. The landlord and the parent filed cross motions for summary judgment.

The parent wins, right? The parent was an affiliate of the debtor, and the guarantee was related to the debtor. It's open and shut, isn't it? There was no suggestion in the opinion that the landlord was unaware of the bankruptcy or the plan. So, didn't the plan release the landlord's claim on the guarantee against the parent?

Answer: No. Not by a long shot.

Narrow Reading of the Plan

Tellingly, Judge Cote began her legal analysis by quoting *Metromedia* where the Second Circuit said that plans may contain third-party releases in "rare cases." *In re Metromedia Fiber Network*, 416 F.3d 136, 141 (2d Cir. 2005). Later in the opinion, she would remark how the parent never explained "why this is one of the 'rare cases' in which a nondebtor release would be essential to the reorganization plan."

Focusing on the plan, Judge Cote said that releases in favor of officers, directors and other entities had to do their potential liability on derivative claims. The landlord's claim, she said, was not derivative. It was direct and primary.

However, the plan explicitly released creditors' direct claims. In other words, without saying so directly, Judge Cote was at least suggesting that a nondebtor release may only pertain to derivative claims.

Next, Judge Cote focused on the word "affiliate," because the plan broadly released claims against the debtor's affiliates.

The parent alluded to the definition of "affiliate" in Section101(2)(A), which includes an entity controlling at least 20% of a debtor's voting securities. Wouldn't "affiliate" cover the parent?

No, Judge Cote said. The definition in Section 101(2)(A) was "irrelevant" because the plan said that capitalized terms would have the meaning given in the Bankruptcy Code. In the plan, "affiliate" bore a lower case "a."

Judge Cote cited an authority that distinguishes between affiliates and parents.

In addition, the plan several times referred to "Parent." Judge Cote said that the drafters of the plan knew how to refer to the parent but didn't when it came to the releases.

Next, Judge Cote said that adoption of the parent's interpretation of the plan "would lead to extreme results." She said that the broad language in the plan would release any claim that any

creditor had against the parent, "regardless of whether that claim had anything to do with [the debtor]."

We heard the same refrain in the district court's opinion overturing confirmation of the chapter 11 plan of Mahwah Bergen Retail Group Inc. and affiliates. *See Patterson v. Mahwah Bergen Retail Group Inc.*, 21-167, 2022 BL 13068, 2022 US Dist. Lexis 7431 (E.D. Va. Jan. 13, 2022). To read ABI's report, click here.

[Note: This writer reads the release quoted above as only releasing a claim that a creditor had against the parent if that claim was related to the debtor.]

Because it was not a "rare" case, Judge Cote ruled that the landlord was entitled to enforce the guarantee against the parent.

Before entering summary judgment against the parent for more than $2 million, Judge Cote dismissed the parent's other affirmative defenses, including failure of consideration and impossibility of performance.

Observations

Looking only at the language of the release in view of the finality of the plan, Judge Cote's ruling might be upset on appeal.

However, an appellate court might find other reasons to affirm.

Notably, the plan released the landlord's direct claim against the parent seemingly without additional consideration. Releases of that sort stuck in the craw of District Judge Colleen McMahon of Manhattan when she overturned confirmation in *In re Purdue Pharma LP*, 635 B.R. 26 (S.D.N.Y. Dec. 16, 2021). However, there was a timely appeal in *Purdue,* and the plan had not been consummated. To read ABI's report on *Purdue*, click here.

Perhaps the bankruptcy court lacked subject matter jurisdiction or constitutional power on its own to release direct claims. Perhaps a circuit court would say that a plan provision is unenforceable if the bankruptcy court lacked constitutional power under *Stern*.

What we are seeing is Article III courts' animosity toward third-party releases. This writer recommends that bankruptcy courts sense which way the wind blows and trim third-party releases back to the bone before circuit courts or Congress toss them out altogether.

The opinion is *605 Fifth Property Owners LLC v. Abasic S.A.*, 21-811 (S.D.N.Y. March 8, 2022).

Dissenter in the Ninth Circuit would have held that unimpaired creditors of a solvent debtor get no interest whatsoever, although impaired creditors are entitled to interest.

Solvent Debtor's Unimpaired Creditors Get Higher Interest Rate, Ninth Circuit Says

The first appeals court to decide a question where the lower courts are split, the Ninth Circuit ruled in a 2/1 opinion that unimpaired, unsecured creditors in a chapter 11 case are presumptively entitled to interest at the contract rate or the default rate for judgments under state law, rather than the lower federal judgment rate.

Like every circuit to consider the issue, the Ninth Circuit also held that the judge-made, solvent-debtor exception survived adoption of the Bankruptcy Code in 1978.

The dissent would have held that unimpaired, unsecured creditors are entitled to no interest whatsoever, be it the contract rate or the judgment rate under federal law. Believing that the solvent-debtor exception did not survive adoption of the Bankruptcy Code, the dissenter would have given no interest to *un*impaired creditors, although *impaired* creditors in a cramdown would receive interest from a solvent debtor.

The PG&E Plan

California power company Pacific Gas & Electric Co. filed a chapter 11 petition to deal with overwhelming claims stemming from wildfires caused by defective equipment. At filing and on confirmation of its plan, the company was and remained solvent, according to the August 29 opinion for the majority by Circuit Judge Carlos F. Lucero, sitting by designation from the Tenth Circuit.

Claims resulting from damage by wildfires were impaired by the plan, but PG&E's general unsecured creditors were deemed unimpaired by the plan. Overruling objections by holders of trade claims, the bankruptcy court ruled that unimpaired, unsecured creditors were only entitled to interest at the federal judgment rate of 2.59%. Trade creditors had wanted interest either at the rates provided in their contracts or at the 10% default rate under California law.

PG&E estimated that the higher rates of interest for general, unsecured creditors would cost about $200 million.

The district court affirmed, and trade creditors appealed to the circuit. The appeal was argued in December.

History of the Solvent-Debtor Exception

Judge Lucero framed the question as: "[W]hat rate of postpetition interest must a solvent debtor pay creditors whose claims are designated as unimpaired pursuant to § 1124(1) of the Bankruptcy Code?" He said that no other circuit had decided the question and that the lower courts are split.

Judge Lucero cited a bankruptcy court in Houston for holding that unimpaired creditors are entitled to the contract rate. One bankruptcy court in Delaware called for the court to rely on "equitable principles," while another Delaware bankruptcy court decided that the federal judgment rate applied to unimpaired creditors.

To begin answering the question, Judge Lucero traced the history of the so-called solvent-debtor exception. In the eighteenth century, English courts adopted the exception to the general rule that interest cuts off at filing. The exception meant that unsecured creditors received interest on their claim from the filing date until the date of distribution, before returning the surplus to the debtor.

U.S. courts, Judge Lucero said, adopted the solvent-debtor exception and continued its application following adoption of the Bankruptcy Act of 1898, even though it was not codified in the words of the statute. Quoting the Seventh Circuit, he said that "multiple circuit courts" adopted the exception "'simply to enforce creditors' rights according to the tenor of the contracts that created those rights.'" It was, he said, "well established under the Bankruptcy Act."

Judge Lucero then turned to the question of whether the Bankruptcy Code continued or abandoned the exception. He said, "No provision of the Code specifies the rate of postpetition interest a creditor must receive from a solvent debtor to be unimpaired."

The starting point was Section 1124(1), which provides that a claim is impaired unless it "leaves unaltered the [creditor's] legal, equitable, and contractual rights . . . ." Section 1129(a)(7)(A)(ii) contains the so-called best-interests test applicable in a cramdown. It says that creditors must receive not less than what they would have received in a chapter 7 liquidation.

In a cramdown, Section 726(a)(5) means that unsecured, *impaired* creditors are entitled to the "legal rate" of interest, which the Ninth Circuit interpreted to mean the federal judgment rate in *In re Cardelucci*, 285 F.3d 1231 (9th Cir. 2002). "Conversely," Judge Lucero said, "no Code provision applies § 726(a)(5) to *unimpaired* chapter 11 claims." [Emphasis in original.]

Cardelucci involved the interpretation of Section 726(a)(5), which pertains in chapter 11 cases only when the best-interests test must be applied. Judge Lucero rejected the debtor's contention that *Cardelucci* controlled and also imposed the federal judgment rate on unimpaired creditors.

Although the *Cardelucci* opinion did not say so, Judge Lucero said that the creditors were impaired. The two lower courts were therefore in error by making *Cardelucci* and its lower interest rate applicable to unimpaired creditors.

With no controlling precedent in the Ninth Circuit, Judge Lucero searched for the applicable rate in the Code or common law.

The Exception Was Not Abrogated by the Code

Judge Lucero cited the Supreme Court for the proposition that the Bankruptcy Code will not be read to "erode" past practice "'absent a clear indication that Congress intended such a departure.' *Cohen v. de la Cruz*, 523 U.S. 213, 221 (1998)." In that regard, he said, "No Code provisions — alone or together — unambiguously displace the long-established solvent-debtor exception or preclude supposedly unimpaired creditors from asserting an equitable right to contractual postpetition interest."

For example, Judge Lucero said that Section 502(b)(2) excluded postpetition interest from "the amount of" a claim and did not ban interest entirely. Similarly, he pointed to the amendment that deleted former Section 1124(3) in 1994. Before deletion, that section had been interpreted to mean that an unimpaired creditor received no interest.

"In sum," Judge Lucero said, "we agree with [trade creditors] that the Code lacks any 'clear indication,' *Cohen*, 523 U.S. at 221, that Congress meant to displace the historic solvent-debtor exception." He therefore held, like "multiple sibling circuits," that the "passage of the Code did not abrogate the solvent-debtor exception, any more than passage of the Bankruptcy Act did so."

What Rate to Apply?

Next, Judge Lucero addressed the interest rate to apply to unimpaired, unsecured claims. He said that "no provision of the Code expressly provides for postpetition interest for unimpaired creditors."

On the other hand, Judge Lucero said that the unimpaired creditors' "equitable" rights under Section 1124(1) entitle them "to recovery of interest pursuant to their contracts." Nonetheless, he did not specify the rate to impose on remand, be it the contract rate or the default rate under state law.

Judge Lucero called on the bankruptcy court "to weigh the equities and determine what rate of interest plaintiffs are entitled to in this instance." Even so, he said that the bankruptcy court would not have "free-floating discretion."

In "most cases," the judge said, the court will enforce a creditor's contractual right to interest, unless the "payment of contractual or default interest could impair the ability of other similarly situated creditors to be paid in full." Although the record was "limited," Judge Lucero saw "no sign of any 'compelling equitable considerations' in this case that would defeat the presumption that plaintiffs are entitled to contractual or default postpetition interest."

For himself and Circuit Judge Lawrence VanDyke, Judge Lucero reversed and remanded in 28 pages.

The Dissent

Circuit Judge Sandra S. Ikuta dissented in a 21-page opinion that took an entirely different approach. She saw the Code as "clear" and that it "does not authorize an award of post-petition interest to unimpaired creditors."

Under Section 502(b)(2), Judge Ikuta said, "there is no dispute" that claims stop accruing interest on filing. She said there must be a provision in the text of the Code to reinstate interest, and she found none in the case of unimpaired creditors.

Judge Ikuta saw the solvent-debtor exception as having been "implicitly incorporated" in several provisions of the Code, but none were applicable to unimpaired creditors. She pointed to Section 726(a)(5), which makes interest the fifth priority in a chapter 7 liquidation, but that section does not apply generally in chapter 11. It only comes into play when addressing best interests on cramdown of impaired creditors under Section 1129(a)(7)(a)(ii).

Addressing the majority's "policy" argument that unimpaired creditors should be treated no worse than impaired creditors, Judge Ikuta said that policy considerations are for Congress to consider, not the courts.

Refusing to believe that the nonstatutory exception survived adoption of the Code, Judge Ikuta said that unimpaired creditors should be governed by the general rule disallowing postpetition interest.

Note: On appeal, the debtor did not argue, like Judge Ikuta would have ruled, that unimpaired creditors are entitled to no interest. The debtor advocated for the federal judgment rate.

Observation

The opinions do not speak of "plain meaning." Still, the opinions demonstrate how radically different the results can be when judges use their common sense or when they struggle to find the answer only in the text of a statute on a question that Congress surely did not consider.

The opinion is *Ad Hoc Committee of Holder of Trade Claims v. Pacific Gas & Electric Co. (In re Pacific Gas & Electric Co.)*, 21-16043 (9th Cir. Aug. 29, 2022).

Mallinckrodt's nondebtor releases didn't have the defects that infected Purdue and Patterson.

Horizontal 'Gifting' Approved in Mallinckrodt's Confirmed Chapter 11 Plan

On top of crippling opioid liability, drug-producer and distributor Mallinckrodt was saddled with securities class actions and lawsuits by governmental units regarding a different drug called Acthar. The chapter 11 petition filed in October 2020 was the only hope for avoiding slow corporate death and liquidation from insufferable litigation costing $1 million a week.

Before and after filing, the debtor hashed out settlements and a chapter 11 plan that garnered approval from every fiduciary, almost every organized creditor group and 88% of voting creditors. The plan has $1.725 billion in cash, new secured notes, warrants and other consideration parceled out among the creditor classes.

Of course, there were dissenters, including the U.S. Trustee, the Securities and Exchange Commission and classes deemed to reject the plan. With a minor modification of exculpations that were overly broad, Bankruptcy Judge John T. Dorsey of Delaware confirmed the plan in a 98-page opinion on February 3.

The confirmed plan had nondebtor, third-party releases. However, the alleged shortcomings in Mallinckrodt's plan did not rise to the level that recently resulted in reversals of confirmation in New York and Virginia. *See In re Purdue Pharma LP*, 21-07532, 2021 BL 482465, 2021 WL 5979108, 2022 US Dist Lexis 8160 (S.D.N.Y. Dec. 16, 2021); and *Patterson v. Mahwah Bergen Retail Group Inc.*, 21-167, 2022 BL 13068, 2022 US Dist Lexis 7431 (E.D. Va. Jan. 13, 2022). To read ABI's reports, click here and here.

Although some may disagree, Mallinckrodt's plan would not have been offensive to the district judge in *Purdue*, because it did not release creditors' nonderivative, direct claims against nondebtors. Although subject more to doubt, Mallinckrodt's plan might not have offended the district judge in *Patterson*, because the creditor groups giving nondebtor releases negotiated the plan and are receiving substantial recoveries.

However, the district judge in *Patterson* might believe that Judge Dorsey erred in ruling that the bankruptcy court had constitutional power to issue releases in favor of third parties.

Mallinckrodt's plan is notable in several respects, according to Prof. Bruce A. Markell. He told ABI:

> The opinion accomplishes everything I would want, but very little I would grant. It tackles all the current hot-buttons of mass tort reorganization — third party releases, consents obtained through the use of opt-outs, and validation of gifting that freezes out identifiable classes to the benefit of those favored by the donor — and resolves each of them in favor of the debtor's reorganization. Unfortunately, I disagree that the reorganization achieved is one anticipated or authorized by the Code. The result may be the best one possible on utilitarian grounds, but those grounds are not written into the Code nor have they been embraced or enacted by Congress.

Prof. Markell is the Professor of Bankruptcy Law and Practice at the Northwestern Univ. Pritzker School of Law.

Chapter 11 practitioners should set aside several hours to read the opinion in full text.

Nondebtor Releases

The plan releases claims against nondebtors, such as officers and directors. Unlike *Millennium Lab Holdings II, LLC*, 945 F.3d 126 (3d Cir. 2019), where shareholder defendants paid $325 million for their releases, the U.S. Trustee opposed the releases because the released third parties are paying nothing for theirs. For ABI's report on *Millennium*, click here.

Judge Dorsey noted that the third-party releases were negotiated, to a large extent, with fiduciaries for claimants giving the releases. Were there no releases, he said that the debtor would be dragged back into litigation in view of indemnification rights. If there were continued litigation and no settlements and releases, Judge Dorsey concluded that claimants would have lower recoveries because the debtor would end up in liquidation.

With regard to releases that might be nonconsensual for some classes, Judge Dorsey said it was "exactly the type of extraordinary case the Third Circuit alluded to in *Continental*, where nonconsensual releases might be appropriate." For the classes that negotiate the settlements and releases, he said they were "both necessary and fair" and "overwhelmingly supported by the creditor body."

To the argument that the bankruptcy court lacked statutory or constitutional power, "the fact is," Judge Dorsey said, "that only one single creditor out of hundreds of thousands actually objected to these releases. To apply a blanket prohibition on non-consensual releases in this case would simply not make sense."

Opting Out

The Securities and Exchange Commission and the U.S. Trustee objected to releases on the part of shareholders, arguing that the releases were impermissibly nonconsensual because the class was deemed to reject the plan. They contended that the ability to opt out did not make the releases consensual and subjected the releases to the *Continental* test.

Despite the debtor's extensive trolling for opt-outs, Judge Dorsey said there had only been 2,200. Conceding that not all courts agree, he decided "that they are appropriate." He noted that the plan was "supported by every estate fiduciary, almost every organized creditor group, and 88% of voting creditors."

Unfair Discrimination, Horizontal Gifting

The so-called waterfall proffered by the debtor indicated that some subgroups of unsecured creditors would receive no recovery if distributions were made solely in accordance with bankruptcy priorities. Significantly, unsecured noteholders held guarantees from all of the myriad debtor entities. Other unsecured creditor groups might have recourse against only one debtor entity with little value.

The waterfall revealed that unsecured noteholders would be entitled to $1.4 billion. Under the same scenario, other general unsecured creditors receive $22.5 million, but only three of the seven subclasses would receive anything at all.

"To avoid litigation with constituents in the other unsecured classes and facilitate settlements," Judge Dorsey said that the noteholders "agreed to reallocate or 'gift' $228.5 million of their Entitled Recovery" to other classes of unsecured creditors.

As a result, Judge Dorsey said one subclass of unsecured creditors with $41 million in claims would have its recovery rise from 1% to 100%. Another subclass would go from nothing to 4%.

To analyze the propriety of gifting in the case before him, Judge Dorsey adopted the test proffered by Prof. Markell and decided there was a rebuttable presumption of gifting that would amount to unfair discrimination prohibited by Section 1129(b)(1).

On the question of unfair discrimination, Judge Dorsey found none, because the debtor had rebutted the presumption. He cited Third Circuit authority and said it is "irrelevant" when one "out of the money unsecured creditor class is doing better" than another out-of-the-money creditor.

Observations

Prof. Markell is the leading scholarly authority among those who believe that gifting is not permitted by the Bankruptcy Code. His commentaries are to be found in Bruce A. Markell, "A New Perspective on Unfair Discrimination in Chapter 11," 72 *Am. Bankr. L.J.* 227 (1998); and

Bruce A. Markell, "The Clock Strikes Thirteen: The Blight of Horizontal Gifting," 38 *Bankr. L. Ltr.* 12 (Dec. 2018). To read his more recent discussion, click here.

In his later work on horizontal gifting, like that afoot in Mallinckrodt's plan, Prof. Markell contends there is no gift. Rather, he says, the gift-giver is obtaining releases and injunctions and a shorter path to confirmation. He said, "Creditors ought not to be able to change results Congress picked by bribes to out-of-the-money classes."

The opinion is *In re Mallinckrodt PLC*, 20-12522 (Bankr. D. Del. Feb. 3, 2022).

The first court of appeals to reach the issue decides that the SBA properly interpreted the CARES Act to bar chapter 11 debtors from receiving PPP 'loans.'

Second Circuit Holds that Debtors Are Properly Barred from Receiving PPP Loans

On an issue where the lower courts are divided, the Second Circuit became the first court of appeals to rule that a "loan" under the Paycheck Protection Program, "as a matter of law, . . . is a loan guaranty program and not an 'other similar grant,' and thus is not covered by [the antidiscrimination provision in] Section 525(a)" of the Bankruptcy Code.

In other words, the Small Business Administration properly barred companies in chapter 11 from receiving PPP "loans," according to a March 16 opinion by Circuit Judge Joseph F. Bianco.

The Debtor Wins in Bankruptcy Court

The Paycheck Protection Program, or PPP, was part of the $2.2 trillion Coronavirus Aid, Relief and Economic Security Act (CARES Act), which became law in March 2020. Although denominated as a loan, it will be forgiven if the proceeds are spent on eligible expenses like payroll and rent.

A hospital in Vermont was in chapter 11 and applied for a PPP loan. The Small Business Administration denied the loan solely because the debtor answered "yes" to a question on the loan application asking whether the borrower was in bankruptcy.

The debtor sued the SBA in bankruptcy court, where the judge decided that a PPP "loan" was a "grant" protected by the antidiscrimination provision in Section 525(a). The bankruptcy court granted summary judgment in favor of the debtor and entered a permanent injunction requiring the SBA to make the loan. *Springfield Hospital Inc. v. Carranza (In re Springfield Hospital Inc.)*, 618 B.R. 70 (Bankr. D. Vt. June 22, 2020). To read ABI's report, click here.

The bankruptcy court authorized a direct appeal, which the Second Circuit accepted.

The Circuit Sides with the Majority

In his 53-page opinion, Judge Bianco said that 18 courts to date have ruled that the PPP is not protected by Section 525(a), while six courts have decided that the section requires the SBA to grant loans to businesses in chapter 11.

Principally, Judge Bianco found the answer in the plain language of Section 525(a), which provides:

> [A] governmental unit may not deny . . . a license, permit, charter, franchise, or other similar grant to . . . a person that is or has been a debtor under this title . . . .

A PPP loan was not a license, permit, charter or franchise. Judge Bianco therefore focused on whether it was a "grant," a word not defined in the statute.

Two Second Circuit decisions were controlling: *In re Goldrich*, 771 F.2d 28 (2d Cir. 1985), and *Stoltz v. Brattleboro Hous. Auth. (In re Stoltz)*, 315 F.3d 80, 90 (2d Cir. 2002). In *Goldrich*, the circuit held that Section 525, as it was then written, did not cover a guaranteed student-loan program.

Almost a decade after *Goldrich*, Judge Bianco said that "Congress amended Section 525 to include a subsection prohibiting discrimination against debtor-borrowers by any 'governmental unit that operates a student grant or loan program.' 11 U.S.C. § 525(c)."

In *Stoltz*, the Second Circuit held that a lease for a public housing unit was a "grant" protected by Section 525(a).

Taken together, Judge Bianco said that the two opinions mean that a "grant" is something that is "'unobtainable from the private sector' [and] 'essential to a debtor's fresh start.' *Stoltz v. Brattleboro Hous. Auth. (In re Stoltz)*, 315 F.3d 80, 90 (2d Cir. 2002)."

Judge Bianco said that *Goldrich*, which precluded loans from coverage in Section 525(a), remained good law after *Stoltz.* He said that the amendment to Section 525 "narrowly abrogated *Goldrich'*s specific holding as to *student* loans but had not abrogated its broader holding that Section 525(a) did not cover loans in general." [Emphasis in original.]

"[W]e reaffirm here," Judge Bianco said, "that the plain text of Section 525(a) does not cover loan programs."

PPP 'Loans' Aren't Grants

Even if loans are not protected by Section 525(a), the debtor contended that PPP loans are actually grants.

Judge Bianco disagreed. He said that the CARES Act refers to PPP loans as "loans" 75 times. Furthermore, he said, the forgiveness of PPP loans is "neither automatic nor guaranteed."

Judge Bianco again referred to the dual standards in *Goldrich/Stoltz*. Unlike the refusal to grant a license that would put a company out of business, he said that the refusal of the SBA to grant a loan does not exclude a debtor "from receiving capital from other sources," nor is an SBA loan "essential to a debtor's fresh start."

Subsequent Legislation

Although Judge Bianco found the answer in the plain language of the statute, he said that "the additional PPP legislation enacted after the Cares Act provides further support for our interpretation of Section 525(a)."

In the Consolidated Appropriations Act of 2021, he said,

> Congress amended Section 525 to expressly bar discrimination based on bankruptcy status in the provisioning of certain Cares Act benefits — such as foreclosure moratoriums, 15 U.S.C. § 9056, forbearance of certain residential mortgages, *id.* § 9057, and eviction moratoriums, *id.* § 9058 — but notably did *not* include PPP loans in this amendment. [Emphasis in original.]

Judge Bianco drew a "clear negative inference from this amendment . . . that other provisions of the Cares Act are *not* covered by Section 525(a)." [Emphasis in original.]

Judge Bianco vacated the permanent injunction and remanded with instructions that the SBA was entitled to summary judgment in its favor. However, he did not rule on whether the SBA was "immune from injunctive relief" under Section 634(b)(1) of the Small Business Act.

The opinion is *Guzman v. Springfield Hospital Inc.*, 20-3902 (2d Cir. March 16, 2022).

To take advantage of a change in decisional law, a plan must be modified within the time limits imposed by Federal Rule 60(c), the Seventh Circuit says.

Change in Decisional Law Requires Plan Amendment in One Year, Seventh Circuit Says

If the law changes dramatically after confirmation of a plan, the Seventh Circuit tells us that the debtor must move within one year of confirmation to amend the plan. Otherwise, the debtor will be stuck with the original plan and a provision no longer reflective of the law.

The debtors confirmed a 60-month chapter 13 plan that dealt with a $30,000 claim by the state for overpayment of public assistance. The plan treated the state's claim as having Section 507(a)(1)(B) priority as a "domestic support obligation." Owing secured debt and unpaid taxes, the plan would have paid little of the state's priority support claim.

Four months after confirmation, the Seventh Circuit handed down *In re Dennis*, 927 F.3d 1015 (7th Cir. 2019). In *Dennis*, the Chicago-based appeals court held that overpayments of public assistance are not entitled to Section 507(a)(1)(B) priority as a "domestic support obligation." To read ABI's report on *Dennis*, click here.

Had *Dennis* been the law when the debtors confirmed their plan, the duration of the plan would have been only 36 months, saving them considerable amounts. However, the debtors and their counsel did not become aware of *Dennis* until more than one year after the plan was confirmed.

Finally aware of *Dennis*, the debtors filed a motion objecting to the state's priority claim about 17 months after confirmation. According to the July 12 opinion by Circuit Judge Frank H. Easterbrook, the bankruptcy court "sensibly treated" the application as a motion to amend the plan, not as a claim objection.

Over the state's objection, the bankruptcy court eliminated the state's priority status and shortened the duration of the plan from 60 to 36 months. The state appealed, and the Seventh Circuit agreed to hear a direct appeal.

The eight-page opinion by Judge Easterbrook is largely an exploration of the grounds for *not* allowing the bankruptcy court to amend the plan. We will mention just a few. So our readers will not be held in suspense, Judge Easterbrook saw no basis for amending the plan and reversed.

Judge Easterbrook found his own reasons for reversal, not those proffered by the state.

First, the state argued that the confirmed plan was binding on the debtors under Section 1307(a). Judge Easterbrook said it was proper to say that the plan was binding on the debtors "unless modified."

Although binding, Judge Easterbrook said that confirmation orders "like other kinds of judicial orders . . . may be revisited and changed through authorized means."

Judge Easterbrook said that Section 1329 did not supply grounds for amending the plan, "for good reason." That section, he said, contains "a lengthy list of authorized changes, but eliminating the priority of a claim . . . is not among the sorts of changes covered by Section 1329."

Nonetheless, Section 1329 was not the debtor's only potential salvation. Judge Easterbrook identified Civil Rule 60(b)(1), made applicable by Bankruptcy Rule 9024. The rule allows relief from a judgment attributable to a "mistake," among other grounds. As *Dennis* demonstrated, belief that the claim was entitled to priority was a mistake.

Judge Easterbrook said that the debtors "could have sought timely relief under Rule 60(b)(1) . . . when *Dennis* was decided," but they did not. They did not move to modify the plan until more than one year had elapsed since confirmation, and Rule 60(b)(1) has a time limitation of one year under Rule 60(c)(1).

Bankruptcy Rule 9024(1) provides that the time limitations in Rule 60(c) do not apply to a motion to reopen a case or to reconsider allowance of a claim that had been allowed without contest, but Judge Easterbrook said it was no help for the debtors.

The debtors' best hope might have been the catch-all in Rule 60(b)(6), which allows relief from a judgment for "any other reason that justifies relief." However, Rule 60(c) requires that the motion be made "within a reasonable time."

Judge Easterbrook said it was "hard to see" how 17 months was "reasonable."

Judge Easterbrook ended his opinion by considering whether the state had waived its right to rely on the time limitations governing Rule 60(b).

In the court below and in briefing in the circuit, neither party had mentioned Rule 60(b). Indeed, the rule wasn't mentioned until questions from the bench at oral argument. Judge Easterbrook said that the state could not forfeit a right "by remaining silent about a topic to which its adversary and the judge never adverted."

"A bankruptcy court needs authority from a statute, rule, or the litigant's consent to modify a confirmed plan of reorganization," Judge Easterbrook said. Reversing, he said, "Modification is

possible in principle, but the [debtors] acted too late to use Rule 60(b), the best if not the only source of authority for the relief they were seeking."

Observation

Assuming other courts would agree with Judge Easterbrook, the opinion seems to mean that a change in decisional law would similarly require modification of a chapter 11 plan within one year of confirmation.

The opinion is *In re Terrell*, 21-3059 (7th Cir. July 12, 2022).

The appeals court barred the holder of a personal guarantee from launching a collateral attack on a confirmed chapter 11 plan.

Reducing a Personal Guarantee Under a Plan Isn't a Discharge, Fifth Circuit Says

Although the Fifth Circuit is among the most restrictive courts of appeals when it comes to non-debtor, third-party releases, the New Orleans-based court once again held that a chapter 11 plan can reduce the amount of a non-debtor guarantor's liability to a creditor.

A couple owned a corporation that operated a grocery store. The couple owned the real estate occupied by the grocery store. The store borrowed $325,000. The couple personally guaranteed the debt and secured the debt with a mortgage on the store and a mortgage on their home.

The grocery store filed a chapter 11 petition and confirmed a plan that called for surrendering the store and its contents to the lender in return for a $225,000 reduction in the couple's debt on their personal guarantee. The lender had an unsecured claim for the $100,000 deficiency.

After confirmation, the lender evidently decided that the store was not worth $225,000. The lender apparently believed it would have a larger recovery by asserting a claim against the couple for the entire $325,000.

So, the lender began foreclosure proceedings against the couple's home. The couple filed their own chapter 11 petition in response.

Overruling the lender's objection, the bankruptcy court confirmed the couple's chapter 11 plan and held that their debt to the lender had been reduced to $100,000. The district court affirmed, ruling that the lender could not relitigate the debt that had been reduced to $100,000 in the grocery store's confirmed chapter 11 plan.

Circuit Judge Gregg Costa affirmed once again in an opinion on November 12.

According to Judge Costa, the grocery store's plan lifted the automatic stay by allowing the lender to foreclose. He found no provision in the plan conditioning the reduction in the guarantee on the lender's taking title to the store, either by foreclosure or voluntary transfer.

Judge Costa said that the lender could not "upend the arrangement by ignoring the [store's] obligation and going after the [couple] for the entire debt."

Even so, the lender argued in the circuit court that Section 524(e) barred the couple from using the grocery store's plan to reduce their obligations on the guarantee. The section provides that the "discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt."

Citing two earlier decisions by the Fifth Circuit, Judge Costa responded by saying:

> But discharge is not the issue here. The [grocery store's] bankruptcy plan does not discharge the [debt to the lender] or the [the couple's] obligations under it . . . . [A] partial release of liability for the secured portion of the debt is not a discharge.

To understand the principle, Judge Costa said, "imagine that the bankruptcy court had ordered the [grocery store] to turn over cash instead of real estate." If the lender had received cash, he said, "No one would view an order requiring the [the grocery store's] estate to pay [the lender] $250,000 in cash as eliminating a guaranty."

Judge Costa held that a "bankruptcy plan, then, can limit a creditor's claim against third-party guarantors — not by discharging the guaranty but by determining the source and value of payments satisfying the guaranteed debt."

Judge Costa buttressed his conclusion by alluding to the preclusive effect of the grocery store's chapter 11 plan under Section 1141(a), which says that "the provisions of a confirmed plan bind the debtor . . . and any creditor . . . whether or not . . . such creditor . . . has accepted the plan."

Judge Costa quoted the *Collier* treatise, which says Section 1141(a), like *res judicata*, "precludes parties from raising claims or issues that they could have or should have raised before confirmation." 8 *Collier on Bankruptcy* § 1141.02 (16th ed. 2021).

Had there been a post-confirmation default by the grocery store under its plan, Judge Costa said that the default "would not void the credit but would instead give rise to a new and separate claim against the [the grocery store] for noncompliance with the plan."

Judge Costa upheld the judgment, calling the lender's theory "a collateral attack on the [grocery store's] bankruptcy plan's disposition of the secured debt."

The opinion is *New Falls Corp. v. LaHaye (In re LaHaye)*, 19-30795 (5th Cir. Nov. 12, 2021).

The Eleventh Circuit has two standards for non-debtor releases: One for free-standing settlements and another for releases engrafted into chapter 11 reorganization plans.

Eleventh Circuit Differentiates the Two Standards for Approval of Non-Debtor Releases

The Eleventh Circuit has two standards for approval of non-debtor, third-party releases. In a nonprecedential opinion on November 5, the appeals court explained why one applies to chapter 11 reorganizations and the other to settlements.

One company acquired another. After the acquisition, the buyer discovered that officers of the seller had misappropriated about $2 million. Both companies later ended up in chapter 11 with a creditors' committee.

The two companies, the committee and the defendants worked out a settlement, which included a bar order, as the appeals court called it. The bar order prevented anyone from suing the defendants.

The buyer's dominant shareholder unsuccessfully objected to the settlement and appealed. The district court affirmed. In the Eleventh Circuit, the shareholder contended that the bankruptcy court had applied the wrong standard for imposing a bar order.

Twenty years apart, the Eleventh Circuit wrote two opinions laying out standards for approval of bar orders. *See In re Munford*, 97 F.3d 449 (11th Cir. 1996); and *In re Seaside Engineering & Surveying, Inc.*, 780 F.3d 1070 (11th Cir. 2015). In both cases, the corporate debtors were in chapter 11.

In *Munford*, the bankruptcy court approved a bar order included in settlement of an adversary proceeding. The November 5 *per curiam* opinion explained how the panel in *Munford* approved the bar order as "necessary because at least one of the [defendants] 'would not have entered into the settlement agreement' without it, and as such, it was 'integral' to the settlement." *Munford, supra*, 97 F.3d at 455.

In *Seaside*, the debtor proposed a chapter 11 plan to reorganize and continue operating. The plan included a bar order precluding lawsuits against company officers "related to or arising out of the bankruptcy."

The panel in the November 5 opinion said that *Seaside* approved the bar order "because it was deemed necessary for the reorganized entity to succeed." *Seaside, supra*, 780 F.3d. at 1077. The panel in 2015 said that failing to prevent "claims against non-debtors . . . would undermine the operations of, and doom the possibility of success for, the reorganized entity." *Id*.

The November 5 opinion said that *Munford* and *Seaside* presented "non-comparable bar orders." The fact that they both arose in chapter 11 cases was "non-determinative." To decide which precedent to apply, the court must review the "context and facts underlying the bar order."

Munford, the circuit said, applies "to bar orders assessed in the settlement context." They are "appropriate where the parties would not have entered into a settlement agreement without it, and thus it is 'integral' to the settlement."

Seaside is applicable "to bar orders that are specifically within the reorganization context" and are proper in "unusual cases in which such an order is necessary for the success of the reorganization." *Seaside, supra*, 780 F.3d at 1078–1079.

The panel decided that the case on appeal was "more like *Munford*" because "the Bar Order under review was integral to settlement." The appeals court said that the bar order was not intended "to ensure success for a reorganized entity by eliminating liability," because neither corporate debtor "sought to reorganize and continue operations."

Instead, the bar order was adopted "to facilitate a settlement agreement."

The circuit affirmed because the bankruptcy court had not abused its discretion in applying the *Munford* factors.

The opinion is *Markland v. Davis (In re Centro Group LLC)*, 21-11364 (11th Cir. Nov. 5, 2021).

Although averse to third-party releases in chapter 11 plans, the Fifth Circuit will allow bankruptcy courts to enforce releases given by one third party to another.

Consent Orders Strictly Enforced in the Fifth Circuit, Even if the Result Is Unreasonable

The Fifth Circuit teaches us to beware of negotiated consent orders. Without regard to the intent of the parties, a consent order will be interpreted strictly according to its terms, just like a contract, even if it produces an arguably "unreasonable result."

The appeals court's February 9 opinion also attests to the power of a bankruptcy court over noncore matters when the parties consented.

The Broadly Worded Consent Order

A creditor was a party to a contract with the debtor. Before bankruptcy, the creditor and the debtor were asserting claims against one another in state court. The debtor filed a chapter 11 petition, halting the suit in state court.

In bankruptcy, the debtor sold its assets to the secured lender, including the debtor's claims against the creditor in state court. To some extent, both the lender and the creditor wanted the suit to proceed in state court. Entered by the bankruptcy court, a consent order negotiated among the parties modified the automatic stay and provided the following:

- In state court, the creditor could liquidate its claims against the debtor for the purpose of exercising its rights of setoff and recoupment;
- If the creditor were to obtain a judgment in excess of the debtor's claims, the excess could only be enforced by a proof of claim in the bankruptcy case; and
- The creditor could recover "*no money damages*" *from the lender* "*under any circumstances* on account of any claims that have been or could have been asserted in" state court. [Emphasis added.]

With the benefit of hindsight, the creditor came to realize that the italicized language in the agreed order was too broad. Here's why:

In discovery in state court, the creditor learned that the lender allegedly directed the debtor to breach the contract with the creditor. The creditor then sought leave from the state court to assert new claims against both the debtor and the lender.

Trumpeting the agreed order, the lender moved in bankruptcy court to bar the creditor from asserting any direct claims against the lender. Bankruptcy Judge Harlan D. Hale of Dallas sided with the lender and interpreted the agreed order as barring the creditor from asserting any claims in state court against the lender.

Later, the creditor filed a motion in bankruptcy court under Rules 60(b)(4) and (b)(6), contending that the bankruptcy court lacked jurisdiction to enter an order barring one nondebtor (the creditor) from suing another nondebtor (the lender). Bankruptcy Judge Hale found that he had jurisdiction and denied the motion for reconsideration because the language in the lift-stay order had been negotiated among the parties.

The district court affirmed, prompting the creditor to appeal unsuccessfully to the circuit court.

The Bankruptcy Court's Jurisdiction

In his February 9 opinion, Circuit Judge Patrick E. Higginbotham first addressed the jurisdiction and power of the bankruptcy court to enjoin one nondebtor from suing another nondebtor. Odds would have seemed to favor reversal, because the Fifth Circuit is one of three circuits commonly understood as prohibiting nonconsensual, third-party releases in chapter 11 plans. *See Bank of N.Y. Trust Co. v. Official Unsecured Creditors' Comm. (In re Pacific Lumber Co.),* 584 F.3d 229 (5th Cir. 2009).

Making no analogy to chapter 11, Judge Higginbotham did not depart from established law closer to home. He quickly concluded that a claim by the creditor against the lender could "conceivably" affect the bankruptcy estate, thus conferring "related to" jurisdiction.

Even given jurisdiction, the constitutional power of the bankruptcy court was another question, because the claims by one nondebtor against another were noncore.

Without hesitation, Judge Higginbotham concluded that the lender and the creditor had "knowingly and voluntarily consented to the bankruptcy court's jurisdiction over the claims in the California Action." He said,

> The parties agreed to the language of the [consent order] and presented it to the bankruptcy court, which then entered the proposed order. The parties having thus consented, the bankruptcy court had jurisdiction to hear and enter appropriate orders related to the proceedings surrounding the entry of the Lift Stay Order.

With jurisdiction and constitutional power to enter the consent order, Judge Higginbotham said that the bankruptcy court "retained jurisdiction to interpret and enforce its orders."

Interpreting a Consent Order

Referring to the motion for rehearing that the bankruptcy court denied, the creditor argued that the court ignored the parties' intent and "surrounding circumstances" to "produce an unreasonable result."

Given that the consent order was negotiated and drafted by the parties, Judge Higginbotham approached interpretation as matter of contract law. He said,

> Where a contract's terms are unambiguous, it must be enforced irrespective of the parties' subjective intent; the same applies to an unambiguous court order such as the [consent order].

Judge Higginbotham said that the consent order "unambiguously conditioned" stay modification by ordering that the creditor could obtain "no money damages . . . of any kind" from the lender. Reliance on "subjective intent" was "unavailing," and references to the circumstances were "also irrelevant when interpreting an unambiguous consent order."

The lesson to be learned: Be careful when negotiating consent orders. They will be interpreted strictly in accordance with the plain language.

The opinion is *VSP Labs Inc. v. Hillair Capital Investments LP (In re PFO Global Inc.)*, 20-10885 (5th Cir. Feb. 9, 2022).

Over a dissent, the Eleventh Circuit held that a 1995 chapter 11 plan discharged the liability of 'related persons' to pay health care benefits when a coal producer defaulted on the obligation in 2016.

Circuits Possibly Split on Bankruptcy as Discharging Coal Act Liability for Health Benefits

The Eleventh Circuit wrote a highly complex opinion describing when liabilities that seemingly arose recently were actually discharged in bankruptcy decades earlier.

The majority's holding comes down to this: Affiliates of a coal producer discharged their joint liabilities under the Coal Act to pay health care benefits for miners by having emerged from chapter 11 in 1995, even though the coal miner itself only stopped paying the benefits in 2016.

In other words, according to the majority, the claims against the affiliates for payments toward health care benefits had been discharged in 1995, although the obligation for the affiliates to make the payments only arose in 2016.

The majority opinion and the dissent combine to represent an obtuse exposition of the competing concepts pinpointing the time when a claim arises and is discharged.

The Coal Act Claims

Coal producers were going out of business right and left, depriving coal miners of their health care benefits. In 1992, Congress enacted the Coal Act, which made "related persons" jointly and severally liable for health care benefits no longer being paid by a coal producer.

In 1989, a coal producer and its affiliates went into chapter 11. They all confirmed a plan in 1995. Under the plan, the coal producer alone shouldered ongoing responsibility for providing health care. The affiliates split off from the coal producer several years after confirmation.

There was no dispute that the affiliates were "related persons" theoretically liable for health care benefits once the coal producer stopped paying for them.

The coal producer filed a second bankruptcy in 2015 and stopped paying for health care benefits in 2016. Aiming to compel the former affiliates to pay the benefits, the fund established by the Coal Act to pay benefits sued the affiliates in district court in Washington, D.C.

The affiliates responded by reopening their 1989 bankruptcies and arguing that their liabilities under the Coal Act had been discharged by the plan in 1995. Affirmed in district court, the bankruptcy court granted summary judgment for the fund by ruling that the claims had not been discharged.

The Majority Opinion

In a 26-page opinion for the majority, Circuit Judge William Pryor reversed, ruling that the claims against the affiliates had been discharged in 1995.

To Judge Prior's way of thinking, the outcome of the appeal depended on whether there was a claim against the affiliates in 1995. If there was a claim in 1995, then it was discharged, he reasoned.

Judge Pryor began from the proposition that the definition of a claim in Section 101(5) is given the broadest meaning. He said that the discharge of the affiliates' liability on a claim based on their conduct before confirmation depended on whether there had been a relationship between the affiliates and the fund before confirmation.

Simply put (but explained in detail in later pages), Judge Pryor said that the fund

> held "claims" for future [benefits] in 1995 because their right to payment was based on the [affiliates'] pre-confirmation conduct. In 1995, the [affiliates'] liability to the retirees had already been fixed; only the amount owed was uncertain.

The amount of the eventual claim in 1995 was "uncertain," Judge Pryor said, but the uncertain amount only meant that the claim was contingent, and contingent claims are discharged.

The opinion by Judge Pryor may represent a split with the Second Circuit in *LTV Corp. v. Shalala (In re Chateaugay II)*, 53 F.3d 478 (2d Cir. 1995). There, he said, the New York-based appeals court held that post-confirmation liability under the Coal Act was not dischargeable.

Judge Pryor found the Second Circuit's opinion "unpersuasive" because "our sister circuit failed to provide any rationale for its holding." He read the Second Circuit as saying that premiums under the Coal Act were nondischargeable taxes.

Even if the liabilities were taxes, Judge Pryor said, the affiliates' liability would rest entirely on their pre-bankruptcy conduct and would be discharged. He said that *Chateaugay II* "has no bearing on when claims for those premiums arise."

Judge Pryor reversed and remanded.

The Dissent

Circuit Judge R. Lanier Anderson, III dissented in a 15-page opinion. He said that the obligation to fund an individual employer plan under Section 101(5)(B) or a so-called 1992 Plan premium did not arise until 2016 and was not discharged in 1995.

Judge Anderson latched on to Section 101(5)(B). The subsection, he said, means there is a claim only if an equitable remedy gives rise to a right to payment.

"Before there is a 'breach of performance' by the debtor," Judge Anderson said, "the creditor can have no 'right to an equitable remedy.'" Since the relevant breach occurred in 2016, "the claim arising out of that breach cannot have been discharged in 1995."

Judge Anderson saw the majority's opinion as being "in tension with the established law that a bankruptcy confirmation plan does not discharge claims that arise on account of post-confirmation conduct of the debtor."

Judge Anderson "respectfully" dissented because, in his view, the "breach occurred in 2016, [and the affiliates'] 1995 bankruptcy confirmation could not discharge the . . . claim arising from it."

The opinion is *U.S. Pipe & Foundry Co. v. Holland (In re U.S. Pipe & Foundry Co.)*, 20-13832 (11th Cir. May 3, 2022)

Stays & Injunctions

Adhering to the categorial prohibition of nondebtor third-party releases, the Fifth Circuit now allows a workaround to protect principal participants in chapter 11 cases.

Fifth Circuit Permits Gatekeeping to Serve the Function of Third-Party Releases

Except for the debtor, a trustee, the creditors' committee and committee members, the Fifth Circuit reiterated its categorial preclusion of nondebtor third-party releases.

However, and it's a mammoth however, the New Orleans-based appeals court sanctified a workaround to accomplish the same function as third-party nondebtor releases: A chapter 11 plan may give the bankruptcy court a gating function to approve or disapprove the commencement of lawsuits against those who would be protected by exculpations in other circuits.

The Fifth Circuit justified the gating function by relying on the venerable *Barton* doctrine, announced by the Supreme Court in 1881. *Barton v. Barbour*, 104 U.S. 126 (1881).

The August 19 opinion by Circuit Judge Stuart Kyle Duncan puts the Fifth Circuit firmly on par with Delaware and New York in terms of hospitality toward large chapter 11 cases, although Houston's recent popularity indicates that the Southern District of Texas already achieved preeminence.

The Obstreperous CEO

The debtor was a Dallas-based investment firm that managed billion-dollar publicly traded investment portfolios. The company filed a chapter 11 case in Delaware that was transferred to Dallas.

Short of appointing a chapter 11 trustee, the chief executive officer stepped down as a director and officer. In his place, the creditors' committee tapped three independent directors to act as a "quasi-trustee," Judge Duncan said. One of independent directors was a retired bankruptcy judge.

To say that the debtor's founder and former CEO was litigious is perhaps an understatement. After the former CEO filed several chapter 11 plans that failed, Judge Duncan said that "he and other creditors began to frustrate the proceedings by objecting to settlements, appealing orders, seeking writs of mandamus, interfering with [the debtor's] management, threatening employees, and canceling trades between [the debtor] and its clients."

An independent director was quoted by Judge Duncan as saying that the former CEO wanted to "burn the place down." Later, one of the independent directors was named CEO by order of the bankruptcy court.

Well before confirmation, the bankruptcy court entered an order barring any claims against the independent directors and the new CEO "without the bankruptcy court's authorizing the claim as a 'colorable claim[] of willful misconduct or gross negligence,'" Judge Duncan said. The order became final without appeal.

By way of cramdown, the bankruptcy court confirmed a chapter 11 plan proposed by the independent directors.

The Exculpations and Gatekeeper Function

"Anticipating [the former's CEO's] continued litigiousness," Judge Duncan said, "the Plan shields [the debtor] and bankruptcy participants from lawsuits through an exculpation provision, which is enforced by an injunction and a gatekeeper provision."

According to Judge Duncan, the beneficiaries of the gatekeeper provision and the third-party nondebtor exculpations were "nearly all bankruptcy participants: [the debtor] and its employees and [the new] CEO; [the debtor's sole general partner]; the Independent Directors; the Committee; the successor entities and Oversight Board; professionals retained in this case; and all 'Related Persons.'" The oversight board was created by the plan to monitor implementation of the plan after confirmation.

Judge Duncan said that the exculpation covered any claims "in connection with or arising out of" the chapter 11 case, excluding, of course, bad faith, fraud, gross misconduct, and the like.

Judge Duncan said that the gatekeeper function barred "bankruptcy participants" from "'taking any actions to interfere with the implementation or consummation of the Plan' or filing any claim related to the Plan or proceeding."

Should someone intend to assert a claim against "protected parties, it must go to the bankruptcy court to 'first determin[e], after notice and a hearing, that such claim or cause of action represents a colorable claim of any kind,'" Judge Duncan said. "Only then," he went on to say, "may the bankruptcy court 'specifically authoriz[e]' the party to bring the claim."

Judge Duncan said that the "Plan reserves for the bankruptcy court the 'sole and exclusive jurisdiction to determine whether a claim or cause of action is colorable' and then to adjudicate the claim if the court has jurisdiction over the merits."

Equitable Mootness

The former CEO and others appealed. Because the plan had been consummated, the debtor moved to dismiss the appeal as equitably moot.

After laying out the elements of equitable mootness recognized by circuits arounds the country, Judge Duncan said that the invocation of the doctrine "turns on whether the court can craft relief for that claim that would not have significant adverse consequences to the reorganization."

Citing *In re Pacific Lumber Co. (Pacific Lumber)*, 584 F.3d 229, 252 (5th Cir. 2009), Judge Duncan said that equitable mootness "does not bar our review" of third-party releases. Again citing *Pacific Lumber*, he said that equitable mootness does not prevent an appellate court from examining application of the absolute priority rule.

Third-Party Releases on the Merits

Summarizing, Judge Duncan said that the plan "exculpates certain non-debtor third parties supporting the Plan from post-petition lawsuits not arising from gross negligence, bad faith, or willful or criminal misconduct." He described the gatekeeper provisions as requiring "the bankruptcy court's approval of the claim" before "any lawsuit is filed."

"Together," Judge Duncan said, the plan provisions prohibit "bad-faith litigation" that "could disrupt the plan's effectiveness."

Both sides agreed that *Pacific Lumber* controlled and that exculpation for the debtor and the committee were permissible. According to the debtor, the broader exculpations were "a commonplace Chapter 11 term" that "merely provides a heightened standard of care."

Judge Duncan acknowledged that there is a circuit split, placing the Fifth Circuit at odds with other circuits condoning nondebtor third-party releases. He characterized the Fifth Circuit as being in league with the Tenth Circuit by "categorically bar[ring] third-party exculpations absent express authority in another provision of the Bankruptcy Code."

Judge Duncan said that other laws permitting exculpations were Section 524(g), applicable to "asbestos" cases, and the qualified immunity conferred on trustees and creditors' committees. He went on to "reject[] the parsing between limited exculpations and full releases that Highland Capital now requests."

The bankruptcy court's findings of fact about the need for insulating the plan and its participants from the predations of the former CEO "do not alter whether it has statutory authority to exculpate a non-debtor," Judge Duncan said.

The independent directors were playing a unique role in the case. Judge Duncan said they were "appointed to act together as the bankruptcy trustee" for the debtor. As such, he said, they are "entitled to all the rights and powers of a trustee" and "to the limited qualified immunity for any actions short of gross negligence."

Judge Duncan struck provisions in the plan providing exculpations for anyone other than the debtor, the creditors' committee and its members for conduct within the scope of their duties, and the independent directors. In other words, he excised exculpations in favor of the debtor's employees, the new CEO, the general partner, the trust created by the plan, the professionals for the debtor and the committee, the plan's oversight board and "related persons."

Gatekeeping Ok'd

Having eviscerated exculpations that are commonplace in other circuits, Judge Duncan said that the "injunction and gatekeeper provisions are, on the other hand, perfectly lawful." Citing the *Barton* doctrine, he said that "[c]ourts have long recognized [that] bankruptcy courts can perform a gatekeeping function."

The appellants argued that the gatekeeping function extended to claims not within the bankruptcy court's jurisdiction. Judge Duncan saw no need to "evaluate whether the bankruptcy court would have jurisdiction under every conceivable claim falling under the widest interpretation of the gatekeeper provision. We leave that to the bankruptcy court in the first instance."

Judge Duncan went on to say in a footnote that the opinion should not be interpreted "to hinder the bankruptcy court's power to enjoin and impose sanctions on [the former CEO] and other entities by following the procedures to designate them vexatious litigants."

Another Protection Left Standing

Well before confirmation, the bankruptcy court had entered an order barring claims against the independent directors and the new CEO without the court's approval. The order was not appealed and became final.

The circuit court had no jurisdiction to entertain a collateral attack on that order, Judge Duncan said. To the extent the appellants sought to "roll back the protections [in that order]," he said that "such a collateral attack is precluded."

The finality of the order was a big deal. Judge Duncan said that it had "the effect of exculpating the Independent Directors and [the new CEO] in his executive capacities."

The mid-case order was even more expansive. Judge Duncan said that it gave *res judicata* protection to the independent directors' agents, advisors and employees.

Chapter 11 Issues on the Merits

Judge Duncan upheld the bankruptcy court on the merits of issues regarding plan confirmation.

The former CEO contended there was a violation of the absolute priority rule by giving out-of-the-money paper to two classes of unsecured creditors. Judge Duncan said that absolute priority "has never required us to bar junior creditors from ever receiving property."

Judge Duncan also saw no clear error in the bankruptcy court's voluminous findings of fact to justify confirmation of the plan.

The opinion is *NexPoint Advisors LP v. Highland Capital Management LP (In re Highland Capital Management LP)*, 21-10449 (5th Cir. Aug. 19, 2022).

Second Circuit exercises 'hypothetical' appellate jurisdiction when finality is murky.

Second Circuit Bright-Line Rule: It's Always a Stay Violation if Debtor Is a Defendant

The chapter 7 debtor lived in a home belonging to a limited liability corporation that she owned. Before bankruptcy, the lender filed a foreclosure suit against both the debtor and the LLC. Notified of the filing, the lender nonetheless conducted a foreclosure sale after bankruptcy.

Even though the home was not the debtor's property, the Second Circuit found willful violations of the automatic stay in Sections 362(a)(1) and (a)(2).

The Facts

The debtor was the 99% owner of an LLC that owned the home that was her principal residence. The debtor had no personal liability on the mortgage.

The debtor stopped paying the mortgage in 2010. The lender initiated a foreclosure proceeding in 2011, eventually naming both the debtor and the LLC as defendants.

The lender won a judgment of foreclosure and sale in 2018. After entry of the judgment and a few days before the sale, the debtor filed a chapter 7 petition. Counsel for the debtor notified the lender about the bankruptcy and asserted that a sale would violate the automatic stay. The lender responded by claiming there was no stay because the home was not the debtor's property.

The lender proceeded with the foreclosure sale after filing. The property was purchased by a third party.

Before the referee delivered the deed to the purchaser, the debtor sued the lender in bankruptcy court, alleging a willful violation of the automatic stay. At some later time during the bankruptcy case, the referee delivered the deed. The purchaser obtained a termination of the automatic stay and evicted the debtor from the home.

Finding no violation of the automatic stay, the bankruptcy court reasoned that the foreclosure action was purely *in rem*. The bankruptcy court dismissed the debtor's suit.

The district court reversed, finding violations of Sections 362(a)(1) and (a)(2) and ruling that the stay violations were willful. The district court held that the debtor was entitled to actual

damages. It remanded to the bankruptcy court to determine the amount of actual damages and to decide whether punitive damage should be imposed.

The lender appealed to the Second Circuit.

Finality

Neither party questioned the finality of the district court's judgment, but the appeals court on its own examined its appellate jurisdiction in a lengthy footnote.

Unquestionably, the bankruptcy court's order was final, but the district court remanded for further proceedings. Typically, a remand does not render an order nonfinal unless the remand is for significant further proceedings.

In her July 6 opinion handed down more than 12 months after argument, Circuit Judge Susan L. Carney said that the Second Circuit has not ruled in a precedential opinion whether a remand to fix damages amounts to "significant further proceedings." She said her circuit has "repeatedly explained" in different contexts that the appeals court has discretion to decline to rule on difficult jurisdictional questions "so long as we are satisfied that we have Article III jurisdiction."

Finding "hypothetical" appellate jurisdiction, Judge Carney held:

> Here, where there is no doubt that we have Article III jurisdiction, where the statutory jurisdictional issue is novel and not addressed by the parties, and where the merits turn on a straightforward textual analysis, we will exercise our discretion to assume hypothetical jurisdiction and proceed to resolve the appeal on the merits.

In this writer's view, the Second Circuit was reaching out to decide the merits of an important automatic stay question even though there may have been no appellate jurisdiction had the appeals court explored the issue.

The Stay Violation

In the circuit, the lender admitted that the debtor's possessory interest in the property was part of her estate protected by the automatic stay. Judge Carney found stay violations under the "plain text" of Sections 362(a)(1) and (a)(2).

Subsection (a)(1) bars continuation of a judicial proceeding against a debtor. Given that the debtor was a named defendant in the foreclosure proceedings, Judge Carney said, "we can only conclude that the Foreclosure Action was 'against the debtor' and therefore covered by Section 362(a)(1)."

More particularly, she said that the sale conducted after filing was a "continuation" of an action against the debtor.

Subsection 362(a)(2) precludes "enforcement" against the debtor of a judgment obtained before bankruptcy.

The judgment of foreclosure and sale was entered before bankruptcy. The sale, conducted after bankruptcy, enforced a judgment against the debtor, Judge Carney said. She held, "The Sale therefore violated the plain terms of the stay imposed by Section 362(a)(2)."

The lender advanced numerous defenses not grounded on statutory language. Judge Carney dismissed the purported defenses, saying,

> Here, that language [in Sections 362(a)(1) and (a)(2)] demands a bright-line rule that, so long as the debtor is a named party in a proceeding or action, the automatic stay applies to the continuation of that proceeding, and to the enforcement of, a judgment rendered in that proceeding.

Reliance on the canon against surplusage was one of the lender's defenses, based on the idea that one action cannot violate two subdivisions in Section 362(a). Judge Carney found no indication that "Congress intended the automatic stay provisions to be mutually exclusive." She expanded on the idea, saying,

> Indeed, a congressional desire for comprehensiveness may lead the drafters of legislation to craft provisions that intentionally overlap to some extent in an attempt to avoid any inadvertent gaps. That some overlap occurs on occasion does not require either striking or ignoring the scheme.

Judge Carney also rejected the idea that the foreclosure was only *in rem* because the debtor had no personal liability on the mortgage. The argument, she said, was "fundamentally flawed," because "Section 362(a) draws no textual distinction between *in rem* and *in personam* proceedings in which the debtor is a named party."

The lender argued that foreclosure did not violate the stay because there was no effect on the estate.

Again declining not to venture beyond the language of the statute, Judge Carney said,

> Here, we need not resolve whether the Sale would have a "likely" or a "certain" effect on [the debtor's] estate. The inescapable fact is that [the debtor] was a named party in the Foreclosure Action. And that fact subjected the Foreclosure Action to the automatic stay regardless of its precise effects, equitable or legal, on her estate.

Rejecting numerous nonstatutory defenses, Judge Carney held:

> [O]ur holding effects a bright-line rule: if the debtor is a named party in a proceeding or action, then the automatic stay imposed by those subsections applies to the continuation of such a proceeding or action, under Section 362(a)(1), and to the enforcement of an earlier judgment in that proceeding or action, under Section 362(a)(2). [The debtor's] bankruptcy filing triggered the automatic stay established by Section 362, and [the lender] violated that stay when it proceeded with the Sale.

Judge Carney affirmed the district court and remanded for further proceedings.

Observations

We recommend reading the opinion in full text to appreciate the range of defenses that Judge Carney rejected, because we mentioned only a few.

Judge Carney's opinion is important in the wake of *Taggart v. Lorenzen*, 139 S. Ct. 1795, 1809 (2019), where the Supreme Court held that there can be no sanctions for civil contempt of the discharge injunction if there was an "objectively reasonable basis for concluding that the creditor's conduct might be lawful under the discharge order." The Second Circuit held in *PHH Mortgage Corp. v. Sensenich (In re Gravel)*, 6 F.4th 503 (2d Cir. Aug. 2, 2021), that *Taggart* applies to all contempt citations in bankruptcy court. To read ABI's report on *Gravel*, click here.

In sum, Judge Carney found no objectively reasonable basis for the lender to believe the stay was inapplicable.

This writer interprets the opinion in that manner because Carney upheld the district's finding of a willful violation and remanded to consider punitive damages. Consideration of damages would have been inappropriate had the appeals court found an objectively reasonable basis for the lender's defenses.

However, we note that the lender did not cite *Taggart* to the circuit. Should the lender raise *Taggart* on remand, the debtor can argue that the circuit's mandate does not allow raising a defense that had been waived on appeal.

The opinion is *Bayview Loan Servicing LLC v. Fogarty (In re Fogarty)*, 20-2187 (2d Cir. July 6, 2022).

Reliance on advice of counsel is not a complete defense to contempt citations.

Fourth Circuit Rules Emphatically that *Taggart* Applies to All Contempt in Bankruptcy

The Fourth Circuit has ruled emphatically that *Taggart* applies to all contempt citations in bankruptcy court.

However, the Richmond, Va.-based appeals court held that advice of counsel is not a complete defense to civil contempt in bankruptcy court.

A couple filed a chapter 11 petition after falling $23,000 behind on their mortgage. The bankruptcy court confirmed the plan without modifying the plan to specify how future mortgage payments would be applied to principal, interest and arrears.

The plan and confirmation order were vague in other respects. The papers (1) did not state how much the debtors would owe on confirmation; (2) did not say how the $23,000 in arrears would be paid, if at all; (3) set the first day for payment but did not say how much the payment would be; and (4) said that the original loan terms would remain in effect, except as modified.

The servicer did not appeal confirmation.

The debtors made monthly payments. For five years after confirmation, the lender treated the loan as being in default. After the debtors objected and claimed that their mortgage should be treated as current, the servicer conferred with counsel a dozen times. Counsel told the servicer that the loan was correctly listed as being in default.

The servicer eventually listed the property for foreclosure. After further complaints from the debtors, the servicer withdrew the foreclosure and treated the loan as being current.

The debtors then brought proceedings in bankruptcy court to impose civil contempt sanctions. Ultimately, the bankruptcy court imposed monetary sanctions of almost $115,000, including lost wages, attorneys' fees and "loss of fresh start."

The servicer appealed and won a reversal in district court last July. *See Newrez LLC v. Beckhart*, 20-192, 2021 BL 294572, 2021 US Dist Lexis 146230, 2021 WL 3361707 (E.D.N.C. July 2, 2021). To read ABI's report, click here.

The district court evaluated the servicer's contempt liability by the standard in *Taggart v. Lorenzen*, 139 S. Ct. 1795 (2019), where the Supreme Court held that there can be no sanctions for civil contempt of a discharge injunction if there was an "objectively reasonable basis for concluding that the creditor's conduct might be lawful under the discharge order." *Id*. at 1801. To read ABI's discussion of *Taggart*, click here.

The district judge went on to say that he was "not convinced . . . that the discharge order . . . in *Taggart* is different from the confirmation order at issue here." Applying *Taggart*, the district judge decided that the servicer had acted in good faith and "adopted a reading that seemed consistent with the contractual terms of the loan and was objectively reasonable."

The district judge reversed and remanded for further proceedings because "the bankruptcy court's contempt order falls far short of the standard required for a finding of civil contempt." The district court also noted that the servicer had acted several times on advice of counsel.

The debtors appealed to the circuit.

Taggart Applies

The debtors argued in the circuit that *Taggart* only applies to alleged discharge violations. Circuit Judge Toby J. Heytens rejected this contention in his April 15 opinion. He said that "*Taggart* applies broadly and cannot be confined to Chapter 7 bankruptcy in the way the [debtors] seek."

Judge Heytens said,

> Nothing about the Supreme Court's analysis in *Taggart* suggests it is limited to violations of Chapter 7 discharge orders — which liquidate a debtor's assets and then discharge the debt — or that the Court's decision turned on considerations unique to the Chapter 7 context.

Judge Heytens held "that the standard articulated by the Supreme Court in *Taggart* governs civil contempt under Chapter 11 of the Bankruptcy Code as well." Although chapter 11 may differ from chapter 7, he said that "a bankruptcy court's authority to enforce its own orders — regardless of which chapter of the Bankruptcy Code those orders were issued under — derives from the same statutes and the same general principles the Supreme Court relied on in *Taggart*."

But Judge Heytens was not prepared to affirm. He found fault with one important aspect of the district court's opinion: He said that "the district court erred in appearing to grant controlling weight to the fact that [the servicer] had requested and received legal advice from outside counsel."

Judge Heytens cited the Fourth Circuit for holding before *Taggart* that advice of counsel is not a defense in civil contempt. Consequently, he held that "the district court erred when concluding that [the servicer's] reliance on the advice of outside counsel was seemingly dispositive as a defense to civil contempt."

Although advice of counsel is not a complete defense, Judge Heytens added in a footnote that it "may still be considered in appropriate circumstances as a relevant factor under the *Taggart* standard." More particularly, he said that "a party's reliance on guidance from outside counsel may be instructive, at least in part, when determining whether that party's belief that she was complying with the order was objectively unreasonable."

Having found error in the decisions by both the bankruptcy and district courts, Judge Heytens reversed and remanded to the bankruptcy court "as the court of first instance and the tribunal closest to the facts." He gave instructions to "reconsider the contempt motion under the correct legal standard, including any additional factfinding that may be necessary."

The opinion is *Bechkart v. Newrez LLC*, 21-1838 (4th Cir. April 15, 2022).

Judge Graham in Indianapolis sees the Seventh Circuit as interpreting 'related to' jurisdiction narrowly and not inclined to halt lawsuits against nondebtors without a direct effect on the bankrupt estate.

Judge Predicts Seventh Circuit Wouldn't Halt Earplug Lawsuits Against Nondebtor 3M

Betting that the Seventh Circuit would create a circuit split on the facts of the case before him, Bankruptcy Judge Jeffrey J. Graham of Indianapolis refused to expand the automatic stay to cover 3M Corp., the nondebtor parent of a company in chapter 11 dealing with the largest mass torts ever to hit the federal courts.

Judge Graham's August 26 opinion could be read to mean that he might have protected the nondebtor parent with an expanded stay had pre-filing financial arrangements been written differently.

Beginning in 2000, the debtor made earplugs for the military. 3M acquired the debtor in 2008. Two years later, the debtor's businesses were "upstreamed" to 3M in return for a $965 million payable to the debtor. Judge Graham said that 80% of the sales of the earplugs occurred before the upstreaming. He said it was "unclear" whether 3M assumed any liabilities as part of the upstreaming.

In settlement of a *qui tam* action, 3M paid $9.1 million to the government on account of allegedly defective earplugs.

Then, the lawsuits began. By the time the debtor filed a chapter 11 petition in late July, there were 290,000 claims covered by multidistrict litigation in Florida, where the debtor and 3M are co-defendants. In addition, Judge Graham said there are 2,000 more suits in state court in Minnesota, where 3M is headquartered.

The debtor, by the way, is also a Delaware corporation like 3M but is headquartered in Indianapolis.

Judge Graham said that the multidistrict litigation is the largest in history and represents 30% of all civil cases currently pending in federal courts.

There already have been several bellwether trials. 3M and the debtor won six of them, but the plaintiffs won 12, yielding verdicts ranging between $1.7 million and $77.5 million.

Before the subsidiary's chapter 11 filing, independent directors for the debtor negotiated a financial arrangement with 3M. The complex arrangement committed 3M to a $240 million fund for the chapter 11 process plus an uncapped commitment to fund a trust to cover claims.

The debtor is obligated to indemnify 3M for whatever it spends, but the debtor can cover its liability by drawing funds from 3M. Judge Graham said that the "net effect to [the debtor] is zero."

The P.I. Motion

On filing in chapter 11, the debtor began an adversary proceeding and sought a preliminary injunction. The debtor wanted Judge Graham to rule that the Section 362(a) automatic stay covered 3M or, alternatively, that the debtor wanted Judge Graham to protect 3M with an injunction made under Section 105(a).

Claimants objected to an expansion of the automatic stay. Judge Graham denied the initiative in a 37-page opinion.

Before delving into the merits, Judge Graham said the chapter 11 is not "the *only* avenue" for achieving a "global settlement." [Emphasis in original.] He also said that he was not deciding whether the chapter 11 filing was in good faith.

The debtor and 3M are also facing a separate spate of lawsuits alleging that respirators made by the debtor were defective. The respirator lawsuits are substantial but pale in comparison to the earplug suits. Judge Graham barely mentioned the respirators.

By the way, the 3M parent was not a party in the debtor's attempt at halting lawsuits against it.

Section 362(a)(1)

First, Judge Graham dealt with the debtor's contention that Section 362(a)(1) automatically stopped lawsuits against the parent. The section halts the commencement or continuation of actions against the debtor.

Working from the proposition that the automatic stay "generally protects only the debtor," Judge Graham said he was "reluctant to conclude that Section 362(a)(1), standing alone, offers sufficient statutory authority to conclude that the Pending Actions are stayed automatically as to 3M or to extend the protections of the stay to 3M."

Citing the Fourth Circuit's 1987 decision in *A.H. Robbins*, Judge Graham admitted "there is ample case law holding otherwise."

Bound by precedent from the Seventh Circuit, Judge Graham said that his court of appeals "has not, to date, expansively discussed or formally adopted *A.H. Robbins* in this regard…. Nor has the Circuit actually extended the stay to a non-debtor party under that reasoning."

"Without more guidance from the Seventh Circuit," Judge Graham declined to extend Section 362(a)(1) to cover 3M.

Section 362(a)(3)

Next, Judge Graham turned to Section 362(a)(3), which bars "any action" to obtain property of or from the estate. It is "broader than just the debtor," the judge said, and entails a two-step analysis. First, is property of the estate at issue, and, second, does the action threaten to obtain or exercise control over estate property?

Judge Graham assumed that insurance policies held by the debtor and 3M were estate property. On the question of obtaining property of or from the estate, he saw "no evidence" that the claimants were "proceeding directly against the insurance policies."

Judge Graham next analyzed whether the suits were an indirect attempt at glomming the insurance policies. He found no violation of Section 362(a)(3) because the funding agreement signed just before bankruptcy means that "3M will fully fund any liability incurred" by the debtor. Given the uncapped backstop by 3M, tapping insurance policies would not affect how much creditors receive or cause an inequitable distribution among creditors.

Section 105(a)

The debtor was left with arguing that Judge Graham should expand the stay to cover 3M under Section 105(a), which gives the court power to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title."

Citing the Seventh Circuit, Judge Graham said that the court may stay actions that may affect the amount of property in the bankrupt estate. But first, he said, the court must have "related to" jurisdiction to stay lawsuits pending in state court and in the multidistrict litigation.

Regarding "related to" jurisdiction, Judge Graham said that the Seventh Circuit has taken a "more constrained approach" and said that it must be interpreted "narrowly." Again citing the Seventh Circuit, he said that "related to" jurisdiction requires "a direct effect" on either the estate or the distribution to creditors.

Looking for a direct effect on the estate, Judge Graham discounted the debtor's obligation to indemnify 3M because the funding agreement "provides for an uncapped, non-recourse

commitment from 3M to fund all of the [debtor's] liabilities" and was not conditioned on obtaining a stay to protect 3M. He was therefore "unable to discern any financial impact to creditors."

"A number of other courts have extended the stay notwithstanding the existence of an uncapped funding agreement," Judge Graham said. "Respectfully, this Court cannot follow suit," because the Seventh Circuit instructed courts to focus "on the *actual* economic effect" that continuation of the suits would have on the estate. [Emphasis in original.]

Judge Graham gave short shrift to the idea that continuation of the suits would be a "'significant' distraction." He put "little stock on this claim."

In short, Judge Graham saw no "related to" jurisdiction that would enable him to issue an injunction under Section 105(a). Even if there were jurisdiction, he said he "would reach the same conclusion" because a stay under Section 105(a) "should issue only in extraordinary circumstances" necessary to carry out other provisions of the Bankruptcy Code.

At the end of his opinion, Judge Graham admitted that a stay might give 3M and the debtor "additional leverage" to "negotiate a global settlement."

"Alas," Judge Graham said, "those questions are not things to be considered" under Section 362 or in deciding whether there is jurisdiction under Section 105(a).

Judge Graham sustained the objections and denied the motion for a preliminary injunction.

Note: The debtor is pursuing a direct appeal to the Seventh Circuit.

Observations

The opinion reminds this writer of basketball: no harm, no foul.

Further trials absent an expanded stay may well deplete insurance coverage and result in a clear effect on the estate, but Judge Graham saw no harm given 3M's uncapped commitment. If it were shown as a matter of fact that 3M won't be able to cover all damages, would Judge Graham have expanded the stay under Section 362(a)(3)?

Plaintiffs would not argue that 3M is insolvent and thereby open the door to a broader stay. To avoid damaging stockholders, 3M likewise would not claim insolvency.

So, 3M might have won an expanded stay were the commitment not uncapped, but uncapping the commitment would expose the debtor to a better argument about a bad faith filing. Thus, 3M was between a rock and a hard place.

The case raises the question of whether the U.S. legal system as currently configured — be it the tort system or bankruptcy — is adequately designed for dealing with massive tort claims threatening to destroy an otherwise profitable company employing thousands of workers. Were Congress to begin drafting a solution, any legislation would inevitably favor one side or the other. Proposing legislative action seems like voluntarily stepping on the third rail.

The fact that 3M won't have an expanded stay at this juncture does not preclude the possibility of a settlement to be effected through a traditional class action. Perhaps we should sit back and wait to see whether companies like 3M can survive without an expanded stay.

The foregoing are this writer's thoughts and do not represent the opinions of ABI.

The opinion is *3M Occupational Safety LLC v. Those Parties Listed on Appendix to the Complaint (In re Aearo Technologies LLC)*, 22-50059 (Bankr. S.D. Ind. Aug. 26, 2022).

The BAP decision may have a hint that failure to stop proceedings after bankruptcy can be an automatic stay violation, even after Fulton.

No Duty to Release an Attachment After *Fulton*, Ninth Circuit BAP Says

Concluding that the Supreme Court's *Fulton* decision overruled prior Ninth Circuit authority, the Ninth Circuit Bankruptcy Appellate Panel held that a creditor no longer violates any provision of the automatic stay in Section 362(a) by maintaining the *status quo* and declining to vacate a prepetition attachment.

While the decision under Section 362(a)(3) is no surprise given that *Fulton* addressed the same subsection, the November 10 BAP opinion is noteworthy for finding no stay violations under any other subsection in Section 362(a).

The Prepetition Attachment

A municipality in Arizona obtained a $30,000 judgment against an individual and served a writ of garnishment on a bank that held about $9,000 belonging to the judgment debtor in three accounts.

The judgment debtor moved in state court to quash the garnishment, contending that the accounts were community property. The state court allowed the city to take discovery, but the debtor filed a chapter 13 petition before the city took further action in state court.

Once in bankruptcy, the debtor's counsel sent messages to both the city and bank demanding the release of the attachment. The city's attorney responded by filing a motion to stay the litigation in state court.

The debtor moved the state court to vacate the garnishment. The city's attorney responded by saying that the city would abide by whatever decision was made under the Bankruptcy Code and did not oppose releasing the funds.

More specifically, the city told the debtor that Section 362(a) only required staying the proceedings, not dismissing the garnishment.

The state court vacated the garnishment, and the bank released the funds. The debtor then filed a motion in bankruptcy court seeking $30,000 in damages for a willful violation of the stay under Section 362(k).

The Pre-*Fulton* Finding of a Stay Violation

At the ensuing hearing held before the Supreme Court handed down *Fulton*, the bankruptcy court cited Ninth Circuit authority from 2017, faulted the city for not vacating the garnishment, and entered an order finding a stay violation. The bankruptcy court told the debtor to proceed with a hearing to fix damages.

After *Fulton* came down, the city filed a motion for rehearing under Bankruptcy Rule 9024 and Federal Rule 60(b). The bankruptcy court granted rehearing.

The Ruling After *Fulton*

Ruling under *Fulton*, the bankruptcy court said that its prior ruling was wrong and that the automatic stay does not require a creditor to take affirmative action under any of the subsections in Section 362(a).

The debtor appealed to the BAP, but Bankruptcy Judge Robert J. Faris affirmed for the BAP in an opinion on November 10.

First, Judge Faris dealt with the question of whether the city properly moved for rehearing under Bankruptcy Rule 9024. He said that the finding of a stay violation was not a final order in the absence of a decision fixing damages.

Because there was no final order, Judge Faris said that Rule 9024 did not apply and that the "bankruptcy court was free to review and change its own interlocutory order whether or not Rule 9024 permitted it to do so."

Judge Faris therefore reviewed the reconsideration order *de novo*.

Fulton Means No Stay Violation

Citing *City of Chicago v. Fulton*, 141 S. Ct. 585, 208 L. Ed. 2d 384 (Sup. Ct. Jan. 14, 2021), Judge Faris saw no error when the city "failed to move to quash the writ of garnishment or cause [the bank] to unfreeze the bank accounts." To read ABI's report on *Fulton*, click here.

Before *Fulton*, Judge Faris cited the Ninth Circuit for having held that the knowing retention of estate property violates Section 362(a)(3). *Fulton*, he said, overruled those decisions.

Judge Faris quoted *Fulton* for saying that Section 362(a)(3) contains no affirmative turnover obligation and that mere retention of estate property does not violate the stay. He affirmed the bankruptcy court's ruling on subsection (a)(3) by saying that the city "had no affirmative duty to ensure the return of estate property to [the debtor]."

Judge Faris cited *Margavitch v. Southlake Holdings LLC (In re Margavitch)*, 20-00014, 021 BL 383922, 2021 Bankr. Lexis 2784, 2021 WL 4597760 (Bankr. M.D. Pa. Oct. 6, 2021), as being directly on point. In *Margavitch*, he described Bankruptcy Judge Mark J. Conway of Wilkes-Barre, Pa., as finding "no affirmative obligation to release the funds and [said that the creditor] need only maintain the *status quo*." To read ABI's report on *Margavitch*, click here.

Having found no violation of Section 362(a)(3), Judge Faris saw no violation of any other subsection in Section 362(a).

By promptly taking steps to stay the litigation in state court, Judge Faris said there was no violation of subsection (a)(1), which bars the continuation of a suit against a debtor. Because the city had done nothing to enforce the judgment or the writ, he saw no violation of subsection (a)(2).

Likewise, there was no act to recover a claim against the debtor and no violation of subsection (a)(6), because the city only maintained the *status quo*.

A Possible Qualification

Judge Faris concluded his opinion by saying there was no stay violation because the city "did nothing to change the *status quo*" and "immediately asked the state court to stay the case."

Is there significance in Judge Faris's use of the word "immediately"?

Assume that the motion was *sub judice* in state court to convey estate property to a creditor. Would the creditor violate the automatic stay if the creditor does not ask the state court to withhold a decision conveying property to the creditor?

The opinion is *Stuart v. City of Scottsdale (In re Stuart)*, 21-1063 (B.A.P. 9th Cir. Nov. 10, 2021).

False advertising that violates non-bankruptcy law isn't necessarily a violation of the automatic stay, New York district judge says.

Misleading Advertising to Poach a Debtor's Customers Is No Stay Violation

Reversing the bankruptcy court and setting aside $19 million in sanctions, a district judge in New York handed down an opinion on October 6 that could be read to mean that misleading advertising designed to poach a debtor's customers does not violate the automatic stay.

The debtor, a provider of commercial and residential communications services, filed a chapter 11 petition to reorganize. A competitor mounted a direct mail campaign targeting the debtor's customers.

The competitor's advertising announced that the debtor was in chapter 11 and asked whether the debtor would be able to stay in business. For example, the advertising said that the debtor's future was "unknown" and insinuated that the debtor might cease providing services.

Alleging that the advertising was "knowingly false" and caused "confusion" among its customers, the debtor filed an adversary proceeding in bankruptcy court contending that the competitor had violated the automatic stay.

On summary judgment, the bankruptcy court held that the competitor's advertising violated the automatic stay in Section 362(a)(3) as "an act to control property of the estate, namely, the debtors' customers or contracts with those customers." After trial, the bankruptcy court issued an order imposing almost $19.2 million in sanctions for a "literally false and intentionally misleading advertising campaign that wrongfully interfered with the Debtors' customer contracts and goodwill."

District Judge Cathy Seibel reversed on appeal. Sitting in White Plains, N.Y, she analyzed whether the advertising violated the automatic stay and whether, under *Taggart v. Lorenzen*, 139 S. Ct. 1795 (2019), there was a "fair ground of doubt" about the advertising as a stay violation.

Control over Estate Property

Although she found the evidence to be "quite thin," Judge Seibel said that the bankruptcy court "did not clearly err in concluding that [the debtor] had some kind of contracts under which it provided services to at least some customers." However, she went on to explain why the

"advertisements were not acts to 'obtain' or 'control' any such contracts," even if the debtor's goodwill was also protected by the automatic stay.

The governing statute, Section 362(a)(3), proscribes "any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate." Judge Seibel said that the "plain language of this statute does not clearly encompass solicitation of a debtor's customers, which one does not typically regard as 'exercising control' over 'property.'"

Judge Seibel went on to say that "there is nothing in the 'plain terms' of § 362(a)(3) that suggests that 'improper' advertisements are methods of 'control' but 'legitimate' ones are not." She said that "[t]he *statute does not prohibit all conduct that harms or interferes with a debtor's business*, but only that which amounts to an effort to obtain or control estate property." [Emphasis added.]

Even if the competitor's advertising violated non-bankruptcy laws, Judge Seibel said it was "not clear how it was an act to 'exercise control' over contracts or goodwill." She added that it was not correct to say that "any attempt to compete with an entity going through reorganization would be stayed, whether wrongful or not."

Focusing on the language of the statute, Judge Seibel said,

> [T]the customer is not property of the estate. It is thus difficult to see how, without more, influencing or manipulating a customer to opt for a competitor's service over a debtor's through advertisements, false or otherwise, is an act of control over estate property.

In other words, Judge Seibel said, "The mere fact that the conduct may be wrongful or unlawful does not automatically convert it into a violation of the automatic stay."

Judge Seibel found no stay violation because the "advertisements cannot reasonably be seen as an act to exercise control over property of [the debtor's] estate."

Taggart Issues

Even if there were a stay violation, Judge Seibel asked whether there was a "fair ground of doubt" about a stay violation to exonerate the competitor under *Taggart*, *supra*,139 S. Ct. 1799, 1801.

Judge Seibel quoted the bankruptcy court for saying, in substance, that someone in doubt about whether an act would violate the stay should first seek a so-called comfort order from the bankruptcy court. She said that *Taggart* rejected a "substantially similar standard" under Section 105(a).

Although there are differences between the discharge injunction in *Taggart* and the automatic stay in the case on appeal, Judge Seibel said it was "contrary to *Taggart* to read into § 105(a) a requirement that a creditor 'seek clarification from the court or be sanctioned for shooting first and aiming later' if the creditor is unsure whether its contemplated course of conduct would run afoul of the automatic stay." She therefore held that "there is no requirement that the would-be violator move to lift the stay prior to acting."

Because it was "at least highly debatable" whether the advertising amounted to an attempt to "exercise control" over estate property, Judge Seibel held that the bankruptcy court abused its discretion by holding the competitor in contempt. She vacated the contempt citation and the $19.2 million sanction.

It Ain't Over Yet

The competitor is not out of the woods.

The debtor had also sued the competitor in bankruptcy court for violating the Lanham Act and state law equivalents. Judge Seibel had withdrawn the reference.

Despite the reversal of the contempt finding, Judge Seibel said that the debtor "still may pursue its false advertising and breach of contract claims."

The opinion is *Holdings Inc. v. Charter Communications Inc. (In re Windstream Holdings Inc.)*, 21-4552 (S.D.N.Y. Oct. 6, 2022).

Retention & Compensation

Following the Model Rules and erecting ethical screens allows adversary lawyers to date and marry.

Marrying an Adversary Doesn't Mean Disqualification, Third Circuit Says

News flash: Bankruptcy lawyers are human beings. Some have human emotions. Sometimes, they fall in love and marry. They may even fall in love when their firms are adversaries.

Upholding a decision by retired Bankruptcy Judge Christopher S. Sontchi of Delaware, the Third Circuit described how firms should handle romances to avoid disqualification. Basically, the circuit says to employ an elaborate screen and follow the details described in the September 9 opinion by Circuit Judge David J. Porter.

The Conflict

A large company confirmed a chapter 11 plan in 2016, creating a liquidating trust. In June 2018, the trust filed a $14 billion lawsuit against the debtor's former parent.

The trust-plaintiff was represented by a large, international law firm with more than 2,000 lawyers. The defendant-parent was represented by several other large firms.

A partner in one of the defendant's firms left that firm and joined the plaintiff's firm as a partner in October 2020. The departing partner had billed 300 hours to the case on behalf of the defendant.

So far, nothing surprising. Moves like that take place all the time. Conflicts and disqualifications are avoided by ethical screens, and a screen is what the plaintiff's firm put in place immediately after the move.

After the partner left the defendant's firm to join the plaintiff's firm, the defendant-parent filed a motion to disqualify the plaintiff's law firm. Bankruptcy Judge Sontchi denied the motion. *Maxus Liquidating Trust v. YPF SA (In re Maxus Energy Corp.)*, 626 B.R. 249 (Bankr. D. Del. April 6, 2021). To read ABI's report, click here.

Here's what makes the case different: The department head for the plaintiff was in a romantic relationship with the defendant's departing partner. The relationship turned into marriage. The department head at the plaintiff's firm never billed any time to the matter.

According to the opinion by Bankruptcy Judge Sontchi, the timeline for the relationship went like this:

The two began dating in early 2017. The lawsuit was filed in 2018. The relationship became "exclusive" in the fall of 2018, and they began living together in July 2019.

Judge Sontchi found that the partner who moved had disclosed the relationship to the firm in 2018 and believed that the relationship had been disclosed to the defendant. The lawyer with the defendant's firm joined the plaintiff's firm as a partner on October 1, 2020. They married in November 2020.

As previously mentioned, the plaintiff's firm set up an ethical screen immediately after the move and notified the defendant.

After denying the motion for disqualification, Judge Sontchi authorized a direct appeal, which the Third Circuit accepted.

The Affirmance

Because the appeals court was reviewing for abuse of discretion, the affirmance by Judge Porter is sparse, compared to the meticulous opinion by Bankruptcy Judge Sontchi. Judge Porter said that "an abuse of discretion occurs 'where no reasonable person would adopt' the lower court's view. *United States v. Foster*, 891 F.3d 93, 107 n.11 (3d Cir. 2018)."

Judge Porter explained that the bankruptcy court in Delaware has adopted the American Bar Association's Model Rules of Professional Conduct as local rules. Model Rule 1.9 bars a client's former lawyer from representing someone "materially adverse" on a "substantially related matter." Model Rule 1.10(a) disqualifies an entire firm if one lawyer is disqualified "unless" the "disqualified lawyer is timely screened" and receives "no part" of the fee.

Summarizing the rules, Judge Porter said:

> [I]f a firm adheres to the conditions subsequent by screening the disqualified attorney, allocating to him no part of the fee from the conflicted representation, and following the other procedures in Model Rule 1.10(a)(2), the disqualified attorney's conflict cannot be imputed to the entire firm.

Despite screening the departing partner and despite the departing partner's exclusion from fees from the engagement, the defendant argued that the plaintiff's firm was disqualified because the department head at the plaintiff's firm had not been barred from receiving fees from the firm's representation of the plaintiff.

Judge Porter rejected the argument. He said that "the rule directs that only the 'disqualified lawyer' must be 'apportioned no part of the fee' from the matter at issue. Model Rules of Pro. Conduct r. 1.10(a)(2)(i). Here, that means [the departing partner], not her spouse, must not receive proceeds of fees arising from the conflicted representation."

Judge Porter affirmed because he found no abuse of discretion in denial of the disqualification motion. He said that the firm had established "a thorough, robust ethical screen."

The Interesting Footnote

In text on the last page of the opinion, Judge Porter said that the departing partner would receive no part of the fees from the new firm's representation of the plaintiff. In a footnote, he said that the plaintiff's firm did not compensate partners "based on specific case outcomes or earnings."

Although the Model's Rule's comments are not incorporated into the Delaware local rules, Judge Porter said that a comment on Rule 1.10 "persuasively says" that a screened lawyer is not prohibited "'from receiving a salary or partnership share established by prior independent agreement, but that lawyer may not receive compensation directly related to the matter in which the lawyer is disqualified. Model Rules of Pro. Conduct r. 1.10, cmt 8.'"

The footnote appears to be *dicta* allowing screened lawyers to suffer no cut in compensation as long as the lawyer's earnings are not "directly related" to the matter giving rise to the conflict.

Observations

Whenever two lawyers kiss, and they're from different firms, must they run a conflict check? If a casual date doesn't raise a potential conflict, when does a conflict arise as the relationship becomes "serious"? When should both lawyers notify their firms? Do firms really want to know whom their lawyers are dating? Are the rules different if one or both of the lawyers are married to someone else?

Respectfully, the Model Rules don't give answers.

The Model Rules also don't deal with potential conflicts arising from working at home, when the couple are lawyers from different firms. Must each lawyer have a computer that the other can't use? What about overhearing phone conversations? To be safe, must the lawyers work from separate, soundproof rooms? Is there automatically a conflict if a couple, both lawyers, are in firms that are adversaries but neither is working on the matter? When must there be disclosure and screening?

Respectfully, the Model Rules don't give answers. This writer submits that the ABA should amplify the rules to deal with personal relationships and working from home. Remember, the rules were written when few women were lawyers and everyone worked in the office.

Without better rules, perfectly innocent lawyers will be in a world of hurt if a court applies the existing rules rigorously.

The opinion is *In re Maxus Energy Corp.*, 21-2496 (3d Cir. Sept. 9, 2022).

Absent an 'actual conflict,' disqualification is not automatic, the Third Circuit says.

Judge Ambro Explains the Primacy of Section 327(a) over State Ethics Rules

The disqualification of a lawyer for a conflict in a bankruptcy case is governed by Section 327(a), the Third Circuit recently said. Absent an "actual conflict," disqualification is discretionary and is not required under Section 327(a), even if there is a potential conflict.

The courts have discretion to apply the state's rules of professional conduct when they are relevant and compatible with federal law and policy, Circuit Judge Thomas L. Ambro said for the Philadelphia-based appeals court in his opinion on May 24. Otherwise, the inquiry does not go beyond Section 327(a).

Boy Scouts' Counsel

The Boy Scouts purchased primary insurance from an insurer that bought reinsurance from other insurers. The law firm at issue in the Third Circuit opinion was the primary insurer's counsel in disputes with the Boy Scouts' reinsurers. At about the same time the primary insurer retained the law firm, the Boy Scouts retained the same law firm to explore restructuring options in response to sexual abuse lawsuits.

In agreeing to represent the Boy Scouts, the firm told the organization that it would not give counsel on insurance coverage. The Boy Scouts retained another firm for insurance matters.

The primary insurer first learned that the firm was representing the Boy Scouts on reading an article in *The Wall Street Journal* about three months after hiring the firm for reinsurance disputes. The insurer did not object at the time.

As counsel for the Boy Scouts, lawyers from the firm attended some meetings with the primary insurer where the Boy Scouts was chiefly represented by the other firm. The insurer did not object at the time.

About 10 months after reading that the firm was also representing the Boy Scouts, the primary insurer told the firm that the dual representation was a conflict. The insurer also objected when the firm participated in mediation on the side of the Boy Scouts. The firm then responded by setting up a formal ethical screen between the firm's bankruptcy and insurance lawyers.

The insurer refused to give the firm a waiver of the alleged conflict or to consent to the firm's withdrawal. So, the firm withdrew unilaterally.

The firm filed the Boy Scouts' chapter 11 petition in February 2020. The debtor filed an application to retain the firm as its bankruptcy counsel, but the primary insurer objected.

In an opinion that Judge Ambro called "well reasoned," Bankruptcy Judge Laurie Selber Silverstein overruled the objection and authorized the firm's retention. She saw no actual conflict and found that the firm's two teams of lawyers had not shared the insurer's confidential information. The district court affirmed, but the insurer appealed to the circuit.

In the meantime, the firm's bankruptcy lawyers moved to a new firm, taking the Boy Scouts' case with them. Consequently, the firm is no longer representing either the Boy Scouts or the insurer.

Jurisdiction and Standing

Arguably, the retention order was not a final order subject to appeal as of right. Much like the Second Circuit's recent opinion in *Alix v. McKinsey & Co. Inc.*, 20-2548 (2d Cir. Jan. 19, 2022), Judge Ambro said that retention of counsel implicates the integrity of the bankruptcy system and is extremely important to resolve. For ABI's report on *Alix*, click here.

Although the firm no longer represents the Boy Scouts, Judge Ambro found constitutional and prudential standing because the possibility of disgorgement of fees gave the appeal "continuing implications" for the debtor and its creditors.

Section 327 Disqualification

Judge Ambro's opinion is a *tour de force* on disqualification under Section 327 and the relationship between Section 327 and states' ethics rules. He began analyzing the merits by laying out the fundamentals of Section 327(a).

To be eligible for employment, the professional may not "represent an adverse interest" and must be "disinterested." Although the two prongs are "distinct," Judge Ambro said, "they effectively collapse into a single test" in the case on appeal.

Conflicts under Section 327 are divisible into three categories, Judge Ambro said: (1) actual conflicts; (2) potential conflicts; and (3) appearances of conflict. If there is an actual conflict, counsel face *per se* disqualification, the judge said.

On the other hand, disqualification is discretionary if the conflict is potential, and an attorney is not disqualified on the appearance of a conflict alone, Judge Ambro said.

"Pragmatically," Judge Ambro said, "a conflict is actual when the specific facts before the bankruptcy court suggest that 'it is likely that a professional will be placed in a position permitting it to favor one interest over an impermissibly conflicting interest.'" *In re Marvel Ent. Grp., Inc.*, 140 F.3d 463, 476 (3d Cir. 1998).

The bankruptcy court had found no actual conflict under Section 327. On appeal, the insurer "has not meaningfully challenged the Bankruptcy Court's factual finding that [the firm] did not have an interest adverse to the estate," Judge Ambro said. Therefore, the firm was not saddled with an actual conflict, for the purposes of the appeal.

The insurer argued that the bankruptcy court committed error by not also evaluating the dual representation under Rules 1.7 and 1.9 of the ABA's Model Rules of Professional Conduct.

"We decline to do so," Judge Ambro said, holding that "Section 327 and the Rules of Professional Conduct impose independent obligations." He went on to say that "[p]rofessional conduct rules may be relevant and 'consulted when they are compatible with federal law and policy . . . . *In re Congoleum Corp.*, 426 F.3d 675, 687 (3d Cir. 2005).'"

Thus, the appeal at best presented a potential conflict, requiring the court to determine whether the potential conflict implicated the economic interests of the estate. In that regard, the Boy Scouts had other insurance counsel, and the Boy Scouts were not a party to the reinsurance agreement where the firm was counsel for the principal reinsurer. Given the facts, "the conflict alleged by [the insurer] was outside the scope of § 327(a)," Judge Ambro held.

Although ethics rules "may be informative in some cases," Judge Ambro said, "We never stated that violations of the Rules of Professional Conduct are themselves sufficient to create a § 327 conflict." Therefore, Judge Ambro concluded that the bankruptcy court "reasonably ruled" that the dual representation did not require disqualification under Section 327.

Judge Ambro went on to explain that disqualification is never automatic. "Even when an ethical conflict exists (or is assumed to exist) [under state ethics rules], a court may conclude based on the facts before it that disqualification is not an appropriate remedy."

In the case on appeal, the bankruptcy court did not decide whether the firm had violated any state ethics rules but decided that disqualification was inappropriate. He found that the insurer could not have been adversely affected because the firm's bankruptcy team had not received any confidential information.

To the contrary, the Boy Scouts would have been adversely affected had the firm been disqualified. Judge Ambro therefore ruled that the bankruptcy court's decision was "nowhere close to an abuse of discretion." He affirmed.

The opinion is *In re Boy Scouts of America*, 21-2035 (3d Cir. May 24, 2022).

Being seen at bar events in the company of those who appear in court doesn't show judicial bias.

Bankruptcy Courts Have 'Core' Power to Order Fee Disgorgement, Third Circuit Says

Sometimes, nonprecedential opinions have something important to say. And sometimes, opinions are fun to read.

As so it was with an April 19 opinion for the Third Circuit by Circuit Judge Kent A. Jordan. He began by alluding to "the famous first law of holes: when you're in one, stop digging."

Judge Jordan devoted the first eight pages of his April 19 opinion to laying out the dimensions of the hole that the chapter 11 debtor's lawyer had dug for himself. Basically, the lawyer failed to disclose a $19,000 payment he had received from the debtor's owner. The payment only came out when the lawyer filed an application for compensation after conversion to chapter 7.

Although the lawyer's story changed from time to time, he claimed that the payment was a loan from the owner to be repaid after a final allowance. Whatever the circumstances, the payment should have been disclosed early and often.

Judge Jordan said that the lawyer "evaded" and made "contradictory responses" to questions by the bankruptcy judge about the undisclosed payment.

Bankruptcy Judge Stacey L. Meisel of Newark, N.J., denied the fee application with prejudice and ordered the lawyer to disgorge the payment. Given the lawyer's "egregious" conduct, she also referred the matter to the chief district judge for an ethics investigation.

The district court affirmed. The lawyer fared no better in the circuit.

The lawyer led off by arguing that the bankruptcy court had no constitutional power to order disgorgement under *Stern v. Marshall*, 564 U.S. 462 (2011). He theorized that the dispute was not core because the payment came from a third party and not from the estate.

Judge Jordan dispensed with the contention by citing Third Circuit precedent, *In re Lazy Days' RV Ctr. Inc.*, 724 F.3d 418 (3d Cir. 2013). There, the Third Circuit said that the payment of legal fees is "based on a federal bankruptcy law provision [not a state tort claim] with no common law analogue, so the *Stern* line of cases is plainly inapposite." *Id*. at 423.

Violation of disclosure requirements "are thus appropriately policed through equitable remedies fashioned by the Bankruptcy Court," Judge Jordan said. He held that the "fees paid by [the owner] were to the benefit of the estate and thus were core matters within the Bankruptcy Court's purview."

Failing on constitutional grounds, the lawyer argued that the bankruptcy judge abused her discretion in ordering disgorgement. Responding to the argument, Judge Jordan said, "The word 'chutzpah' comes to mind."

The "repeated violations" of the Code and Rules and the "lack of candor," Judge Jordan said, "more than justified entry of the Fee [disgorgement] Order."

Judge Jordan ended his opinion by telling bankruptcy judges that they need not fear being seen in the company of those who appear in their courts.

Claiming judicial bias, the lawyer cited a photograph of the bankruptcy judge standing with the chapter 7 trustee at a bar event. Judge Jordan said that "[i]t does not" evidence bias.

The opinion is *In re Greenville Ave. LLC*, 21-2164 (3d Cir. April 19, 2022).

Counsel run the risk of being paid lower local rates in 'mega' cases filed in the Eastern District of Virginia.

The War Between National and Local Rates Continues in Eastern Virginia

In the Eastern District of Virginia, counsel in "mega" chapter 11 cases run the risk of only being paid the prevailing local rates, not "national rates," as a consequence of two decisions by a district judge in the reorganization of Mahwah Bergen Retail Group, Inc., a retailer that operated 2,800 stores with names like Ann Taylor, LOFT and Lane Bryant.

After vacating the debtor's plan confirmation order due to overly broad nondebtor releases, District Judge David J. Novak of Richmond, Va., remanded the case with instructions that the bankruptcy court not allow further fee applications at rates in excess of those in Richmond.

Following remand, Chief Bankruptcy Judge Frank J. Santoro of Norfolk, Va., recommended that Judge Novak grant allowances for work performed after the reversal of confirmation at rates almost as high as the "national" rates of firms representing the debtor and the official committee.

In his recommendation on fees to Judge Novak, Judge Santoro wrote a 30-page opinion amounting to a plea for the allowance of "national" rates for counsel in "mega" cases.

Judge Novak granted the fee allowances in the amounts recommended by Judge Santoro, but he said that the calculation "in future mega cases . . . must begin with the prevailing rates in the District, not a national rate suggested by Judge Santoro."

Reading between the lines, this writer believes that Judge Santoro allowed the fees at national rates because cutting the rates in half would have been unfair to counsel who accepted and completed the difficult engagement on the belief that they would not be paid at "local" rates.

It remains to be seen whether "mega" debtors in the future will be able to attract qualified, "national" counsel to file chapter 11 petitions in the Eastern District of Virginia.

The Reversal of Confirmation

In a scorching opinion, District Judge Novak set aside confirmation of the debtor's chapter 11 plan in January because it contained "extremely broad third-party (non-debtor) releases." *Patterson v. Mahwah Bergen Retail Group Inc.*, 21-167, 2022 BL 328437, 2022 U.S. Dist. Lexis 167953 (E.D. Va. Jan. 13, 2022).

Judge Novak vacated the confirmation order, voided third-party releases, severed the third-party releases from the plan, and voided an exculpation clause. To read ABI's report, click here.

Judge Novak directed that further proceedings be held before another bankruptcy judge. Later, Judge Santoro reassigned the case to himself as the chief judge.

On January 13, the same day that he vacated confirmation, Judge Novak entered a second order disabling the bankruptcy court from exercising core powers by entering final orders of compensation in the case. Instead, he directed that the bankruptcy court issue proposed findings of fact and conclusions of law, "with respect to further petitions for approval of attorneys' fees."

In his second order, Judge Novak ordered "that attorneys' fees approved in this case shall not be for rates exceeding the prevailing market rates in the Richmond Division of the Eastern District of Virginia."

The Subsequent Fee Allowances in Bankruptcy Court

Fortunately, setting aside confirmation did not upset the apple cart entirely. As directed by Judge Novak, the debtor modified the plan, and it was confirmed by the bankruptcy court on March 3.

After re-confirmation, counsel filed fee applications covering the period from the reversal of confirmation on January 13 to the conclusion of the case.

Local counsel for the debtor filed an application for almost $7,700, at a blended rate of slightly under $500 an hour. The U.S. Trustee negotiated a $500 reduction.

"National" co-counsel for the debtor filed an application for just over $1 million, at a blended rate of almost $1,000. The highest-billing lawyer charged almost $1,500 per hour. The U.S. Trustee negotiated a reduction of $10,000.

Chief counsel for the official creditors' committee, a "national" law firm, sought about $270,000 at a blended rate just under $1,000. The U.S. Trustee negotiated a $17,000 reduction.

Judge Santoro's Fee Allowances

We won't keep you in suspense. In an opinion on August 30, Judge Santoro recommended allowing fees in the amounts negotiated by the U.S. Trustee. In other words, the fees he recommended for the two "national" firms were about twice the local rate. No one objected.

Judge Santoro's 30-page recommendation explained why he believed it would not be proper to cut national counsels' fees to local rates. He began by laying out the history of Section 330(a) and how it differed from the "spirit of economy" that prevailed under the former Bankruptcy Act.

Judge Santoro explained that Section 330(a)(3)(f), as amended, now permits the court to consider "whether the compensation is reasonable based on the customary compensation charged by comparably skilled practitioners in cases other than cases under this title." He said that the Fourth Circuit also requires consideration of the so-called *Johnson* factors.

Judge Santoro pointed out how the Fourth Circuit had said in 1994 that rates in other communities can be considered "where it is reasonable to retain attorneys from other communities." *Rum Creek Coal Sales, Inc. v. Caperton*, 31 F.3d 169, 175 (4th Cir. 1994) (citations omitted).

Around the country Judge Santoro found a "theme" in fee allowances "for out-of-market attorneys' fees[:] . . . national bankruptcy cases are different." Citing bankruptcy court decisions from California, northern New York, and Arizona, he went on to say that "limiting counsel to local-market rates in cases that are national or regional in scope would cap attorneys' fees without consideration of whether the rate is reasonable in the particular case."

Instead, Judge Santoro said that "the court must assess whether a requested rate is justified based upon the facts and circumstances of the case." He said that the "interdisciplinary nature of large Chapter 11 bankruptcy cases, together with the exigencies and sheer magnitude of work involved, typically means that local counsel is not 'truly available' to take on such cases."

With regard to the services by the two national firms, Judge Santoro referred to the "favorable outcome" they achieved and their "high level of experience, legal knowledge, and skill in the face of unique issues and significant time pressure." With regard to one firm, he found that "out-of-market rates are reasonable under the particular facts and circumstances of this case." Regarding the other, he said that "the rates reflect the firm's experience, capabilities, and position in the national market."

Given the "excellent results under challenging circumstances," Judge Santoro recommended that the district court grant the fee allowances with the small cuts negotiated by the U.S. Trustee.

Approval in District Court

In his four-page opinion on September 16, District Judge Novak recited the instruction in his January 13 order that fees may not exceed the "prevailing rate" in the district. Acknowledging that no one objected, he went on to say that the "Bankruptcy Court approved the rates requested, although they exceeded the prevailing rates" in the district.

Judge Novak adopted the report "as the opinion of the Court, subject to the modifications below." He approved payment of the negotiated fees, "[d]ue to the unique procedural posture of the case." He added that he "agrees with the Bankruptcy Court's analysis that this case warrants rates exceeding the prevailing market rates in the Eastern District of Virginia."

"In future mega cases," Judge Novak said, "the 'yardstick' for the rate calculation must begin with the prevailing rates in this District, not a national rate suggested by Judge Santoro. . . . [T]he appropriate rate calculation is a mega case must be determined on a case-by-case basis with detailed findings addressing Section 330(a)(3) and the *Johnson* factors in each case."

Pure Speculation

It's pure speculation on the part of this writer, but it is possible that Judge Novak did not impose local rates from concern that the two "national" firms would appeal and win reversal in the Fourth Circuit. It remains to be seen whether other bankruptcy and district courts in eastern Virginia will follow Judge Novak. We may never know, because "national" firms may henceforth shy away from Virginia.

The recommendation by Judge Santoro is *Retail Group Inc.*, 20-33113 (Bankr. E.D. Va. Aug. 30, 2022); and the opinion by District Judge Novak is *Patterson v. Mahwah Bergen Retail Group Inc.*, 21-167 (E.D. Va. Sept. 13, 2022).

Preferences, Fraudulent Transfers & Claims

Creating a circuit split, the Fifth Circuit holds that the solvent-debtor exception to the allowance of post-petition interest survived adoption of the Bankruptcy Code.

Possibly *Dicta*, the Fifth Circuit Disallows Make-Wholes

Institutional lenders and bondholders won big and lost big in an October 14 opinion from the Fifth Circuit. If you're an unsecured lender with a "make-whole" and "default interest" owing by a *solvent* debtor, you won. If an *insolvent* debtor owes you a "make-whole," you lost.

Unanimously, the Fifth Circuit panel decided that a so-called make-whole is "the economic equivalent of unmatured interest" and is therefore disallowed by Section 502(b)(2). The opinion may or may not have created a *cert*-worthy circuit split.

In a 2/1 ruling, the majority upheld the bankruptcy court's decision that the so-called solvent-debtor exception to the disallowance of post-petition interest was not abrogated by the adoption of the Bankruptcy Code in 1978. The decision in this regard does seem to give rise to a circuit split.

The lenders in the Fifth Circuit lost on make-wholes as a stand-alone issue, but they walked away with victory because the majority decided that the solvent-debtor exception survives. Consequently, the majority awarded the lenders both the make-whole plus default interest at the higher contract rate. The majority's holding on the solvent-debtor exception created a split of circuits.

The dissent and the circuit splits invite the debtor to file a petition for rehearing *en banc* or a petition for *certiorari* to the Supreme Court, or both.

Ultra Resources, a 'Massively' Solvent Debtor

Ultra Resources, an oil and gas producer, was forced into chapter 11 in 2016 when the price of petroleum imploded. Insolvent on filing, both the bankruptcy court and the Fifth Circuit said that the debtor became "massively solvent" when oil prices rose. The solvent debtors proposed a plan where creditors were unimpaired and thus not entitled to vote on the plan.

The bondholders' loan agreement included a make-whole premium, which compensates a lender for being forced to reinvest at a lower interest rate if the loan is paid before maturity. The

plan did not pay the make-whole, contending that it was unmatured interest disallowed under Section 502(b)(2).

The bondholders' and the revolving credit lenders' loan agreements both called for interest after default of about 2 percentage points higher than the contract rate. The plan, however, only proposed paying post-petition interest at the federal judgment rate, not at the higher default rate called for by the loan agreements.

Although not entitled to vote on the plan, the noteholders and revolving-credit lenders objected to the plan. To confirm the plan without resolving the objection, the bankruptcy court set aside $400 million to compensate the bondholders and the revolving-credit lenders if the court were later to decide that their claims for the make-whole and the default rate must be paid for the claims to be unimpaired.

Later, the bankruptcy court ruled that the claims must be paid in full under state law for the lenders to be unimpaired. The bankruptcy court did not decide whether make-wholes are prohibited under Section 502(b)(2) or whether the solvent-debtor exception persisted after the adoption of the Code.

The lenders appealed, and the bankruptcy court certified a direct appeal to the Fifth Circuit.

For now truncating the procedural history, suffice it to say that the Fifth Circuit reversed, holding in November 2019 that disallowing the make-whole and default interest under provisions of the Bankruptcy Code by itself did not render the claims impaired. *Ultra Petroleum Corp. v. Ad Hoc Committee of Unsecured Creditors (In re Ultra Petroleum Corp.)*, 943 F.3d 758 (5th Cir. Nov. 26, 2019). To read ABI's report, click here.

The circuit court said that the bankruptcy court was "best able" to rule in the first instance on the allowance of make-wholes and default interest. *Id*. at 765. Nonetheless, the appeals court went on to say, "Our review of the record reveals no reason why the solvent-debtor exception could not apply." *Id*.

Back in bankruptcy court on remand, Bankruptcy Judge Marvin Isgur of Houston ruled that make-wholes were *not* the equivalent of unmatured interest and should be allowed for the creditors to be unimpaired. Likewise, he concluded that the solvent-debtor exception was not abrogated by the adoption of the Bankruptcy Code. He therefore allowed both the make-whole and the default rates of interest. *In re Ultra Petroleum Corp.*, 624 B.R. 178 (Bankr. S.D. Tex. Oct. 26, 2020). To read ABI's report, click here.

For a second time, the Fifth Circuit agreed to hear a direct appeal.

Make-Wholes Aren't Allowed

On the allowance of make-wholes, the lenders lost the battle as a general principle but won the war because the majority, as we shall discuss later, decided they were entitled to makes-wholes and default interest given to a solvent debtor.

Writing the opinion for the panel on make-wholes, Circuit Judge Jennifer Walker Elrod first analyzed whether make-wholes are a disguised form of unmatured interest to be disallowed as a matter of law under Section 502(b)(2). That section disallows a claim "to the extent that . . . such claim is for unmatured interest."

In substance, Judge Elrod saw her panel as being bound by *In re Pengo Indus., Inc.*, 962 F.2d 543, 546 (5th Cir. 1992), where the Fifth Circuit held that original-issue discount is disallowed as unmatured interest as a matter of "economic fact." Interpreting *Pengo*, she said, "What matters in this context is the underlying 'economic reality' of the thing — not dictionary definitions or formalistic labels."

In other words, Judge Elrod said, a claim is disallowed if it "is really just the functional equivalent of unmatured interest."

Applying *Pengo*'s principles, Judge Elrod said that a make-whole "compensates Creditors for the *future* use of their money. . . . This is simply another way of saying that the interest is *unmatured*. And unmatured interest is still interest." [Emphasis in original.]

Judge Elrod rejected the notion that make-wholes are liquidated damages, which some lower courts have allowed. She held that a make-whole "is indeed a claim for unmatured interest or its economic equivalent [and is] disallowed under 11 U.S.C. § 502(b)(2)."

The Solvent-Debtor Exception

Although defeated on unmatured interest, the lenders had another route to victory: the solvent-debtor exception to the disallowance of interest in bankruptcy cases. Here, they won.

Ordinarily, Judge Elrod said, a make-whole would be disallowed. "But this is not an ordinary case," she said, because the debtor was solvent.

Judge Elrod traced the 300-year history of the solvent-debtor exception. Generally, English common law disallowed interest on creditors' claims after bankruptcy or the equivalent. The solvent-debtor exception allowed claims for interest when the debtor was solvent.

Judge Elrod cited the Supreme Court for saying that the exception was imported into the U.S. from England and was embraced by the Bankruptcy Act of 1898.

The debtor argued that the exception had been abrogated by the adoption of the Bankruptcy Code in 1978 and the absolute language in Section 502(b)(2). Judge Elrod cited the First and Sixth Circuits for holding that interest is disallowed under the Code even if the debtor is solvent.

Addressing the seemingly absolute language in Section 502(b)(2), Judge Elrod said, "[O]ne would expect [Congress] to have *expressly* abrogated the judicial exception if it intended to do so." [Emphasis in original.] She supported her notion of statutory interpretation by alluding to Supreme Court authority, which she interpreted to mean that "[w]e must defer to prior bankruptcy practice unless expressly abrogated."

Because the alleged abrogation of the solvent-debtor exception was not "absolutely clear," Judge Elrod held that the exception "is alive and well." For that reason, she said that the debtor must pay the make-whole, "even though . . . it is indeed otherwise disallowed unmatured interest."

The Make-Whole Is Enforceable

So far, Judge Elrod had been working on the assumption that the make-whole was enforceable under New York law governing the loan agreements. The debtor contended that it was an unenforceable penalty.

To be a penalty under New York law, the make-whole must be grossly disproportionate to the probable loss. Because it wasn't, Judge Elrod held that the make-whole was enforceable under New York law. Therefore, she said, "§ 502(b)(1) does not stand in the way of the solvent-debtor exception."

Post-Petition Interest

The debtor conceded that the creditors were entitled to some post-petition interest because the estate was solvent. But the debtor also argued that the lenders were only entitled to the lower federal judgment rate in 28 U.S.C. § 1961(a), not the higher default rates in the loan agreements.

To find the answer, Judge Elrod studied the concept of impairment and the requirements of cramdown.

Section 726(a)(5) was seemingly relevant because cramdown requires proving that the creditors were being treated no worse than they would have been in a chapter 7 liquidation. As fifth priority when the debtor is solvent, the section requires "payment of interest at the legal rate from the date of the filing of the petition."

At that juncture, Judge Elrod was confronted by *In re Cardelucci*, 285 F.3d 1231 (9th Cir. 2002), where the Ninth Circuit held that Section 726(a)(5) mandates the federal judgment rate.

However, she was able to avoid deciding, like *Cardelucci*, whether the reference to "the legal rate" in Section 726(a)(5) means the federal judgment rate in 28 U.S.C. § 1961(a).

Instead, Judge Elrod pointed out that Section 1129(a)(7)(ii) does not require paying the "legal rate" in a hypothetical chapter 7 case. Rather, it says that the creditor must receive an amount "that is not less than the amount that such holder would so receive" in chapter 7. In other words, she said that Section 726(a)(5) only sets a "floor," not a "ceiling."

Although Judge Elrod disagreed with the bankruptcy court regarding the allowance of a make-whole, the other considerations in her opinion led her to affirm the judgment of the bankruptcy court by giving the lenders "what they bargained for with this solvent debtor."

The Dissent

Circuit Judge Andrew S. Oldham dissented in part. He agreed with the majority that "the Make-Whole Amount is unmatured interest in disguise."

He parted company with the majority because he did not believe that the solvent-debtor exception survived adoption of the Bankruptcy Code. He read Section 502(b)(2) to mean that "all claims for unmatured interest are disallowed."

Judge Oldman dissected the predecessors to the Bankruptcy Code and found that they prohibited "some" unmatured interest but did "not contain a blanket bar on all unmatured interest — unlike § 502(b)(2)." Specifically, he believes that unmatured interest was disallowed by a combination of Sections 63(a)(1) and 65(e) of the former Bankruptcy Act.

In contrast, Judge Oldham said that the Code "goes for the jugular by flatly disallowing 'claim[s] for unmatured interest.' 11 U.S.C. § 502(b)(2)."

Judge Oldham would have disallowed the make-whole and limited the lenders' recovery to the federal judgment rate. He "respectfully" dissented.

Observations

The Fifth Circuit's opinion also seems to raise a circuit split on the disallowance of make-wholes.

The Third Circuit allowed a make-whole in *Delaware Trust Co. v. Energy Future Intermediate Holding Co. LLC (In re Energy Future Holdings Corp.)*, 842 F.3d 247 (3d Cir. 2016), but the Second Circuit seemingly disallowed make-wholes in *BOKF NA v. Momentive Performance Materials Inc. (In re MPM Silicones LLC)*, 874 F.3d 787 (2d Cir. 2017), *cert. den. sub nom BOKF*

N.A. v. Momentive Performance Materials Inc., 138 S. Ct. 2653 (2018). For some of ABI's coverage of *Energy Future* and *MPM*, click here and here.

Bankruptcy Judge Isgur and some other courts believe that *MPM's* disallowance of make-wholes was *dicta*. If the Second Circuit's ruling was *dicta*, then there wasn't a concrete circuit split until the Fifth Circuit came along.

But think for a minute. Was the Fifth Circuit's decision *dicta* with regard to make-wholes?

The Fifth Circuit's disallowance of make-wholes was not necessary to the opinion, because the New Orleans-based court found other reasons for allowing a make-whole when the debtor is insolvent. Some therefore might say that the Fifth Circuit's opinion on make-wholes is *dicta*. The lack of a clear-cut circuit split on make-wholes doesn't make the case an attractive candidate for a grant of *certiorari* by the Supreme Court.

On the other hand, there is a circuit split on the Bankruptcy Code's abrogation (or not) of the solvent-debtor exception. To enhance the chance of a successful rehearing or a grant of *certiorari*, the debtor can also point to the dissent by Judge Oldham.

The Withdraw Opinion

We glossed over a curious procedural fact. The Fifth Circuit's prior opinion in November 2019 was not the first.

In January 2019 on the first direct appeal, Judge Oldham wrote at length about the allowance of make-wholes. *Ultra Petroleum Corp. v. Ad Hoc Committee of Unsecured Creditors (In re Ultra Petroleum Corp.)*, 913 F.3d 533 (5th Cir. Jan. 17, 2019). To read ABI's reports on the original opinion, click here.

When the debtor moved for panel rehearing, Judge Oldham withdrew the January opinion and issued a shorter opinion in November 2019, eliminating pages of *dicta* about make-wholes and limiting the ruling to a declaration that disallowance of portions of a claim by the operation of provisions of the Bankruptcy Code does not amount to "impairment" of the claim entitling the creditor to vote for or against confirmation of a chapter 11 plan.

Now, we have a second opinion by the Fifth Circuit on make-wholes, but it too may be *dicta*.

The opinion is *Ultra Petroleum Corp. v. Ad Hoc Committee of OpCo Unsecured Creditors (In re Ultra Petroleum Corp.)*, 21-200008 (5th Cir. Oct. 14, 2022).

In spreading the automatic stay, the bankruptcy court again employed the traditional analysis without recognition that the non-debtors are solvent.

Court Halts States' Police and Regulatory Suits against Non-Debtor Johnson & Johnson

In a follow-up to his opinion in February declining to dismiss the chapter 11 case filed by an indirect subsidiary of Johnson & Johnson, Chief Bankruptcy Judge Michael B. Kaplan of Trenton, N.J., held that the bankruptcy court has power to impose a stay on states' exercise of their police and regulatory powers, even though the continuation of the states' suits is exempt from the automatic stay under Section 362(b)(4).

Background

Just before chapter 11 one year ago, Johnson & Johnson formed two new subsidiaries. LTL Management LLC was created to be the debtor, and the other took over J&J's operating businesses. Two days later, LTL filed a chapter 11 petition in Charlotte, N.C. The bankruptcy judge in North Carolina transferred the case to New Jersey, where Judge Kaplan landed the dubious assignment.

LTL has no business operations of its own but assumed liability for all talc-related asbestos claims. J&J and the other non-debtor businesses agreed to supply the funds necessary for LTL to prosecute the reorganization and emerge from chapter 11.

The official committee representing talc claimants filed a motion to dismiss the chapter 11 case under Section 1112(b), contending that the filing was in bad faith. The U.S. Trustee supported either dismissal or appointment of a chapter 11 trustee. Judge Kaplan denied the motion on February 25. *In re LTL Management LLC*, 637 B.R. 396 (Bankr. D.N.J. Feb. 25, 2022).

Refusing to dismiss the case after a five-day trial, Judge Kaplan said that the chapter 11 filing "is unquestionably a proper purpose under the Bankruptcy Code." *Id.* at 408. He also granted a preliminary injunction barring the continuation of lawsuits against the non-debtor J&J parent and affiliates. The talc claimants appealed directly to the Third Circuit, which heard argument on September 19. To read ABI's report on the February 25 opinion, click here.

The Lawsuits by New Mexico and Mississippi

Before bankruptcy, the states of New Mexico and Mississippi had sued J&J, alleging that the sale of products laced with asbestos violated state laws prohibiting unfair trade practices and false advertising. Among other relief, the states sought money damages.

The debtor filed an adversary proceeding against the two states in June, asking Judge Kaplan for injunctive relief to stop the states' lawsuits. The states opposed, contending that the suits were immune from the automatic stay as an exercise of governmental police and regulatory powers under Section 362(b)(4).

The Bankruptcy Court Has Jurisdiction

Judge Kaplan began with the debtor's contention that the automatic stay applied, but first, he dismissed the states' contention that the bankruptcy court lacked subject matter jurisdiction to issue or enforce a stay against them.

The states argued that the bankruptcy court had no subject matter jurisdiction because the bankruptcy court would have had no jurisdiction to preside over the police and regulatory enforcement actions. Judge Kaplan said that the proper focus was on the bankruptcy court's jurisdiction over the adversary proceeding, not the suits in state courts.

Judge Kaplan found jurisdiction because the adversary proceeding "unquestionably" involves the automatic stay and whether it was "appropriate" to extend the stay's protection to non-debtors. He held that the bankruptcy court had jurisdiction and that it was "core."

Just in case, Judge Kaplan went on to find "related to" jurisdiction because the outcome might affect the debtor's insurance coverage and its indemnification obligations.

The Automatic Stay

Next, Judge Kaplan examined whether it was "appropriate" to extend to the automatic stay to cover non-debtors.

Although the J&J entities named as defendants in the states' suits were not in bankruptcy, Judge Kaplan found that the suits were, "fundamentally, an attempt to liquidate and recover claims against the Debtor."

"Accepting the premise that [the] Debtor is a true defendant," Judge Kaplan ruled that the automatic stay applied to the suits under Section 362(a)(1). Likewise, he held that the suits were enjoined as an act to obtain possession or control of estate property under Section 362(a)(3), given the "shared insurance policies" that would be invaded by a judgment.

Extension of the Stay

If the stay were not automatically applicable to non-debtors, Judge Kaplan confronted the question of whether there were "unusual circumstances" to warrant an extension of the stay to protect non-debtors.

Having held in his February 25 opinion that there is an "identity of interest" between the debtor and its affiliates, Judge Kaplan concluded that an extension of the stay was proper, because the suits would divert resources and "disrupt the flow of funds."

Judge Kaplan also found that continuation of the actions against non-debtors "would impair mediation efforts and ongoing negotiations taking place within this bankruptcy."

The Exception for Regulatory Actions

Although he found the automatic stay to apply, Judge Kaplan focused on Section 362(b)(4) to decide whether there was "any applicable statutory exception" allowing the states to continue their suits. The section provides that the automatic stay does not apply to "the commencement or continuation of an action or proceeding by a governmental unit . . . to enforce such governmental unit's or organization's police and regulatory power. . . ."

Judge Kaplan cited the advisory committee notes for saying that the exception should be given a "narrow construction." The Third Circuit created two tests for the exception, "the pecuniary purpose and public policy tests."

Because the suits were "proceedings related to public safety and welfare," Judge Kaplan found with little hesitation that the exception to the automatic stay in Section 362(b)(4) did apply, even though the states also sought monetary damages. But, he said, the "conclusion does not end this Court's inquiry," he said.

Judge Kaplan found "nothing in the statute [that] prevents a court from imposing or extending the stay under § 362(a) subsequent to the filing." Likewise, he found "nothing in the statute [that] precludes a bankruptcy court from issuing injunctive relief under § 105(a) enjoining the governmental unit's proceedings where circumstances so warrant."

Judge Kaplan found "that the exercise of the States' police power seriously conflicts with the policies underlying the Bankruptcy Code." He therefore held that "§ 362(b)(4)'s prevention of an 'automatic' stay upon the filing of the bankruptcy does not bar this Court from imposing or extending the stay under § 362(a), or otherwise restrict this Court's ability to issue injunctive relief under § 105(a)."

A Section 105(a) Injunction

Judge Kaplan ended his 45-page opinion by finding justification and power for a non-debtor stay under Section 105(a) and the traditional rules for preliminary injunctions.

In that regard, he found that the debtor had a likelihood of success on the merits and had shown irreparable harm in the absence of stay. On the other hand, he saw only "minimal harm" to the states resulting from a stay.

In terms of public interest, Judge Kaplan said it would be "patently unfair to permit the States to proceed while others — particularly those who allege more direct, personal harm — must wait."

The stay will not be open ended. Judge Kaplan said that he would "revisit continuation of the automatic stay" at a hearing in December.

The opinion is *LTL Management LLC v. State of New Mexico (In re LTL Management LLC)*, 22-01231 (Bankr. D.N.J. Oct. 4, 2022).

Circuit courts differ on their understanding of Supreme Court precedent and are now split 3/3 on whether a real estate tax foreclosure can be set aside as a constructive fraudulent transfer.

Split Grows on Barring Fraudulent Transfer Attacks on Real Estate Tax Foreclosures

Add the Sixth Circuit to the courts holding that real estate tax foreclosures can be attacked as fraudulent transfers despite *BFP v. Resolution Trust*, 511 U.S. 531 (1994), where the Supreme Court ruled that mortgage foreclosures are immune from fraudulent transfer attack.

Although the appeals court's decision was non-precedential, the opinion has equally important language about limitations on the *Rooker-Feldman* doctrine.

The Circuit Split

Regarding tax foreclosure, the Third, Sixth and Seventh Circuits now hold that they can be attacked as fraudulent transfers. Regarding the Third Circuit, *see Hackler v. Arianna Holdings Co., LLC*, 938 F.3d 473 (3d Cir. 2019). To read ABI's report, click here. Regarding the Seventh Circuit, *see Smith*, *infra*.

The Fifth, Ninth and Tenth Circuits hold to the contrary, having extended *BFP* from immunizing mortgage foreclosures to protecting tax foreclosures. The most recent of those decisions came from the Ninth Circuit. *See Tracht Gut, LLC v. Los Angeles County Treasurer*, 836 F.3d 1146 (9th Cir. 2016). To read ABI's report on *Tracht Gut*, click here.

Delinquent Taxes

In the Sixth Circuit appeal, the debtor had been several years behind in paying real estate taxes on his home. The county obtained a final judgment of foreclosure. Because the debtor did not redeem the property by paying the taxes on time, the city exercised its statutory right to purchase the property for the amount of the unpaid taxes, about $14,500.

At the time, the property was assessed for $104,000. The debtor alleged that the fair market value was $152,000.

The debtor filed a chapter 13 petition and a complaint alleging that the tax sale could be avoided as a constructively fraudulent transfer under Section 548(a)(1)(B). The city filed a motion for summary judgment and won.

The bankruptcy court reasoned that the *Rooker-Feldman* doctrine barred relitigating the state court foreclosure. The bankruptcy court also said that the fraudulent transfer attack was precluded by *BFP*.

The debtor appealed. The district court affirmed, but based only on *BFP*. The debtor appealed again and won a remand.

By the way, the debtor remains in chapter 13, having confirmed a plan.

Rooker-Feldman

In his December 27 opinion, Circuit Judge John M. Rogers first dealt with *Rooker-Feldman*. Named for two Supreme Court decisions, the doctrine bars lower federal courts from engaging in appellate review of state court judgments.

Judge Rogers quoted the Supreme Court for saying that *Rooker-Feldman* is a narrow doctrine that should not be applied broadly. He cited the Third Circuit for holding that the court may decide whether foreclosure amounted to a fraudulent transfer under Section 548 while still assuming that the state court foreclosure was proper. *See In re Philadelphia Ent. & Dev. Partners*, 879 F.3d 492, 500-01 (3d Cir. 2018). To read ABI's report, click here.

In the case on appeal, Judge Rogers ruled that *Rooker-Feldman* "does not apply here because this appeal does not involve a review of the merits of a state court judgment." He said that the debtor's "alleged injury in this case is not the state court foreclosure judgment, but instead is the fact that he could not use § 548 to avoid the foreclosure as a fraudulent transfer."

The bankruptcy court therefore erred in barring the fraudulent transfer claim under *Rooker-Feldman*.

BFP

Next, Judge Rogers tackled the bankruptcy court's second ground for dismissal, the expansion of *BFP* to cover real estate tax foreclosures.

Tersely, Judge Rogers said that the "Supreme Court's rule in *BFP* does not apply to the facts of this case," because the Supreme Court was ruling on mortgage foreclosure, not tax foreclosure.

Judge Rogers noted the differences between the two types of foreclosure. In tax foreclosure in Michigan, there is no public auction and no minimum bid. In the case on appeal, the sale price of $14,500 "had no apparent relation to the value of the property and was only about ten percent of the alleged fair-market value."

Based on the same factual distinctions, Judge Rogers cited the Seventh Circuit for "persuasively" holding "that *BFP* did not extend to the state court tax foreclosure at issue." *See In re Smith*, 811 F.3d 228, 234 (7th Cir. 2016). For ABI's report, click here.

Judge Rogers held that the two grounds for upholding dismissal of the suit are "insufficient at this juncture." However, he was unable to award judgment altogether to the debtor.

Remand

There were two undecided issues that precluded the Sixth Circuit from granting judgment in favor of the debtor. First, the lower courts had not decided whether the debtor was insolvent on filing and thus eligible to raise a claim for a constructively fraudulent transfer. Second, there was an unresolved question about the debtor's ability to attack the sale once the redemption period had elapsed.

So, Judge Rogers reversed and remanded, saying that the "district court may in its discretion further remand the case to the bankruptcy court."

The opinion is *Lowry v. Southfield Neighborhood Revitalization Initiative (In re Lowry)*, 20-1712 (6th Cir. Dec. 27, 2021).

Although a stock purchase and a loan payoff were only one month apart, the two transactions lacked a sufficient nexus to invoke the safe harbor, Bankruptcy Judge James Carr said.

Indiana Bankruptcy Judge Narrowly Reads the Section 546(e) Safe Harbor

Building on Supreme Court authority, Bankruptcy Judge James M. Carr of Indianapolis narrowly interpreted the safe harbor in Section 546(e) by refusing to dismiss a lawsuit against a guarantor whose liability was eliminated by the debtor's payment to the bank that held the guarantee.

A company was owned by an employee stock ownership plan trust. A private equity investor negotiated a deal to purchase the company by acquiring the stock from the ESOP. The stock owned by the ESOP was not traded publicly.

To complete the acquisition, the buyer obtained a $24.9 million bridge loan from a bank. The buyer was obligated to the bank, but the company being acquired was not liable on the loan. One month after the acquisition was completed, the debtor obtained loans from another bank and paid off the $24.9 million bridge loan for which the buyer had been liable but the debtor was not.

The debtor pledged its assets as security for the new loans that paid off the $24.9 million bridge loan.

The debtor's business turned sour after the acquisition. Slightly more than two years after closing, creditors filed an involuntary petition, leading to an order for relief in chapter 7.

Because the transfer occurred more than two years before filing, the chapter 7 trustee invoked powers under Section 544(b) to step into the shoes of an actual creditor and sue the buyer for a constructive fraudulent transfer under Indiana law. The trustee alleged that the transfer paying off the bridge loan was "to or for the benefit" of the buyer and that the debtor received no consideration for encumbering its property.

Noting that the new loan paid off a financial institution and was used to buy stock from the ESOP, the buyer filed a motion to dismiss based on the Section 546(e) safe harbor. The subsection provides:

> the trustee may not avoid a transfer . . . made by or to (or for the benefit of) a . . . financial institution . . . or that is a transfer made by or to (or for the benefit of) a . . . financial institution . . . in connection with a securities contract, as defined in section 741(7), . . . except under section 548(a)(1)(A) of this title [for a transfer made with actual intent to hinder, delay or defraud].

Judge Carr denied the motion on August 18.

Judge Carr first ruled that the trustee had made a plausible claim for a constructive fraudulent transfer for the benefit of the buyer and then turned to the buyer's safe harbor defense.

In the 1984 amendments giving rise to Section 546(e), Judge Carr said that Congress intended "to clarify that the safe harbor applies to all transfers (other than actual fraudulent transfers) made to designated financial intermediaries in connection with their facilitation of trades executed through the Securities Clearance and Settlement System or the commodities clearance system."

Even given "this clear legislative intent," Judge Carr said that

> courts have no clear mandate in the language of § 546(e) to apply the safe harbor to shield transfers that do not implicate the Securities Clearance and Settlement System. Courts should be particularly reluctant to do so where, as here, the transfer under attack does not implicate the national System for trades of publicly-held securities or pose a systemic risk to the financial marketplace.

Judge Carr said that the buyer wanted "a liberal interpretation of the broadly defined terms of the safe harbor . . . even though the underlying purchase of stock was a private transaction that did not in any sense involve the System that § 546(e) was intended to protect."

Quoting the Seventh Circuit, Judge Carr said that "a strictly literal interpretation (without any consideration of the statutory purpose) is disfavored when it 'would frustrate the overall purpose of the statutory scheme, lead to absurd results, or contravene clearly expressed legislative intent.'"

To invoke the safe harbor, Judge Carr said there must be a "sufficient nexus" between the transfer and a securities contract to conclude that the transfer was made "in connection with" a securities contract.

For definition of "in connection with," Judge Carr cited *Chadbourne & Parke LLP v. Troice*, 571 U.S. 377, 387 (2014), where the Supreme Court said in a suit under SLUSA that "in connection with" "suggests a connection that matters." The Court went on to eschew an overly broad construction to avoid interfering "with state efforts to provide remedies for victims of ordinary state-law frauds." *Id*. at 391.

To Judge Carr's way of thinking,

> an overly expansive interpretation of "in connection with" would not advance any purpose underlying Congress' enactment of the safe harbor of § 546(e) or the policies underlying the avoidance provisions of the Bankruptcy Code's chapter 5 or the [state fraudulent transfer law].

Judge Carr saw "no material nexus" between the buyer's contract to purchase stock from the ESOP and the payoff of the loan to the bridge lender. He said that nothing in the stock purchase agreement "indicates that [it] was executed or performed 'in connection with'" paying off the bridge loan.

"Instead," Judge Carr said, the stock purchase and the loan payoff were "two separate transactions" that occurred "one month apart." He noted that the trustee was not aiming to avoid the payment to the ESOP that effected the stock purchase.

Judge Carr denied the motion to dismiss under the safe harbor because the new loan one month after closing had "nothing to do with the purchase or sale of any securities or any 'securities contract'" and there was no "sufficient nexus between the [stock purchase agreement] and the [loan payoff] to bring the 'safe harbor' of Section 546(e) into play."

The opinion is *Petr v. BMO Harris Bank N.A. (In re BWGS LLC)*, 21-50007 (Bankr. S.D. Ind. Aug. 18, 2022).

Bankruptcy Judge Sean Lane in New York barred a chapter 11 claims agent from selling the claims docket to a claims trader in return for a share of the fees earned by the trader.

Claims Agents Are Barred from Making Money on the Side from the Claims Docket

A claims agent for a chapter 11 debtor cannot earn extra income by uploading the claims docket to a claims trader in return for a cut of the fees earned by the claims trader, according to an August 18 opinion by Bankruptcy Judge Sean H. Lane of Manhattan.

In the Southern District of New York, local rules require a chapter 11 debtor to retain a claims and noticing agent whenever there will be more than 250 claims. The claims agents are retained by court order, and their fees are paid by the debtor as administrative claims. The claims agent maintains a docket of filed claims.

In its retention application in a mass-tort chapter 11 case in Manhattan, the claims agent disclosed that it had an agreement with a claims trader under which the claims agent would upload the claims docket to the trader in a form compatible with the trader's software.

In return for the upload and updates, the trader would pay the claims agent 10% of the fees it received for effecting trades in claims against the debtor.

At the first day hearing, Judge Lane approved the claims agent's retention on an interim basis but asked for briefing on the propriety of the arrangement with the trader. In response, the claims agent filed the full text of the agreements with the trader and contended that the arrangement was not inappropriate. More particularly, the claims agent said that the agreement was not in its capacity as an agent for the court clerk but was "in its capacity as a private, for-profit enterprise."

Judge Lane did not leave the reader in suspense. "Because [the claims agent] is acting in its capacity as an agent of the Clerk," he said on the first page of the opinion that the claims agent "may not enter into this business arrangement with [the claims trader] because the Clerk of Court would not be permitted to enter into such a relationship or receive such fees."

Judge Lane justified his conclusion by the statutes and local rules.

Claims agents may be retained under 28 U.S.C. § 156(c), which says:

> Any court may utilize facilities or services, either on or off the court's premises, which pertain to the provision of notices, dockets, calendars, and other administrative information to parties in cases filed under the provisions of title 11, United States Code, where the costs of such facilities or services are paid for out of the assets of the estate and are not charged to the United States.

In other words, Judge Lane said, "a claims agent may be retained in a bankruptcy case to assist the Clerk with certain administrative tasks and be compensated by the bankruptcy estate." He added that the activities of a claims agent "are further governed" by the bankruptcy court's "Protocol," which "provides that the claims agent's activities should not extend beyond the notice and processing tasks that the Clerk of Court may perform." To read the Protocol, click here.

As agent for the court clerk, Judge Lane said that the claims agent was also bound by the Code of Conduct for Judicial Employees, which says, among other things, that "a judicial employee should not . . . appear to advance the private interests of others. A judicial employee should not use public office for private gain."

Judge Lane said that the clerk, and by extension the claims agent, is limited to accepting fees authorized by 28 U.S.C. § 1930. In turn, Section 1914(b) allows the Judicial Conference to authorize additional fees. Those fees, he said, "are set forth in extensive and painstaking detail in the Bankruptcy Court Miscellaneous Fee Schedule." However, those fees are paid to the U.S. Treasury.

Having laid out the governing law, Judge Lane said that the claims agent's "authority to act is derivative of the Clerk's authority" and is limited to the duties that would be performed by the clerk.

By uploading the claims docket to the trader's platform, Judge Lane said that "the [claims agent's] obligations and duties under the [contract with the trader] clearly go beyond the 156(c) Activities." The clerk, he said, "cannot engage in a for-profit relationship solely to benefit" the trader.

If the clerk were to share fees generated by the trader, Judge Lane said that the clerk would violate the rule against using public office for private gain. Since the clerk can only collect fees permitted under Section 1930, he said that the claims agent cannot make an agreement that the clerk would be prohibited from making.

Judge Lane rejected five additional arguments by the claims agent. He ended his opinion by approving retention of the claims agent, with the proviso that the claims agent may not have "any file sharing" agreement with the trader.

Observations

Consider the results had Judge Lane allowed the agent to sell the claims docket and profit in return.

Were the claims agent not prohibited from profiting on the side from the claims docket, the claims agent presumably could put advertising on the docket. The advertising could include the names of law firms for creditors to hire. The appearance of law firms on the docket would seem like an endorsement by the court.

The opinion is *Madison Square Boys & Girls Club Inc.*, 22-10910 (Bankr. S.D.N.Y. Aug. 18, 2022).

The transferee of a claim doesn't have standing to object to recording the transfer of a claim to it on the claims docket, Judge Garrity says.

Claims Agents Aren't Junior Judges Ruling on the Validity of Claim Transfers

Bankruptcy Judge James L. Garrity, Jr., of New York wrote a devilishly complex opinion standing for the proposition that a claims and noticing agent is not a junior judge acting as a gatekeeper to rule initially on the validity of the transfer of a claim.

Rather, Judge Garrity said in his September 13 opinion that a claims agent must record a transfer if the transfer was made before the proof of claim was filed. After a claim has been filed, the claims agent must record the transfer on the claims docket if there was no objection by the transferor. The transferee has no right to lodge an objection to the transfer of a claim allegedly transferred to it.

The dispute arose in the chapter 11 reorganization of a large company. With the court's authorization, the debtor engaged a claims and noticing agent. The claims agent was tasked with maintaining the claims docket and recording transfers of claims in the manner a court clerk would record claims and transfers under Bankruptcy Rule 3001.

A subsidiary of another large company held a claim for more than $15 million. Before the subsidiary-creditor filed the claim, it sold the claim for about $10 million to an entity that we shall refer to as Transferee I.

The next day, Transferee I sold the claim for the same price plus a $100,000 brokerage commission to an entity that we shall refer to as Transferee II. Transferees I and II both quickly filed appropriate notices of the transfers with the claims agent.

Later, Transferee II evidently had buyer's remorse and attempted to undo the purchase of the claim on grounds we shall discuss below.

When both transfers took place, the subsidiary-creditor had not filed a proof of claim. Then, the bankruptcy court entered an order allowing the claim for $15 million. The allowance order did not require the subsidiary-creditor to file a proof of claim.

The claims agent learned that the bankruptcy court would enter an order somehow amending the order allowing the claim. The claims agent "paused" the processing of the two transfers. The

subsequently amended order allowed the claim in the same amount but gave the subsidiary-creditor 30 days to file a proof of claim.

The subsidiary-creditor did not file a claim. With no claim on file, the claims agent did not process the transfers. Instead, it served notices of defective transfers with respect to both transfers. All of this was occurring before any proof of claim had been filed.

Months after the 30-day deadline, the subsidiary-creditor's parent filed the claim, but the parent was not the holder of the allowed claim. (Just goes to show, anything that *can* go wrong, *will* go wrong.)

The claims agent still refused to process both transfers because the parent that filed the proof of claim was not the holder of the claim allowed by court order. The claims agent said it would record the transfers if the subsidiary-plaintiff filed the claim.

Around that time, Transferee II decided it no longer wanted the claim. Pointing to the notices of defective transfers and provisions in the agreement under which it bought the claim, Transferee II demanded that the subsidiary-creditor repay the purchase price, with interest.

Aiming to clean up the mess, the subsidiary-creditor filed the proof of claim, and the parent withdrew the claim it had filed. The claims agent then sent the subsidiary-creditor and Transferee I notices of the transfer under Bankruptcy Rule 3001(e)(2). (We're getting ahead of ourselves, but note that Rule 3001(e)(2) lays out the procedure for transfers *after* a claim has been filed, but these transfers were *before* the claim was filed.)

Transferee II reacted by telling the claims agent that it did not consent to recording the transfers. The claims agent responded by reversing the processing of both transfers. Transferee II also filed a lawsuit in state court against the subsidiary-creditor, demanding return of the purchase price.

The subsidiary-creditor filed a motion asking Judge Garrity for a direction that the claims agent record the transfers. Transferee II objected to the motion, contending that the bankruptcy court had no right or jurisdiction to decide who owned the claim.

Judge Garrity said in his opinion that he was not ruling on ownership of the claim, only deciding narrow issues regarding the transfer of the claim. Rather, he said that the motion called on him to decide whether the transfer to Transferee I should be recognized on the claims docket.

Unraveling the mess, Judge Garrity began by saying that the claims agent "is acting as an agent of the Clerk of the Court under section 156(c)." He said there was "no dispute" that there had been an unconditional transfer to Transferee I and that the transfer "conformed with nonbankruptcy law and Bankruptcy Rule 3001(e)."

Judge Garrity said that the claims agent erred by refusing to record the first transfer "since [the claims agent] misapplied Bankruptcy Rule 3001(e)(1) — the rule under which the [claim] was transferred."

Other minor errors aside, Judge Garrity said that transfers were of a claim before the filing of a proof of claim. For transfers before the filing of a claim, he cited Bankruptcy Rule 3001(e)(1) and the *Collier* treatise to say that the rule "does not mandate the filing of a proof of claim in order to fully effectuate such a transfer." Therefore, the fact that the claim had not been filed when the transfers occurred was not grounds for the claims agent to issue the notice of defective transfer.

Judge Garrity held that the retention of the claims agent "does not authorize [the claims agent] to adjudge the validity of the transfer of claims under Bankruptcy Rule 3001(e)(1)." The claims agent therefore erred when it "paused" the processing of the first transfer because "it misapplied Bankruptcy Rule 3001(e)(2) to a claim that was transferred under Bankruptcy Rule 3001(e)(1)."

Judge Garrity had an alternative ground for his decision. Even if the claims agent properly issued the notice of defective transfer, he said that the transfer to Transferee I "should be recognized and recorded on the claims register under Bankruptcy Rule 3001(e)(2)" because the transferor [the subsidiary-creditor] did not object to the transfer.

Judge Garrity explained:

> [U]nder the plain language of the statute, only the transferor has standing to object to the transfer of a filed proof of claim under Bankruptcy Rule 3001(e)(2). Third parties, like [Transferee II], do not have standing to object to a claim assignment itself.

Judge Garrity granted the motion and directed the claims agent to recognize the transfer to Transferee I and recognize Transferee I as the holder of the claim.

The opinion is *In LATAM Airlines Group S.A.*, 20-11254 (Bankr. S.D.N.Y. Sept. 13, 2022).

Judge Glenn allowed the redaction of individual crypto customers' home and email addresses, but requires the disclosure of their names and the amount of their claims. No redactions for business customers.

New York Judge Splits with Colleagues on Redaction of Crypto Customers' Names

Is there something special about a crypto company to justify the nondisclosure of the names of its creditors and customers?

Evidently not, in the opinion of Bankruptcy Judge Martin Glenn of New York. In his September 28 ruling, he only allowed the debtor to redact the home and email addresses of *individual* customers and creditors, "to protect the individuals from harassment and identity theft."

Judge Glenn is requiring the crypto debtor to file schedules showing the creditors' names and how much they are owed, without showing individual creditors' home or email addresses. However, the debtor must show the physical and email addresses of corporate or business customers and creditors.

To ensure that redaction will not hinder securities law regulators, Judge Glenn dropped a footnote to say that he would "consider releasing unredacted information" for "good cause shown on motion of any party in interest."

Judge Glenn conceded that his decision is at odds with a recent case in New York and two from the bankruptcy court in Delaware.

The Crypto Debtor

The debtor described itself as "one of the largest and most sophisticated cryptocurrency-based finance platforms in the world [with] clients across more than 100 countries." In addition to holding customers' deposits of crypto assets, the debtor said that its users could "take loans using those transferred crypto assets as collateral." The debtor claimed to have "more than 1.7 million registered users and approximately 300,000 active users with account balances greater than $100."

Before bankruptcy, Judge Glenn described how the debtor "froze all customer accounts, refusing to permit any withdrawals of crypto assets. That step," he said, "has not won many fans among Debtors' customers," as shown by "the flood of *pro se* filings on the docket."

About two weeks after the chapter 11 filing, the debtor filed a motion to redact information in court filings regarding customers, creditors, officers and employees.

More specifically, the debtor wanted authorization from Judge Glenn to redact (1) the home and email addresses of individual U.S. citizens, including customers, creditors and the debtor's employees and shareholders; and (2) the names, home addresses and email addresses of any citizens of the U.K. or E.U. countries and anyone whose citizenship was unknown.

Later, the debtor filed a motion to expand the redactions to include all individuals' names, not just their email and physical addresses. The objective was to disassociate account balance with customers' claims.

Judge Glenn quoted the debtor's papers as saying that "retaining anonymity is one of the key features of holding crypto assets." The debtor, he said, argued that "customers, employees, directors, and officers . . . fear for their safety and their families' safety if their home addresses, email addresses, and/or names are published on the public court docket."

The official creditors' committee supported the redaction motion, but the U.S. Trustee opposed.

The Statutory Criteria

Judge Glenn began with the "strong presumption and public policy in favor of public access to court records" and comprehensively laid out the various statutes and rules that allow sealing or redaction.

The principal authority for authorizing redactions is found in Section 107(b), which allows the court to protect trade secrets "or commercial information." A debtor is not required to show good cause for redacting commercial information, which need not rise to the level of a trade secret. However, the debtor must how that disclosing the information would give "an unfair advantage" to competitors.

Under Section 107(c), the court, "for cause, may protect an individual . . . to the extent the court finds that disclosure of such information would create undue risk of identity theft or other unlawful injury to the individual." The protected information is "[a]ny means of identification." According to the *Collier* treatise, the purpose is to obviate "an undue risk of identity theft or unlawful injury to the individual or the individual's property."

The debtor argued that redacting the names of customers and creditors was necessary to prevent competitors from poaching the debtor's customers. Judge Glenn rejected the idea, saying it was not "sufficient evidence to support sealing of the *names* of all creditors." [Emphasis in original.]

"[A]t least for *individuals* who maintained accounts with the Debtors," Judge Glenn held that the "Debtors should redact home addresses, telephone numbers and email addresses, but not the creditors' names, from any Court filings, to protect the individuals from harassment and identity theft." [Emphasis in original.] He went on to say that his ruling would give the debtor protection for "whatever commercial value may flow from that information."

Judge Glenn emphasized that he was "only granting that protection with respect to addresses of individual customers, not for corporate, LLP or LLC customers." He explained that "personally identifiable information" is defined in Section 101(41A) as covering only information provided to a debtor by "an individual." He said "it does not include information provided by business entities."

Once email and physical addresses for individuals are removed, Judge Glenn ruled that the names of 300,000 customers "[do] not meet the standard for confidential 'commercial information' under section 107(b)(1)." He reasoned that names alone would not provide "a viable means" for poaching customers, "assuming that alone would be enough to justify protection."

To protect the debtor's employees, officers and directors from harassment, Judge Glenn authorized the debtor to redact their home and email addresses.

In short, Judge Glenn said he was authorizing "the redaction of the home addresses and email addresses, but not the names, of the individual account holders."

Because he did not see Section 107(c) as covering businesses, Judge Glenn refused to permit the redaction of the "names, email addresses and physical addresses to the extent the sealing requests apply to business entities and not individuals."

The debtor wanted all information redacted regarding customers who reside in the U.K. and the E.U., because disclosure might violate regulations in those countries. Judge Glenn said he would "not treat the UK and EU citizens differently than the United States citizens implicated in this case filed in New York."

Judge Glenn said the debtor provided "no legal authority explicitly dictating why [laws in Europe] should apply to the bankruptcy cases of the Debtors filed in the United States, or specifically, why the foreign laws would take precedence in a situation where United States law requires the disclosure of the information."

Judge Glenn made several other rulings of moment. Applicants for professional retention must disclose the identity of those covered in their conflict checks. However, he allowed counsel to redact the identity of parties that might participate in financing.

Finally, Judge Glenn dealt with the debtor's separate motion to disassociate creditors' names from the amount of their claims. He denied the debtor's request because creditors should be able to consult the schedules to ascertain whether their claims were listed and whether they were disputed or undisputed.

The opinion is *In re Celsius Network LLC*, 22-10964 (Bankr. S.D.N.Y. Sept. 28, 2022).

A shipment received by a debtor within 20 days of filing gives the creditor both an administrative claim and a new value defense to a preference, the Eleventh Circuit says.

'Admin' Claims for 20-Day Shipments Don't Offset the New Value Defense, Circuit Says

The Eleventh Circuit joined the Third Circuit in holding that the amount of a new value defense to a preference is not reduced if the debtor pays for some of the new value after filing. In other words, the new value defense is set in stone on filing, without regard to whether the debtor pays some of the new value invoices after filing.

At filing, the creditor was facing a large preference claim. Before filing, the creditor had given new value after receipt of the preferences that would have the effect of reducing the preference claim.

Some of the new value was in the form of shipments received by the debtor within 20 days of filing. The creditor had a valid administrative claim for the shipments within 20 days of filing. The 20-day shipments were a fraction of the new value given within the preference period.

The debtor confirmed a chapter 11 plan providing for payment in full of the creditor's 20-day shipments. However, the liquidating trustee under the plan sued the creditor for preferences. The trustee conceded that the creditor was entitled to the new value defense for shipments within the 90-day period, but not for the shipments that would be paid via the 20-day administrative claim.

The creditor argued that the shipments within 20 days should not be excluded from the new value defense, although the 20-day shipments would be paid in full under the plan. The bankruptcy court agreed with the liquidating trustee and excluded the 20-day shipments from the new value defense.

The Eleventh Circuit accepted a direct appeal and reversed in an opinion on July 18 by Circuit Judge Barbara Lagoa.

The outcome turned on the interplay between Section 547(c)(4), the new value defense, and Section 503(b)(9), giving administrative status for claims resulting from shipments received within 20 days of filing.

Creating the new value defense, Section 547(c)(4), precludes recovery of an otherwise preferential transfer made

> to or for the benefit of a creditor, to the extent that, after such transfer, such creditor gave new value to or for the benefit of the debtor —
> (A) not secured by an otherwise unavoidable security interest; and
> (B) on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor.

Section 503(b)(9) gives administrative status to a claim for

> the value of any goods received by the debtor within 20 days before the date of commencement of a case under this title in which the goods have been sold to the debtor in the ordinary course of such debtor's business.

For Judge Lagoa, the principal question was: Would the eventual payment of the 20-day administrative claim be "an otherwise unavoidable transfer" under Section 547(c)(4)(B) and thereby reduce the new value defense?

Judge Lagoa said the question was "unsettled" in the Eleventh Circuit. Among the courts of appeals, only the Third Circuit had issued an opinion. *See In re Friedman's Inc.*, 738 F.3d 547 (3d Cir. 2013). The Philadelphia-based appeals court held that only prepetition transfers can offset the new value defense.

Contrary to the Third Circuit's holding, the liquidating trustee saw nothing in the language of the statute limiting the new value offset to transfers made before filing.

To answer the question, Judge Lagoa looked to the "broader, contextual view." She admitted, though, that the section has "no temporal limit on when a 'transfer' occurs." However, she noted that Section 547(c) uses the word "transfer" three times.

The first two uses refer to transfers that must have occurred before filing. The third use of "transfer" in subsection (c)(4)(B) is pivotal. It defines the types of transfers that will bar an offset.

"We should likewise read the third use of 'transfer' to refer to preference transfers, which necessarily occur pre-petition," Judge Lagoa said.

"Notwithstanding the lack of an explicit pre-petition limit," Judge Lagoa said that "most courts" and the *Norton* treatise "have concluded that new value advanced after the petition date does not increase a creditor's new value defense."

Drawing an analogy, Judge Lagoa said,

> If the statute does not allow post-petition extensions of new value to become part of a creditor's new value defense, then logically it does not allow post-petition payments to affect the preference analysis.

"Reading the plain text in context," Judge Lagoa reversed the bankruptcy court and held that "only pre-petition transfers will affect a creditor's subsequent new value defense.

Observations

The Third and Eleventh Circuit opinions mean that shipments of goods within 20 days of filing serve double duty for a creditor: (1) The creditor has an administrative claim; and (2) the administrative claim will not offset the new value defense.

There is unlikely to be a unified theory behind both Sections 547(c)(4)(B) and 503(b)(9). They were adopted by Congress decades apart to address different policy considerations. On the other hand, both sections have the effect of encouraging suppliers to continue dealing with companies in financial distress.

Allowing a double dip certainly encourages continued trading with troubled companies. Indeed, Judge Lagoa had a point when she said that the first two uses of "transfer" in Section 547(c)(4)(B) must refer to prepetition transfers. Logically, the third use of "transfer" should have the same implied meaning.

When the Bankruptcy Code overall aims to achieve equality of distribution, why would the statute allow a creditor to realize value twice from the same transfer?

The opinion is *Auriga Polymers Inc. v. PMCMK2 LLC*, 20-14646 (11th Cir. July 18, 2022).

Judges again refuse to make an exception for trustees regarding the judge-made doctrine of in pari delicto.

Fourth Circuit Rejects Frontal Assault on *In Pari Delicto* as a Bar to Suits by a Trustee

In pari delicto is the bane of bankruptcy trustees. Invocation of the judge-made rule of equity can preclude a trustee from suing non-debtor third parties who assisted the debtor's wrongdoing.

To no avail, a bankruptcy trustee in South Carolina mounted a frontal assault in the Fourth Circuit on *in pari delicto*, which means "in equal fault."

The doctrine was originally invented by English courts to bar one thief from suing a cohort for part of the stolen goods. Today, *in pari delicto* bars a plaintiff from suing a defendant when the plaintiff was in equal or greater fault.

Some states have adopted exceptions, such as the "adverse interest exception," which bars the defense when an agent was acting for the agent's own benefit and abandoned the interests of the corporation.

In the South Carolina chapter 7 case, officers of the corporate debtor had cooked the books with assistance from an outside accounting firm. The trustee sued the corporate officers, the accountants and the debtor's financial advisors. Everyone defaulted or settled, except the financial advisors. Some of the defendants went to jail.

The suit against the financial advisors asserted claims including common law fraud, breach of fiduciary duty and aiding and abetting breach of fiduciary duty.

After an 18-day bench trial, the bankruptcy judge gave judgment in favor of the financial advisors. The court decided that the trustee had failed to establish the elements of any of the claims. In addition, the bankruptcy court ruled that the defense of *in pari delicto* barred the suit.

The district court affirmed on the same grounds, prompting another appeal where Circuit Judge Toby J. Heytens affirmed in an opinion on April 19.

The trustee advanced five theories designed to forestall invocation of *in pari delicto*. Judge Heytens knocked them down one by one.

First, the trustee argued that *in pari delicto* should not apply because he represented both the debtor and blameless creditors. The argument got nowhere.

Judge Heytens cited the Fourth Circuit for holding in 2013 that "a trustee proceeding under 11 U.S.C. § 541 is subject to the same defenses as the debtor *because* the trustee stands in the debtor's shoes in such an action." *Grayson Consulting, Inc. v. Wachovia Secs., LLC*, 716 F.3d 355, 367 (4th Cir. 2013). [Emphasis in original.]

In *Grayson*, Judge Heytens said, the Fourth Circuit "specifically held that this includes *in pari delicto*."

Judge Heytens therefore held that "the trustee is plainly subject to *in pari delicto* to the extent he brings this action under Section 541." That section creates an estate with all of the debtor's legal and equitable interests.

Next, the trustee contended that *in pari delicto* should not apply because he was exercising the powers of a hypothetical judicial lien creditor under Section 544(a)(1).

Under applicable Nevada law, Judge Heytens said that a judgment creditor has no greater rights than the debtor. He therefore held, "[W]hen a bankruptcy trustee steps into the shoes of a hypothetical creditor who would herself stand in the shoes of the debtor in bringing a given action, the trustee is still subject to the same defenses as the debtor, including *in pari delicto.*"

Third, the trustee argued that someone who colluded with the debtor cannot invoke the doctrine under principles of agency.

On the facts, Judge Heytens alluded to the bankrupty court's finding that there was no collusion and therefore no basis for invoking the exception to *in pari delicto*.

Fourth, the trustee contended that the doctrine did not apply because the corporate officers were acting adversely to the debtor's corporate interests.

In Nevada, like "most jurisdiction," Judge Heytens said, the exception only applies when the agent's actions have been "completely and totally adverse" to the corporation. In response, the trustees argued that South Carolina law only requires that the interests be "clearly adverse."

Judge Heytens did not "see much daylight" between the two standards. It "simply is not a close case," he said, because the corporation derived benefits from the misconduct, such as raising capital and extending the life of the business.

Finally, the trustee argued that Nevada and South Carolina would follow Delaware by holding that *in pari delicto* is inapplicable to violations of fiduciary duties or aiding and abetting.

To the contrary, Judge Heytens said that Nevada "squarely held" to the contrary. In a factually similar South Carolina appellate decision, he said that *in pari delicto* "barred a breach of fiduciary duty claim."

Upholding the lower courts, Judge Heytens ended his opinion by saying that the debtor's "officers and auditors were the authors of the company's demise — not [the financial advisors]. At worst, the [advisors] simply failed to stop a ship that was already sinking, and the law does not hold them responsible for that failure."

The opinion is *Anderson v. Morgan Keegan & Co. (In re Infinity Business Group Inc.)*, 21-1536 (4th Cir. April 19, 2022).

Reducing a claim between the first and second bankruptcy didn't prevent the Fifth Circuit from employing res judicata.

Res Judicata Limits an Objection to a Claim Allowed in a Prior Bankruptcy

Res judicata limits the ability of a debtor in a second chapter 11 case to object to a claim allowed in a prior bankruptcy, the Fifth Circuit said.

A company and its individual owner were in parallel chapter 11 cases. The two debtors proposed and confirmed a joint plan.

The plan allowed the claim of a secured creditor for $1.8 million (rounded off). The plan called for the claim to accrue 5% interest and to be paid in 59 equal installments, with a so-called balloon payment in the 60th month.

After the 38th payment, the company filed in chapter 11 again and stopped making payments under the plan from the prior case. In the new case, the lender filed a proof of claim for $1.3 million (rounded off).

The corporate debtor objected to the $1.3 million claim, contending that most of the original $1.8 million claim was owing solely by the owner. Bankruptcy Judge Ronald B. King overruled the objection, holding that the objection was barred by *res judicata*, among other theories.

The district court affirmed, and so did Circuit Judge Edith Brown Clement in an opinion on November 15.

First, Judge Clement dealt with the bankruptcy court's subject matter jurisdiction.

The corporate debtor argued that most of the debt was owed only by the individual, thus giving the bankruptcy court no subject matter jurisdiction to rule on the allowance of a debt owed by a non-debtor.

"[W]hether the bankruptcy court's allowance of [the lender's] claim was *proper* is an entirely different question from whether it had the *jurisdiction* to do so," Judge Clement said. She held that the "*propriety* of the bankruptcy court's determination to allow or disallow a claim against the debtor's estate is simply not a jurisdictional inquiry." [Emphasis in original.]

Next, Judge Clement analyzed whether the requisites of *res judicata* were satisfied.

There was no dispute about three elements: (1) The lender and the debtor were both parties in the first bankruptcy; (2) confirmation in the first bankruptcy was final; and (3) the bankruptcy court had jurisdiction in the first bankruptcy.

The debtor disputed the fourth element: whether the objection in the second bankruptcy arose out of the same transaction that underlay the prior bankruptcy.

The Fifth Circuit employs a "transactional test," Judge Clement said. Citing *Nilsen v. City of Moss Point*, 701 F.2d 556, 560 (5th Cir. 1983) (*en banc*), she asked whether the two actions were based on the "same nucleus of operative facts."

In the case on appeal, Judge Clement inquired as to "whether the transactions at the heart of [the debtor's] claim objection in the second bankruptcy were the source of [the lender's] claim in the first bankruptcy." In other words, was the claim objection in the second bankruptcy "based on the same transaction or series of transactions that gave rise to the terms of the [chapter 11 plan in the first bankruptcy] as it relates to the amount of [the lender's] claim"?

Judge Clement held "that it is," because the objection in the second case "depends entirely on" the subject matter "that formed the basis" for the lender's claim in the first bankruptcy.

Even if all four elements were present, Judge Clement said that *res judicata* would not apply unless the debtor "could have or should have" raised the claim in the first bankruptcy.

Since the claim objection in the second bankruptcy was "undeniably a question" about the propriety of the claim in the first bankruptcy, Judge Clement said the debtor could have raised the objection in the first bankruptcy. Consequently, she said, the debtor was precluded from contending that the claim had been allowed "for the wrong amount."

Judge Clement raised a caveat. *Res judicata* did not prevent the debtor "from maintaining *any* claim objection in the second bankruptcy." [Emphasis in original.] The doctrine only barred "a claim objection that is premised, in part or in whole, on the impropriety of [the lender's] claim from the" plan in the first bankruptcy.

The claim had been reduced between the first and second bankruptcies, raising the question of whether the allowance of the claim in the second bankruptcy for $1.3 million was the correct amount. That issue, Judge Clement said, was "merely a factual determination reviewed for clear error."

Examining the evidence and the bankruptcy judge's findings in the second bankruptcy, Judge Clement found no clear error and affirmed.

The opinion is *BVS Construction Inc. v. Prosperity Bank (In re BSV Construction Inc.)*, 21-50274 (5th Cir. Nov. 15, 2021).

Over a vigorous dissent, the First Circuit Joins the Ninth Circuit by holding that Section 106(a) waives tribes' sovereign immunity.

Circuits More Deeply Split on Waiver of Sovereign Immunity for Native American Tribes

Deepening a split of circuits, the First Circuit held over a lengthy dissent that the Bankruptcy Code waived sovereign immunity as to tribes of Native Americans.

The majority's May 6 opinion by Circuit Judge Sandra L. Lynch took sides with the Ninth Circuit, which had held in 2004 that Section 106(a) abrogated sovereign immunity for tribes. *Krystal Energy Co. v. Navajo Nation*, 357 F.3d 1055, 1061 (9th Cir. 2004).

Judge Lynch disagreed with the Sixth Circuit, which found no waiver in 2019. *In re Greektown Holdings, LLC*, 917 F.3d 451, 460- 61 (6th Cir. 2019), *cert. dismissed sub nom. Buchwald Cap. Advisors LLC v. Sault Ste. Marie Tribe*, 140 S. Ct. 2638 (2020). While the *certiorari* petition was pending in *Greektown*, the case settled, and the petition was dismissed. To read ABI's report on *Greektown*, click here.

Chief Circuit Judge David J. Barron "respectfully" dissented. His 33-page dissent is half again as long as the majority's.

The likelihood of a petition for *certiorari* is high. Assuming there is a petition, Prof. Jack F. Williams told ABI he "believe[s] that *certiorari* will be granted." Prof. Williams is a professor at Georgia State University College of Law and the university's Middle East Studies Center. He is a leading authority on both bankruptcy law and tribal law.

The Compelling Facts

Someone wanting a waiver of sovereign immunity could not have found more compelling facts.

Before bankruptcy, the debtor borrowed $1,100 from a corporate payday lender owned by a federally recognized tribe. By the time the debtor filed a chapter 13 petition, the debt had grown to almost $1,600 as an unsecured, nonpriority claim.

Despite the automatic stay and despite being told about the bankruptcy, the tribal lender continually called the debtor demanding payment.

Two months after bankruptcy, the debtor attempted to commit suicide, blaming his action on the incessant calls.

In bankruptcy court, the debtor sought an injunction to halt collections attempts, along with damages and attorneys' fees. The bankruptcy court granted the tribe's motion to dismiss, based on sovereign immunity.

The First Circuit accepted a direct appeal.

The Majority Opinion

For the majority, Judge Lynch began by laying out the general principle that Congress must "unequivocally" express an intent to abrogate tribal sovereign immunity. Did Section 106(a) accomplish the task?

Section 106(a) says that "sovereign immunity is abrogated as to a governmental unit to the extent set forth in this section with respect to" dozens of provisions in the Bankruptcy Code, including Section 362. In turn, "governmental unit" is defined in Section 101(27) to mean:

> United States; State; Commonwealth; District; Territory; municipality; foreign state; department, agency, or instrumentality of the United States, (but not a United States trustee while serving as a trustee in a case under this title), a State, a Commonwealth, a District, a Territory, a municipality, or a foreign state; or other foreign or *domestic government*. [Emphasis added.]

Judge Lynch noted that Section 106 was amended in 1994 because the prior version had been held to be insufficiently clear to abrogate state and federal sovereign immunity.

For Judge Lynch, the question was whether "domestic government" includes tribes. She said there was "no real disagreement" that a tribe is a government." It "is also clear," she said, that a tribe is domestic.

Judge Lynch had "no doubt that Congress understood tribes to be domestic dependent nations . . . that are a form of domestic government." "Thus," she said, "a tribe is a domestic government and therefore a government unit."

Having held that Congress "unmistakably abrogated the sovereign immunity of tribes," Judge Lynch devoted the remainder of her opinion to countering arguments made by the tribe and the dissent. Noting that the Supreme Court does not require "magic words" to waive immunity, she first rejected the idea that the waiver could not apply to tribes without the use of the word "tribes" in the statute.

Next, Judge Lynch dismissed the argument that the legislative history led to ambiguity, because "legislative history cannot introduce ambiguity into an unambiguous statute."

Judge Lynch did not agree with the idea that "domestic government" only refers to governments that arose under the Constitution. To the contrary, she said that "domestic refers to the territory in which the government exists."

Finally, Judge Lynch said that an "interpretation of the phrase 'domestic government' that excludes Indian tribes with no textual basis for so doing is implausible."

The Dissent

By failing to use the word "tribes" in the statute, Judge Barron said in dissent that Congress "did not use the surest means of clearly and unequivocally demonstrating that they are" governmental units.

Judge Barron asked:

> Why, if Congress wanted to be crystal clear in abrogating tribal immunity through the Code, did it not use the clearest means of abrogating that immunity by including "Indian Tribe" — or its equivalent — in the list of expressly named governmental types that makes up the bulk of § 101(27)?

Judge Barron noted the peculiar absence of the word "tribes" in the Bankruptcy Code's immunity waiver. He said that "Congress has expressly named them when abrogating their sovereign immunity in every other instance in which a federal court has found that immunity to have been abrogated."

Judge Barron said he had "no choice but to conclude that § 101(27) does not clearly and unequivocally include Indian tribes, because, as I have explained, its text plausibly may be read not to cover them."

Scholarly Commentary

"Aside from the split," Prof. Williams told ABI that "this is an important issue striking at the meaning of sovereignty and self-determination of Indian tribes. This is especially the case in the commercial and economic landscape largely because it is through these vehicles a tribe can fund all the governmental activities that are necessary for tribal governance."

The opinion is *Coughlin v. Lac du Flambeau Band of Lake Superior Chippewa Indians (In re Coughlin)*, 21-1153 (1st Cir. May 6, 2022).

The circuits are now split 2/1 on the waiver of sovereign immunity under Section 544(b) for lawsuits by a trustee based on claims that could have been made by an actual creditor.

Circuit Split Widens Sovereign Immunity for Section 544(b) Claims

Taking sides on an issue that will likely reach the Supreme Court on a *certiorari* petition within the next year, the Fourth Circuit held that the Internal Revenue Service has no sovereign immunity protection to preclude an avoidance action under Section 544(b)(1).

Although it might seem obvious, Circuit Judge Marvin A. Quattlebaum, Jr. also held that tax penalties paid by a debtor are not avoidable as constructively fraudulent transfers.

The Sovereign Immunity Split

In 2017, the Ninth Circuit held in *Zazzali v. U.S. (In re DBSI Inc.)*, 869 F.3d 1004 (9th Cir. Aug. 31, 2017), that the waiver of sovereign immunity under Section 106(a)(1) allows a trustee to file a derivative suit against the IRS for receipt of a state law fraudulent transfer under Section 544(b)(1). To read ABI's report, click here.

The Ninth Circuit split with a Seventh Circuit opinion rendered three years earlier, *In re Equipment Acquisition Resources Inc.*, 742 F.3d 743 (7th Cir. 2014). The Chicago-based appeals court reasoned that the waiver of immunity does not extend to Section 544(b)(1) suits because any actual creditor would have been barred from suing by the government's sovereign immunity.

The Tenth Circuit is considering the issue now. In *U.S. v. Miller*, 20-00248, 2021 BL 340200 (D. Utah Sept. 8, 2021), the district court in Utah upheld Bankruptcy Judge R. Kimball Mosier by ruling that Section 106(a)(1) waives the federal government's sovereign immunity with respect to underlying state law causes of action incorporated through Section 544(b). To read ABI's report, click here.

The appellee's brief in the Tenth Circuit is due this week. *See U.S. v. Miller*, 21-4135 (10th Cir.).

Tax Penalties Attacked

The corporate debtor had failed to pay state and local income taxes going back to 2003. The IRS assessed taxes, penalties and interest, some of which the debtor paid. The IRS also asserted liens.

In chapter 11, the IRS filed a claim for secured, unsecured priority and unsecured general claims.

After confirmation of a chapter 11 plan, the plan trustee sued the IRS under Section 544(b)(1) to avoid unpaid tax penalties, claiming that the payments were constructively fraudulent transfers under North Carolina's version of the Uniform Voidable Transactions Act. Under the same theory, the plan trustee also sought to recover penalties that the debtor had paid.

The IRS raised sovereign immunity as a defense and also argued there was no fraudulent transfer on the merits.

The bankruptcy court found a waiver of sovereign immunity but dismissed the claims on the merits. The district court affirmed.

Sovereign Immunity Waived

On appeal to the circuit, the IRS contended there was sovereign immunity in bankruptcy court because sovereign immunity would have barred any actual creditor of the debtor from suing the IRS for a fraudulent transfer outside of bankruptcy court.

In his March 8 opinion, Judge Quattlebaum acknowledged the split but sided with the result reached in the Ninth Circuit. He said that the waiver of sovereign immunity in Section 106(a) "forecloses the government's position that sovereign immunity bars any action by an unsecured creditor under" state law. Section 106(a)(1) includes Section 544 among the provisions in the Bankruptcy Code under which sovereign immunity "is abrogated as to a governmental unit."

"In addition," Judge Quattlebaum said, the filing of a claim by the IRS waived sovereign immunity under Section 106(b). That section says that a "governmental unit that has filed a proof of claim in the case is deemed to have waived sovereign immunity with respect to a claim against such governmental unit . . . ."

Because the IRS had filed a claim, Judge Quattlebaum said that "the government would have waived sovereign immunity if an unsecured creditor were to file a claim against it."

No Claim on the Merits

The Fourth Circuit had not decided whether tax penalties could be fraudulent transfers, on the theory that the debtor received nothing in return. Judge Quattlebaum cited the Sixth Circuit for rejecting the same theory that the plan trustee had advanced. *See In re Southeast Waffles, LLC*, 702 F.3d 850 (6th Cir. 2012).

In *Southeast Waffles*, the Sixth Circuit said that Tennessee's fraudulent transfer law required an "exchange," but the IRS was an involuntary creditor. Tax penalties were imposed by operation of statute, with no value exchanged in the process.

Like Tennessee law, Judge Quattlebaum said that "North Carolina's [Fraudulent Transactions] Act presumes a voluntary exchange between the debtor and the creditor" and "expressly" requires an "exchange." The North Carolina fraudulent transfer law also requires "an oral or written agreement."

"But none of that takes place with an IRS tax penalty obligation," Judge Quattlebaum said. There was no written or oral agreement. "Since tax penalties are not obligations incurred as contemplated by the [state fraudulent transfer statute]," he said, the state law "cannot be the 'applicable law' required for [the plan trustee] to bring this action under 11 U.S.C. § 544(b)(1)."

There being no state law on which the plan trustee could base a Section 544(b)(1) claim, Judge Quattlebaum upheld dismissal of the claim to avoid unpaid tax penalty obligations.

Judge Quattlebaum also dismissed the claim to recover tax penalties that the debtor had paid, because there had been a dollar-for-dollar reduction in the debtor's obligations.

Judge Quattlebaum added a proviso at the end of his opinion when he said that "our conclusion about the tax penalty payments turns on the legitimacy of the underlying tax penalty obligation." In essence, he said that a payment might be recoverable if the underlying tax liability had been avoidable.

The opinion is *Cook v. U.S. (In re Yahweh Center Inc.)*, 20-1685 (4th Cir. March 8, 2022).

Hounding a debtor for payment and shortening credit terms defeated an 'ordinary course' defense to a preference.

Supplier Socked for $3.5 Million in Preferences Although All Bills Were Paid on Time

Even though the debtor paid its bills on time, a supplier who hounded the debtor for payment may be unable to prove the "ordinary course" defense and can be liable for a preference, as shown in an opinion by Chief Bankruptcy Judge Jeffrey J. Graham of Indianapolis.

As Judge Graham said in his January 13 opinion, a supplier may not have the ordinary course defense if the evidence shows that the debtor "prioritized paying [the preference defendant] over other creditors."

Trial counsel for plaintiffs and defendants in preference suits should read Judge Graham's opinion in full text for tips on the more effective evidence to be introduced at trial.

The time for appeal has not begun to run because Judge Graham is yet to rule on the amount of prejudgment interest. If there are one or more appeals, the outcome will indicate whether a supplier can be liable for a preference, even though payments were never late.

The 'Ordinary Course' Defense

The debtor was a 220-store appliance and electronics retailer. The supplier was one of the debtor's primary providers of consumer electronics and the sole supplier of some products. The debtor's same-store sales began declining about three years before the chapter 11 filing.

The creditors' committee was given the right to pursue preferences. The committee sued the supplier for about $4.7 million in preferences received in the three months before filing. On summary judgment, the committee had established all of the elements of a preference under Section 547(b). Disputed facts precluded summary judgment on the supplier's "ordinary course" defense.

Judge Graham held a trial regarding the "ordinary course" defense under Section 547(c)(2). The subsection gives the supplier a defense:

> to the extent that such transfer was in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee, and such transfer was—

> (A) made in the ordinary course of business or financial affairs of the debtor and the transferee; *or*
>
> (B) made according to ordinary business terms. [Emphasis added. Note the word "or," making "A" and "B" disjunctive.]

Judge Graham meticulously recited the trial testimony about the ordinary course defense. We shall mention only a few pivotal facts.

Three years before bankruptcy, the debtor's credit limit with the supplier was $12 million. Over the ensuing years, the supplier reduced the credit limit until it was $1 million. So the debtor could purchase $2 million in goods a month, the supplier gave the debtor 15-day terms. Leading up to bankruptcy, the debtor increased its purchases from the supplier because other suppliers were restricting or cutting off credit.

When the debtor filed bankruptcy, the supplier had been paid in full. In fact, the supplier paid the debtor $365,000 after filing on account of vendor credits.

The supplier did not file a claim but consented to permitting the bankruptcy court to enter final judgment.

The Tests for 'Ordinary Course'

Judge Graham laid out the law on what he referred to as the "subjective" ordinary course defense, where the supplier shoulders the burden of proof by a preponderance of the evidence. The supplier, he said, must establish a "baseline of dealing" to show whether the payments were "consistent with the parties' practice before the preference period." The testing period, he said, should be based on a time when the debtor "was financially healthy."

For the testing period, Judge Graham eliminated the 15 months before the chapter 11 filing when the debtor was in financial distress. The limitation didn't matter, he said, because 98% of the invoices within the preference period were paid either before or within the required 15 days of invoicing.

Judge Graham therefore found that the payments in the preference period "remained consistent" with payments in the testing period. He found other facts in favor of the supplier. For example, the supplier never (1) withheld shipments, (2) sought personal guarantees, (3) threatened to turn the receivables over to a collection agent, or (4) threatened litigation.

Still, the supplier was unable to prove the defense by a preponderance of the evidence because (a) the supplier "consistently" sought payment by communicating "frequently" with the debtor's senior management, (b) the supplier threatened to withhold shipments if payments were not made, (c) the debtor's employees "advocated" for payment to the supplier because they "valued their

relationship" with the supplier, and (d) the supplier "significantly" reduced the debtor's credit to $1 million "at a time when the Debtor's business with [the supplier] was at an all-time high."

Judge Graham said the outcome was "not an easy call." The evidence on both sides was in balance. He tipped the scale in favor of the debtor in view of the supplier's "concerted effort to limit [its] exposure," the significant reduction in the credit limit, and the supplier's frequent communications seeking payment.

The facts led Judge Graham to the "inescapable conclusion" that the debtor "prioritized paying [the supplier] over other creditors. And this is what Congress meant to remedy when drafting Section 547(b)."

Because the supplier failed to prove the defense by a preponderance of the evidence, Judge Graham gave the debtor a judgment for a net preference of about $3.5 million, given the supplier's $1.2 million offset for new value.

Observations

Is there anything wrong with this picture?

The supplier provided badly needed goods when other suppliers would not. For vigilantly policing the receivables, the supplier was slapped with a $3.5 million preference judgment.

When a debtor's finances are precarious, should suppliers be at risk of receiving preferences for restricting credit terms, even though the debtor pays on time?

Section 547 was designed to encourage suppliers to deal with companies in financial distress. Should suppliers be liable for hounding debtors for payment, or should suppliers remain silent and cut debtors off when they don't pay?

The foregoing are policy considerations, which don't matter much these days. The statute matters.

In terms of the statute, hounding the debtor for payments may not be in the ordinary course of business between the two parties, but did the supplier nonetheless qualify for the defense under Section 547(c)(2)(B)?

The credit terms were 15 days, and the debtor always paid within 15 days. Are 15 days not "ordinary business terms" for a retailer in financial distress? Were the terms not ordinary because the supplier hounded the debtor for payment?

The opinion is *Official Committee of Unsecured Creditors of Gregg Appliance Inc. v. D&H Distributing Co. (In re HHGregg Inc.)*, 17-50282 (Bankr. S.D. Ind. Jan. 13, 2022).

The 'average-lateness' test reveals payments that were not made in the 'ordinary course.'

Ordinary Course Defense Works When the Supplier Doesn't 'Hound' for Payment

Yesterday, we analyzed a case where hounding a debtor for payment and shortening credit terms defeated the "ordinary course" defense and saddled the supplier with a $3.5 million preference judgment, even though none of the payments was late.

Today, we review an "ordinary course" opinion by Bankruptcy Judge Robert E. Grossman where there was no unusual collection activity, the suppliers did not know the debtor was in financial trouble, and the suppliers did not pressure the debtor to pay during the so-called 90-day preference period before bankruptcy.

Judge Grossman, of Central Islip, N.Y., upheld the "ordinary course" defense under Section 547(c)(2)(A) and dismissed a passel of preference complaints on summary judgment.

After confirmation of a chapter 11 plan, the trustee of a creditor's trust sued several suppliers for a preference. For simplicity, we shall refer to the plan trustee as the debtor.

Previously, Judge Grossman ruled on motions for partial summary judgment that the debtor had established all of the elements of a preference under Section 547(b). In his February 3 opinion, Judge Grossman reviewed the undisputed facts about the debtor's payment history to apply the "ordinary course" defense under Section 547(c)(2)(A).

Section 547(c)(2) gives the supplier a defense:

> to the extent that such transfer was in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee, and such transfer was—
>
> (A) made in the ordinary course of business or financial affairs of the debtor and the transferee; or
>
> (B) made according to ordinary business terms.

Citing the *Collier* treatise, Judge Grossman said that Section 547(c)(2)(A) is a subjective test designed to protect customary credit transactions paid in the ordinary course of business of the debtor and the supplier. He said that the defense provides "a level of predictability so that suppliers

such as the Defendants are permitted to keep payments that would otherwise be deemed preferences."

Citing legislative history, Judge Grossman said that Congress intended for the defense to discourage "unusual activity" by either the debtor or creditors in the slide toward bankruptcy.

All of the suppliers in the cases before him had been dealing with the debtor for years and had scores of transactions among them.

In reviewing credit history, Judge Grossman said there are two predominant tests: the average-lateness method and the total-range method. The former compares the average days to pay in the pre-preference period to those in the preference period.

The total-range method comes into play if the averages are skewed by "outliers." Under the "total range of payments" test, Judge Grossman said:

> [T]the Court reviews all of the payments made during the Baseline Period (which is agreed by all parties as the two years prior to the 90-day preference period) and determines the range of payments from the earliest to the latest. If the payments made during the preference period fit within the range, they are protected by the ordinary course of business defense. If the Court finds that the range of payments during the Baseline Period is too broad, the Court may adopt the bucketing analysis. Under the bucketing analysis, the Court reviews the payments made during the baseline period and groups them into buckets by age, then applies an appropriately sized bucket to the preference period payments to determine what is ordinary and what is not. As this Court previously stated, a range from the Baseline Period that captures around 80% of the payments would be an appropriate size bucket. [Citation omitted.]

Judge Grossman sided with the suppliers and decided to apply the average-lateness test, because it "is more likely to 'weed out' payments that could skew the analysis."

In the cases before him, the average lateness in the two years before the preference period ranged between 39 and 47 days. In the preference period, payments ranged between four days early to seven days late.

Judge Grossman cited the Seventh and Eighth Circuits for holding that deviations of five to seven days from the pre-bankruptcy average were not enough to deprive the supplier of the defense. In the cases before him, he saw no reason to go beyond the average-lateness test to uphold the suppliers' defenses.

Had he employed the bucketing analysis, the result would be the same, Judge Grossman said. Eighty-two percent of the payments before the preference period would encompass all but one of the payments made in the preference period. In the case of that one payment, it was also covered by the new value defense.

Judge Grossman gave judgment to the suppliers on the preference claims. The debtor also had lodged fraudulent transfer claims.

Judge Grossman dismissed the fraudulent transfer claims because the allowance of the ordinary course defenses established that the suppliers had provided reasonably equivalent value.

The opinion is *Ryniker v. Bravo Fabrics Inc. (In re Décor Holdings Inc.)*, 20-08125 (Bankr. E.D.N.Y. Feb. 3, 2022).

Fifth Circuit opinion shows that disallowance of a class proof of claim may preclude individual class members from filing late claims.

No 'Excusable Neglect' for Late Claim if Class Claim Was Denied, Fifth Circuit Says

If a class has not been certified before bankruptcy, every member of the class should file an individual proof of claim before the bar date. That's the practice point gleaned from a Fifth Circuit opinion on March 10.

If the class is so numerous that individual claims are not practicable, the opinion by Circuit Judge Edith Brown Clement counsels the attorney for the class to file a motion in bankruptcy court for authority to file a class claim, followed by a motion in bankruptcy court to approve the class.

Why go to so much trouble? Easy answer: The bankruptcy court may not approve a class claim, and a court like the Fifth Circuit might not allow individual claims after the bar date.

The Two-Year, Nine-Month Delay in Filing Individual Claims

On behalf of a class of about 100 former employees, two plaintiffs filed a wages and hours class action before the employer's bankruptcy. Also before bankruptcy, the district court refused to enforce an arbitration clause. The employer appealed to the Ninth Circuit.

While the appeal was pending, the employer filed a chapter 11 petition and served a bar-date notice on each of the 100 former employees in the class. The named plaintiffs filed a $14 million proof of claim for the class, which had not been certified in any court.

Almost 30 class members filed individual claims before the bar date. The remaining 70 did not file claims. Before confirmation of the chapter 11 plan, the debtor signaled its intention to object to the class claim.

After modification of the automatic stay, the Ninth Circuit reversed the district court and directed that the wages and hours claims be arbitrated. As Judge Clement said, enforcing arbitration effectively disallowed the class claim and meant "that all claims by the purported 'class' members had to be arbitrated individually."

Only then, two years and nine months after the bar date, did the 70-some former workers file individual proofs of claim accompanied by a motion to allow late-filed claims for "excusable neglect." The bankruptcy court refused to allow the late-filed claims, but the district court reversed.

The Fifth Circuit reversed the district court and reinstated the bankruptcy court's disallowance of the late-filed claims.

Disallowing Late Claims Wasn't an Abuse of Discretion

The outcome of the appeal was governed by Supreme Court precedent laying out four factors to consider when deciding whether there was excusable neglect. *See Pioneer Investment Services Co. v. Brunswick Associates Ltd. Partnership*, 507 U.S. 380 (1993).

Although some circuits have held that one factor is more important than the others, Judge Clement said that the Fifth Circuit has not made any factor dominant. She reviewed the bankruptcy court's excusable-neglect decision for what she called the "exceptionally deferential" abuse of discretion standard.

The first *Pioneer* factor considers the danger of prejudice to the debtor. The bankruptcy court had found in favor of the debtor, but Judge Clement disagreed.

The debtor had notice of the wages and hours claims long before bankruptcy and "that they might ultimately be allowed in the bankruptcy proceeding," Judge Clement said. In addition, the plan had a disputed-claims reserve. The first factor "cuts in favor of the Claimants here," she said.

The second *Pioneer* factor considers the length of delay and the impact on judicial proceedings if creditors could file late claims. The bankruptcy court decided that the second factor favored the debtor, and Judge Clement agreed.

The debtor's knowledge of the claims before confirmation "does not mean that they expected to have to resolve those claims even if they were filed *late*," Judge Clement said. [Emphasis in original.]

Moreover, the claimants' counsel presented no evidence to the bankruptcy court regarding the impact on judicial proceedings. Even if the circuit court were to consider the claimants' argument, Judge Clement said "it permits the reasonable inference that the delay that would result from allowing [approximately 70] additional arbitrations to proceed could significantly impact the resolution of the wage litigation and bankruptcy."

Judge Clement agreed with the bankruptcy court that the length-of-delay factor favored the debtor.

The reason for the delay is the third *Pioneer* factor.

Judge Clement said that courts are "less likely to find excusable neglect when the reason for the delay was within the movant's reasonable control." She said that the claimants had notice that the debtor would object to the class claim, but they did not protect themselves, even though all 70 had notice of the bar date.

In other words, the "Claimants took a risk that a class proof of claim would be allowed; that risk did not pan out for the Claimants, and the Debtors are not responsible for the consequences that followed," Judge Clement said.

The third factor focuses on whether the failure to perform on time was "beyond the reasonable control" of the party seeking an extension of time, according to Judge Clement. In the case at hand, she said, "Most of what caused the delay in this case was not beyond the reasonable control of the Claimants, whose duty it was to file timely proofs of claim."

Judge Clement agreed with the bankruptcy court's finding that the third factor favored the debtor.

The fourth *Pioneer* factor weighs the claimants' good faith. In that respect, Judge Clement noted the bankruptcy court's observation that the action of the claimants' counsel "verged on malpractice." She said that "counsel's failure to act diligently throughout the bankruptcy proceeding was so severe that it undermines their argument that they acted in good faith."

Specifically, Judge Clement said that the claimants' counsel's failure to invoke Federal Rule 23 in the bankruptcy case "evinces both a severe lack of diligence and a misunderstanding of bankruptcy procedural rules." In that regard, she noted that the Fifth Circuit is yet to rule on whether a class claim is even permitted in bankruptcy.

Judge Clement agreed with the bankruptcy court: Good faith favored the debtor.

Even though one of the four factors favored the claimants, Judge Clement reversed the district court because she could not "say that the bankruptcy court abused its discretion by denying the Claimants' motion for relief from the bar date."

The opinion is *West Wilmington Oil Field Claimants v. Nabors Corporate Services Inc. (In re CJ Holding Co.)*, 21-20394 (5th Cir. March 10, 2022).

The transfer of title in a real estate foreclosure is not a transfer on account of an antecedent debt and therefore can't be a preference, at least in Florida.

Judge Isicoff Explains Why a Foreclosure Sale Can't Be a Preference

Although some courts reach the same result for different reasons, Bankruptcy Judge Laurel M. Isicoff of Miami explained why a mortgage foreclosure cannot be a preference in Florida.

In short, there is no payment of antecedent debt.

A homeowner defaulted on a $150,000 mortgage. The lender went through the steps required in Florida to take title through a credit bid: The lender filed a foreclosure complaint; the state court entered a final judgment of foreclosure; the lender was the successful bidder at the foreclosure sale with a $69,000 credit bid; a certificate of sale was entered; and after the homeowner unsuccessfully objected to the sale, the state court issued a certificate of title.

The same day the state court overruled the objection and said it would issue a certificate of title, the homeowner filed a chapter 13 petition and immediately filed a complaint to set aside the foreclosure sale as a preference under Section 547. The lender filed a motion to dismiss, contending that the complaint failed to state a claim.

The lender conceded that the home had been property of the debtor and that the debtor was insolvent in the 90 days before bankruptcy.

In her November 10 opinion, Judge Isicoff listed the two remaining questions: (1) Was the transfer on account of an antecedent debt; and (2) did the lender receive more than it would have in chapter 7?

The debtor argued that the transfer of the home to the lender was on account of the lender's status as a creditor and was therefore on account of antecedent debt.

Some courts, Judge Isicoff said, believe that the first transfer in foreclosure is a transfer to the lender that can be set aside as a preference if the lender recovers more than it would in a hypothetical liquidation. Other courts, according to Judge Isicoff, believe that a foreclosure sale is not on account of antecedent debt.

In Florida, a foreclosure entails two transfers, Judge Isicoff said. The first transfer is the issuance of the certificate of title. The payment of the sale proceeds to the foreclosing lender is the second transfer.

In Florida, though, lenders are entitled to credit bid, to avoid requiring the lender to pay cash that will be repaid to the lender almost immediately. Consequently, the transfer to the lender at a foreclosure sale "is in consideration of the payment of the bid amount," Judge Isicoff said.

Judge Isicoff explained how foreclosure works and where the transfers are found:

> [T]he transfer to [the lender] on account of the antecedent debt was the transfer of the sale proceeds (had there been sale proceeds) to [the lender]. The issuance of the certificate of sale to [the lender] was not on account of the antecedent debt, but rather on account of [the lender's] payment of the purchase price, which, in this case, was done by the credit bid.

Therefore, the lender received title in its capacity as a purchaser, not as a creditor, Judge Isicoff explained. As a result, the foreclosure sale could not be avoided as a preference because there was no transfer on account of antecedent debt.

Because one of the elements of a preference was not present, Judge Isicoff was not required to decide whether the lender received more than it would in chapter 7.

In a footnote, Judge Isicoff said she believes that *BFP v. Resolution Trust*, 511 U.S. 531 (1994), is not applicable to preferences. The Supreme Court held in *BFP* that a regularly conducted mortgage foreclosure cannot be set aside as a fraudulent transfer.

Under Florida law, the amount bid at a foreclosure sale is "conclusively presumed" to be sufficient consideration. On that basis, Judge Isicoff said she also would have granted the lender's motion to dismiss.

The opinion is *Nunez v. Wilmington Savings Fund Society (In re Nunez)*, 21-01157 (Bankr. S.D. Fla. Nov. 10, 2021).

Sales

Delaware corporations must have shareholder approval to sell all or substantially all assets outside of bankruptcy.

Delaware Supreme Court: No 'Insolvency Exception' for Asset Sales

Delaware corporate law has no "insolvency exception" allowing a corporation's board of directors to dispose of all or substantially all the assets without shareholder approval, the Delaware Supreme Court held in reversing the Delaware Court of Chancery.

The June 15 opinion is important for Delaware corporations on the brink of bankruptcy. The opinion means that an insolvent corporation cannot give a deed in lieu of foreclosure to secured lenders without shareholder approval. The opinion may also mean that a Delaware corporation's initiation of an assignment for the benefit of creditors requires shareholder approval.

Here's an unanswered question: Does the opinion prevent a Delaware corporation from negotiating and signing up documents for a prepackaged chapter 11 plan without shareholder approval?

The Insolvent Startup

The development-stage company had been in business for more than 10 years but was still not generating income. The two largest secured creditors had liens on all assets and were calling defaults and initiating foreclosure proceedings.

A special committee of the board was formed to negotiate a workout. The committee was given power to bind the company to a disposition of the assets to solve its financial problems.

Without shareholder approval, the committee negotiated a deal where the assets would be transferred to a new corporation primarily owned and controlled by the two secured lenders, in return for extinguishing the secured debt. Existing shareholders were slated to have a slice of the new company's equity.

The company's executives (who did not control the special committee) owned a controlling stock position. They objected to the transaction, which looked like a glorified deed in lieu of foreclosure. The dispute ended up in the Chancery Court of Delaware.

The vice chancellor upheld the workout agreement, believing that Delaware had an "insolvency exception" allowing the board to dispose of the assets without stockholder approval.

As part of a broader strategy to stop the transaction, the corporate officers had filed a chapter 11 petition, which the bankruptcy court dismissed as a bad faith filing.

The executives appealed the decision by the vice chancellor to the Delaware Supreme Court. *En banc*, the Court reversed in a 54-page opinion by Justice Karen L. Valihura, who had been a partner with Skadden Arps Slate Meagher & Flom LLC before her appointment to the Court in 2014.

The opinion covers myriad corporate law issues and bears reading in full text by lawyers involved in major corporate restructurings. Our readers may wish to consider whether other states with similar corporate laws would follow Delaware.

Section 271 of the Delaware General Corporation Law

The Court's primary focus on was Section 271(a) of the DGCL, which provides, in pertinent part:

> Every corporation may at any meeting of its board of directors . . . sell, lease or exchange all or substantially all of its property and assets . . . , as its board of directors . . . deems expedient and for the best interests of the corporation, when and as authorized by a resolution adopted by the holders of a majority of the outstanding stock of the corporation entitled to vote thereon . . . .

Although not identical to Section 271(a), the corporation's charter contained a similar provision calling for shareholder approval.

The vice chancellor believed that Delaware courts had adopted a common law "insolvency exception" allowing the board to dispose of all or substantially all of the assets, without shareholder approval, if the corporation was insolvent. Justice Valihura disagreed.

Justice Valihura held "that a common law insolvency exception, if one existed in Delaware, did not survive the enactment of Section 271 and its predecessor." In other words, she said, "we clarify that a common law insolvency exception, if one existed in Delaware, did not survive the enactment of Section 271 and its predecessor."

Regarding corporate law in states around the country, Justice Valihura said that the belief of the vice chancellor was based on caselaw and treatises between 1926 and 1948, "with no case cited after 1948 upholding such an exception."

Justice Valihura found 15 states that recognized the board-only insolvency exception "from the late 1800's to the early 1900's." However, she found "no Delaware case [that] expressly addresses or adopts the board-only insolvency exception."

Justice Valihura based her conclusion on "the plain language of Section 271, which contains no exceptions and is not ambiguous." She said that the holding was "consistent with our policy of seeking to promote stability and predictability in our corporate laws, and with recognition that Delaware is a contractarian state."

The Court reversed the decision by the vice chancellor and remanded for further proceedings.

Observations

The decision means at least two things for Delaware companies on the brink of bankruptcy: (1) They may not transfer all of the assets to creditors outside of court protection without shareholder approval; and (2) assuming they represent a "[sale], lease or exchange [of] all or substantially all of its property and assets," assignments for the benefit of creditors require shareholder approval.

Regarding ABCs, former ABI president Geoff Berman told us:

> The Delaware Supreme Court decision answered the question [of] whether shareholder approval was required to ratify a company's Board resolution on addressing options for distressed or "failing" businesses. This includes companies looking to make an assignment for the benefit of creditors.

Mr. Berman is senior managing director of Development Specialists Inc. He specializes in assignments for the benefit of creditors and post-confirmation estate management, and wrote ABI's treatise on ABCs, available at store.abi.org.

The opinion is *Stream TV Networks Inc. v. SeeCubic Inc.*, 360, 2021 (Del. June 15, 2022).

To be a good faith purchaser under Section 363(m), a purchaser must be given actual notice to those with an interest in the property. Constructive notice won't suffice.

Constructive Notice Won't Save a Sale Under 363(m) Absent Actual Notice, Circuit Says

Even if a creditor had constitutionally adequate constructive notice of a bankruptcy sale, the Seventh Circuit is saying that the buyer will not be in good faith and will not have protection from Section 363(m) if the buyer knew about a creditor's interest in the property but did not give actual notice.

Three years before bankruptcy, the creditor was given a right of first refusal to buy the debtor's real property. The ROFR was recorded with the land records.

In chapter 11, the debtor did not schedule the ROFR. Alongside a confirmed chapter 11 plan, Bankruptcy Judge Susan V. Kelley, now retired, approved the sale of the property free and clear of all liens, claims and encumbrances. No one told her about the ROFR.

According to the April 4 opinion for the Seventh Circuit by Circuit Judge Frank H. Easterbrook, the buyer evidently had run a title search and had a copy of the ROFR before the bankruptcy sale.

Although the debtor obviously knew about the ROFR, neither the debtor nor the buyer gave the creditor actual notice of the bankruptcy or the sale. In fact, Judge Easterbrook said that the buyer did not give notice to the creditor even after the creditor's lawyer inquired about one week before the pending sale.

In other words, the creditor might have had constitutionally adequate constructive notice of the sale but was not given actual notice.

Four years after the chapter 11 sale, the buyer resold the property to a third party. The creditor responded with a suit in state court seeking damages from the original buyer for disregarding the ROFR.

The original buyer returned to bankruptcy court, aiming to enforce the "free and clear" aspects of the sale. Bankruptcy Judge Kelley refused to enjoin the suit in state court under Section 363(m), and the district court affirmed. *See Archer-Daniels Midland Co. v. Country Visions Cooperative*,

628 B.R. 315 (E.D. Wis. Feb. 19, 2021). To read ABI's report on the district court affirmance, click here.

On appeal to the Seventh Circuit, Judge Easterbrook said that the parties "devoted a lot of time and space" to the question of whether the creditor had sufficient notice before the 2011 sale to comply with the Fifth Amendment requirement of constitutionally adequate notice.

"We do not address that subject," Judge Easterbrook said, "because statutory questions [under Section 363(m)] precede constitutional ones." The section says,

> The reversal or modification on appeal of . . . a sale . . . of property does not affect the validity of a sale . . . to an entity that purchased . . . such property in good faith . . . .

If the buyer "did not buy the parcel in 'good faith' in 2011," Judge Easterbrook said, "it loses no matter what the Constitution has to say about the sort of notice [that the creditor] should have received."

Turning to the facts, Judge Easterbrook said it was "clear" that the debtor "proceeded in bad faith" by not giving notice to the creditor. However, he said that the "question is whether [the buyer] bought the parcel in good faith, not whether the [debtor] sold it in bad faith."

Still, Judge Easterbrook could not resist adding *dicta* when he said, "If anyone should be made to compensate [the creditor], it is the [debtor's two principals]."

Turning to the responsibility of the buyer, Judge Easterbrook noted that the buyer had constructive notice of the ROFR by the real estate recording and actual notice by possession of the title search.

Judge Easterbrook therefore found it "impossible to disagree" with the two lower courts that "someone who has both actual and constructive knowledge of a competing interest, yet permits the sale to proceed without seeking the judge's assurance that the competing interest-holder may be excluded from the proceedings, is not acting in good faith."

Judge Easterbrook affirmed the lower courts, saying, "Good-faith purchasers enjoy strong protection under §363(m). But [the buyer] is not a good-faith purchaser. It must defend the state litigation."

Observation

This is an important decision. It could be cited for the following proposition:

A buyer will not be in good faith under Section 363(m) if the buyer does not give written notice required by the Bankruptcy Code and Rules to someone with an interest in the property being sold. The buyer is not in good faith even if the holder of the interest knew about the bankruptcy or the sale.

The opinion is *Archer-Daniels Midland Co. v. Country Visions Cooperative*, 21-1400 (7th Cir. April 4, 2022).

Small Biz. Reorg. Act

Both individuals and corporations in subchapter V of chapter 11 are barred from discharging debts that are nondischargeable under Section 523(a).

Corporate Debtors in Subchapter V Can't Discharge Nondischargeable Debts, Circuit Says

Debts that are nondischargeable as to *individuals* under Section 523(a) cannot be discharged by *corporate debtors* in Subchapter V of chapter 11, according to the Fourth Circuit.

Resolving what it called a "close" question, the Fourth Circuit believes that "fairness and equity" require making the debts nondischargeable since a small business debtor in Subchapter V has an easier road to confirmation given the absence of the absolute priority rule.

Corporations saddled with debts that would be nondischargeable under Section 523(a) must undergo the rigors of an "ordinary" chapter 11 case to discharge those debts, if the Fourth Circuit's opinion is accepted nationwide.

The Judgment for Willful and Malicious Injury

A creditor won a $4.7 million judgment in state court for tortious interference with contract. More specifically, the jury found that the debtor had stolen customer information from the creditor.

The debtor filed a small business petition under Subchapter V of chapter 11, intending to discharge the judgment under Section 1192. The plan would have paid the creditor about 3% of its claim over five years.

Asserting that the judgment was not dischargeable under Section 523(a)(6) as a "willful and malicious" injury to its property, the creditor filed a complaint seeking a declaration that the judgment would not be discharged under Section 1192(2).

Deciding that the debt was dischargeable, the bankruptcy court dismissed the complaint in what Circuit Judge Paul V. Niemeyer called a "nicely crafted opinion." The bankruptcy court authorized a direct appeal, which the Fourth Circuit accepted.

The 'Discordant' Statutes

The appeal called for an interpretation of two statutes which Judge Niemeyer called "a bit discordant — or perhaps more accurately, clumsy."

Applicable only in Subchapter V cases, Section 1192 discharges debts, "except any debt . . . (2) of the kind specified in section 523(a) of this title."

Section 523(a) provides that a "discharge under section . . . 1192 . . . does not discharge an individual debtor from any debt . . . (6) for willful and malicious injury by the debtor to another entity or to the property of another entity."

In his June 7 opinion, Judge Niemeyer relied on a "textual review" along with "practical and equitable considerations" in holding that the debt was nondischargeable in Subchapter V despite "a certain lack of clarity in the relationship between § 1192(2) and § 523(a)."

Textual Analysis and Policy

Before focusing on dischargeability, Judge Niemeyer said that one of the "main features" of Subchapter V is the elimination of the absolute priority rule that otherwise governs confirmation of chapter 11 plans. It enables "the owners of a Subchapter V debtor . . . to retain their equity in the bankruptcy estate despite creditors' objections," he said.

Turning to dischargeability and focusing on Section 1192(2) alone, Judge Niemeyer said it "provides for the discharge of debts for *both* individual and corporate debtors." [Emphasis in original.]

"Still," Judge Niemeyer said, the question remains "whether the exception to such discharges — based on § 1192(2)'s reference to § 523(a) — applies to both individuals and corporations or to only individuals."

To answer the question, Judge Niemeyer focused on Section 1192(2) because it "specifically" governs dischargeability in Subchapter V. He paraphrased the section by saying it excepts from discharge "'any *debt . . . of the kind* specified in section 523(a).'" [Emphasis in original]. To his way of thinking, the use of the word "debt" was "decisive, as it does not lend itself to encompass the 'kind' of *debtors* discussed in the language of § 523(a)." [Emphasis in original.]

Judge Niemeyer concluded that "the combination of the terms 'debt' and 'of the kind' indicates that Congress intended to reference only the *list of nondischargeable debts* found in § 523(a)." [Emphasis in original.] He said that use of the words "of the kind" was statutory "shorthand to avoid listing all 21 types of debts."

Judge Niemeyer held that "*the debtors* covered by the discharge language of § 1192(2) — *i.e.*, both individual and corporate debtors — remain subject to the 21 *kinds of debt* listed in § 523(a)." [Emphasis in original.] He was persuaded in part by the idea that the specific governs the general.

Having construed the statutory language alone, Judge Niemeyer looked at similar provisions in the Code. He said it would be difficult to reconcile Section 523(a) with Section 1141(d)(6).

Judge Niemeyer also referred to Section 1228(a) of chapter 12 and its language "that is virtually identical" to Section 1192(2). Section 1228(a), he said, has been interpreted by two bankruptcy courts to mean that exceptions to discharge apply to both individual and corporate debtors.

Judge Niemeyer ended his opinion by discussing "fairness and equity" and the ability of a chapter 12 debtor to confirm a cramdown plan without satisfying the absolute priority rule. He said that "Congress understandably applied limitations on the discharge of debts to provide an additional layer of fairness and equity to creditors to balance against the altered order of priority that favors the debtor."

Reversing and remanding, Judge Niemeyer said that a small business debtor "should not especially benefit from the discharge of debts incurred in circumstances of fraud, willful and malicious injury, and the other violations of public policy reflected in § 523(a)'s list of exceptions" when that debtor is immune from the absolute priority rule.

Questions

Congress decided to make virtually all debts dischargeable in chapter 11 because a finding of nondischargeability would injure the greater body of creditors. Similarly, Congress created Subchapter V because the rigors and expense of traditional chapter 11 was hurting creditors as well as the owners of small businesses.

Given the history and tradition of broad dischargeability in chapter 11, is the language in Section 1192 sufficiently clear to swim against the tide? Is the plain meaning of Section 523(a) overcome by the less than clear meaning of Section 1192(2)?

The opinion is *Cantwell-Cleary Co. v. Clearly Packaging LLC (In re Cleary Packaging LLC)*, 21-1981 (4th Cir. June 7, 2022).

Unlike chapters 12 and 13, the bankruptcy court in Subchapter V has discretion in selecting the commitment period for confirmation of a cramdown plan.

Sub V Has a Flexible Commitment Period in Cramdown, Ninth Circuit BAP Says

The statutory standards for confirming a cramdown plan under Subchapter V of chapter 11 are imprecise, if not downright vague. The Bankruptcy Appellate Panel for the Ninth Circuit has written an opinion "to explain the unique role" played by the bankruptcy court "to set the commitment period in which the debtor must pay its projected disposable income or its value."

The debtor was a bail bond company that had been foundering in chapter 11 before the advent of Subchapter V in March 2020. To gain a new lease on life and avert dismissal, the debtor amended the petition to elect treatment under Subchapter V.

The Sub V Plan

Continuing to operate and hoping to remain in business indefinitely, the debtor sold a parcel of real property that the debtor had foreclosed after a criminal defendant skipped bail. The sale generated net proceeds of some $433,000.

In the three years after confirmation, the debtor estimated its net disposable income would be about $287,000. If it were a five-year period, the estimated net disposable income would be almost $500,000, the debtor said.

Most of the debt was held by one creditor, who had been persistently imploring Bankruptcy Judge Erithe A. Smith to dismiss the case.

With guidance from the Subchapter V trustee, the debtor proposed a plan that would pay the principal creditor $433,000 on confirmation. In addition, the plan committed the debtor to pay all of its disposable income to the principal creditor, whatever it might turn out to be.

The plan did not promise to pay a specific amount of net disposable income. For the debtor to obtain a discharge, the plan did oblige the debtor to pay the principal creditor at least an additional $181,000 above the payment on confirmation.

Creditors did not approve the plan, so the debtor was obliged to invoke cramdown. Naturally, the principal creditor opposed confirmation. Using cramdown, Judge Smith confirmed the plan nonetheless.

In his April 27 opinion for the BAP, Bankruptcy Judge Scott H. Gan upheld confirmation.

Flexible Rules on the Commitment Period

The appeal from the confirmation order called on the BAP to determine whether the cramdown plan satisfied the so-called fair and equitable test under Section 1191(b). The subsection requires the court to confirm the plan "if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan."

Section 1191(c)(2) contains a unique definition of "fair and equitable" for the purposes of Subchapter V. Subsection (c)(2)(A) requires the plan to provide that:

> all of the projected disposable income of the debtor to be received in the 3-year period, or such longer period not to exceed 5 years as the court may fix, . . . will be applied to make payments under the plan.

The plan did not comply with subsection (c)(2)(A), Judge Gan said, because it only promised a "possible payment of an unknown amount from Debtor's actual disposable income."

The plan was not doomed, however, because Section 1191(c)(2) permits a debtor to satisfy either subsection (c)(2)(A) or (c)(2)(B). Subsection (c)(2)(B) permits confirmation if:

> the value of the property to be distributed under the plan in the 3-year period, or such longer period not to exceed 5 years as the court may fix, . . . is not less than the projected disposable income of the debtor.

For Judge Gan, "the record is clear" that the plan satisfied subsection (c)(2)(B) "because the effective date payment [of $433,000] is greater than Debtor's projected disposable income for the minimum three-year period required by § 1191(c)(2)."

Judge Gan said that Subchapter V "sets a baseline requirement that a debtor commit three years of projected disposable income, while it also affords the bankruptcy court discretion to require more as a condition of finding a plan fair and equitable."

The ability of the court to set a longer commitment period "is unique to subchapter V," Judge Gan said. The commitment periods are fixed in chapters 13 and 12, he said.

"By giving the bankruptcy court the sole authority to require a longer commitment period in appropriate cases, subchapter V ensures an efficient confirmation process for small business debtors," Judge Gan said.

To satisfy the minimum requirement of subsection (c)(2)(B), Judge Gan said that the plan must provide for payments in three years after confirmation "having a present value of not less than [the debtor's estimate of some $287,000]."

Judge Gan held that the bankruptcy court did not err in finding the plan to be fair and equitable and in satisfaction of Section 1191(c)(2)(B) because "the Plan provides for distribution of the [sale proceeds] on the effective date in the amount of [about $433,000]."

Although the plan satisfied cramdown confirmation requirements with the initial payment of $433,000, Judge Gan noted that the debtor will not receive a discharge unless the later payments of disposable income end up totaling at least $181,000.

If the debtors' "projections are as fanciful" as the objecting creditor argued, Judge Gan said that the debtor "may not receive a discharge," even though it complied with confirmation requirements.

The BAP upheld the bankruptcy court's other findings on issues such as good faith and affirmed the bankruptcy court's confirmation of the plan.

The opinion is *Legal Services Bureau Inc. v. Orange County Bail Bonds Inc. (In re Orange County Bail Bonds Inc.)*, 212-1086 (B.A.P. April 27, 2022).

If a loan benefits both a debtor and someone else, the loan still may be included in counting whether the debt "arose from the commercial or business activities of the debtor."

To Count in Subchapter V, Loans Need Not Benefit Only the Small Business Debtor

Loans made to finance a leveraged buyout may be included in calculating eligibility for reorganization under Subchapter V of chapter 11, even if the loan also conferred benefits on the buyers, according to Bankruptcy Judge Thomas J. Catliota of Greenbelt, Md.

In his October 26 opinion, Judge Catliota said that Section 1182(1)(A) does not require "excluding debt that directly benefitted others," such as the buyers in a leveraged buyout, or LBO.

The LBO Loans

Two individuals arranged to buy a corporation. To effect the purchase, the buyers formed a holding company of which they were the exclusive owners.

For the holding company to acquire the equity interests in the target corporation, a lender made three loans totaling $5.75 million. The target corporation (soon to be the chapter 11 debtor) was the borrower and pledged all of its assets.

The corporate borrower filed a chapter 11 petition and elected treatment as a small business debtor under Subsection V of chapter 11. The debtor listed debts of about $6.4 million.

The former owner (that is, the seller in the LBO) purchased a $500 claim to have status as a creditor. As a creditor, the former owner objected to the debtor's eligibility to proceed as a small business debtor.

Must a Debt Benefit Only the Debtor?

The outcome of the objection was controlled by Section 1182(1)(A), which says that a small business debtor must be

> a person engaged in commercial or business activities . . . that has aggregate noncontingent liquidated secured and unsecured debts as of the date of the filing of the petition or the date of the order for relief in an amount not more than $7,500,000 . . . not

> less than 50 percent of which arose from the commercial or business activities of the debtor.

The creditor conceded that the debtor was a "person" with no more debt that the statute allows. The creditor also admitted that the loans were "commercial or business activities."

However, the creditor argued that the $5.75 million in LBO loans could not be counted because they did not arise "from the commercial or business activities *of the debtor*." [Emphasis added.] According to the creditor, the LBO loans primarily benefitted the two buyers in acquiring the corporate debtor.

Interpreting "the commercial or business activities of the debtor," Judge Catliota said that "virtually" all courts "have applied a liberal construction of the phrase in keeping with the [Small Business Reorganization Act's] purpose and the language of § 1182(1)(A)." He cited Bankruptcy Judge Thomas B. McNamara of Denver, who said in *In re Ikalowych*, 629 B.R. 261, 276 (Bankr. D. Colo. 2021), that the phrase is "exceptionally broad." To read ABI's report on *Ikalowych*, click here.

The creditor relied on *In re Ventura,* 615 B.R. 1 (Bankr. E.D.N.Y. 2020). To read ABI's report on *Ventura*, click here.

To Judge Catliota's way of thinking, *Ventura* was inapposite. *Ventura* decided whether a debt was primarily a commercial or consumer debt under Section 101(8).

Judge Catliota said:

> The primary purpose test is applied to resolve the binary question of whether a debt is commercial or consumer. A transaction can have both commercial and consumer attributes, and a court must determine whether it is one or the other by assessing why the debt was "primarily" incurred. § 101(8). The language of § 1182(1)(A) does not require, or even invite, this inquiry where the debt so clearly arose from the commercial or business activities of the debtor.

"Primacy," Judge Catliota said, "is not included in the assessment once the debt is determined to be incurred through the debtor's commercial or business activities." The statute, he said, "does not require the court to dissect the various benefits obtained by all the parties and, for purposes of § 1182(1)(A), include only debt that is linked to a direct benefit obtained by a debtor, while excluding debt that directly benefitted others."

Judge Catliota noted several benefits received by the debtor from the LBO loans. Among other things, he pointed to a $250,000 working capital loan and a covenant requiring $600,000 in working capital.

"It simply cannot be disputed," Judge Catliota said, "that, under the ordinary, contemporary, common meaning of the phrase, the debt 'arose from the commercial or business activities . . . of the debtor.'" He denied the objection to treatment under Subchapter V because the objection was "not consistent with the statutory language and ignores the substance of the transaction, including an assessment of the direct and indirect benefits the Debtor obtained."

The opinion is *Lyons v. Family Friendly Contracting LLC (In re Family Friendly Contracting LLC)*, 21-14213 (Bankr. D. Md. Oct. 26, 2021).

Consumer Bankruptcy

Discharge/Dischargeability

The Ninth Circuit again questions the Supreme Court's 'atextual' analysis of Section 523(a)(7).

Ninth Circuit Invited to Sit *En Banc* Regarding Dischargeability of Disciplinary Costs

The Ninth Circuit and its Bankruptcy Appellate Panel have been at the forefront in criticizing *Kelly v. Robinson*, where the Supreme Court arguably departed from the language of the statute to achieve a socially desirable result. A panel of the Ninth Circuit appears to be urging a disbarred lawyer to file a motion for rehearing *en banc* where the appeals court could limit *Kelly* strictly to its facts and overturn Ninth Circuit precedent based on *Kelly*.

Kelly and its progeny interpret Section 523(a)(7), which provides that a debt is nondischargeable "to the extent such debt is for a fine, penalty, or forfeiture payable *to and for the benefit of* a governmental unit, and is *not compensation for actual pecuniary loss* . . . ." [Emphasis added.]

The Supreme court held in *Kelly* that criminal restitution was nondischargeable under Section 523(a)(7), even though it was payable to the victim of the crime, because (1) the victim had no control over the decision to award restitution or the amount of the award, and (2) the decision to impose restitution turned on the penal goals of the state, not the victim's injuries. *Kelly v. Robinson*, 479 U.S. 36 (1986). The high court based the decision on its "deep conviction that federal bankruptcy courts should not invalidate the results of state criminal proceedings." *Id.* at 47.

In June 2020, Ninth Circuit Judge Patrick J. Bumatay upheld the nondischargeability of the costs of a lawyer's disciplinary proceeding but reversed the BAP by holding that discovery sanctions were dischargeable. The appeals court also ruled that the state bar could condition reinstatement on payment of the nondischargeable debt.

In his opinion, Judge Bumatay said, "Like other relics of the 1980s, such as big hair, jam shorts, and acid-wash jeans, *Kelly*'s atextual interpretative method should not come back into fashion." *In re Albert-Sheridan*, 960 F.3d 1188, 1195 (9th Cir. 2020). To read ABI's report on *Albert-Sheridan*, click here.

Before *Albert-Sheridan* went to the circuit, the BAP said in footnote seven that "*Kelly* seems to have been expanded to the point where the requirement that the fine or penalty must be payable 'to and for the benefit of a governmental unit' has been read out of the statute." However, the appellate panel noted that Congress amended the Bankruptcy Code 33 times after *Kelly* but never legislatively overruled the Supreme Court's interpretation of Section 523(a)(7). *Albert-Sheridan*

v. Golden (In re Albert-Sheridan), 18-1222, 2019 BL 131713, 2019 Bankr. Lexis 1187, 2019 WL 1594012 (B.A.P. 9th Cir. Dec. 18, 2019). To read ABI's report on the BAP opinion, click here.

The New Case

The opportunity for the Ninth Circuit to assess *Kelly* anew arose once again in the aftermath of attorney disciplinary proceedings.

A lawyer evidently had misappropriated clients' funds. The disciplinary tribunal in California disbarred the lawyer and directed him to pay about $200,000 in restitution to 56 clients, along with some $61,000 as costs of the disciplinary proceeding. In addition, the tribunal directed the lawyer to reimburse the state bar's client security fund for almost $1.4 million that it paid to 305 other clients.

The lawyer filed a chapter 7 petition and received a general discharge. The lawyer filed a complaint in bankruptcy court contending that all of his debts arising from the disciplinary proceedings were discharged under Section 523(a)(7).

The bankruptcy court held that the $200,000 was discharged because restitution was not payable to a governmental unit.

Interpolating *Kelly*, the bankruptcy court decided that the $1.4 million was nondischargeable as a penalty imposed to further the state's interest in rehabilitating miscreant attorneys. Similarly, the bankruptcy court ruled that the $61,000 was not dischargeable under *In re Findley*, 593 F.3d 1048 (9th Cir. 2010).

Findley is now in the Ninth Circuit's crosshairs. Here's how *Findley* came about.

Originally, the Ninth Circuit had held in *State Bar of California v. Taggart (In re Taggart)*, 249 F.3d 987 (9th Cir. 2001), that the costs of a disciplinary proceeding were dischargeable under Section 523(a)(7) because the costs were compensation for pecuniary loss.

In response, the California legislature amended the disciplinary statute to provide that the costs imposed on an attorney are "penalties" imposed "to promote rehabilitation and to protect the public."

Given the amended statute, the Ninth Circuit abandoned *Taggart* and held in *Findley* that disciplinary costs were nondischargeable because they were no longer compensation for pecuniary loss.

In the case involving the dischargeability of the $61,000, $200,000 and $1.4 million, the bankruptcy court certified a direct appeal to the circuit. The Ninth Circuit accepted the appeal without an interim stop in district court or the BAP.

Reimbursement Is Dischargeable

On appeal, the state bar did not challenge the ruling that the $200,000 awarded to the former clients was dischargeable. In his August 1 opinion, Circuit Judge Jay S. Bybee was charged with ruling on the dischargeability of the $61,000 in costs and the $1.4 million in reimbursement to the bar fund.

Regarding reimbursement of the $1.4 million, Judge Bybee framed the issue under Section 523(a)(7) as whether the debt was a "fine, penalty, or forfeiture" and not "compensation for actual pecuniary loss."

Reciting the history of *Taggart* and *Findley*, Judge Bybee said that the costs of a disciplinary proceeding are penal and rehabilitative and thus nondischargeable.

With the principles of *Findley* in mind, Judge Bybee analyzed the dischargeability of reimbursing the bar fund for the $1.4 million it paid to the lawyer's former clients. He trotted out several provisions in California law saying that reimbursement was designed to address pecuniary loss. "Considering the totality of the [reimbursement] program," he held that "any reimbursement to the [fund] is payable to and for the benefit of the State bar and is compensation for the [fund's] actual pecuniary loss, . . . even if reimbursement serves some penal or rehabilitative purpose."

Arguably narrowing *Findley*, Judge Bybee said that his conclusion was "controlled by § 523(a)(7)." He reversed the bankruptcy court by holding that the obligation to reimburse the bar fund was dischargeable.

Costs Are Not Dischargeable

In less than one page, Judge Bybee dealt with the dischargeability of the $61,000 in costs for the disciplinary proceeding. The lawyer conceded that the bankruptcy court was bound by *Findley*.

Tersely, Judge Bybee upheld the ruling of nondischargeability by saying, "We are bound by our decision in *In re Findley*."

Seeming to invite a petition for rehearing *en banc*, Judge Bybee said, "If [the lawyer] wishes to pursue this issue, he must do so through a petition for rehearing *en banc*."

The opinion is *Kassas v. State Bar of California*, 21-55900 (9th Cir. Aug. 1, 2022).

Violating a PACA trust does not result in 'defalcation while acting in a fiduciary capacity' that makes a debt nondischargeable, the Eleventh Circuit held in upholding Bankruptcy Judge Roberta Colton.

Eleventh Circuit Holds that PACA Trusts Do Not Give Rise to Nondischargeable Debts

Resolving a split among the lower courts in its jurisdiction, the Eleventh Circuit composed a definitive definition of a technical trust where a "defalcation" by the trustee would result in nondischargeability under Section 523(a)(4). Among other things, the appeals court held that an exception to discharge under that section "does not apply simply because the parties [to a contract] or a statute label the relationship as a trust."

As a consequence of the rigid definition given a technical trust, the Atlanta-based appeals court held in an August 31 opinion that a claim against an individual arising from violation of a trust under the Perishable Agricultural Commodities Act, or PACA, 7 U.S.C. § 499a *et seq.*, is not nondischargeable under Section 523(a)(4). The appeals court tells us that a PACA trust is more akin to a constructive or resulting trust.

The Breach of Trust

A company that purchased and resold produce was unable to pay its suppliers. A couple owned and controlled the business and therefore had personal liability to the sellers under PACA.

The business ran up a debt of more than $260,000 to a produce supplier that was not paid. To extricate themselves from personal liability, the couple filed chapter 7 petitions. The supplier filed a complaint to declare that the debt was incurred by "fraud or defalcation while acting in a fiduciary capacity" and thus was not dischargeable under Section 523(a)(4).

Bankruptcy Judge Roberta A. Colton of Tampa, Fla., granted summary judgment in favor of the debtors. She held that debts subject to PACA, a statutory trust, are dischargeable because PACA does not qualify as a technical trust. *Spring Valley Produce v. Forrest (In re Forrest)*, 20-00447, 2021 BL 169248, 2021 WL 1784085 (Bankr. M.D. Fla. April 2, 2021). To read ABI's report, click here.

The produce supplier appealed. The Eleventh Circuit accepted a direct appeal to resolve a split among the lower courts in the Eleventh Circuit. The appeals court upheld Judge Colton on August 31.

The History of PACA and the Law of Trusts

To protect farmers and dealers of fresh produce, Congress originally adopted PACA in 1930. Amended several times, the statute eventually created a floating trust on a purchaser's inventory and proceeds. The floating trust gives rights in a debtor's inventory and accounts receivable to beneficiaries of the PACA trust ahead of secured creditors. In other words, produce suppliers have priority over secured lenders in the event of the purchaser's bankruptcy.

The opinion by Circuit Judge Charles R. Wilson is the most exhaustive exposition so far on the nature of PACA trusts and underlying case law distinguishing among the differing types of trusts. From the Supreme Court on down, he surveyed caselaw going back to the 1830s and treatises regarding various types of trusts.

Regarding debts arising from violation of PACA trusts, Judge Wilson found a split among lower courts in the Eleventh Circuit. They disagreed, for instance, on whether trust assets must be segregated before Section 523(a)(4) can render the debt nondischargeable.

The pivotal words of the statute are "defalcation" and "fiduciary capacity." Quoting the Seventh Circuit, he said that "defalcation" is "a word that only lawyers and judges could love." However, the appeal turned on "fiduciary capacity."

Having surveyed wide-ranging authorities, Judge Wilson concluded that someone is acting in a "fiduciary capacity" if there is "an identifiable trustee, beneficiary, and trust res." Those prerequisites were met in the case of a PACA trust.

In addition, Judge Wilson said that "a technical trust for purposes of § 523(a)(4) should also impose sufficient trust-like duties."

To have "trust-like duties . . . sufficient to create a technical trust," Judge Wilson said there must be "two duties: the duty to segregate trust assets and the duty to refrain from using trust-assets for non-trust purposes."

Judge Wilson held that a "PACA does not impose sufficient trust-like duties to create a technical trust." Two duties are lacking, he said. There is no duty to segregate and no prohibition against using trust assets for non-trust purposes. In fact, he said that the statute and its regulations "suggest" that comingling "is permitted."

A PACA trust, Judge Wilson said, "bears closer resemblance to a constructive or resulting trust than a technical trust." He added that constructive and resulting trusts do not qualify as technical trusts under Section 523(a)(4) "because they do not meet the third requirement that the debtor must be acting in a fiduciary capacity before the act of defalcation creating the debt."

To soften the blow for creditors deprived of nondischargeable debts, Judge Wilson said that they are "entitled to the highest priority in bankruptcy." He saw the decision as "strik[ing] a balance between" PACA's deference to produce suppliers and the Bankruptcy Code's design to promote a "fresh start."

In case someone missed the holding in his 37-page opinion, Judge Wilson's last paragraph summed up the reasons why the "debts incurred by a produce buyer acting as a PACA trustee are not excepted from discharge under § 523(a)(4)":

> While a PACA trust does identify a trustee, beneficiary, and trust res, thus satisfying the first step of our analysis, it does not impose sufficient trust-like duties to fit the narrow definition of a technical trust under § 523(a)(4). PACA does not impose the duties to segregate trust assets and refrain from using trust assets for a non-trust purpose, which are strong indicia of a technical trust. Instead, a PACA trust more closely resembles a constructive or resulting trust, which do not fall within § 523(a)(4)'s exception to discharge. Therefore, we affirm the bankruptcy court's order dismissing [the creditor's] complaint in this adversary proceeding.

The opinion is *Spring Valley Produce v. Forrest (In re Forrest)*, 21-12133 (11th Cir. Aug. 31, 2022).

Dismissal

Reversing the bankruptcy court, a district court says that renewing a title loan before filing might bar confirmation of a chapter 13 plan.

Filing '13' Immediately After Renewing a Title Loan Might Be Bad Faith

Reversing the bankruptcy court, a district judge in Montgomery, Ala., wrote an opinion that could be read to mean that someone may not renew a title loan and immediately file a chapter 13 petition to reduce the interest rate and pay off the loan over several years.

The appeal involved two chapter 13 debtors. One first obtained a monthly title loan on her car and had renewed the loan four times. The lender had repossessed the car for nonpayment. The annual interest rate was almost 134%.

The first debtor consulted with an attorney and paid the fee to renew the loan and regain possession of the car. She filed a chapter 13 petition the next day. The plan called for paying off the loan over 58 months at an annual interest rate of 3.25%.

The second debtor had a monthly title loan at an annual interest rate of almost 207%. He filed a chapter 13 petition two days after renewing the loan the first time. His plan proposed to pay off the loan over 48 months at an annual interest rate of 5.25%.

Both debtors testified that they had decided to file chapter 13 petitions before they renewed their loans. Both loan agreements contained the same representations:

> [The Borrower] represents, warrants, acknowledges and agrees . . . [that the borrower is] not a debtor in bankruptcy. [The borrower does] not intend to file a federal bankruptcy petition.

Objecting to confirmation, the lender contended that the plans were not filed in good faith and violated Section 1325(a)(3) because the debtors misrepresented their intentions about bankruptcy. The lender said it would not have renewed the loans had it known that bankruptcies were in the offing.

The bankruptcy court overruled the objections, ruling that representations about bankruptcy were unenforceable in violation of public policy. The bankruptcy court confirmed the plans, but the lender appealed.

District Judge R. Austin Huffaker, Jr., reversed and remanded with instructions for the bankruptcy judge to reconsider whether the debtors filed the plans in good faith.

The Representations Weren't Void

Judge Huffaker first considered whether the "no bankruptcy representations" were in violation of public policy and could not be considered in evaluating the debtors' good faith.

The bankruptcy judge "misconstrued the operative language," Judge Huffaker said. The representations were "*not* a prepetition waiver of any rights in bankruptcy." (Emphasis in original.) In addition, he said that the bankruptcy court did not consider the legitimate reasons for the representations.

The representations did not require the borrowers to abjure bankruptcy permanently, Judge Huffaker said. The representation, he said,

> does not prohibit a debtor from later forming the intent to file for bankruptcy after signing the pawn agreement; it only requires the debtor have no such intent at the time of execution.

"But here," Judge Huffaker said, "there was no intervening change because the debtors testified that they had the intent to file for bankruptcy protection when they entered into their pawn agreements."

Judge Huffaker said that the bankruptcy judge erred by failing to consider the representations in the good faith analysis under Section 1325(a)(3).

The *Kitchens* Factors

In *In re Kitchens*, 702 F.2d 885 (11th Cir. 1983) (*per curiam*), the appeals court laid out 11 factors to consider in deciding whether a debtor acted in good faith. The lender contended that the bankruptcy court failed to consider the tenth factor:

> the circumstances under which the debtor has contracted his debts and his demonstrated bona fides, or lack of same, in dealings with his creditors.

Rather than evaluate the debtor's conduct, Judge Kitchens said that the bankruptcy court excoriated the lender for its "predatory loans" and "astronomical interest rates." But "none of these considerations are appropriate for determining the *debtors'* bona fides," he said. (Emphasis in original.) The loans were not usurious under Alabama law.

Judge Huffaker said that the bankruptcy court should have considered the debtors' "clearly relevant" and "admitted intent" to file bankruptcy "almost immediately after executing the pawn agreements." He therefore remanded for the bankruptcy court to reconsider the tenth *Kitchens* factor.

Although vacating the confirmation orders and remanding for "further proceedings consistent with this decision," Judge Huffaker "expresse[d] no view as to what impact, if any, such reconsideration might have on the ultimate issue of whether the debtors proposed their plans in good faith."

Observations

At minimum, the opinion by Judge Huffaker questions every chapter 13 debtor's good faith after renewing a title loan. At the extreme, the opinion could preclude confirmation of a chapter 13 debtor by any debtor with a title loan.

In the two cases on appeal, the debtors filed chapter 13 petitions two or fewer days after renewing month-to-month title loans. How many days must elapse after renewing a title loan before the debtor is unquestionably acting in good faith? Will cases with renewals of title loans inevitably end up in a trial on the debtor's good faith?

Because title loans are so short-term, many if not most debtors may have resolved to file chapter 13 petitions before renewing loans. Truthful testimony could mean failure of the attempt to save the car in chapter 13.

It would be a different case had the debtors taken down title loans for the first time, spent the proceeds and promptly filed in chapter 13 to stretch out the payout and lower the interest rate. Such situations are covered by Section 523(a). That section might inform the court in considering good faith on remand.

Courts facing the issue should consider the peculiar nature of title loans. They are very short-term loans and are often if not typically renewed. The court might consider the amount of the loan compared to the value of the car, the number of times the loan was renewed, the debtor's need for the car and the debtor's use of the proceeds of the loan.

Why would it be worse for a debtor to renew a title loan and pay the interest and fees just before bankruptcy as opposed to defaulting and then filing in chapter 13?

In the cases on appeal, the debtors' actions were not identical. One debtor renewed the loan to regain possession of the car, a fact weighing against a finding of good faith. However, the debtor could have filed in chapter 13 first and then used the bankruptcy court to regain possession, but

filing first would have entailed larger attorneys' fees, adequate protection payments and delay in obtaining possession of the car.

In good faith findings, courts should consider how title loans are legitimately treated in chapter 13. Lenders cannot automatically repossess cars with defaulted loans. Even if repossessed before bankruptcy, debtors generally can regain possession of their cars if they have not been sold by the lender. Plans can lower interest rates and stretch out maturity.

Can it be bad faith to utilize remedies that the Bankruptcy Code affords to chapter 13 debtors?

Chapter 13 was designed to help debtors save their homes and cars. Courts should consider the lender's circumstances and the relief afforded by chapter 13, else title loans become a bar to filing successfully in chapter 13.

The opinion is *TitleMax of Alabama Inc. v. Arentt*, 21-00840 (M.D. Ala. Aug. 22, 2022).

Plans & Confirmation

o more informal 'no-look' fees in the courtroom of Bankruptcy Judge Robert Grossman.

Long Island Judge Ends 'Loss Mitigation' in His Courtroom

Having decided that "Chapter 13 has morphed into the pursuit of loss mitigation as its sole purpose in which debtors file cases they never intend to bring to confirmation," Bankruptcy Judge Robert E. Grossman decided it's time to end so-called loss mitigation in his court.

In his February 28 opinion, Judge Grossman also decided it's time to adopt a so-called no-look fee of $5,500 for chapter 13 cases in his court. Judge Grossman sits in Central Islip, N.Y.

Although Judge Grossman ended loss mitigation in his court, the case before him resulted in a confirmed chapter 13 plan after the debtor and the home mortgage lender agreed on a loan modification. Aside from the case before him, Judge Grossman said he would no longer approve attorneys' fees for participation in loss mitigation, "absent extraordinary circumstances."

The Protracted Loss Mitigation

We will assume everyone knows what "loss mitigation" means. For those who don't, it's typically a local rule where bankruptcy judges on request enter orders compelling the debtor and the mortgage lender to negotiate with the aim of agreeing on loan modification. Some courts have entered contempt citations against lenders who did not negotiate in good faith.

Until now, at least, most bankruptcy judges have had favorable views about loss mitigation. They would typically say that loss mitigation has allowed debtors to keep homes they otherwise would have lost absent court-mandated negotiations.

In the case before Judge Grossman, the debtor filed a chapter 13 petition and obtained an order directing loss mitigation. The process took two years but resulted in a confirmed plan and an agreed loan modification approved by the court.

The delay in reaching accord on loan modification, according to Judge Grossman, was occasioned mostly by the lender's mistakes and ineptitude. The debtor and the debtor's bankruptcy counsel carried out their part of the negotiations and documentation with dispatch.

The delay came at a cost. Before bankruptcy, the debtor had paid counsel a retainer of $3,000. In the engagement agreement, the debtor consented to an additional $2,500 counsel fee to be paid under the chapter 13 plan.

The client also agreed that the $5,500 would only cover specified services. Notably, the $5,500 fee did not cover participation in loss mitigation.

After confirmation, the debtor's counsel filed a fee application for payment of about $9,200 on top of the $3,000 retainer. In other words, counsel's fees for the chapter 13 case totaled some $12,200.

The Eastern District of New York has no local rule establishing a so-called no-look fee for chapter 13 cases. Without filing a fee application, courts with no-look fees will allow payment so long as it doesn't exceed the prescribed amount. For greater compensation, counsel must file a traditional fee application.

In the absence of a formal no-look fee, some chapter 13 trustees in the New York Eastern District developed a practice where they would review counsel's time records and advocate approval of the plan (and payment of the fee) if the trustee had no objection to the requested fee.

And so it was in the case before Judge Grossman. The chapter 13 trustee had no objection to confirmation of the plan and payment of the additional $9,200 fee to be paid by the trustee under the plan.

No More Informal No-Look Fees

In substance, the chapter 13 trustee in the case before Judge Grossman had implemented an informal no-look fee where compensation would be approved by the court if the trustee had no objection. No more, Judge Grossman said.

The informal fee approval process, Judge Grossman said, "was never the intent of the statute and is a process that will cease . . . . [T]he awarding of fees is the sole responsibility of the Court."

Judge Grossman said he would be drafting "new rules" for his court "which give counsel to Chapter 13 debtors the option of either proceeding under what we designate a 'presumptively reasonable [$5,500] fee' which will allow the Court to award fees without the need for a hearing or filing a fee application."

Judge Grossman said he would not require a fee hearing for fees of less than $5,500.

No More Loss Mitigation

"The Court will no longer entertain motions for loss mitigation in Chapter 7 or 13 cases," Judge Grossman said.

During the housing crisis, Judge Grossman said that loss mitigation allowed "many families" to keep their homes, because otherwise it would have been "difficult for debtors to identify the party that held the mortgage."

"While the aim of the loss mitigation program is noble, the circumstances that led to its implementation are now absent," Judge Grossman said.

Now that the "onslaught of foreclosures and bankruptcy filings . . . has abated," Judge Grossman said,

> [L]oss mitigation has morphed into an institutionalized process not supported by the Bankruptcy Code. It now seemingly exists not for the purpose originally intended but rather for the benefit of professionals, trustees, and institutions, often to the economic detriment of the creditors. This is the antithesis of what Chapter 13 was designed to do.

"There is nothing in the Code," Judge Grossman said, "which permits a bankruptcy court to forcibly restructure a residential mortgage." Disagreeing with some other courts, he saw no power in Section 105(a) for mandatory loss mitigation.

Judge Grossman said he would still "encourage Chapter 13 debtors and their secured creditors to reach a consensual arrangement." The judge said he would still order mediation, "but only on consent of the parties."

The Remedy

Judge Grossman examined the attorney's fee request, found it reasonable, and allowed payment "in the full amount requested." He said it would be "the last application for compensation this Court approves which seeks additional fees for loss mitigation absent extraordinary circumstances."

Judge Grossman said his "decision does not modify, amend, or limit loss mitigation procedures for any other judge in this Court or the Court generally."

The opinion is *In re Tcherneva*, 19-71413 (Bankr. E.D.N.Y. Feb. 28, 2022).

Compensation

In fee allowances, considering 'results obtained' survived the 1994 amendments to Section 330(a).

'Results Obtained' Can Justify Cutting Fees by 50%, Sixth Circuit Says

The amendments to Section 330(a) in 1994 do not bar courts from considering "results obtained" when making allowances of professional compensation, the Sixth Circuit held in an opinion on August 16.

The chapter 7 trustee for a corporate debtor hired a law firm as special counsel to investigate and pursue claims of the estate. After a year's investigation, the lawyers identified $1.6 million in possible claims against the debtor's principal for fraudulent transfers and breach of fiduciary duty.

Before filing suit, the lawyers for the trustee held negotiations with counsel for the defendant and learned that the principal had substantial defenses. With advice from special counsel, the trustee obtained bankruptcy court approval to release claims in return for a $38,000 payment by the principal.

In addition to the $38,000, the estate only had $3,000 in other assets.

Special counsel filed a $37,000 fee application. Considering also the fee applications by the trustee and the trustee's general counsel, the entire estate could have been exhausted by professional fees alone.

The bankruptcy court cut special counsel's fee in half. The district court affirmed, leading special counsel to appeal to the Sixth Circuit. The Court of Appeals affirmed.

Circuit Judge John B. Nalbandian identified two issues on appeal: (1) May the court consider results obtained when making an award under Section 330(a)(3); and (2) did the bankruptcy court abuse its discretion by cutting the fees in half?

The History of Section 330(a)

Before adoption of the Bankruptcy Code in 1978, fee awards in bankruptcy cases were governed by the so-called spirit of economy, which usually resulted in lower fees in bankruptcy cases. An overarching purpose in Section 330(a) was to abandon the spirit of economy by paying bankruptcy lawyers the same as specialists in other areas.

Before the amendments in 1994, Judge Nalbandian explained that Section 330(a) called for the court "to look at 'the time, the nature, the extent, and the value' of the services as well as the costs of 'comparable services.'" With no better guidance, courts adopted different approaches, the judge said.

Some courts applied the Fifth Circuit's 12 *Johnson* factors. One *Johnson* factor considered results obtained.

Before the 1994 amendments, the Sixth Circuit adopted the so-called lodestar method, where the court first determines an hourly rate and multiplies the rate by the number of hours reasonably expended. Only then, Judge Nalbandian said, could the court modify the award in view of the *Johnson* factors.

Section 330 was amended in 1994 by codifying some but not all of the *Johnson* factors. Section 330(a)(1)(A) now awards "reasonable compensation for actual, necessary services." In determining the amount of "reasonable compensation," subsection (a)(3) requires the court to "consider the nature, the extent, and the value of such services, taking into account all relevant factors, including" six factors such as time spent and rates charged outside of bankruptcy.

Judge Nalbandian observed that the "results obtained" factor from *Johnson* was not included in subsection (a)(3).

In the amendment, special counsel argued that the omission of "results obtained" bars the bankruptcy court from considering that factor. Instead, special counsel contended that the court, under subsection (a)(3)(C), could only consider whether the services appeared "beneficial at the time at which the service was rendered."

'Results Obtained' Survived

Judge Nalbandian focused on the statute's use of the word "including" and the command that the court take "into account all relevant factors." In addition, he said that the statutory language makes awards discretionary, not mandatory.

Judge Nalbandian therefore held that "the text of § 330(a)(3) permits courts to consider factors not listed, including 'results obtained.'"

But wait, special counsel said, the services seemed beneficial at the time they were rendered, and considering results obtained would bring back the spirit of economy.

Citing decisions from other circuits considering results obtained, Judge Nalbandian once again said that the court may consider results obtained.

No Abuse of Discretion

Special counsel argued that a 50% reduction was an abuse of discretion.

In response, Judge Nalbandian trotted out a Ninth Circuit opinion upholding a 50% reduction. He went on to say that "reducing the fees by half based on the value of the work to the estate is consistent with what other courts have done."

"So," Judge Nalbandian said, "the court did not abuse its discretion in reducing the fees by half . . . . based on the minimal results . . . obtained."

Commentary

Prof. Nancy Rapoport told ABI that it was "an awesome opinion." She saw the court as "signaling" that "if this were a situation in which a law firm was billing its client directly, there's no way the firm would have sent a bill for $37,000 for bringing in $38,000."

Prof. Rapoport is a UNLV Distinguished Professor and the Garman Turner Gordon Professor of Law at the Univ. of Nevada at Las Vegas William S. Boyd School of Law. An expert on ethics and fee allowances in bankruptcy cases, she is often appointed as a fee examiner in large chapter 11 cases.

The opinion is *In re Village Apothecary Inc.*, 21-1555 (6th Cir. Aug. 16, 2022).

Finally, a circuit court cites Taggart to help a debtor enforce the discharge injunction.

Second Circuit Allows Appellate Attorneys' Fees for Upholding a Contempt Citation

Reversing the lower courts, the Second Circuit held that a debtor is entitled to recover attorneys' fees for successfully prosecuting appeals from the bankruptcy court's order holding a creditor in contempt of the discharge injunction.

The May 17 opinion by Circuit Judge Richard J. Sullivan may discourage creditors from appealing contempt citations, because a debtor's appellate attorneys' fees could exceed the damages assessed for violation of the discharge injunction or the automatic stay. In other words, attempting to set aside a hurtful precedent could entail costs greater than the creditor's own attorneys' fees.

The 'Egregious' Discharge Violation

The debtor obtained a discharge in chapter 7. Later, the mortgage lender made erroneous reports to credit agencies and more than 30 phone calls attempting to collect delinquent mortgage payments that had been discharged.

The bankruptcy judge ruled that the lender's actions were "absolutely egregious." She found the lender in contempt of the discharge injunction and assessed some $9,000 for the debtor's legal fees and $17,500 for attempting to collect the discharged debt.

On the first appeal, the district court upheld the $9,000 award for violation of the discharge injunction but remanded for the bankruptcy judge to say whether the $17,500 was for actual or punitive damages.

On remand, the bankruptcy court reinstated the $17,500 award as compensatory damages. On remand, the debtor had sought another $28,000 for the attorney's fees for the first appeal. The bankruptcy judge denied the appellate attorneys' fees, believing that the appeal did not violate the discharge injunction and saying that the debtor should have requested appellate attorneys' fees in district court.

The district court affirmed on a second appeal, saying that the bankruptcy court lacked the power to award attorneys' fees for an appeal in district court.

The debtor's counsel appealed to the circuit and won on both grounds.

'Old Soil' Helps Debtors this Time

Reviewing the bankruptcy court's decision for abuse of discretion, Judge Sullivan found the contempt power in the Section 524 discharge provisions and in Section 105, which empowers the court to enter "any order . . . necessary . . . to carry out the provisions of" the Bankruptcy Code.

Quoting *Taggart v. Lorenzen*, 139 S. Ct. 1795, 1801 (2019), Judge Sullivan said that those "'provisions authorize a court to impose civil contempt sanctions'" and "'bring with them the old soil that has long governed how courts enforce injunctions.'" He went on to say it was "well settled" that "a bankruptcy court may compensate a debtor for a creditor's violation of its discharge order."

For guidance from Second Circuit precedent, Judge Sullivan cited *Weitzman v. Stein*, 98 F.3d 717 (2d Cir. 1996), where the appeals court ruled that a lower court must give persuasive grounds for denying appellate legal costs arising from a contemnor's misconduct. The *Weitzman* court noted that none of the litigation would have been necessary had the contemnor obeyed the district court's order.

Judge Sullivan said that *Weitzman* "foreclosed" the lender's argument that the appeal had not violated the discharge injunction, because the appeal would not have been necessary had the lender respected the discharge. "Put simply," he said, the debtor's appellate fees were caused by the lender's contempt.

On policy grounds, Judge Sullivan noted that the $28,000 in fees for defending the first appeal were higher than the $17,500 damage award. He said that "the failure to compensate the victim of contempt with appellate fees could leave the victim worse off for seeking to enforce a discharge order and would, at the very least, discount any compensatory damages award."

The lender's argument that only the district court could award appellate attorneys' fees was "equally unpersuasive," Judge Sullivan said.

Bankruptcy courts have power to sanction for violation of the discharge injunction, and, Judge Sullivan said, "it is immaterial that this case involves a bankruptcy court's, rather than a district court's, contempt order."

Again, Judge Sullivan said that the "old soil" permits a court to enforce its injunction to compensate for someone's losses arising from noncompliance with an injunction.

The lender made other arguments that were unpersuasive. The bankruptcy and appellate rules allowing sanctions for frivolous appeal, Judge Sullivan said, do not "preclude[] a bankruptcy court from exercising the 'old-soil' power to award fees for non-frivolous appeals of its contempt order in appropriate circumstances."

Judge Sullivan reversed and remanded with directions for the district court to remand the matter for the bankruptcy court to calculate the appropriate amount of appellate attorneys' fees, or to articulate "persuasive grounds" for denying fees.

At the end of his opinion, Judge Sullivan added a zinger. He directed the bankruptcy court to decide on granting fees for the second appeal.

Tension with *Gravel*?

Last year, the Second Circuit held in *PHH Mortgage Corp. v. Sensenich (In re Gravel)*, 6 F.4th 503 (2d Cir. Aug. 2, 2021), that bankruptcy courts may not impose contempt sanctions for violating Bankruptcy Rule 3002.1. Rather, the majority ruled over a vigorous dissent that a debtor may only recover compensatory damages, which often will be nominal. To read ABI's report on *Gravel*, click here.

To this writer, there is tension between the new case, finding common law grounds for imposing appellate attorneys' fees, and the insistence in *Gravel* that contempt sanctions are not permitted under a rule without authorization in the statute or the rule.

True, the two cases can be distinguished on their facts. Perhaps the differing results can be explained, because the two cases had different panels of judges.

Until the Second Circuit smooths out the rough edges, debtors will cite the new case while creditors will rely on *Gravel*.

The opinion is *Law Offices of Francis J. O'Reilly v. Selene Finance LP (In re DiBattista)*, 20-4067 (2d Cir. May 17, 2022).

Local rules require lawyers to prepare and fill all required chapter 7 papers regardless of whether the debtor pays the fee or agrees to pay the fee.

Bankruptcy Courts in Colorado and Minnesota Bar Bifurcated Fee Arrangements

Nine days apart, bankruptcy judges in Colorado and Minnesota disallowed so-called bifurcated fee arrangements where chapter 7 debtors paid nothing before filing. The two judges found multiple misrepresentations in the pre- and post-filing fee agreements, rendering them void and unenforceable under Section 526(c)(1).

It is doubtful whether any artfully drafted fee agreements could pass muster in Colorado and Minnesota, because the lawyer who files the petition is obliged to complete the representation whether or not the debtor pays or agrees to pay the fee after filing.

The impetus for bifurcated fee arrangements arose because the Supreme Court in *Lamie v. U.S. Trustee*, 540 U.S. 526, 538 (2004), ruled that an agreement signed before bankruptcy cannot compel a chapter 7 debtor to pay for services rendered before or after filing. In essence, *Lamie* compels chapter 7 debtors to pay the lawyer's fee in full before filing.

As Bankruptcy Judge Thomas B. McNamara of Denver said in his May 10 opinion, "there may well be sound policy reasons for changing the Bankruptcy Code to allow attorneys to be paid postpetition for performing even pre-petition services. But, that is not the Court's role . . . . Because the Pre-Filing Agreement and Post-Filing Agreement contain misrepresentations and are misleading, they are void."

Scholarly Commentary

Prof. Nancy Rapoport told ABI, "It's past time for Congress to fix this problem."

Elaborating, Prof. Rapoport said:

> There wouldn't be such machinations, with some jurisdictions allowing bifurcations and some not, if Congress would act.
>
> On the other hand, sometimes when Congress messes with the bankruptcy laws, the law gets worse, not better.

> Also, there's a lot to be said for making contracts that non-law-trained people understand that actually give them the correct options.

An expert on ethics in bankruptcy cases, Prof. Rapoport is the Garman Turner Gordon Professor of Law at the Univ. of Nevada at Las Vegas William S. Boyd School of Law.

The Pre- and Post-Filing Agreements

The pre- and post-filing retention agreements in both cases were lengthy and complex. It is questionable whether the debtors ever read them, understood them, or were told what they meant. Basically, the agreements in both Colorado and Minnesota told the clients that the lawyers would prepare and file bare-bones chapter 7 petitions, with no fees paid by the clients before filing.

The clients could elect after filing to sign post-filing retention agreements obliging the lawyers to provide all necessary services apart from adversary proceedings. The clients were also given the option to proceed *pro se* or hire another attorney.

The agreements did not disclose to the clients that both courts had local rules requiring the lawyers who filed the petitions to provide all required services (apart from adversary proceedings) until the court allows the lawyer to withdraw on motion, regardless of whether the client pays the fee after filing. Given the short deadlines for filing all required papers, a motion to withdraw would not be heard before the lawyer would have drafted and filed the remaining chapter 7 papers.

The Minnesota Opinion

In her May 19 opinion, Kesha L. Tanabe of St. Paul, Minn., found numerous "untrue and misleading statements" about the legal services in the retention agreements. For example, the agreements said that the lawyer's services would terminate on filing, absent the client's agreement to pay the fee after filing.

Referring to the court's local rule, Judge Tanabe said,

> Upon filing a petition, counsel agrees to represent the debtor and provide all reasonably necessary bankruptcy services throughout the case, until and unless permitted to withdraw through substitution or court approval, and authorization to withdraw is neither automatic nor presumed. An agreement that purports to withhold such services, or to condition such services upon execution of an additional fee agreement, is fundamentally untrue and misleading, in violation of § 526(a)(2) and (3).

Judge Tanabe said the agreement violated Section 526(a)(2)-(3) because it "affirmatively misrepresent[ed] well-settled law about withdrawal and the scope of services in bankruptcy cases."

She found another violation of Section 526(a)(3), because "the Agreements omit any explanation that counsel would not be permitted to withdraw from representation after filing a partial petition, absent truly extraordinary circumstances."

Judge Tanabe went on to say that the "Agreements obscure the reality that execution of the Post-Petition Agreement was not necessary to ensure the provision of legal services in Debtor's main case after filing the partial petition. In fact, the real purpose of the Post-Petition Agreement is to ensure the collectability of Applicant's unpaid legal fees."

Because the engagement agreements violated Sections 526(a)(2)-(3) and 528(a)(1)(A), Judge Tanabe held that they were "statutorily" void and unenforceable under Section 572(c)(1).

The Colorado Case

The case before Judge McNamara in Denver was similar, but the lawyer was factoring the receivables to be paid by the client in installments after filing.

Were the fee to be paid entirely after filing, the agreements required the client to pay almost $3,000, including the filing fee. If the fee were to be paid in full before filing, the fee would be about $2,000, not including the $335 filing fee.

Judge McNamara's skepticism about the cost of the factoring agreement suggests that he might have nixed the fee arrangement on that basis alone. However, he found defects like those identified by Judge Tanabe, leading him to invalidate the fee arrangements without alluding to factoring.

The agreements in Denver contained a provision intended to skirt conflicts of interest. If the client decided not to pay the fee after filing, the agreements purported to say that the client waived the resulting conflict of interest when the lawyer would move to withdraw.

Judge McNamara found "numerous ways" in which the fee agreements were "false" or "misleading." For example, the agreements didn't mention the "numerous additional filings" that the lawyer would be required to prepare after filing under the local rule, even if the client did not agree to pay the fee.

Similarly, Judge McNamara said that the agreements failed to mention the client's fourth option of having the lawyer "continue to represent her in all aspects of her Chapter 7 case *without* entering into a new Post-Filing Agreement." [Emphasis in original.]

In Judge McNamara's case, the lawyer advanced the $335 filing fee. He said that the retention agreement "misled [the client] into committing to repay the filing fee advanced by [the lawyer]," although the obligation to repay the filing fee had been discharged.

Having found that the agreements contained "misrepresentations" in violation of Sections 524, 526 and 528, Judge McNamara held that the agreements were "void" under Section 526(c)(1).

Judge McNamara said "there may be sound policy reasons supporting a bifurcated payment structure." However, he said that the court "cannot legislate and cannot just make up a new policy framework for Chapter 7 debtor's counsel fees."

As remedy, Judge McNamara voided the retention agreements. Because the client had paid about $1,000 after filing, he required the lawyer to disgorge the payments to the chapter 7 trustee, who would turn over the disgorged fees to the debtor less whatever pre-filing tax refunds the debtor was entitled to receive.

Of *in terrorem* significance, Judge McNamara enjoined the lawyer "from making any of the misrepresentations or misleading statements identified in this Opinion in future Pre-Petition Agreements and Post-Petition Agreements in the District of Colorado." Consequently, the lawyer would run the risk of being found in contempt were he to use a bifurcated fee agreement in the future that didn't clearly tell the client there was no obligation to pay the fee after filing, among other things.

Observations

If there be a fault in either opinion, it may lie in the question of whether the local rules delve into substantive law beyond the courts' rulemaking powers. In South Carolina, a district judge read a similar local rule as not raising a *per se* bar to bifurcated fee arrangements. *Benjamin R. Matthews & Assoc. v. Fitzgerald (In re Prophet)*, 21-01082, 2022 BL 84916, 2022 WL 766390 (D.S.C. Mar. 14, 2022).

However, the court in *Prophet* made no ruling about the reasonableness of the fees, the adequacy of disclosures or informed consent by the debtors regarding the fee structure. To read ABI's report on *Prophet*, click here.

The opinions are *In re Siegle*, 21-42321 (D. Minn. May 19, 2022); and *In re Suazo*, 20-17836 (D. Colo. May 10, 2022).

Reversing the bankruptcy court, the district court decided that a local rule did not bar bifurcated fee arrangements altogether.

The Concept of Bifurcated Fee Agreements Approved on Appeal in South Carolina

Reversing the bankruptcy court, a district judge in South Carolina permitted so-called bifurcated fee arrangements for chapter 7 debtors despite a local rule that could be read to bar them outright.

In her March 14 opinion, District Judge J. Michelle Childs seemed motivated by the realization that prospective chapter 7 debtors who can't afford the entire fee before filing have no suitable alternatives, especially if they need bankruptcy relief quickly.

Judge Childs said,

> Bifurcated agreements, when utilized properly and with sufficient safeguards, enable debtors who otherwise could not afford counsel to obtain legal services of an attorney to aid them in navigating the complex bankruptcy process.

The Bifurcated Fee Structure

When a client cannot pay the entire attorney's fee before filing, a typical bifurcated arrangement entails two engagement agreements, one signed before filing and a second signed after filing. Clients pay nothing or a fraction of the ordinary fee before filing, with an explicit understanding that they are not required to hire the same lawyer for services after filing. The agreements explain what services the lawyer will provide before and after filing.

The attorney who brought three cases on appeal to Judge Childs ordinarily charged a fixed fee of $2,350 (including the filing fee) for clients who could pay before filing. On a sliding scale, the clients paid more when some or all of the fee was paid after filing.

A client who paid nothing before filing was obligated to pay $2,800 under the bifurcated arrangement. The lawyer justified the increase by the cost of factoring the receivable.

Based on a local rule, the U.S. Trustee filed a motion asking the bankruptcy court to cancel the bifurcated fee arrangements in three cases. The local bankruptcy rule provides that an attorney who files a petition is "the responsible attorney of record for all purposes . . . and in all matters arising in connection with the case . . . ."

The bankruptcy court granted the U.S. Trustee's motion, holding that "bifurcated agreements are entirely impermissible" under the local rule, Judge Childs said.

The attorney appealed. Of perhaps no little import, Judge Childs said that the three debtors "obtained satisfactory results" and said in depositions that they appreciated the chance to have bifurcated arrangements.

The lawyer won on appeal.

A 'Charitable' Interpretation of the Local Rule

Judge Childs found no "binding precedent where a court determined that bifurcated fee agreements like those at issue were prohibited as a matter of law."

However, Judge Childs did identify nonbinding decisions coming down both ways. She said that "many courts faced with similar agreements have found that bifurcated fee agreements are not prohibited *per se*, but that the agreements before the court were either improper under the applicable rules or that the court could not determine their propriety based on the record."

Among the courts that have permitted bifurcated fee agreements, Judge Childs cited *In re Carr*, 613 B.R. 427 (Bankr. E.D. Ky. 2020). The *Carr* court, she said, found that "dual contracts satisfied the requirements of the Bankruptcy Code, the Bankruptcy Rules, and applicable ethical rules." *Id.* at 436. To read ABI's report on *Carr*, click here.

Judge Childs said she was "persuaded by the reasoning" in *In re Hazlett*, No. 16-30360, 2019 WL 1567751 (Bankr. D. Utah Apr. 10, 2019), a case where the bankruptcy court had a similar local rule. To read ABI's report on *Hazlett*, click here.

Like *Hazlett*, the attorney on appeal to Judge Childs conceded that he was the attorney of record until allowed by the court to withdraw.

Reading the local rule to bar bifurcated arrangements entirely "would undermine the very purpose of the Rule," Judge Childs said. Assuming there are safeguards, a bifurcated agreement permits a debtor who cannot pay a retainer to have counsel "in navigating the complex bankruptcy process," she said.

Reversing and remanding, Judge Childs ended her opinion by noting that the local rule was the only issue on appeal. She made no ruling about the reasonableness of the fees, the adequacy of disclosures or informed consent by the debtors regarding the fee structure.

The opinion is *Benjamin R. Matthews & Assoc. v. Fitzgerald (In re Prophet)*, 21-01080 (D.S.C. March 14, 2022).

District judge in Idaho finds no ambiguity in a statute that doesn't explicitly say whether a chapter 13 trustee is paid if the case is dismissed before confirmation.

District Court Says Chapter 13 Trustee Is Paid Even if Dismissal Precedes Confirmation

A standing chapter 13 trustee in Idaho twice appealed the denial of her fees because the cases were dismissed before plan confirmation. She won both times, once in the Bankruptcy Appellate Panel in July and now in district court.

In a 2/1 nonprecedential opinion, the Ninth Circuit Bankruptcy Appellate Panel reversed and ruled that the trustee was entitled to her fee. *See McCallister v. Harmon (In re Harmon)*, 20-1168, 2021 BL 276666, 2021 Bankr Lexis 1960, 2021 WL 3087744 (B.A.P. 9th Cir. July 20, 2021). To read ABI's report, click here.

Courts around the country are split; there is no authority from a circuit court, and the facts are always the same: A chapter 13 case is dismissed before plan confirmation, and the bankruptcy court must decide whether the standing trustee is entitled to her or his fee.

In the case on appeal to Chief District Judge David C. Nye of Boise, Idaho, the bankruptcy court had decided that the statutes were ambiguous and concluded that a chapter 13 trustee is paid only if a plan is confirmed. *See In re Evans*, 615 B.R. 290 (Bankr. D. Idaho Feb. 13, 2020). To read ABI's report, click here.

Judge Nye reversed on February 8. His 15-page opinion takes a refreshingly different approach to answering the question.

The Pertinent Statutes

28 U.S.C. § 586(e) says that a standing trustee "shall *collect* such percentage fee from all payments . . . under [chapter 13] plans. . . ." [Emphasis added.]

Section 1326(a)(1) requires a chapter 13 debtor to commence making payments to the trustee within 30 days of filing. Subsection (a)(2) provides that payments made by the debtor "shall be retained by the trustee until confirmation or denial of confirmation. . . . If a plan is not confirmed, the trustee shall return any such payments not previously paid . . . to creditors . . . , after deducting

any unpaid claim allowed under section 503(b)." The subsection says nothing explicitly about the standing trustee's fee.

Chapter 12 and Subchapter V of chapter 11 explicitly say what happens when dismissal precedes confirmation. Section 1226(a)(2) specifically allows the trustee to retain the statutory fee if a plan is not confirmed, and Section 1194(a) allows a Subchapter V trustee to be paid if the case is dismissed before confirmation.

No Statutory Ambiguity

Judge Nye saw no ambiguity in Section 586(e). He looked at the statute word by word.

The first pertinent phrase, "shall collect," Judge Nye said, "conveys something final. There is no condition or exception — collect it and its yours." Collectors, he said, "are not in the business of returning payments." When Congress wants a collection to be conditional or reversible, it says so.

Judge Nye said that the second phrase, "'from all payments' [,] . . . does not limit the percentage fees to those taken from payments received after confirmation. Section 586(e)(2), by itself, does not express any exception to collecting the percentage fee."

The third phrase is "under plans." Judge Nye said that the "statute places no limitations or exceptions on which plans are subject to the percentage fee. This generalization of 'plans' includes confirmed, not yet confirmed, and denied plans. If there is a plan, there is also a percentage fee."

The fourth phrase is "serves as the standing trustee." Judge Nye noted that the trustee serves before plan confirmation. "She gets the percentage fee as payment for her work as the standing trustee — not only for the work of the standing trustee after plan confirmation," he said.

Judge Nye concluded that Section 586(e)(2) "is plain and unambiguous." It has no "further qualifiers, limitations or exceptions." Because "the fee is already paid to Trustee before confirmation, § 1326(a)(2) does not direct the Trustee to return it if confirmation does not happen."

Judge Nye found ambiguity "only when you look to § 1226 and see that it directs the standing trustee in chapter 12 bankruptcy cases to retain the percentage fee, which is superfluous if § 586(e)(2) already directs the same. Thus, it is inappropriate to apply the rule against surplusage to alter the plain language of § 586(e)(2)."

Judge Nye said that the debtor and the trustee both had "sensible arguments" about policy. "However," he said, "the Debtors' arguments have failed to overcome or cast into doubt the plain language of § 586(e)(2)."

Judge Nye reversed and remanded for the bankruptcy court to enter an order allowing the trustee to retain her fee.

The opinion is *McCallister v. Evans*, 20-00112 (D. Idaho Feb. 8, 2022).

A chapter 13 trustee is not a federal employee for the purposes of the Federal Tort Claims Act.

'13' Trustees Are Paid Even if Dismissal Comes Before Confirmation, District Judge Says

Upholding Bankruptcy Judge Robert E. Grossman, a district judge in Brooklyn, N.Y., ruled that a chapter 13 trustee is entitled to compensation if the case is dismissed before confirmation.

In most chapter 13 cases, the money held by the trustee is so small that it's not worth litigating whether the trustee is entitled to payment if the dismissal precedes plan confirmation. No so in the case that was before Judge Grossman in Central Islip, N.Y.

The debtor filed a chapter 13 plan where she paid the trustee $362,000 in a lump sum. Thirteen months later, the debtor voluntarily dismissed the case. After dismissal, the trustee returned about $341,500 to the debtor but retained some $20,500 as his fee.

The debtor filed a motion asking the court to require the trustee to disgorge the fee. Judge Grossman rebuffed all of the debtor's arguments, finding no ambiguity in the statutes. *In re Soussis*, 624 B.R. 559 (Bankr. E.D.N.Y. Nov. 12, 2020). To read ABI's report, click here.

The debtor appealed. In a tightly worded opinion on January 24, District Judge Joan M. Azrack affirmed Judge Grossman's holdings.

The principal issue revolved around three statutory provisions.

28 U.S.C. § 586(e) says that a trustee "shall *collect* such percentage fee from all payments . . . under [chapter 13] plans . . . ." [Emphasis added.]

Section 1326(a)(1) requires a chapter 13 debtor to commence making payments to the trustee within 30 days of filing.

Subsection (a)(2) provides that payments made by the debtor "shall be retained by the trustee until confirmation or denial of confirmation. . . . If a plan is not confirmed, the trustee shall return any such payments not previously paid . . . to creditors . . . , after deducting any unpaid claim allowed under section 503(b)."

Subsection (a)(2) says nothing explicitly about the trustee's fee if the case is dismissed before confirmation.

Recognizing that not all courts agree, Judge Azrack said that she concurred "with the Bankruptcy Court's well-reasoned interpretation that Section 586 entitles the Chapter 13 Trustee to 'collect[] his percentage fee regardless of whether the plan is confirmed' and that this interpretation of Section 586 is consistent with 11 U.S.C. § 1326."

Judge Azrack cited a split decision by the Ninth Circuit Bankruptcy Appellate Panel as "further [support for] this interpretation." *McCallister v. Harmon (In re Harmon)*, 20-1168, 2021 WL 3087744 (B.A.P. 9th Cir. July 20, 2021). To read ABI's report on *Harmon*, click here.

Like Judge Grossman, Judge Azrack concluded that the debtor had no claim under the Federal Tort Claims Act, because the debtor failed to exhaust her administrative remedies.

Judge Azrack also said that the FTCA only applies to federal employees, and that the chapter 13 trustee "is not an employee of the government."

The opinion is *Soussis v. Macco*, 20-05673 (E.D.N.Y. Jan. 24, 2022).

District judge in Colorado sides with the majority and doesn't allow a chapter 13 trustee to be paid if dismissal occurs before plan confirmation.

On a Split, District Judge Doesn't Pay '13' Trustee if Dismissal Precedes Confirmation

On a question where the lower courts are split, District Judge R. Brooke Jackson of Denver sided with the majority, reversed the bankruptcy court and held that a chapter 13 trustee is not entitled to be paid if the case is dismissed before confirmation of a plan.

The debtor filed a chapter 13 petition in 2017. The bankruptcy court dismissed the case in 2020 because the debtor never confirmed a plan. While the case was pending, the debtor had paid the chapter 13 trustee almost $30,000.

Following dismissal, the chapter 13 trustee paid the debtor's counsel almost $20,000 on an allowed fee application and distributed another $7,500 in payment of a priority tax claim. Toward partial payment of the chapter 13 trustee's fee, the bankruptcy court allowed the trustee to retain the remainder, some $2,600.

With the $2,600 in controversy, the debtor appealed. Judge Jackson reversed in an opinion on December 6.

The Statutes

Arguably, the statutes don't have an explicit answer to whether the trustee gets paid if dismissal precedes confirmation.

28 U.S.C. § 586(e) says that a standing trustee "*shall collect* such percentage fee from all payments . . . under [chapter 13] plans. . . ." [Emphasis added.]

Section 1326(a)(1) requires a chapter 13 debtor to commence making payments to the trustee within 30 days of filing. Subsection (a)(2) provides that payments made by the debtor "shall be retained by the trustee until confirmation or denial of confirmation. . . . If a plan is not confirmed, the trustee shall return any such payments not previously paid and not yet due and owing to creditors pursuant to paragraph (3) to the debtor, after deducting any unpaid claim allowed under section 503(b)."

The subsection has nothing explicit to say about the standing trustee's fee if dismissal precedes confirmation.

However, Chapter 12 and Subchapter V of chapter 11 explicitly say what happens when dismissal precedes confirmation. Section 1226(a)(2) specifically allows the trustee to retain the statutory fee if a plan is not confirmed, and Section 1194(a) allows a Subchapter V trustee to be paid if the case is dismissed before confirmation.

Absence of Specific Language Was Pivotal

Judge Jackson found no controlling authority in the Tenth Circuit. He did cite the recent decision by the Ninth Circuit Bankruptcy Panel in a 2/1, nonprecedential opinion that a chapter 13 trustee is paid if dismissal comes before confirmation. *McCallister v. Harmon (In re Harmon)*, 20-1168, 2021 WL 3087744 (B.A.P. 9th Cir. July 20, 2021).

Harmon contains a lengthy compendium of every argument on both sides of the issue. To read ABI's report on *Harmon*, click here.

In his five-page opinion, Judge Jackson said that Section 586 "could be read as implying that the collected fee may be retained regardless of whether the plan is confirmed."

"However," Judge Jackson said, "it does not expressly address the question, and I conclude that it does not compel that result."

"If the payments must be returned" under Section 1326(a)(2), "it follows that fees collected from such payments must be returned," Judge Jackson said.

Judge Jackson noted there was no language in Section 1326(a)(2) requiring payment to the trustee that is comparable to the language in chapter 12 mandating payment.

Judge Jackson quoted the *U.S. Trustee's Handbook* calling for the return of the fee "if there is controlling law in the district requiring such reversal." He declined "to apply *Chevron* deference, because I conclude that the answer can be found in the language of the statutes."

While reversing the bankruptcy court's order that allowed the trustee to retain the fee, Judge Jackson said that he "might" prefer, "as a policy matter, . . . that the trustee be fairly compensated for his efforts."

The opinion is *Doll v. Goodman (In re Doll)*, 21-00731 (D. Colo. Dec. 6, 2021).

Judge Jacobvitz told counsel for chapter 13 debtors how to write their engagement agreements to ensure being paid from funds held by the trustee if the case converts to chapter 7 before confirmation.

Judge Tells '13' Debtors' Counsel How to Write their Retention Agreements

Debtors' counsel have a problem. If a case *converts* to chapter 7 before confirmation of a chapter 13 plan, they might not be paid.

If a chapter 13 case is *dismissed* before confirmation, Section 1326(a)(2) says that the trustee pays administrative expenses (such as allowed counsel fees) before the remainder is returned to the debtor. However, the statute doesn't say how or whether debtor's counsel is paid if the case *converts* to chapter 7 before confirmation.

Previously, Bankruptcy Judge Robert H. Jacobvitz of Albuquerque, N.M., held that counsel are not paid if the case *converts* before confirmation. He found a solution, however.

Chapter 13 debtor's counsel should include a provision in the retention agreement assigning funds in the trustee's possession to the lawyer to the extent of the lawyer's allowed fees, in the event that the case *converts* to chapter 7 before confirmation.

Conversion to '7' Before '13' Confirmation

A couple's chapter 13 case was on the verge of dismissal or conversion to chapter 7 before confirmation of a chapter 13 plan. The debtors' counsel had withdrawn, but Judge Jacobvitz had granted a fee application by the debtors' counsel. Following Section 1326(a)(2), it called for the chapter 13 trustee to pay the lawyer's allowed compensation if the debtors were to elect having their case *dismissed*.

The fee order was silent about how or whether the allowed fees would be paid if the debtors elected for *conversion* to chapter 7.

That's what happened. The case *converted* to chapter 7, and Judge Jacobvitz was tasked with deciding whether there were any circumstances under which the debtors' counsel could be paid. In other words, could counsel be paid, or was Judge Jacobvitz compelled to return everything to the debtors that was being held by the chapter 13 trustee?

Harris v. Viegelahn, 575 U.S. 510 (2015), did not provide an answer but may have suggested the outcome, although adverse to counsel. In *Viegelahn*, the chapter 13 plan had been confirmed, but the case later converted to chapter 7. The disposition of the money held by the chapter 13 trustee was not answered by Section 1326.

The Supreme Court held that undistributed money goes back to the debtor. After conversion, the Court also said that the services of the chapter 13 trustee terminate and that "no Chapter 13 provision holds sway." *Id*. at 520.

In 2015 after *Viegelahn*, Judge Jacobvitz and his colleague on the Albuquerque bench, Bankruptcy Judge David T. Thuma, ruled together that the court cannot pay counsel fees if the case converts to chapter 7 before confirmation. *See In re Beauregard*, 533 B.R. 826, 832 (Bankr. D.N.M. 2015). However, Judge Jacobvitz cited judges from elsewhere who found reasons for paying counsel in a case converted to chapter 7 before confirmation.

Judge Jacobvitz found a method for (sometimes) paying counsel by following *dicta* in *Beauregard*.

Paraphrasing *Beauregard*, Judge Jacobvitz said that a "possible way" to pay counsel would be the inclusion "in [the lawyer's] engagement letter [of] an assignment of such funds to debtor's counsel." In his November 12 opinion, he held "that such an assignment is permissible."

Viegehahn was no roadblock, Judge Jacobvitz said, because he was giving no effect to any provision in chapter 13, nor was he calling on the chapter 13 trustee to carry out a chapter 13 service. Instead, he was only directing the chapter 13 trustee to "honor the private agreement" between the debtors and their counsel.

Of greater significance, Judge Jacobvitz said he was furthering "an important public policy of giving individuals in financial distress who wish to take advantage of the chapter 13 fresh start access to counsel willing to represent them in a chapter 13 case with little or no upfront payment."

Judge Jacobvitz cited Bankruptcy Judge David E. Rice for having agreed with the *dicta* in *Beauregard*. *See In re Brandon*, 537 B.R. 231, 236-37 (Bankr. D. Md. 2015).

Judge Jacobvitz told bankruptcy lawyers in New Mexico that an "assignment by the debtor to the debtor's bankruptcy counsel of the debtor's right to payment from the chapter 13 trustee upon conversion to chapter 7 may be included in the engagement letter by which the debtor retained bankruptcy counsel."

In the case before him, the retention agreement was not in the record. If debtors' counsel were to file the agreement with the court, and if it had an assignment, Judge Thuma directed the chapter 13 trustee to pay the allowed fee and return the remainder to the debtors.

If the retainer agreement had no assignment, Judge Jacobvitz threw the lawyer a lifeline: The lawyer could have the client sign an assignment belatedly.

In an ordinary case, asking a client to sign an assignment after filing would be ethically "problematic," Judge Thuma said. Because the lawyer had already withdrawn, he said there was not the same "inherent undue pressure."

If the lawyer was to have the clients sign an assignment for the first time after conversion, Judge Thuma required counsel to file a certification to prove that the assignment was voluntary. The certification must read:

> [The debtors] (1) understand that they are under no obligation to direct the former Chapter 13 Trustee to pay any moneys to [the lawyer], (2) understand that if the Chapter 13 Trustee does not pay monies she has on hand to the [lawyer,] she will refund the monies to [the debtors], and (3) of their own free will, and without any duress or pressure, direct the Chapter 13 Trustee to pay the monies she has on hand to the [the lawyer] up to the amount of the court-allowed unpaid compensation, with any excess funds returned to the [the debtors].

The opinion is *In re McCune*, 20-12326 (Bankr. D.N.M. Nov. 12, 2021).

Judicial Liens

The City of Chicago argued unsuccessfully that liens on cars are statutory because they arise automatically when the car is impounded.

Liens on Impounded Cars Are Judicial Liens that May Be Avoided, Seventh Circuit Says

The lien on an impounded car in Chicago is a judicial lien that a debtor may avoid as an impairment of an exemption under Section 522(f), according to the Seventh Circuit.

In ruling on April 21 that the lien was judicial, not statutory, the Seventh Circuit may or may not have created a split with the Third Circuit. We doubt the Supreme Court will be inclined to grant *certiorari* because the liens were based on dissimilar statutes.

A chapter 7 debtor in Chicago had more than $12,000 in parking tickets and other charges on an impounded car that was worth maybe $3,000. The bankruptcy court ruled that it was a judicial lien that the debtor could avoid, because the lien was inextricably tied to prior quasi-judicial proceedings.

The district court affirmed. *See City of Chicago v. Howard*, 625 B.R. 384, 390 (N.D. Ill. 2021), for a similar case where the district court affirmed. To read ABI's report on *Howard*, click here.

As a test case, the city appealed the decision involving the debtor with the $3,000 car and $12,000 in tickets. Circuit Judge David F. Hamilton upheld the two lower courts.

Both sides agreed that the debtor was entitled to avoid the lien if it were found to be judicial. The categorization of the lien was the only issue before the Seventh Circuit.

To rule, Judge Hamilton founded his decision on the definitions of judicial and statutory liens in Sections 101(36) and (53). The statute says that a judicial lien "means [a] lien obtained by judgment, levy, sequestration, or other legal or equitable process or proceeding."

The definition of statutory lien is more complex. It "means [a] lien arising solely by force of a statute on specified circumstances or conditions . . . but does not include security interest or judicial lien, whether or not such interest or lien is provided by or is dependent on a statute and whether or not such interest or lien is made fully effective by statute."

Focusing on the "distinctive language" in the two definitions, Judge Hamilton said that the word "solely" seems "clear enough and signals that prior legal proceedings leading to a lien would

exclude the lien [on the debtor's car] from the category of statutory liens." He cited the Senate and House Reports for saying that a "'statutory lien is only one that arises automatically, and is not based on an agreement to give a lien or on judicial action.'"

Next, Judge Hamilton laid out the complex quasi-judicial procedures that the city must undertake before impounding a car. Among other things, he said that "several legal proceedings had to be completed before impoundment." At the moment the city boots or hauls the car away, the possessory lien attaches.

Judge Hamilton distinguished a mechanics' lien from the lien on an impounded car. In the case of a statutory mechanics' lien, it arises automatically by statute when the debtor fails to make a payment.

For Judge Hamilton, "the substantial quasi-judicial proceedings needed for the City to obtain an impoundment lien" were "decisive."

Hoping to persuade the circuit to the contrary, the city contended that the lien was statutory because it arose automatically upon impoundment and without further judicial or quasi-judicial action.

Judge Hamilton was not persuaded. He said, "we do not think we can ignore all the prior legal process that must occur before the City's possessory lien arises." He refused to regard the prior processes as "irrelevant."

The relevant inquiry, Judge Hamilton said, "is not whether a statute authorizes or governs the lien but what is necessary for the lien to arise."

The city contended that upholding the lower courts would create a split with the Third Circuit where the Philadelphia-based appeals court was ruling on a New Jersey statute. Judge Hamilton said there was a "critical difference" in the procedures that made the statutes "markedly different."

The city next argued that affirming would turn tax liens into avoidable judicial liens.

Judge Hamilton said that tax liens are "unquestionably statutory," because "Congress is entitled to single out a particular category of liens and classify it accordingly. We do not disturb that prerogative or conclusion with this opinion."

Judge Hamilton upheld the lower courts and ruled that the lien was judicial because it did "not arise solely by statute."

The opinion is *City of Chicago v. Mance (In re Mance)*, 21-1355 (7th Cir. April 21, 2022).

Estate Property

If tax foreclosures violate the Takings Clause, it stands to reason that they are also fraudulent transfers.

Sixth Circuit Holds that Tax Foreclosure Violates the Takings Clause of the Constitution

The circuits are split 4/3 on the question of whether a real estate tax foreclosure can be attacked as a fraudulent transfer.

If the Sixth Circuit was correct in holding in an October 13 opinion that a tax foreclosure violated the Takings Clause of the U.S. Constitution, then it stands to reason that a tax foreclosure also can be a fraudulent transfer.

The Split

Recently, the Second Circuit joined the Third, Sixth and Seventh Circuits by holding that real estate tax foreclosures can be attacked as fraudulent transfers. To read ABI's reports, click here, here, here and here.

Extending *BFP v. Resolution Trust*, 511 U.S. 531 (1994), the Fifth, Ninth and Tenth Circuits hold to the contrary by immunizing tax foreclosures just like mortgage foreclosures. The most recent of those decisions came from the Ninth Circuit. *See Tracht Gut, LLC v. Los Angeles County Treasurer*, 836 F.3d 1146 (9th Cir. 2016). To read ABI's report on *Tracht Gut*, click here.

The Michigan Tax Foreclosures

Homeowners sued in federal district court alleging that tax foreclosures under Michigan law violated the Takings Clause of the Fifth Amendment, which says that "private property" shall not "be taken for public use, without just compensation."

The county took title when one of the homeowners owed $22,300 in real estate taxes. The county subsequently transferred title to a nonprofit entity that sold the home for $308,000. Another homeowner owed $30,500 in taxes on a home that the nonprofit sold for $155,000 after the county had foreclosed. Neither of the homeowners received any of the proceeds.

The district court dismissed the suit, finding no violation of the Takings Clause because state law defined the homeowners as having no property interest after forfeiture.

The homeowners appealed to the Sixth Circuit.

State Law and History

Circuit Judge Raymond M. Kethledge laid out Michigan law in detail. Briefly, if real estate taxes are not paid for one year, title is forfeited, but forfeiture does not affect title. Rather, the governmental unit is entitled to petition for a "judgment of foreclosure." Meanwhile, the homeowner is given notices and an opportunity to redeem by paying the taxes, penalties and interest.

About one year later, the state court is required to enter a judgment of foreclosure that vests absolute title if the owner has not redeemed. Thereafter, the government may sell the property at public auction, but the owner is entitled to none of the proceeds.

In the cases on appeal, Judge Kethledge said that the "County forcibly took property worth vastly more than the debts these plaintiffs owed, and failed to refund any of the difference." Even so, was there a violation of the Takings Clause?

To answer the question, Judge Kethledge embarked on a detailed examination of foreclosure in England and the U.S. going back to the fifteenth century, going back to the notion of a "mort gage," or dead pledge. He explained how English chancery courts took issue with the "intolerably harsh sanction" handed down by the law courts when someone defaulted and lost equity in the property.

By the seventeenth century, Judge Kethledge said that the chancery courts recognized a landowners' equity of redemption and "resisted strict foreclosure for the same reasons they recognized the landowner's equity of redemption."

In the U.S., Judge Kethledge said that "American courts were uniformly hostile to strict foreclosure." By the mid-1800s, he said that "foreclosure by sale was 'firmly established' in the law of most states, to the exclusion of strict foreclosure."

The Takings Violation

Judge Kethledge said that "Michigan law flatly contravened all these long-settled principles when it allowed Oakland County to take 'absolute title' to the plaintiffs' homes as payment for their tax delinquencies." More specifically, he said that "the County took their equitable titles . . . without a public foreclosure sale and without payment to the plaintiffs for the value of those titles."

"The County's foreclosure of these properties was thus nothing less than a strict foreclosure — a practice that English courts had steadfastly prevented as far back as the 1600s and that American courts (not least Michigan ones) effectively eradicated as 'unconscionable' and

'draconian' some 200 years ago," Judge Kethledge said. In addition, he said that "Michigan law fails to recognize equitable title in other contexts."

Judge Kethledge reversed the dismissal of the homeowners' suit because the county had forcibly taken the homes "worth vastly more than the debts these plaintiffs owed." By taking property without "just compensation," he said there was a violation of the Takings Clause.

Observation

Courts avoid making constitutional declarations when a case can be decided on more narrow grounds. Thus, we may not see other courts deciding the takings issue raised in the Sixth Circuit, but courts can use the Sixth Circuit's opinion to allow fraudulent transfer attack on tax foreclosures.

The opinion is *Hall v. Meisner*, 21-1700 (6th Cir. Oct. 13, 2022.)

Circuit courts are split 4/3 on their interpretation of Supreme Court precedent holding that regularly conducted mortgage foreclosures are immune from fraudulent transfer attack.

Four Circuits Now Permit Fraudulent Transfer Attacks on Real Estate Tax Foreclosures

The Second Circuit joined three other courts of appeals in holding that real estate tax foreclosures can be attacked as fraudulent transfers despite *BFP v. Resolution Trust*, 511 U.S. 531 (1994), where the Supreme Court ruled that mortgage foreclosures are immune from fraudulent transfer attack.

The Circuit Split

Regarding tax foreclosures, the Second, Third, Sixth and Seventh Circuits now hold that they can be attacked as fraudulent transfers. To read ABI's reports on the prior opinions, click here, here and here.

The Fifth, Ninth and Tenth Circuits hold to the contrary, having extended *BFP* from immunizing mortgage foreclosures to protecting tax foreclosures. The most recent of those decisions came from the Ninth Circuit. *See Tracht Gut, LLC v. Los Angeles County Treasurer*, 836 F.3d 1146 (9th Cir. 2016). To read ABI's report on *Tracht Gut*, click here.

The New York Tax Foreclosure

The debtors owned a modest home that may have been worth no more than $30,000. It had no mortgage.

The husband lost his job, and the couple were unable to pay real estate taxes for a time. With some $1,300 in taxes unpaid, the county gave notice under New York real estate law. Later, the county filed a tax foreclosure action and moved for summary judgment.

The state court granted summary judgment and awarded title and possession of the home to the county.

In his June 27 opinion, Circuit Judge Barrington D. Parker explained that New York law employs so-called strict foreclosure for tax delinquencies.

In foreclosure by sale, Judge Parker said there is a sale, with the proceeds used to satisfy the secured debt and with any surplus paid to the debtor.

In strict foreclosure, by contrast, Judge Parker said that a creditor like the county has the court set a deadline for the payment of taxes. If the deadline passes without payment, he said that "the court enters an order transferring title and possession of the property to the creditor."

In New York's version of strict tax foreclosure, there is no sale, Judge Parker said. Rather, the transfer is effected by court order, and the county may then sell the property. In the subsequent sale, the county retains all proceeds and does not account to the owner for any surplus in excess of the outstanding taxes.

In the case before the Second Circuit, the couple had opposed summary judgment but lost. After the judgment for title and possession but before the sale, the couple filed a chapter 13 petition. Their plan called for paying the tax arrears in full with 12% interest.

After the chapter 13 filing, the county sold the home to a third party for $22,000. As Judge Parker said, "the County pocket[ed] the difference between the tax debt and the sales proceeds and is not accountable to other creditors for what it does with the proceeds." In other words, the couple had no liability for the $1,300 in taxes but lost more than $20,000 in equity.

The county stipulated that the debtors could remain in occupancy of the home pending appeal.

Proceedings Below

Soon after filing, the debtors mounted an adversary proceeding under Section 548(a)(1)(B)(i), alleging that the tax foreclosure was avoidable as a constructive fraudulent transfer because the debtors had not received "reasonably equivalent value" for the transfer.

Initially, the bankruptcy court dismissed the complaint on authority of *BFP*, where the Supreme Court held that a regularly conducted mortgage foreclosure is immune from attack as a fraudulent transfer.

On the first appeal, the district court reversed and remanded for the bankruptcy court to determine whether the debtors had received reasonably equivalent value. Because the $22,000 sale only extinguished $1,300 in taxes, the bankruptcy court decided on remand that the debtors could avoid the transfer for lack of reasonably equivalent value.

The district court affirmed on the second appeal, prompting the county to appeal to the circuit. The debtors were represented by Legal Assistance of Western New York Inc.

The Second Circuit Opinion

Without citing any of the circuit authority on both sides of the issue, Judge Parker affirmed, holding that *BFP*'s presumption of reasonably equivalent value does not apply to a strict real estate tax foreclosure.

On the merits, Judge Parker first held that the debtor had standing to appeal. He rejected the county's contention that their federal homestead exemption left them without standing.

Judge Parker said that the debtors had standing because they remained liable for the taxes, which they paid in their plan.

On the merits of the fraudulent transfer, the county relied on *BFP*. Yet Judge Parker said that *BFP* did not apply "for a host of reasons."

"Critical" to the holding of the Supreme Court, Judge Parker said, was "the existence of an auction or sale which would permit some degree of market forces to set the value of the property even in distressed circumstances." He also quoted *BFP* for saying that the holding only applied to regularly conducted real estate foreclosures. The Supreme Court specifically said that other considerations may apply to tax foreclosures. *BFP*, *supra*, 511 U.S. at 537 n.3.

Comparing strict tax foreclosure with mortgage foreclosure, Judge Parker said that "the strict foreclosure procedures under [New York law] offer far fewer debtor protections than the mortgage foreclosure procedures at issue in *BFP*."

The debtors had lost all of their interest in the property even before the county's tax sale. "The auction was conducted solely for the benefit of the County and the amount of the proceeds bears no relation to the amount of the tax debt that led to the foreclosure," Judge Parker said.

"Moreover," Judge Parker said, the county kept all of the proceeds and was not accountable to other creditors, the estate or the debtors. "In addition," he said, the county's argument "would produce results that are fundamentally at odds with the goals of bankruptcy law."

Judge Parker affirmed the judgment of the district court.

The opinion is *County of Ontario, New York v. Gunsalus*, 20-3865 (2d Cir. June 27, 2022).

In a nonprecedential opinion, the Fifth Circuit suggests that a mortgage that could be reformed in state court cannot be reformed in bankruptcy.

Fifth Circuit Majority Bars Reforming Mortgages in Bankruptcy

In a 2/1 opinion, the Fifth Circuit seemed to hold that a bankruptcy court cannot reform a mortgage to account for a mistake in drafting. In other words, any defects in a mortgage on the filing date, even though they might be corrected in state court outside of bankruptcy, are set in stone as a consequence of the so-called strong-arm clause in Section 544(a).

The dissenter would have reversed and remanded, to permit the bankruptcy court to entertain parol evidence aimed at reforming the mortgage.

The *per curiam* opinion by the majority was nonprecedential. Consequently, there is no binding precedent in the Fifth Circuit disallowing the bankruptcy court from reforming an instrument.

The majority were Circuit Judges Edith H. Jones and Stuart Kyle Duncan. Circuit Judge Stephen A. Higginson "respectfully" dissented.

The Defective (?) Mortgage

An individual was the sole owner and manager of a corporation that ended up being a chapter 11 debtor. The owner was not in bankruptcy.

Before bankruptcy, the owner took down an $8 million loan from a lender. Alongside the note and loan agreement, the owner, in his corporate capacity, signed a mortgage in favor of the lender secured by the company's property.

The lender never made any loans to the corporation, only to the owner personally. In short, the mortgage secured any debt owing by the corporation to the lender, but there was no such debt.

In this writer's view, there is some indication in the loan documents that the mortgage was also intended to secure the owner's debt to the lender but was mistakenly written only to secure debt owing by the corporation.

In chapter 11, a different creditor with a lien on the corporation's property objected to the validity of the lender's mortgage and claim. The lender attempted to introduce parol evidence to say that the mortgage on the corporation's property was intended to secure the owner's debt.

Refusing to hear parol evidence, the bankruptcy court held that the mortgage was unenforceable because there was no underlying debt. On appeal, the district court upheld the invalidation of the mortgage and the disallowance of the lender's claim against the corporation.

The Majority's Affirmance

The majority said that the lender "essentially seeks to reform the publicly recorded Mortgage to cover [the owner's] substantial debt." The majority went on to say in the next breath that what the lender "does not do is grapple with the iron rule of bankruptcy: creditor claims are fixed for allowance purposes as of the date of filing of the debtor's petition. *See* 11 U.S.C. §§ 506(b), 502(b)(1), 544(a)."

Continuing the same train of thought, the majority said that the "strong-arm power enables the Trustee to marshal the assets of the debtor as they existed at the date of bankruptcy, and that date furnishes a stable backdrop for valuing the assets according to the priorities established by the Bankruptcy Code and state law."

Having stated the principles, the majority said that the mortgage "was defective at the inception of bankruptcy because it reflected only an obligation to pay by [the corporation], yet the debtor [corporation] owed it nothing. Louisiana law renders unenforceable such a mortgage that does not support an underlying obligation."

The majority said it had not found a case even "remotely" similar where "a secured creditor was allowed to clean up its documentation and perfect an otherwise unenforceable claim post-bankruptcy."

At the end of the opinion, the majority said,

> The bankruptcy court acknowledged that parol evidence might have been admissible outside of bankruptcy to demonstrate the incompleteness of the Mortgage, but that exception does not come into play in this bankruptcy case, where the rights of other creditors are involved and the strong-arm clause takes effect.

Upholding the lower courts and insinuating that the result might have been different under Louisiana law, the majority said, "we need not consider whether the Mortgage also failed under the state's recording law."

The Dissent

In dissent, Judge Higginson cited testimony and indications in the loan documents that the mortgage may have been written in error. The lower courts, he said, did not consider parol evidence.

In Judge Higginson's view, the failure to consider parol evidence was error because the rule in Louisiana law only prohibits contradictory testimony by one of the parties to the instrument. In the case on appeal, the parol evidence rule did not apply, in his view, because the mortgage was being challenged by another secured creditor who was not a party to the mortgage.

Judge Higginson would have reversed and remanded for a consideration of parol evidence. He did "not see the Bankruptcy Code as having relevance to the issue of whether the Mortgage is valid under Louisiana law, the only issue presented in this appeal."

The opinion is *NCC Financial LLC v. Investar Bank N.A. (In re W Resources LLC)*, 21-30291 (5th Cir. April 14, 2022).

Reversing, a Long Island district judge credits value to a homeowner's ability to delay foreclosure, taking a position contrary to a recent decision from a Ninth Circuit B.A.P.

District Judge Effectively Bars a Short Sale Without Paying the Homestead Exemption

On an issue where the lower courts are split, a district judge on Long Island, N.Y., reversed the bankruptcy court by holding that a debtor is entitled to a homestead exemption in sale proceeds when the mortgage lender offers to buy the home and voluntarily takes a haircut designed to create an estate for unsecured creditors and the trustee's commission.

The debtor's mortgage was long in default. After judgment of foreclosure, the debtor filed a chapter 7 petition and scheduled the property as being worth about $2.2 million. She listed the mortgage debt as some $2.5 million. The lender filed a secured proof of claim for $2.9 million.

Conceding she had no equity in the property, the debtor claimed a New York homestead exemption of $170,825 but stated that she intended to surrender the property. The trustee abandoned the home and filed a report of no distribution. The debtor received a discharge.

Two weeks later, the trustee withdrew his report and filed a motion for permission to sell the home to the mortgage lender, which promised to pay the estate's administrative expenses. To create grounds for selling over-encumbered property, the lender offered to give the trustee an undetermined amount of money to permit some distribution to unsecured creditors.

The trustee told the bankruptcy court that he could not value the property and quantify the amount of the give-up because the debtor was denying access to the property, perhaps based on the idea that the trustee had abandoned the home.

The debtor objected to the sale motion, arguing that she was entitled to payment of her homestead exemption from the sale. The bankruptcy court denied the objection, ruling that carve-outs were sometimes permitted and that the exemption did not apply. *In re Stark*, 20-70948, 2020 BL 368946, 2020 Bankr. Lexis 2520, 2020 WL 5778400 (Bankr. E.D.N.Y. Sept. 25, 2020). For ABI's report on the bankruptcy court's opinion, click here.

District Judge Eric Komitee of Central Islip, N.Y., reversed in an opinion on June 28. Presaging the result of his reversal, Judge Komitee said that the trustee "may . . . no longer to seek to sell the

property through the bankruptcy process because he may decide that the secured creditors would not benefit."

Appellate Jurisdiction

Appellate jurisdiction was an issue because the decision by the bankruptcy court did not resolve the entire controversy. The bankruptcy court had only denied the exemption but had not ruled on the proposed sale, for which no price had been given.

Judge Komitee cited the Second Circuit for holding that an order granting or denying an exemption is final. He said that every other circuit to reach the question has had the same conclusion.

Judge Komitee found appellate jurisdiction under 28 U.S.C. § 158(a)(1) to review a final order denying the claim of exemption.

The Merits Regarding the Homestead Exemption

On the merits, Judge Komitee said there were two issues. Whether carve-outs are ever permissible was the first. He said that "courts generally have found such arrangements permissible, though disfavored."

Judge Komitee did not reach the issue because the debtor did not object to the sale as long as she recovered her homestead exemption from the proceeds.

Even if carve-outs are permissible, the second question asked whether the debtor would be entitled to her homestead exemption "before any creditors are paid." Judge Komitee's opinion explained that the debtor "would be entitled to her homestead exemption in a carve-out deal, because the value of the carve-out is ultimately derived from equity in the Property as defined by New York law."

Judge Komitee quoted the New York law as providing a homestead exemption "in value above liens and encumbrances." The statute, he said, "speaks to equity in the residence," and the debtor had no equity on the filing date. But that wasn't the end of the analysis.

Judge Komitee inquired as to "whether the give-up that the Trustee negotiates is extracted from 'value' in the 'property' that is covered by the New York homestead exemption." If it does not come from the land and buildings, he said, then "where does it come from?"

The bankruptcy court had reasoned that the give-up derived from the trustee's power to sell. Judge Komitee cited bankruptcy courts coming down both ways on the issue.

Judge Komitee said that the buyer was not giving value for the trustee's sale power. Rather, the buyer was paying for the trustee's ability to deliver ownership of the property more quickly and at a lower cost than through foreclosure.

Alluding to the time-value of money and the cost of foreclosure, Judge Komitee said:

> [T]he correct answer, in my view, is that in exchange for the carve-out, the Trustee is delivering the sale of the Property outside a foreclosure proceeding. Said differently, the Trustee is trading away, in exchange for the carve-out, [the debtor's] right to remain in the Property for an extended period without making mortgage payments; her right to exclude others during that period; and the like.

Describing the value in that manner, Judge Komitee said "it is clear that the value resides in the homeowner's 'property' rights in the house, and is thus protected by the homestead exemption." He elaborated:

> When the Trustee trades away those rights via the section 363 sale process, he is trading away the same "property" referred to in the New York homestead exemption.

Having decided that the trustee was selling value in the homestead belonging to the debtor, Judge Komitee next addressed the trustee's argument that no homestead exemption existed on the filing date because there was no equity on the filing date.

Judge Komitee rebutted the trustee's argument by citing to authority for the proposition that the value of exempt property is not frozen on the filing date. If a home's values rises after filing, the debtor is entitled to the appreciation as part of the homestead exemption.

"By their very nature," Judge Komitee said, "carve-out arrangements do the same thing; the secured creditor's agreement to accept less money upon a sale creates equity in the home where none existed before."

Judge Komitee reversed and remanded.

Observations

Judge Komitee's opinion likely means there can be no short sales unless the price covers the entire homestead exemption or whatever smaller amount a debtor might permit. If the exemption is not fully covered, thus creating no estate for unsecured creditors, a bankruptcy court would presumably deny a sale motion on the principle that chapter 7 courts do not liquidate over-encumbered property.

We invite readers to compare the decision by Judge Komitee to the June 17 nonprecedential opinion by the Ninth Circuit Bankruptcy Appellate Panel in *Babaee v. Marshack (In re Babaee)*, 21-1230, 2022 BL 211184 (B.A.P. 9th Cir. June 17, 2022). To read ABI's report, click here.

In *Babaee*, the BAP held that the debtor had neither constitutional nor prudential standing to appeal an order selling an over-encumbered home. Notably, the BAP accorded no value to the debtor's ability to prolong foreclosure or the possibility that the debtor could extract consideration from the lender in return for title.

Judge Komitee recognized the realities of litigation and foreclosure. Sometimes, theoretical rights like foreclosure are encumbered by the real world. The judge's grounding in reality may have resulted from his service as the Chief of the Business and Securities Fraud Section in the office of the U.S. Attorney for the Eastern District of New York.

The opinion is *Stark v. Pryor (In re Stark)*, 20-4766 (E.D.N.Y. June 28, 2022).

The Tenth Circuit left an unanswered question: Do debtors retain post-filing appreciation in a home that is not sold before the case converts from chapter 13 to chapter 7?

Tenth Circuit: Debtors Retain Appreciation in a Home Sold Before Conversion to '7'

One of the great unanswered questions in consumer law these days is whether appreciation in the value of a home becomes part of the chapter 7 estate if the case converts from chapter 13. The courts are split.

Affirming the bankruptcy court and the Bankruptcy Appellate Panel, the Tenth Circuit held that the appreciation in the value of a home sold after confirmation of a chapter 13 plan belongs to the debtor, not to creditors, if the case converts to chapter 7.

In the January 19 opinion by Chief Circuit Judge Timothy Tymkovich, the appeals court was careful to say that it was not ruling on what the result would be in a chapter 13 case converted to chapter 7 before the home was sold.

The Facts

A couple filed a chapter 13 petition and confirmed their plan in 2016. The plan cured arrears on their home mortgage, and the debtors were making payments directly to the mortgagee on the regular monthly payments.

In the petition, the debtors listed the house with a value of about $396,000, subject to a mortgage for some $337,000. The Colorado homestead exemption at the time was $75,000, so they claimed that the equity of about $60,000 was exempt.

While current on their plan payments, the debtors sold the home in 2018 for $520,000, generating net proceeds of $140,000. Two weeks later, they converted the case to chapter 7. Having spent some of the proceeds, they were holding about $100,000 from the sale of the home on the date of conversion.

When the chapter 7 trustee let it be known that he considered the nonexempt portion of the proceeds to be estate property, the debtors attempted to reconvert the case to chapter 13, but the bankruptcy judge denied the motion. The trustee then filed a motion asking the court to compel the debtors to turn over the nonexempt portion of the proceeds.

The trustee stipulated that the value of the home on the original filing date was $396,000, the amount scheduled by the debtors.

Bankruptcy Judge Elizabeth E. Brown of Denver found the statute ambiguous and referred to legislative history. She ruled in favor of the debtor, reasoning that "property" as used in Section 348(f)(1)(A) does not include appreciation in the value of a home. The Bankruptcy Appellate Panel affirmed in an opinion by Bankruptcy Judge Terrence L. Michael, but the trustee appealed. *See In re Barrera*, 620 B.R. 645 (Bankr. D. Colo. 2020); and *Rodriguez v. Barrera (In re Barrera)*, 20-003, 2020 BL 381720 (B.A.P. 10th Cir. Oct. 02, 2020). To read ABI's report, click here.

The Circuit's Analysis

The pivotal statute is Section 348(f)(1), which underwent substantial amendment in 1994.

When a chapter 13 case converts to chapter 7, the section now provides that "property of the estate in the converted case shall consist of property of the estate, as of the date of filing of the petition, that remains in the possession of or is under the control of the debtor on the date of conversion."

The amendment was intended overrule caselaw holding that property obtained after filing a chapter 13 petition becomes estate property once the case converts to chapter 7.

Narrowing his holding to cases where the home was sold before conversion, Judge Tymkovich found the answer in the plain language of the statute, without need for analysis of legislative history.

Judge Tymkovich identified proceeds as a property interest different from the home itself. On the original chapter 13 filing date, there were no proceeds, only the home itself. "Based on the plain language of Section 348(f)(1)" — that estate property in a converted case is estate property "as of the date of filing of the petition" — he held that the sale proceeds "do not enter the converted Chapter 7 estate."

Judge Tymkovich found support for his conclusion in other aspects of the statute's plain language.

On conversion, the debtors no longer owned the home. Under the words of Section 348(f)(1), the home itself was not "under the control of the debtor on the date of conversion" and therefore was not estate property in chapter 7.

Judge Tymkovich saw additional support in Sections 1327(b) and 541(a)(6). Section 1327(b) automatically vests estate property in the debtor on confirmation of a chapter 13 plan, and under Section 541(a)(6), proceeds from estate property become property of the estate.

"Thus," Judge Tymkovich said, "proceeds generated from the debtor's property after confirmation do not become property of the estate as the underlying property no longer belongs to the estate."

The Unanswered Question

Judge Tymkovich pointedly declined to say whether appreciation would have become property of the chapter 7 estate if there had been no sale of the home before conversion to chapter 7.

Had there been no sale, the home would have become estate property in chapter 7. Generally speaking, a chapter 7 trustee can sell a home and take proceeds into the estate in excess of encumbrances and the debtor's exemption.

Given that the home and its proceeds would be estate property in chapter 7, it would seem that the trustee would retain appreciation. But perhaps that's not the end of the story.

Assume the facts were like those in the Tenth Circuit appeal. That is to say, the chapter 13 debtors claimed an exemption in the entire equity. Further assume that there was no timely objection to the homestead exemption.

A debtor would argue that the chapter 7 trustee could not revisit the homestead exemption that supposedly locked in when there was no objection. It's set in stone, the debtor would say, barring the chapter 7 trustee from claiming there were proceeds in excess of the homestead exemption.

On a question where the courts are split, the First Circuit has taken the position that a debtor's homestead exemption, valid on the chapter 13 filing date, is not lost if the debtor sells the home but does not reinvest the proceeds within six months as required by state law. *See Rockwell v. Hull (In re Rockwell)*, 968 F.3d 12, 23 (1st Cir. 2020), *cert. denied*, 141 S. Ct. 1372 (2021). To read ABI's report on *Rockwell*, click here.

The opinions by Judge Brown and the BAP offer more elaborate explanations for why appreciation would not vest in a chapter 7 estate on conversion from chapter 13. For ABI's discussion of a recent case where the debtors lost appreciation in a homestead on conversion, click here.

The opinion is *Rodriguez v. Barrera (In re Barrera)*, 20-1376 (10th Cir. Jan. 19, 2022).

On an issue where the courts are split, a district judge in Washington State holds that the debtors lose the post-petition appreciation in the value of estate property when a chapter 13 case converts to chapter 7.

District Court Affirms: '13' Debtors Lose Appreciation in a Home After Conversion to '7'

Who gets the appreciation in a home when a chapter 13 case converts to chapter 7 after confirmation? Does the debtor keep the appreciation, or does it belong to the chapter 7 trustee?

It's one of the hottest topics in chapter 13 these days. The courts are split.

Having confirmed a plan, the debtors were in chapter 13 for about 18 months before converting to chapter 7. In chapter 13, they had scheduled their home as being worth $500,000 at filing. With a $500,000 valuation, there was no equity in the property on the filing date in view of a $375,000 mortgage and the debtor's claimed homestead exemption of $125,000.

After conversion, the chapter 7 trustee alleged that the property was worth $700,000 and filed a motion for authority to sell the home. The debtors argued that the valuation at conversion didn't matter because appreciation during chapter 13 was theirs.

Bankruptcy Judge Marc Barreca of Seattle disagreed with the debtors and held that post-petition, pre-conversion appreciation belonged to the chapter 7 estate. *In re Castleman*, 631 B.R. 914 (Bankr. W.D. Wash. June 4, 2021). To read ABI's report, click here.

The debtors appealed, but District Judge John H. Chun affirmed in a seven-page opinion on July 1.

Judge Chun looked primarily at Sections 541(a)(1) and (a)(6). The former defines the estate broadly to include all legal and equitable interests in property as of the filing date. Subsection (a)(6) brings proceeds, rents and profits into the estate, except earnings by an individual for services performed after filing.

Judge Chun also examined Section 348(f)(1)(A). When a chapter 13 case converts to a case under another chapter, it provides that "property of the estate in the converted case shall consist of property of the estate, as of the date of filing of the petition, that remains in the possession of or is under the control of the debtor on the date of conversion."

However, Judge Chun said that Section 348(f)(1)(A)

> does not address whether the increase in equity of a pre-petition asset qualifies as a separate, after-acquired property interest — as with after-acquired wages — or whether it is inseparable from the asset itself. Put another way, § 348(f)(1)(A) does not indicate whether "property of the estate, as of the date of filing of the petition," refers to property as it existed at the time of filing, with all its attributes, including equity interests.

For not addressing the question directly, the debtor contended that the statute was ambiguous. Judge Chun still found the answer within the four corners of the statute in view of the Ninth Circuit's decision in *Wilson v. Rigby*, 909 F.3d 306 (9th Cir. 2018). Over a vigorous dissent, the circuit held that Sections 541(a)(1) and (a)(6), read together, lead to the conclusion that post-petition appreciation in the value of a home belongs to the chapter 7 trustee. To read ABI's report on *Wilson*, click here.

However, *Wilson* was not entirely on point because the 2018 precedent dealt with a case in chapter 7 from the outset, not one converted from chapter 13.

Judge Chun worked from the proposition that a chapter 7 debtor keeps property acquired after filing. Therefore, he said, the question is whether appreciation is "a separate, after-acquired property interest" belonging to the debtor.

By having held in *Wilson* "that appreciation inures to the estate under 541(a)(6)," Judge Chun inferred that the Ninth Circuit "has necessarily found that increased equity in a pre-petition asset cannot be a separate, after-acquired property interest."

"This logic," Judge Chun said, "applies with equal force in a conversion case."

Although Section 348(f)(1)(A) might seem ambiguous initially, Judge Chun concluded that "it is unambiguous when considered in the context of the Code as a whole and under the Ninth Circuit's holding in *Wilson*."

Judge Chun upheld Bankruptcy Judge Barreca and allowed the trustee to sell the home and retain appreciation for the estate, after covering the debtors' homestead exemption. He permitted the debtors to file a motion for payment of an administrative expense for mortgage payments the debtors made after filing.

The opinion is *In re Castleman*, 21-00829 (W.D. Wash. July 1, 2022).

Judge Rosania answered a question left open by the Tenth Circuit in Barrera.

Debtor Retains Appreciation in Nonexempt Property Sold During Chapter 13

Answering a question left open by the Tenth Circuit in *Rodriguez v. Barrera (In re Barrera)*, 22 F.4th 1217 (10th Cir. Jan. 19, 2022), Bankruptcy Judge Joseph G. Rosania, Jr., of Denver decided that a chapter 13 debtor retains appreciation in the value of nonexempt property that the debtor owned on the filing date but sold in the course of the chapter 13 case.

In *Barrera*, the Tenth Circuit held that nonexempt appreciation in the value of a home sold after confirmation of a chapter 13 plan belongs to the debtor, not to creditors, if the case converts to chapter 7 after the sale. The appeals court specifically declined to opine on the result if the debtors were to remain in chapter 13 after the sale. To read ABI's report on *Barrera*, click here.

A couple confirmed a chapter 13 plan, after disputes with the chapter 13 trustee concerning the value of a limited liability corporation in which the husband owned a 13% interest. The LLC was the owner of a small office building in which the husband maintained his office.

To confirm the plan, the debtors obtained a valuation of the husband's interest in the LLC from a chapter 7 panel trustee. The panel trustee opined that the interest was worth $15,000. The couple confirmed their five-year plan based on the $15,000 valuation.

Three years into the plan, the other owners of the LLC decided to sell the office building. The sale resulted in net proceeds to the husband-debtor of about $75,000. The chapter 13 trustee filed a motion aiming to compel the debtors to turn over the sale proceeds and to modify the plan.

The debtors objected and won. Judge Rosania allowed the debtors to retain the sale proceeds in his August 23 opinion.

The case called for Judge Rosania to find the answer in what he called the "apparent contradiction" between Sections 1325(a)(4) and 1306.

In addition to property in Section 541, Section 1306 says that property of the estate in chapter 13 includes property of the type in Section 541 "that the debtor acquires" after filing but before the case is closed.

Section 1325(a)(4) requires the plan to provide value to creditors, as of the effective date of the plan, that is "not less" than what would be paid "if the estate of the debtor were liquidated in Chapter 7 . . . on such date."

In addition, Section 1327(b) provides that "the confirmation of a plan vests all of the property of the estate in the debtor," unless the plan or the confirmation order provides otherwise.

Judge Rosania framed the question as whether the proceeds from the sale of prepetition property "should be contributed to the chapter 13 plan." Under the "estate termination theory" espoused by other bankruptcy judges in Colorado, he said that "property vested with the debtors upon confirmation was no longer property of the estate."

Other courts, Judge Rosania said, adopted the "estate replenishment theory" where the estate "refills" with property acquired after confirmation without regard to whether the property is necessary to perform the plan. The replenishment theory, he said, requires "continued revaluation of estate property throughout the term of the plan."

To resolve the contradiction in the statute that the Tenth Circuit recognized in *Barrera*, Judge Rosania "determined [that] the revesting requirement under 11 U.S.C. § 1327(b) is more specific than the general language of 11 U.S.C. § 1306(a)(1)" and that "the estate termination theory gives meaning to both statutes."

To rule in favor of the debtor, Judge Rosania observed that the sale proceeds were generated from the sale of a business entity and were not earnings under Section 1306(a)(2).

Of greater significance, perhaps, he said that the value of the interest in the LLC "was appropriately disclosed and reconciled in the best-interest-of-creditors test" and "revested with the Debtors upon confirmation."

Judge Rosania held that the "estate termination theory . . . allows the Debtors to retain proceeds from the post-confirmation sale of prepetition property under the facts and circumstances of this case."

The opinion is *In re Klein*, 17-19106 (Bankr. D. Colo. Aug. 23, 2022).

FDCPA and FCRA

The Ninth Circuit equates nonjudicial foreclosure with bankruptcy discharge in terms of the effect on deficiencies following foreclosure.

Nonjudicial Foreclosure Wipes Out Deficiencies for the FCRA, Ninth Circuit Says

Following nonjudicial foreclosure, a lender's failure to report a deficiency as having been "abolished" (or discharged) establishes "inaccuracy" and opens the door to the "furnisher's" liability under the federal Fair Credit Reporting Act, 15 U.S.C. § 1681 *et seq*., according to the Ninth Circuit.

Although the deficiency may still survive in some existential sense after nonjudicial foreclosure or discharge in bankruptcy, the Ninth Circuit is saying in its May 16 opinion that a lender is barred from mounting a lawsuit or reporting the debt as outstanding. On the other hand, the Supreme Court held 5/3 in *Midland Funding LLC v. Johnson,* 137 S. Ct. 1407, 197 L. Ed. 2d 790 (2017), that a debt collector who files a proof of 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. To read ABI's report on *Midland Funding*, click here.

So, is the Ninth Circuit on thin ice? If a lender can file a proof of claim based on a time-barred debt and not violate the FDCPA, why is there an FCRA violation when the lender reports that the debt remains outstanding?

Does the inconsistency between the two opinions result from the courts' differing views about consumer protection laws, or do the factual distinctions justify the differing outcomes?

The Nonjudicial Foreclosure

An individual bought a home in Arizona in 2007 that crashed in value a few years later. The owner lost the home in a nonjudicial foreclosure in 2013.

The home had two mortgages. The foreclosure sale barely covered the first mortgage.

Several years later, the former owner was unable to obtain a mortgage for purchasing a new home because the lender on the foreclosed second mortgage was reporting that the debt was unpaid, outstanding and in default.

The former owner filed a written dispute with a national credit reporting agency, stating that the debt had been "abolished" by Arizona law. Indeed, Circuit Judge M. Margaret McKeown said in her opinion for the Ninth Circuit that the Arizona Supreme Court had held under the state's Anti-Deficiency Statute that nonjudicial foreclosure "abolish[es]" a borrower's personal liability.

The former owner filed a second dispute with the reporting agency after the lender continued to report the deficiency as outstanding. After the second dispute, the lender reported the debt as "charged off," an inaccuracy in itself.

The former owner then sued the lender under the FCRA for providing inaccurate information. The district court dismissed the suit on motion for summary judgment, believing that the reports were accurate as a matter of law. The owner appealed to the circuit.

The Reports Were Inaccurate, as a Matter of Law

To prove a claim under the FCRA against a so-called furnisher like the second-mortgage lender, Judge McKeown said that a consumer must first make a *prima facie* case demonstrating that the report was inaccurate. Then, the consumer must show that the furnisher did not follow "reasonable procedures" to ensure the "maximum possible accuracy."

Citing the Arizona Supreme Court's interpretation of the state's Anti-Deficiency Statute, Judge McKeown said that the former owner's liability for a deficiency on the foreclosed second mortgage had been "abolished." She then held that the former owner "was no longer obligated to repay the debt."

Therefore, Judge McKeown said, "It was 'patently incorrect' for [the lender-furnisher] to report otherwise."

Of significance in bankruptcy circles, Judge McKeown said that abolishing the debt under the state statute "was no different than" a discharge of a personal liability in bankruptcy under Section 524(a)(1).

For Judge McKeown, the question was not whether the debt had been entirely extinguished, as the district court had ruled. Rather, she said, "no outstanding balance existed, because the statute abolished his personal liability."

Judge McKeown therefore held that the former owner had "more than satisfied" his burden of showing *prima facie* inaccuracy.

Next, Judge McKeown addressed the question of whether the lender had conducted a reasonable investigation. Providing guidance for the district court on remand, she said that an

investigation by a lender "will often be more extensive and more thorough" than an investigation by a reporting agency.

In fact, Judge McKeown said, lenders will "sometimes" be required to "resolve" questions of "legal significance."

Because there were genuine factual disputes about the lender's investigation, Judge McKeown reversed and remanded for further proceedings or a trial regarding the sufficiency of the lender's investigation.

Taggart Questions

There is tension between the outcome in *Midland Funding* and the new case from the Ninth Circuit. But there is more.

In *Taggart v. Lorenzen*, 139 S. Ct. 1795, 1809 (2019), the Supreme Court held that there can be no sanctions for civil contempt of the discharge injunction if there was an "objectively reasonable basis for concluding that the creditor's conduct might be lawful under the discharge order."

Had the Ninth Circuit applied *Taggart* to the FCRA, the lender surely would have had a solid defense given that the debt under Arizona law continued to exist but was unenforceable.

Judge McKeown did not discuss *Taggart*. Was it error?

This writer submits there was no error. The discharge injunction contains no statutory standards for contempt, so the Supreme Court in *Taggart* applied common law notions of contempt.

Suits under the FCRA do not entail contempt. Rather, the FCRA sets up its own unique thresholds that must be met before imposing liability.

Although *Taggart* and the case in the Ninth Circuit can be reconciled, the same can't be said for *Midland Funding* and the Ninth Circuit opinion. Moreover, the Supreme Court will sometimes erect nonstatutory barriers to the enforcement of consumer protection laws by invoking federal common law using the doctrine of prudential standing. *See, e.g.*, *Spokeo Inc. v. Robins*, 136 S. Ct. 1540 (2016); and *TransUnion LLC v. Ramirez*, 20-297 (Sup. Ct. June 25, 2021).

To read ABI's reports on *Spokeo* and *TransUnion*, click here and here.

This writer submits there is a fundament difference between the Ninth Circuit and the Supreme Court when it comes to consumer protection. We leave it for the reader to decide which court has the better approach.

The opinion is *Gross v. CitiMortgage Inc.*, 20-17160 (9th Cir. May 16, 2022).

Priority Claims

The Affordable Care Act's 'individual mandate' was a tax measured by income, thus giving the IRS a priority tax claim.

Two Circuits Now Give Priority Status to Obamacare's Individual Mandate Penalty

Agreeing with a nonprecedential opinion from the Fifth Circuit and the majority on a recent decision from the Sixth Circuit Bankruptcy Appellate Panel, the Third Circuit held that the "penalty" imposed on a taxpayer for failure to purchase health insurance under the Affordable Care Act (a/k/a ACA or Obamacare) is a "tax" afforded priority under Section 507(a)(8).

The Fifth Circuit opinion is *U.S. v. Chesteen (In re Chesteen)*, 799 F. App'x 236, 241 (5th Cir. Feb. 20, 2020). To read ABI's report, click here. The BAP opinion from the Sixth Circuit is *In re Juntoff*, 636 B.R. 868 (B.A.P. 6th Cir. Mar. 21, 2022). Click here to read ABI's report on *Juntoff*.

At least for the time being, the decisions on the ACA lack broad significance because Congress lowered the "penalty" to zero after the taxes were assessed in the cases that went up on appeal. However, the courts' analyses will provide guidance for legislators in the future if they adopt a new form of health care built on the ACA and invoke another individual mandate intended to be (or intended not to be) a priority tax.

Typical Facts

In 2018, the debtor did not purchase health insurance under the so-called individual mandate, which the ACA referred to as a "penalty" and a "shared responsibility payment." The debtor filed a chapter 13 petition in 2019.

The Internal Revenue Service filed a $927 priority proof of claim for unpaid taxes resulting from the failure to purchase health insurance in 2018. The debtor objected to the claim, contending that the exaction was not a tax and was not entitled to priority.

The bankruptcy court ruled that the exaction was a tax, not a penalty, and was entitled to priority.

The district court upheld the judgment by holding that the exaction was a tax on income entitled to priority. The debtor appealed to the circuit.

In his May 11 opinion, Circuit Judge Thomas M. Hardiman said that his panel was tasked with deciding whether the exaction was a tax for bankruptcy purposes and, if it was, whether the tax was entitled to priority.

Governing Law

In *National Federation of Independent Business v. Sebelius*, 567 U.S. 519 (2012), the Supreme Court held that the shared responsibility payment was a tax for constitutional purposes but was not a tax for the Anti-Injunction Act. However, Judge Hardiman said that the ACA "exaction could function as a tax for the broader purpose of constitutional validity, but not within the narrower confines of bankruptcy priority."

"Accordingly," Judge Hardiman said, "there is no reason to conclude that *Sebelius*'s constitutional analysis is controlling in the context of the Bankruptcy Code."

Following other Supreme Court authority in characterizing an exaction as a "tax," Judge Hardiman said that the Third Circuit conducts a "functional analysis." Of special significance, he said, is whether the exaction confers any benefit on the taxpayer not enjoyed by everyone else.

Under the Third Circuit's governing analysis adopted in 2005 from a 1982 Ninth Circuit opinion, Judge Hardiman said that the exaction was not exchanged for a benefit not shared by others. Furthermore, he said, it was calculated and administered like a tax. In addition, the exaction "lacks typical penal characteristics."

Judge Hardiman therefore held that the exaction "is a tax for bankruptcy purposes."

Priority Status?

Next, Judge Hardiman confronted the question of whether the tax was entitled to priority under Section 507(a)(8) as either "a tax on or measured by income" or "an excise tax on . . . a transaction."

Judge Hardiman conceded that the payment was not a traditional tax on income. Still, he said, the plain language of the statute gives priority not only to income taxes but also to taxes "whose amounts are calculated based on the taxpayer's income."

The debtor's income "played an essential role" in deciding the amount of the tax, Judge Hardiman said. He therefore held that the exaction was entitled to priority as a tax "measured by income," even though the relevant provision in the IRS Code was titled "Miscellaneous Excise Taxes."

Judge Hardiman said that titles within the IRS Code "have no legal effect."

If the exaction were found to be an excise tax, Judge Hardiman said in a footnote that it would not be entitled to priority because the failure to purchase health insurance was not a "transaction."

The opinion is *In re Szczyporski*, 21-1858 (3d Cir. May 11, 2022).

Cross-Border Insolvency & Puerto Rico

Being registered, plus having directors and an address, on the Isle of Man wasn't sufficient to show COMI or an 'establishment' justifying recognition under chapter 15.

A 'Letter Box' Company Denied Foreign Main and Nonmain Recognition in Chapter 15

The liquidation of a "letter box" company with no operations, assets or actual management on the Isle of Man was not entitled to either foreign main or foreign nonmain recognition under chapter 15, because the island was not the center of main interests, nor did the company have an "establishment" there, according to Bankruptcy Judge Janice D. Loyd of Oklahoma City.

Judge Loyd's October 14 opinion stands in contrast to *In re Modern Land (China) Co., Ltd.,* 641 B.R. 768, 784 (Bankr. S.D.N.Y. July 18, 2022), where the bankruptcy court granted foreign main recognition to proceedings in the Cayman Islands, even though the company's assets, management and business were in mainland China. In *Modern Land*, however, there was debt governed by New York law. Furthermore, the creditors were almost unanimous in their approval of a scheme of arrangement approved in the Caymans, and no creditor objected to recognition in the U.S. To read ABI's report on *Modern Land*, click here.

Prof. Jay L. Westbrook told ABI that he found the Oklahoma case "interesting . . . because mere incorporation was not enough to make the Isle of Man the COMI even though accompanied by the usual lineup of statutory offices and resident directors where the offices and the directors were all associated with the corporate service organization."

The country's leading authority on cross-border insolvency, Prof. Westbrook went on to say that the "court relies on *SPhinX* [*infra*], which I regret, but nonetheless finds correctly that there was a failure of proof on COMI, especially where failure to produce knowledgeable management or liquidator witnesses permitted the court to make adverse inferences from their nonproduction."

Prof. Westbrook is the Benno C. Schmidt Chair of Business Law at the University of Texas School of Law.

The Liquidation on the Isle of Man

The debtor was a limited liability company that was incorporated in the Isle of Man and maintained its registered office there. It owned an aircraft and contracted to sell it to a third party,

after the completion of heavy maintenance. Two years later, disputes arose regarding the repairs. At the time, the escrow agent for the sale was holding more than $500,000.

The escrow agent filed an interpleader action that ended up in federal district court in Oklahoma to determine whether the debtor, the repair shop or the buyer was entitled to the $500,000. Later, the debtor was placed in a "creditors' voluntary liquidation" on the Isle of Man, where a liquidator was appointed.

Four months later, the liquidator filed a petition in Oklahoma City for recognition of the proceedings on the Isle of Man as either a foreign main or nonmain proceeding under chapter 15.

The Paucity of Relevant Evidence

Regarding recognition, there was no dispute that the proceedings abroad were a "foreign proceeding" and that the liquidator was a "foreign representative." Recognition turned on whether the liquidation abroad was a foreign main or nonmain proceeding as defined by Section 1502.

Under Section 1502(4), the proceedings would be foreign main if they were "pending in the country where the debtor has the center of its main interests," or COMI. Under Section 1502(5), the proceedings abroad would be nonmain if they were being conducted "where the debtor has an establishment." The debtor's registered office is presumed to be the COMI under Section 1516(c). Of course, the presumption can be overcome.

The repair shop and the buyer opposed recognition as main or nonmain. To decide whether the presumption had been overcome and the liquidator was entitled to foreign main recognition, Judge Loyd applied the five-factor test from *In re SPhinX, Ltd.*, 351 B.R. 103 (Bankr. S.D.N.Y. 2006), *aff'd*, 371 B.R. 10 (S.D.N.Y. 2007).

The first factor was the location of the debtor's headquarters.

The debtor's address on the Isle of Man was that of a "worldwide corporate service company." Although the debtor's directors lived on the island, they were employees of the service company. As Judge Loyd said, the service company's "corporate and governance services include[] acting as a registered office and providing directors."

The liquidator testified that the debtor's business model was to own an aircraft leased to an affiliate located in the Togalese Republic. Otherwise, there was no additional testimony about the debtor's operations or actual management.

The lack of further evidence led Judge Loyd to conclude that the first factor was "neutral."

The second factor inquires about the location of those who actually manage the debtor.

Because there was "no evidence" that the two employees from the service company "independently managed or exercised control," Judge Loyd decided that the second factor "weights against a finding of COMI."

The third factor is the debtor's primary assets.

The debtor claimed an interest in the aircraft, which was in Delaware, and had some $600,000 in a bank account in Switzerland, along with the $500,000 held by the court in Oklahoma. Finding "no evidence" about assets on the Isle of Man, Judge Loyd held that the location of assets "weighs heavily" against a finding of COMI.

The fourth factor, the location of creditors, similarly weighed against COMI because there were none on the island.

The fifth factor is the law to govern "most" disputes. It was neutral because Judge Loyd had no evidence on the issue.

Judge Loyd held that the liquidator was not entitled to foreign main recognition because the *SPhinX* factors weighed against a finding of COMI on the Isle of Man.

Still, the proceeding could be "foreign nonmain" if there was an "establishment" on the Isle of Man.

To qualify for nonmain recognition, Judge Loyd said that "the foreign debtor must establish a degree of stable connections with the jurisdiction to constitute a nontransitory 'establishment.' 11 U.S.C. § 1502(2)." She cited authority for the proposition that mere incorporation and record-keeping is not enough. There must be "a local effect on the marketplace," she said.

Judge Loyd found no establishment on the Isle of Man and therefore no right to nonmain recognition, because the liquidator had not shown that the debtor had not "sufficiently engaged the local economy."

To contravene the findings, the liquidator contended that the buyer and the repair shop had waived the right to object because they both participated in the proceedings on the Isle of Man by voting in favor of the creditors' voluntary liquidation.

Judge Loyd presumed that they were protecting their rights to share in a distribution. She declined to "infer" that the creditors waived "their substantive, statutory rights" to object to recognition.

Judge Loyd denied the liquidator's petition for both foreign main and foreign nonmain recognition.

Commentary by Prof. Westbrook

Prof. Westbrook elaborated on "letter box" companies and COMI:

> The point was made recently that the idea of jurisdiction of incorporation having broad jurisdiction over a corporation was invented by the English as a way of ensuring English law would control for an English corporation operating elsewhere in or out of the empire. I don't know if that is true, but it is plausible and I intend to explore it, because *incorporation standing alone should never be a sufficient basis for COMI jurisdiction*. [Emphasis added.]
>
> As Bankruptcy Judge Martin Glenn held, it certainly cannot be the basis for nonmain jurisdiction. Yet *SPhinX* makes too much turn on what "the parties" want, which is to say the parties with the means and incentive to show up in the U.S. court. The rock-solid core of COMI doctrine is, of course, the opinion of Judge Lifland in *In re Bear Stearns High-Grade Structured Credit Strategies Master Fund Ltd.*, 389 B.R. 325 (S.D.N.Y. 2008), where the court takes on the burden of ensuring the COMI policy of Chapter 15 is enforced.

The opinion is *In re Comfort Jet Aviation Ltd.*, 22-10039 (Bankr. W.D. Okla. Oct. 14, 2022).

A country that was ineligible to host a nonmain foreign proceeding was nonetheless held to have the foreign main proceeding.

Caymans Recognized as the 'COMI' for a Property Company Operating in China

The *Modern Land* opinion on July 18 by Bankruptcy Judge Martin Glenn of New York appears to mean that the Cayman Islands can be the center of main interests for the purpose of chapter 15 foreign main recognition even though the company's assets, management and business are in mainland China, in the absence of an objection by an affected creditor.

"With great respect," Prof. Jay L. Westbrook said, "I disagree with the approach in *Modern Land*, where the foreign note holders of a [mainland Chinese] company had their rights substantially altered by an insolvency proceeding in a haven jurisdiction." Prof. Westbrook is the country's leading authority on cross-border insolvency and occupies the Benno C. Schmidt Chair of Business Law at the University of Texas School of Law.

Extension of *Fairfield Sentry*

Judge Glenn's opinion could be seen as an extension of Second Circuit authority holding that the center of main interests, or COMI, can shift to the Caymans as a consequence of substantial activities by liquidators appointed by the court in the Caymans. *See Morning Mist Holdings Ltd. v. Krys (In re Fairfield Sentry Ltd.)*, 714 F.3d 127 (2d Cir. 2013).

The *Modern Land* chapter 15 case before Judge Glenn did not involve the culmination of a liquidation conducted in the Caymans, as was the case in *Fairfield Sentry*. Rather, *Modern Land* dealt with a scheme of arrangement presumably negotiated elsewhere and then approved by a court in the Caymans.

The opinion by Judge Glenn recognizes the policy of chapter 15 to fulfill the expectations of creditors. But does policy allow the court to override the language of the statute, which precludes the finding of COMI where the company never operated?

Laudably, Judge Glenn's opinion corrects a Hong Kong court's misinterpretation of a significant chapter 15 decision from the Southern District of New York dealing with a different issue.

The COMI Issue

Judge Glenn's opinion is required reading for anyone who may ever participate in a chapter 15 case.

Incorporated in the Caymans, the debtor was the ultimate parent of subsidiaries that were property developers in mainland China. Half of the subsidiaries were also incorporated in the Caymans, and they maintained their registered offices in the Caymans. The debtor's stock was listed on the Hong Kong Stock Exchange.

Judge Glenn said it was "undisputed" that the debtor and its subsidiaries "managed and conducted their business" in mainland China.

The total debt was some $4.3 billion, including about $1.3 billion in notes governed by New York law. The notes were in default.

The debtor negotiated a scheme of arrangement to be implemented under Caymans law in a court in the Caymans. The scheme was accepted by 99% in number and 95% in amount of notes voting in an arrangement proceeding in the Caymans. No other creditors were to be affected by the scheme.

The scheme was designed to extinguish existing notes. In exchange, the holders were to receive some cash and new notes. The court in the Caymans approved the scheme. The company continued to operate throughout and was not being liquidated.

The debtor's foreign representative filed a chapter 15 petition in New York asking for recognition of the proceedings in the Caymans as the foreign main proceeding under Section 1517(a)(1). Under Section 1502(4), Judge Glenn would find the Caymans to be the host of the "foreign main proceeding" if he were to find that the Caymans was "the country where the debtor has the center of its main interests."

"In the absence of evidence to the contrary," Section 1516(c) provides that "the debtor's registered office . . . is presumed to be the center of the debtor's main interests." To decide whether the COMI presumption has been overcome, Judge Glenn said that courts consider factors such as the location of the debtor's headquarters, the location of individuals who actually manage the business and the location of the primary assets.

Judge Glenn said that the Second Circuit "and other courts often examine" whether the COMI "would have been ascertainable to interested third parties."

Judge Glenn cited *Fairfield Sentry* and *In re Suntech Power Holdings Co.*, 520 B.R. 399 (Bankr. S.D.N.Y. 2014), for the proposition that COMI is determined as of the date of the filing of the chapter 15 petition, not necessarily the location from which activities were conducted

historically. Thus, substantial activities by foreign liquidators can have the effect of moving the COMI to the Caymans from the country where the business was conducted historically.

In the case before him, there were no liquidators because the debtor was in arrangement proceedings. "So," Judge Glenn said, "the question is whether the absence of court-supervised fiduciaries, such as [liquidators], requires a different result in finding COMI in the Cayman Islands in this case given that no [liquidators] were appointed."

The two creditors who voted against the scheme in the Caymans did not oppose finding the Caymans to be the COMI.

It's Main, but Can't Be Nonmain

Judge Glenn explained in detail why the Caymans was not hosting a foreign nonmain proceeding.

Section 1502(5) says that a foreign proceeding is nonmain if it is "pending in a country where the debtor has an establishment." In turn, "an establishment" is defined in Section 1502(2) to be "any place of operations where the debtor carries out a nontransitory economic activity."

The debtor conducted no "nontransitory" business in the Caymans. Prof. Westbrook therefore said, "The court was quite right in finding that the Cayman's proceeding could not be classified as nonmain under Chapter 15 because there was no real economic activity there."

"Mere paper shuffling or a director's weekend on a sun-kissed island should not be enough," the professor added.

Although the Caymans could not conduct a nonmain proceeding, Judge Glenn cited several reasons why the Caymans nonetheless could be the COMI, and thus home to a foreign main proceeding. Among other considerations, he cited the "goals" of chapter 15, the creditors' expectations and the prevalent judicial role of the court in the Caymans.

In other words, Judge Glenn held that a country that couldn't host a nonmain proceeding nevertheless could be the COMI and expect countries around the world to enforce its decisions.

Discharging Debt in Chapter 15

Judge Glenn opined on the proper interpretation of *In re Agrokor d.d.*, 591 B.R. 163 (Bankr. S.D.N.Y. 2018). *Agrokor* was an opinion by Judge Glenn where he recognized a Croatian plan "in full within the territorial jurisdiction of the U.S., including the provisions modifying the English law governed debt and the New York law governed debt." *Id*. at 191-192. To read ABI's report on *Agrokor*, click here.

In June, a court in Hong Kong evidently interpreted *Agrokor* to mean that foreign main recognition under chapter 15 does not discharge debt in the U.S.

"With great respect for the Hong Kong court," Judge Glenn said, the "court misinterprets this Court's earlier decision in *Agrokor*, as well as many other decisions in the United States which have recognized and enforced foreign court sanctioned schemes or restructuring plans that have modified or discharged New York law governed debt."

Assuming that factual and procedural prerequisites are met, Judge Glenn said that "a decision of the foreign court approving a scheme or plan that modifies or discharges New York law governed debt is enforceable" in the U.S. by virtue of a chapter 15 case in the U.S.

Identifying the mistaken interpretation by the Hong Kong court, he said that the geographical "limits [of] a U.S. bankruptcy court's authority to enjoin conduct outside the territorial jurisdiction of the United States [under chapter 15] does not make a discharge of New York law governed debt any less controlling."

Even if a Hong Kong court were to believe that the proceedings in New York did not discharge the debt under the "old" notes, Judge Glenn was saying that the discharge would be enforceable in the territorial U.S.

Judge Glenn recognized the Caymans proceedings as the foreign main proceeding and enforced the scheme of arrangement in the U.S. that had been approved by the court in the Caymans.

Of note, the debtor said it did not intend to have a court in Hong Kong rule that the debt on the "old" notes was discharged. As a result, the obligations on the "old" notes would be discharged in the U.S. as a consequence of foreign main recognition but not discharged in Hong Kong, where the debtor's stock was traded and where the company operated.

Commentary by Prof. Westbrook

Prof. Westbrook believes that "the court was mistaken in its second finding that mere incorporation in the jurisdiction was sufficient to make the proceeding a main one. That combination of findings turns the structure of the Model Law upside down, with the standard for a main proceeding requiring less real economic contact with a jurisdiction than the nonmain standard."

Regarding the finding of COMI, Prof. Westbrook added:

> The result is especially troubling if the noteholders were protected by the Trust Indenture Act and the choice of New York law. While a foreign insolvency proceeding can stand in for a U.S. bankruptcy as an exception to the TIA protections, only a true main proceeding in the debtor's COMI should be permitted to have that effect.
>
> Where there is no meaningful economic activity in the rendering jurisdiction, how can it be "the center" of its business as Chapter 15 (and the Model Law) require? My touchstone is the seminal opinion by the late Judge Burton R. Lifland, *In re Bear Stearns High-Grade Structured Credit Strategies*, 374 B.R. 122 (Bankr. S.D.N.Y 2007).

The opinion is *In re Modern Land (China) Co. Ltd.*, 22-10707 (Bankr. S.D.N.Y. July 18, 2022).

The bankruptcy court has no discretion to deny recognition in chapter 15 if the requirements of Section 1517(a) have been met.

Bad Faith Filings in Chapter 15 Entitled to 'Foreign Main Recognition,' BAP Says

A bad faith filing is no basis for denying recognition of a foreign main proceeding under chapter 15 "if all three requirements of § 1517(a) are met," the Ninth Circuit Bankruptcy Appellate Panel recently held.

A foreign representative is entitled to recognition even if the filing was not a legitimate use of chapter 15, Bankruptcy Judge Julia W. Brand said in her February 17 opinion for the BAP.

Before concluding that the BAP lost its mind by condoning bad faith, be sure to read the end of this report, where Judge Brand lays out the relief available to a creditor who can show that chapter 15 is being misused.

The Bankruptcy in Monaco

Incorporated in Monaco, the debtor was the sole distributor in Europe for a California-based producer of lubricants. The California creditor held 96% of the debt owing by the debtor.

The creditor alleged that the debtor had misappropriated its trade secrets and customer lists to establish a competing business. The creditor initiated an arbitration in California where the arbitrator awarded the creditor almost $1.1 million. The federal court in California confirmed the arbitration award.

Believing that the debtor's owner had fraudulently transferred the debtor's assets, the creditor was undertaking discovery in California aimed at identifying assets or transfers of assets.

The debtor filed an insolvency proceeding in Monaco followed by a chapter 15 petition in Oakland, Calif. The chapter 15 filing imposed an automatic stay on discovery.

The Monegasque trustee sought recognition of the proceedings in Monaco as a foreign main proceeding under Section 1517(b)(1). The creditor opposed.

The creditor argued in bankruptcy court that the Monegasque bankruptcy and the chapter 15 cases were shams to protect the debtor's owner and shield fraudulently transferred assets.

Among other things, the bankruptcy court found that the owner was paying the Monegasque trustee's attorneys' fees and that the trustee's lawyers had also represented the debtor in California district court. According to Judge Brand, the bankruptcy judge found that the trustee was not a "true fiduciary" and that the facts "cast doubt on the integrity of the proceeding and [the debtor's] good faith."

The bankruptcy court denied recognition, concluding that the case was not a legitimate use of chapter 15 for the purposes intended by Section 1501. According to Judge Brand, the bankruptcy court "believed that the real purpose of the filing was to preclude [the creditor] from recovering on its Judgment and to protect [the owner and another business he owned] from their own wrongful conduct."

"Because the [bankruptcy] court found the filing to be improper under § 1501, it made no findings under § 1517," Judge Brand said. The debtor appealed to the BAP, which reversed.

The Standards for Recognition

Judge Brand devoted several pages to laying out the nuts and bolts of reorganization and liquidation proceedings in Monaco. Although insolvencies in Monaco do not mimic U.S. bankruptcies precisely, the Monegasque law struck this writer as similar to the laws of other countries entitled to recognition under chapter 15.

Judge Brand laid out the two most relevant statutes, Sections 1501 and 1517(a).

Section 1501 contains the statement of purpose for chapter 15, including cooperation between courts in the U.S. and those abroad with the provision of "effective mechanisms for dealing with cases of cross-border insolvency."

Section 1517(a) demands that recognition "shall" be granted if (1) the foreign proceeding is main or non-main, (2) the foreign representative is a person or body and (3) the petition meets the requirements of Section 1515.

In bankruptcy court, there had been no dispute about the satisfaction of the three requirements.

Reversal was foretold early in her opinion when Judge Brand said she "could not locate . . . another case where a court has applied § 1501 to determine recognition of a foreign proceeding." She said that the bankruptcy court "impermissibly engaged in a more discretionary analysis than what recognition under § 1517 authorizes."

Judge Brand said that "Section 1501 does not control recognition of a foreign proceeding. Rather, recognition is governed by §§ 1515 through 1524."

However, there is a safety valve in Section 1506, Judge Brand said. It says,

> Nothing in this chapter prevents the court from refusing to take an action governed by this chapter if the action would be manifestly contrary to the public policy of the United States.

In other words, "recognition is mandatory if all three requirements of § 1517(a) are met and there is no public policy basis to deny it," Judge Brand said.

Given that the requirements of Section 1517(a) were satisfied, Judge Brand examined whether recognition would be "manifestly contrary" to U.S. public policy.

With the facts not in dispute, Judge Brand found nothing "manifestly contrary" to U.S. public policy. She analyzed several other chapter 15 cases where "a party's misconduct or bad faith [was] not a proper basis for invoking § 1506 to deny recognition." She cited a case with "more egregious" facts where recognition had been granted.

Judge Brand reversed and ruled that the proceedings in Monaco were entitled to foreign main recognition.

The Safety Valve

Although the foreign proceeding was entitled to recognition, Judge Brand said the court is not "helpless when faced with misconduct or bad faith in a chapter 15 case." After recognition, she said that the court "has a considerable amount of discretion."

If there is misconduct or bad faith, Judge Brand said that the court's tools include relief from the automatic stay, abstention or dismissal.

The opinion is *Samba v. International Petroleum Products & Additives Co. (In re Black Gold SARL)*, 21-168 (B.A.P. 9th Cir. Feb. 17, 2022).

Judge Garrity wasn't required to rule on whether Bankruptcy Rule 2004 applies in chapter 15 cases.

Chapter 15 Permits Discovery to Lay Groundwork for a Lawsuit, New York Judge Says

Bankruptcy Judge James L. Garrity, Jr., authorized the foreign representative of a South African airline to take discovery from Boeing under Section 1521(a)(4) regarding claims and defenses related to a purchase agreement for eight 737 MAX 8 aircraft.

The airline had 27 aircraft and 2,000 employees. In 2013, the airline contracted to buy the eight aircraft from Boeing.

The airline's finances were deteriorating even before the pandemic. Eventually, the airline was forced to ground all aircraft.

Under the aegis of joint business rescue practitioners, or BRPs, the airline commenced business rescue proceedings in South Africa in May 2020 under Chapter 6 of the South African Companies Act of 2008. Later, the BRPs obtained approval of a business rescue plan.

Before the airline's insolvency proceedings, the airline had paid for and Boeing had delivered the first of the eight new aircraft. The new aircraft was delivered just before the second crash of a 737 MAX 8, which resulted in the grounding of the MAX 8 fleet worldwide. The airline had also made pre-delivery payments for additional aircraft.

Before the insolvency proceedings, the airline had purported to cancel the purchase agreement for all eight aircraft. The BRPs confirmed the airline's cancellation. The rescue plan also authorized the cancellation of the purchase agreement.

The BRPs commenced a chapter 15 case in New York in February 2021. The bankruptcy court granted foreign main recognition and recognized the BRPs as foreign representatives. The recognition order authorized the foreign representatives to exercise the powers of a trustee provided by Sections 1520 and 1521.

In March 2021, the foreign representatives sent a letter to Boeing outlining claims for breach of contract and fraudulent inducement. Boeing responded by confirming that the purchase agreement was terminated but otherwise reserved its rights against the airline.

In August 2021, the foreign representative filed a motion in bankruptcy court under Section 1521 and Bankruptcy Rule 2004 to take discovery from Boeing. The aircraft manufacturer objected on a variety of grounds, but Judge Garrity granted the motion in an opinion on November 14.

Judge Garrity explained how Section 1521(a) contains a non-exclusive list of relief available to a foreign representative. "[T]o effectuate the purpose of this chapter and to protect the assets of the debtor," the section provides that "the court may, at the request of the foreign representative, grant any appropriate relief, including . . . (4) providing for the examination of witnesses, the taking of evidence or the delivery of information concerning the debtor's assets . . . or liabilities."

Section 1522(a) provides that the court may grant relief under Section 1521 "only if the interests of the creditors and other interested entities, including the debtor, are sufficiently protected."

Bankruptcy Rule 2004 provides that the court may allow an examination, but it "may relate only to the acts, conduct, or property or to the liabilities and financial condition of the debtor, or to any matter which may affect the administration of the debtor's estate."

The grant of chapter 15 recognition did not "bar the requested relief," Judge Garrity said, because the foreign representatives have a statutory duty under South African law to investigate the company's affairs. He therefore ruled that "the requested discovery is necessary to facilitate his efforts to assess the viability, strength, and magnitude of potential causes of action against Boeing and the likelihood and extent of a monetary recovery."

Section 1521, Judge Garrity said, authorizes discovery "without any limitation based on how the foreign representative intends to use the fruits of the requested discovery." He therefore found that the requested discovery would "effectuate the purpose" of chapter 15.

The aircraft manufacturer contended there was no need to protect the airline's assets because it was preserving the evidence that the foreign representatives might seek to discover when there is a lawsuit. Boeing also argued that the foreign insolvency proceeding was "essentially complete" because the plan had been approved.

Judge Garrity said there had been no "Termination Events" under South African law. "Accordingly," he said, "the Rescue Plan and South African law do not foreclose the Foreign Representative from pursuing claims against Boeing in furtherance of his effort to rescue the company."

"Moreover," Judge Garrity said, "the fact that the Debtor can seek discovery under the applicable rules of civil procedure if it ultimately commences litigation against Boeing . . . is not

a bar to the relief sought in the Motion." [Reference omitted.] Ruling otherwise, he said, "would completely eviscerate the investigatory function that section 1521(a)(4) is designed to serve."

Judge Garrity therefore concluded that discovery was "necessary to protect [the airline's] assets." He said that the foreign representatives were pursuing discovery to satisfy their duties under South African law and had "established grounds under section 1521(a)(4) to conduct discovery of Boeing relating to causes of action that [the airline] may hold against Boeing and the extent of [the airline's] potential monetary recovery from Boeing."

Last, Judge Garrity held that Boeing's interests were "sufficiently protected," although Boeing argued that the foreign representatives' 40 document requests were "massively overbroad."

With regard to Boeing's contention that the document requests were overbroad, Judge Garrity directed the parties to meet and confer. In the absence of agreement, he called on them to arrange a discovery conference under the district's local rules.

Boeing argued that Rule 2004 does not apply in chapter 15 cases. Judge Garrity said the issue was "academic" because the foreign representatives were entitled to discovery under Section 1521(a)(4).

Judge Garrity granted the motion allowing the foreign representatives to conduct discovery.

The opinion is *In re Comair Ltd*., 21-10298 (Bankr. S.D.N.Y. Nov. 14, 2021).

Splitting with the Ninth Circuit, the First Circuit holds that claims under the Takings Clause cannot be discharged in a municipal bankruptcy.

First and Ninth Circuits Split on Discharge of Takings Clause Claims

Creating a split of circuits, the First Circuit ruled that just compensation for a government's taking of private property must be paid in full under the Fifth Amendment and not at the discount afforded to holders of unsecured claims in a municipal bankruptcy.

Beginning in 2017, Puerto Rico and some of its instrumentalities filed debt-adjustment proceedings under the Puerto Rico Oversight, Management, and Economic Stability Act, or PROMESA (48 U.S.C. §§ 2161 *et. seq.*). PROMESA adopts large swaths of chapter 9, governing municipal bankruptcy.

Five years later, Puerto Rico and two of its instrumentalities confirmed debt-adjustment proceedings in district court. However, the confirmed plan was not to the liking of the Financial Oversight and Management Board for Puerto Rico, the proponent of the plans. Here's how it happened.

Several creditors had filed claims seeking "just compensation" for Puerto Rico's alleged prepetition takings of their private property. In some instances, Puerto Rico had made cash deposits to cover what the commonwealth believed to be the value of the properties. In other cases, there were no deposits.

Originally, Puerto Rico's plan treated the takings claims as secured to the extent there were cash deposits and unsecured claims to the extent that the value exceeded the deposits. Where there were there no deposits, the entire claim was treated as unsecured.

The district court sustained objections by the takings creditors. Once Puerto Rico amended the plan to pay takings claims in full, the district court confirmed the plans. Puerto Rico appealed to the First Circuit in February, seeking to reinstate the prior version of the plan where some or all of the takings claims would be treated as unsecured.

The appeals court heard oral argument on April 28. Circuit Judge William J. Kayatta, Jr. affirmed in a 31-page opinion on July 18. He said that the appeal presented "important questions about the interplay between the power to equitably restructure debts in bankruptcy and the

Constitution's requirement that just compensation be paid whenever the government takes private property for public use."

The Board asserted the primacy of the Bankruptcy Clause over the Takings Clause. The Bankruptcy Clause gives Congress the power "to establish . . . uniform Laws on the subject of Bankruptcies throughout the United States." The Takings Clause of the Fifth Amendment says, "Nor shall private property be taken for public use, without just compensation."

Primacy of the Takings Clause

Judge Kayatta framed the question as whether "the Fifth Amendment precludes the impairment or discharge of prepetition claims for just compensation" under PROMESA. He characterized the Board as contending "that, by reorganizing in bankruptcy, the debtors can eliminate their obligation to pay just compensation and instead pay only reduced amounts based on a formula applicable to most unsecured creditors."

For Judge Kayatta, the relationship between the Takings Clause and the bankruptcy laws was "very clear." He cited cases from the Supreme Court in 1935 and 1982 for saying that "bankruptcy laws are subordinate to the Takings Clause."

"Accordingly," Judge Kayatta said, bankruptcy laws "are not categorically exempt from the requirements of the Fifth Amendment (any more than they are exempt from, for example, the First Amendment)."

Before pronouncing the Takings Clause victorious, he rejected several "fallback" arguments proffered by the Board.

First, the Board contended that the takings claimants no longer had any interests in property protected by the Takings Clause and held only unsecured claims subject to adjustment in bankruptcy. There being agreement that takings had occurred, Judge Kayatta was "not persuaded that the Fifth Amendment should be read to permit the impairment of prepetition claims for just compensation simply because the claimants no longer possess rights in the taken property postpetition."

Next, the Board argued there was nothing about a takings claim making it different from a claim for money damages resulting from any other constitutional violation. Judge Kayatta saw a distinction because the Takings Clause "clearly spells out both a monetary remedy and even the necessary quantum of compensation due."

The Circuit Split

The Board cast its lot with *In re City of Stockton*, 909 F.3d 1256 (9th Cir. 2018), which was "favorable" to the Board's position, Judge Kayatta said. In *Stockton*, the majority on the Ninth Circuit panel held that an appeal from a chapter 9 municipal reorganization can be dismissed under the doctrine of equitable mootness.

Ruling also on the merits, the majority in the Ninth Circuit held that a takings claim "is only implicated in bankruptcy if the creditor has actual property rights." *Id*. at 1266. Evidently conceding that the Takings Clause provides protection to a creditor claiming "actual property rights," the majority said that a debt can be adjusted in bankruptcy if the creditor only has a right to monetary relief, citing the *Collier* treatise. *Id*. To read ABI's report on *Stockton*, click here.

Judge Kayatta found the dissenting opinion in *Stockton* to be "more persuasive." The dissenter would have held that "the Fifth Amendment's requirement that the government provide just compensation for any taking of private property constrains the powers granted to Congress by the Bankruptcy Clause of Article I. Takings claims should therefore be excepted from discharge in bankruptcy." *Id*. at 1269.

For Judge Kayatta, the answer to the question was "rather simple. The Fifth Amendment provides that if the government takes private property, it must pay just compensation." He affirmed the district court, holding "that otherwise valid Fifth Amendment takings claims arising prepetition cannot be discharged in [PROMESA] bankruptcy proceedings without payment of just compensation."

'*Cert*' Petition?

This writer will not be surprised if the Board files a petition for *certiorari*, raising the question with the Supreme Court. There is a split of circuits, although not yet entrenched. The Puerto Rico case is a good vehicle to raise the issue.

The Supreme Court has already agreed to hear two bankruptcy cases in the term to begin in October. Having a third bankruptcy case on the calendar would be unusual but not unprecedented.

If there is a *certiorari* petition, the Court may ask for the views of the Solicitor General, but the request might not come until early October. Because the Solicitor General would need several months to file a brief for or against a grant of *certiorari*, a decision by the Court to hear the case may not arrive in time for argument in the upcoming term.

As far as bankruptcy is concerned, the issue is attractive because a ruling by the Supreme Court should not have widespread repercussions for personal bankruptcy or corporate reorganization. That is to say, a decision should not rock the bankruptcy world like *Stern v. Marshall*.

The opinion is *Financial Oversight and Management Board for Puerto Rico v. Cooperativa de Ahorro y Credito Abraham Rosa (In re Financial Oversight and Management Board for Puerto Rico)*, 22-1119 (1st Cir. June 18, 2022).

Faculty

Hon. Janet S. Baer is a U.S. Bankruptcy Judge for the Northern District of Illinois in Chicago, appointed on March 5, 2012. She also acts on a regular basis as the presiding judge in the Northern District of Illinois for naturalization ceremonies. Previously, Judge Baer was a restructuring lawyer for more than 25 years and was involved in some of the most significant chapter 11 bankruptcy cases in the country. The majority of her practice focused on the representation of large, publicly held debtors in both restructuring and chapter 11 matters, and she also represented companies in commercial litigation matters, including lender liability, fraud, breach of contract and breach of fiduciary duty. Prior to forming her own firm in 2009, Judge Baer was a partner at Kirkland & Ellis LLP, Winston & Strawn and Schwartz, Cooper, Greenberger & Krauss. She is a member of the ABI Board of Directors, the CARE National and Chicago Advisory Boards, and the Chicago IWIRC Network Board, as well as several committees. She also is chair of the NCBJ 2023 Education Committee and a frequent speaker for ABI, the ABA, the Chicago Bar Association, IWIRC and NCBJ, and she regularly acts as the presiding judge for the Northern District of Illinois in naturalization ceremonies. Judge Baer earned her B.A. from the University of Wisconsin - Madison and her J.D. from DePaul College of Law.

Hon. Hannah L. Blumenstiel is a U.S. Bankruptcy Judge for the Northern District of California in San Francisco. Prior to her appointment on Feb. 11, 2013, Judge Blumenstiel was an associate (2003-08) and then a partner (2008-12) with Winston & Strawn LLP, where she focused her practice on creditors' rights litigation in state and federal court, including bankruptcy court. From 2001 to 2003, Judge Blumenstiel was an associate with Murphy Sheneman Julian & Rogers LLP, where she represented debtors, creditors and trustees in bankruptcy cases and adversary proceedings. She served as a law clerk to Hon. Charles M. Caldwell of the U.S. Bankruptcy Court for the Southern District of Ohio (Eastern Division) from 1998 to 2001, and from 1997-98, she represented the State of Ohio's interests in bankruptcy cases as an assistant attorney general with the Revenue Recovery Section of the Ohio Attorney General's Office. Judge Blumenstiel sits on ABI's Board of Directors. She received her J.D. from Capital University Law School in 1997 while working full-time for the Columbus Bar Association as director of its *pro bono* initiative, "Lawyers for Justice," and her B.A. from Ohio State University in 1992.

Hon. Kevin J. Carey is a partner in Hogan Lovells US LLP's Business Restructuring and Insolvency practice in Philadelphia and is a retired bankruptcy judge. He also is ABI's President and represents both companies and creditors in domestic and cross-border bankruptcy proceedings. Judge Carey was first appointed to the U.S. Bankruptcy Court for the Eastern District of Pennsylvania in 2001, then in 2005 began service on the U.S. Bankruptcy Court for the District of Delaware (serving as chief judge from 2008-11). During that time, he authored more than 200 reported decisions, issued important rulings on key issues such as valuation, fiduciary duties and other complex chapter 11 and confirmation issues, and presided over such high-profile cases as Exide Technologies, Tribune Co. and New Century Financial. Judge Carey was the first judge to serve as global chair of the Turnaround Management Association and is an honorary member of the Turnaround, Restructuring and Distressed Investing Hall of Fame, as well as a Distinguished Fellow of the Association of Insolvency & Restructuring Advisors. In addition, he is a Fellow of the American College of Bankruptcy and a member of the International Insolvency Institute, as well as a contributing author to *Collier on*

Bankruptcy and a member of the National Conference of Bankruptcy Judges. He also is a part-time adjunct professor in the LL.M. in Bankruptcy program at St. John's University School of Law in New York City. Judge Carey began his legal career in 1979 clerking for Bankruptcy Judge Thomas M. Twardowski, then served as clerk of court of the U.S. Bankruptcy Court for the Eastern District of Pennsylvania. He received his B.A. in 1976 from Pennsylvania State University and his J.D. in 1979 from Villanova University School of Law.

Hon. Daniel P. Collins is a U.S. Bankruptcy Judge for the District of Arizona in Phoenix, appointed on Jan. 18, 2013. He served as chief judge from 2014-18. Previously, he was a shareholder with the law firm of Collins, May, Potenza, Baran & Gillespie, P.C. in downtown Phoenix, practicing primarily in the areas of bankruptcy, commercial litigation and commercial transactions. Judge Collins Dan is President-Elect for the National Conference of Bankruptcy Judges, is a Fellow in the American College of Bankruptcy, served on ABI's Board of Directors, is on the board of the Phoenix Chapter of the Federal Bar Association and is a member of the University of Arizona Law School's Board of Visitors. He also is a founding member of the Arizona Bankruptcy American Inn of Court. Judge Collins received both his B.S. in finance and accounting in 1980 and his J.D. in 1983 from the University of Arizona.

Hon. John T. Gregg is a U.S. Bankruptcy Judge for the Western District of Michigan in Grand Rapids, appointed on July 17, 2014. Previously, he was a partner with the law firm of Barnes & Thornburg LLP, where he focused on corporate restructuring, bankruptcy and other insolvency matters. Judge Gregg is the chair of the education committee of the National Conference of Bankruptcy Judges for 2022, serves on the ABI's Board of Directors, was recently inducted as a Fellow of the American College of Bankruptcy, and is a member of the American Law Institute. He is a frequent writer and speaker on bankruptcy and other commercial issues, and he has written and co-edited numerous secondary sources, including *Collier Guide to Chapter 11*, published by LexisNexis; *Strategies for Secured Creditors in Workouts and Foreclosures*, published by ALI-ABA; *Issues for Suppliers and Customers of Financially Troubled Auto Suppliers*, published by ABI; *Michigan Security Interests in Personal Property*, published by the Institute of Continuing Legal Education; *Handling Consumer and Small Business Bankruptcies in Michigan*, published by the Institute of Continuing Legal Education; *Interrupted! Understanding Bankruptcy's Effects on Manufacturing Supply Chains*, published by ABI; and *Receiverships in Michigan*, published by the Institute of Continuing Legal Education. Judge Gregg received his B.A. in 1996 from the University of Michigan and his J.D. in 2002 from DePaul University College of Law.

Hon. Bruce A. Harwood is Chief U.S. Bankruptcy Judge for the District of New Hampshire in Concord, appointed to the bench in March 2013. He also serves on the First Circuit's Bankruptcy Appellate Panel. Prior to his appointment to the bench, Judge Harwood chaired the Bankruptcy, Insolvency and Creditors' Rights Group at Sheehan Phinney Bass + Green in Manchester, N.H., representing business debtors, asset-purchasers, secured and unsecured creditors, creditors' committees, trustees in bankruptcy, and insurance and banking regulators in connection with the rehabilitation and liquidation of insolvent insurers and trust companies. He was a chapter 7 panel trustee in the District of New Hampshire and mediated disputes arising in debtor/creditor relations. Judge Harwood serves on ABI's Board of Directors on its Communication, Information and Technology Committee. He served as co-chair of ABI's Commercial Fraud Committee, as program co-chair of (and presently

as judicial advisor to) ABI's Northeast Bankruptcy Conference; and as Northeast Regional Chair of the ABI Endowment Fund's Development Committee. He also served on ABI's Civility Task Force. Judge Harwood is a Fellow in the American College of Bankruptcy and was consistently recognized in the bankruptcy law section of *The Best Lawyers in America*, in *New England SuperLawyers* and by *Chambers USA*. He received his B.A. from Northwestern University and his J.D. from Washington University School of Law.

Hon. Barbara J. Houser is a retired U.S. Bankruptcy Judge for the Northern District of Texas in Dallas, now serving on recall status, and she is ABI's Immediate Past President. She previously was with Locke, Purnell, Boren, Laney & Neely in Dallas and became a shareholder there in 1985. In 1988, she joined Sheinfeld, Maley & Kay, P.C. as the shareholder-in-charge of the Dallas office and remained there until she was sworn in as a U.S. Bankruptcy Judge in 2000. While at Sheinfeld, Judge Houser led the firm's representation of clients in a variety of significant national chapter 11 cases. She lectures and publishes frequently, is a past chairman of the Dallas Bar Association's Committee on Bankruptcy and Corporate Reorganization, is a member of the Dallas, Texas and American Bar Associations, and is a Fellow of the Texas and American Bar Foundations. Judge Houser served as a contributing author to *Collier on Bankruptcy* for many years and taught creditors' rights as a visiting professor at the SMU Dedman School of Law. She was elected a Fellow of the American College of Bankruptcy in 1994, and in 1996, she was elected a conferee of the National Bankruptcy Conference. In 1998, the National Law Journal named Judge Houser as one of the 50 most influential women lawyers in America. After becoming a bankruptcy judge, she joined the National Conference of Bankruptcy Judges and served as its president from 2009-10. Judge Houser has received a variety of awards and honors since taking the bench, the Distinguished Alumni Award for Judicial Service from the SMU Dedman School of Law in February 2011, ABI's Judge William Norton Jr. Judicial Excellence Award in October 2014, and the Distinguished Service Award from the Alliance of Bankruptcy Inns of the American Inns of Court in October 2016. She also received the Distinguished Service Award from the American College of Bankruptcy in October 2021. Judge Houser has served the judiciary in a number of capacities during her 21 years on the bench, including as a member of the Judicial Conference Committee on the Administration of the Bankruptcy System for seven years, as a member of the faculty that the Federal Judicial Center selected to teach new bankruptcy judges for many years, and as a member of the board of directors of the Federal Judicial Center, which is chaired by Chief Justice John Roberts. In June 2017, she was appointed to serve as the leader of a five-federal-judge mediation team tasked with settling all of the issues in dispute in connection with the historic insolvency filings by the Commonwealth of Puerto Rico and certain related instrumentalities under Title III of PROMESA. Judge Houser received her undergraduate degree with high distinction from the University of Nebraska and her J.D. from Southern Methodist University Law School, where she was editor of its law review.

William J. Rochelle, III is ABI's editor-at-large, based in New York. He joined ABI in 2015 and writes every day on developments in consumer and reorganization law. For the prior nine years, Mr. Rochelle was the bankruptcy columnist for Bloomberg News. Before turning to journalism, he practiced bankruptcy law for 35 years, including 17 years as a partner in the New York office of Fulbright & Jaworski LLP. In addition to writing, Mr. Rochelle travels the country for ABI, speaking to bar groups and professional organizations on hot topics in the turnaround community and trends in consumer bankruptcies. He earned his undergraduate and law degrees from Columbia University, where he was a Harlan Fiske Stone Scholar.

Hon. Christopher S. Sontchi is a retired U.S. Bankruptcy Judge for the District of Delaware in Wilmington, initially appointed in 2006. He also served a term as the court's Chief Judge. Judge Sontchi was recently appointed as an International Judge of the Singapore International Commercial Court. He is a frequent speaker in the U.S. and abroad on issues relating to corporate reorganizations, and he has been a Lecturer in Law at The University of Chicago Law School. In addition, he has taught corporate bankruptcy to international judges through the auspices of the World Bank and INSOL International. Judge Sontchi is a member of the International Insolvency Institute, Judicial Insolvency Network, National Conference of Bankruptcy Judges, ABI and INSOL International. He was recently appointed to the International Advisory Council of the Singapore Global Restructuring Initiative and the Founders' Committee of The University of Chicago Law School's Center on Law and Finance. Judge Sontchi has testified before Congress on the safe harbors for financial contracts, and has published articles on creditors' committees, valuation, asset sales and safe harbors. Prior to his appointment, he was in private practice, representing a wide variety of nationally based enterprises with diverse interests in most of the larger chapter 11 reorganization proceedings filed in Delaware. Judge Sontchi served on the ABI Commission to Study the Reform of Chapter 11's Financial Contracts, Derivatives and Safe Harbors Committee and testified on safe harbors for financial contracts before the Subcommittee on Regulatory Reform, Commercial and Antitrust Law of the House Committee on the Judiciary. Following law school, Judge Sontchi clerked for Hon. Joseph T. Walsh in the Delaware Supreme Court. He received his B.A. Phi Beta Kappa with distinction in political science from the University of North Carolina at Chapel Hill and his J.D. from the University of Chicago Law School.