AMERICAN BANKRUPTCY INSTITUTE

2017 Southwest Bankruptcy Conference

Very Good Debates

John W. Lucas, Moderator
Pachulski Stang Ziehl & Jones LLP; San Francisco

Judicial Debate

Resolved: A debtor must obtain a judgment under chapter 5 of the Bankruptcy Code before it may invoke disallowance of a claim under § 502(d).

Pro: Hon. Brenda Moody Whinery
U.S. Bankruptcy Court (D. Ariz.); Tucson

Con: Hon. Eugene R. Wedoff (ret.)
Sole Practitioner; Oak Park, Ill.
ABI President

Business Debate

Resolved: Cure and reinstatement of a credit agreement under § 1124(2) requires the payment of default interest.

Pro: Dillon E. Jackson
Foster Pepper PLLC; Seattle

Con: Joshua D. Morse
DLA Piper LLP; San Francisco

Consumer Debate

Resolved: Flat fees that are earned upon receipt may not be recovered by chapter 7 trustee upon the rejection of the fee agreement.

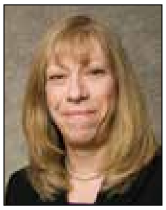
Pro: Cody J. Jess
Schian Walker PLC; Phoenix

Con: Tiffany L. Carroll
Office of the U.S. Trustee, Region 15; San Diego

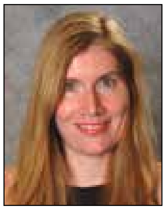
Problems in the Code

By Annette W. Jarvis, Monica Clark and Megan K. Baker

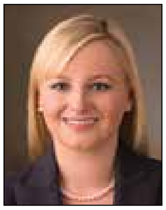
The Enigma that Is § 502(d)



Annette W. Jarvis
Dorsey & Whitney LLP
Salt Lake City



Monica Clark
Dorsey & Whitney LLP
Salt Lake City



Megan K. Baker
Dorsey & Whitney LLP
Minneapolis

Annette Jarvis is a partner and Megan Baker is an associate with Dorsey & Whitney LLP in Salt Lake City. Monica Clark is partner in the firm's Minneapolis office.

In *United States v. Ron Pair Enterprises Inc.*,[1] the late Justice Harry Blackmun explained: "[A]s long as the statutory scheme is coherent and consistent, there generally is no need for a court to inquire beyond the plain language of the statute." In a statement reminiscent of Dr. Seuss, the late Justice Antonin Scalia elaborated on this point, speaking for a unanimous Court in *Hartford Underwriters Ins. Co. v. Union Planters Bank NA*:[2] "[W]e begin with the understanding that Congress 'says in a statute what it means and means in a statute what it says....'"

While the Bankruptcy Code is a "coherent and consistent" statutory scheme, the conflicting views on the application of § 502(d) indicate that this provision neither says what it means nor means what it says. Rather, this much-litigated section has produced a jumble of inconsistent interpretations caused by its complex wording and ambiguous policy concerns.

In certain circumstances, § 502(d) permits the disallowance of claims of recipients of avoidable transfers from which transferred property is recoverable. Section 502(d) requires a bankruptcy court to:

> [D]isallow any claim of any entity from which property is *recoverable* under section 542, 543, 550, or 553 ... or that is a transferee of a transfer *avoidable* under section 522(f), 522(h), 544, 545, 547, 548, 549, or 724(a) ... *unless* such entity or transferee has paid the amount, or turned over any such property, for which such entity or transferee is *liable* under section 522(i), 542, 543, 550, or 553....[3]

The crux of the circuit split revolves around the timing and predicates to § 502(d)'s mandatory disallowance of claims. Some courts have refused to apply § 502(d) unless a final order is entered establishing a claimant's liability under one of the referenced statutory provisions, and the claimant has a reasonable opportunity to comply with that order. Other courts have concluded that allegations of liability will support claims disallowance under § 502(d), even when the statutory cause of action, on which the disallowance is based, is time-barred. Still other courts have muddied the waters by combining the two approaches. From a textual standpoint, the controversy centers on the meaning of the statutory words "recoverable," "avoidable," "unless" and "liable." From a policy standpoint, the debate pits the policy of enforcing compliance with court orders against the policy of ensuring equitable distribution to creditors.

To further complicate the discussion, § 502(d)'s mandatory disallowance of claims is subject to § 502(j), which provides that allowed or disallowed claims "may be reconsidered for cause." Thus, while disallowance is mandatory if § 502(d) applies, that disallowance is not immutable.

First Approach: Disallowance After Final Judgment and Opportunity to Comply

Some courts, including the Fifth and Eighth Circuits, have refused to apply § 502(d) unless the claimant has been afforded a reasonable opportunity to comply with a prior judicial order. These courts reason that a creditor is only "liable" under § 502(d) after a trustee has obtained a final judgment under one of the enumerated related sections. In this view, as expressed by the Fifth Circuit in *Campbell v. U.S. (In the Matter of Davis)*,[4] § 502(d) "is intended to have the coercive effect of [e]nsuring compliance with judicial orders."

In *Davis*, the Internal Revenue Service (IRS) sought approximately $6.5 million in unpaid taxes, penalties and interest from the debtors. In an adversary proceeding commenced by the debtors, the bankruptcy court determined that the IRS was owed $84,000.

While the IRS's appeal was pending, the bankruptcy court confirmed the debtors' plan, which created a creditors' trust and prohibited the trustee from making distributions to unsecured creditors until the debtors' tax liabilities were finally adjudicated. Before the appeal was resolved, the trustee sought turnover of approximately $400,000 in refunds and interest from the IRS and asserted that the IRS's claims should be disallowed under § 502(d).

While the turnover action was stayed, the district court affirmed the tax determination. Five days after the IRS dismissed its appeal to the Fifth Circuit, the district court disallowed a significant portion of the IRS's claim in the turnover action, relying on § 502(d), and found that the IRS had unduly delayed its turnover of refunds.

On appeal, the Fifth Circuit concluded that the district court had erred in using § 502(d) to penalize the IRS for exercising its setoff right, recogniz-

1 489 U.S. 235, 240-41 (1989).
2 530 U.S. 1, 5 (2000) (internal citations omitted).
3 Emphasis added.
4 889 F.2d 658, 661 (5th Cir. 1989).

ing that taxpayers are generally limited to refunds in excess of tax liabilities. The court stated that § 502(d) is triggered only after a creditor "has been afforded *a reasonable time in which to turn over amounts adjudicated to belong to the bankruptcy estate*."[5]

Similarly, in *Holloway v. IRS (In re Odom Antennas Inc.)*,[6] the Eighth Circuit determined that § 502(d) does not apply until liability has been established. In *Odom*, individual holders of competing liens on real estate proceeds generated in a chapter 7 case sought to disallow the liens of the IRS and a judgment creditor on such proceeds under § 502(d). The bankruptcy court, affirmed by the district court, determined that § 502(d) did not apply because the IRS and the judgment creditor were not subject to a turnover order.

In affirming the lower courts, the Eighth Circuit noted that neither the IRS nor the judgment creditor "ha[d] received property from a transaction that is voidable under the sections identified in section 502(d)...."[7] Citing *Davis*, the Eighth Circuit rejected the individual lienholder's assertion that § 502(d) permitted liens to be avoided when the trustee had forfeited his opportunity to avoid those liens under § 724(a). Noting that § 502(d) "does not provide affirmative relief" and is designed to ensure compliance with judicial orders, the Eighth Circuit determined that § 502(d) "should be used to disallow a claim *after the entity is first adjudged liable*...."[8]

Second Approach: Disallowance upon Allegations of Avoidability

Other courts, including the Ninth and Sixth Circuits, have held that § 502(d) applies when liability is alleged,[9] even before a final judgment is obtained and even if the underlying claim is time-barred. These courts focus on the words "recoverable" and "avoidable," reasoning that if Congress had intended for the trustee to first obtain a judgment to recover or avoid a transfer, it would have used the terms "recovered" and "avoided." They read the word "unless" as creating an exception. The Ninth Circuit in *In re America West Airlines Inc*.[10] explained that

> [t]he use of the word "unless" indicates that the phrase is not an additional requirement for disallowance, but an exception to the general rule that a claim based on an avoidable transfer must be disallowed. The exception to the general rule of disallowance exists because, if the transferee has already relinquished the avoidable transfer, there is no need to disallow the claim.[11]

In this case, the creditor conceded, based on undisputed facts, that the creditor's lien was an avoidable statutory lien under § 545(2), but no action had been brought to avoid the lien within the limitations period. The court disallowed the creditor's claim because the creditor "is a transferee of an avoidable transfer, and it has not relinquished its transfer; therefore the exception in § 502(d) does not apply."[12] Citing approvingly to *In re KF Dairies Inc.*,[13] the Ninth Circuit noted that the court there distinguished between an avoidance action, by which a trustee seeks affirmative relief, and a claim objection — reasoning that § 502(d) would lack purpose "if it applied only when the transfer could be avoided in an independent avoidance action, and therefore concluded that § 502(d) may be used to disallow a claim even if the underlying avoidance action would be time barred."[14]

In the context of a relief-from-stay motion brought by a creditor to foreclose on a lien that was avoidable under § 547, the Sixth Circuit concluded in *In re McKenzie*[15] that a trustee may use his/her avoidance powers defensively under § 502(d) — even if the governing statute of limitations had expired. The Sixth Circuit explained that a defensive use of avoidance powers did not constitute a "procedural windfall" because § 502(d) limits the trustee to "offsetting the claim asserted by the creditor" and "does not permit any additional recovery by the trustee."[16] The court noted that § 502(d) "does not refer to § 546(a)(1)(A)'s two-year statute of limitations, nor does § 502(d) contain a limitations period of its own."[17] The court stated that this interpretation of § 502(d) "furthers one of the central purposes of the Bankruptcy Code — to ensure the 'equality of distribution among creditors of the debtor.'"[18]

Confusion Reigns: Combining the Competing Approaches

These two competing interpretations of § 502(d)'s wording and purpose have created substantive confusion. In *In re Vivaro*,[19] the court stated that a claim should not be disallowed under § 502(d) "without first determining whether the claimant is liable to the estate." However, the court also approved the immediate or temporary disallowance of claims under § 502(d), provided that "such initial disallowance [is] made by judicial determination and [is] subject to judicial reconsideration."[20] While lacking a clear textual differentiation in the statute between the two statements, one way to reconcile the court's adoption of both approaches is to distinguish between a claim that has been temporarily disallowed upon the allegation of an avoidable transfer (subject to reconsideration under § 502(j)), and a permanent disallow-

5 *Id.* at 661-62 (emphasis added).
6 340 F.3d 705, 708 (8th Cir. 2003).
7 *Id.* at 708.
8 *Id.* (emphasis added).
9 While this approach is sometimes described as permitting disallowance upon mere allegations of an avoidable transfer, the courts essentially require a *prima facie* showing that the allegations are well founded and an avoidable transfer has occurred.
10 217 F.3d 1161, 1166 (9th Cir. 2000). Ms. Jarvis argued and prevailed in this case, which created the circuit split on the interpretation of § 502(d).
11 *Id.* at 1166.
12 *Id.* at 1166-67. *See In re Enron Corp.*, 340 B.R. 180, 190 (Bankr. S.D.N.Y. 2006) (claim may be disallowed temporarily and for certain purposes, subject to reconsideration, upon allegation of avoidable transfer).
13 143 B.R. 734 (B.A.P. 9th Cir. 1992).
14 *Id.* at 1167. *See also In re Larry's Marineland of Richmond Inc.*, 166 B.R. 871, 874-75 (Bankr. E.D. Ky. 1993) (trustee's inability to obtain affirmative monetary recovery does not prevent use of § 502(d)); *In re Discount Family Boats of Texas Inc.*, 233 B.R. 365, 368 (Bankr. E.D. Tex. 1999) (creditor's claim must be disallowed if trustee makes *prima facie* showing that transfer was avoidable, even if statute of limitations had expired). In *In the Matter of Mid Atlantic Fund Inc.*, 60 B.R. 604 (Bankr. S.D.N.Y. 1986), in allowing the trustee to use § 502(d) defensively to prohibit distributions of estate assets to voidable transfer recipients unless and until the voidable transfers were returned, the court relied on case law developed under the former Bankruptcy Act that allowed a trustee to raise an otherwise-time-barred voidable transfer to disallow claims under § 57(g) of the Act.
15 737 F.3d 1034, 1041 (6th Cir. 2013).
16 *Id.* (internal citations omitted).
17 *Id.* at 1042 (internal citations omitted).
18 *Id.* (internal citations omitted).
19 541 B.R. 144, 154 (Bankr. S.D.N.Y. 2015).
20 *Id.* at 155.

continued on page 66

Problems in the Code: The Enigma that Is § 502(d)

from page 19

ance following a final judgment on the avoidance action or as a defense to an asserted claim.

While addressing a slightly different issue, the Third Circuit, in *In re KB Toys Inc.*,[21] held that claims subject to disallowance under § 502(d) in the hands of the original claimant are disallowable in the hands of a subsequent transferee. Acknowledging the policy goals of ensuring "equality of distribution of estate assets" and "coercing compliance with judicial orders" relied on in the competing approaches, the court reasoned that "[b]ecause the statute focuses on claims — and not the claimants — claims that are disallowable under § 502(d) must be disallowed no matter who holds them."[22] The Third Circuit noted that § 502(d)'s legislative history reflects that it was "derived from present law," referring to § 57(g) of the Bankruptcy Act of 1898, and that "the case law interpreting section 57(g) is consistent with our interpretation of § 502(d)."[23]

The two approaches have also engendered procedural confusion. While the cited decisions in the Fifth and Eighth Circuits suggest that an avoidability determination must be made in an adversary proceeding prior to applying § 502(d), at least one court has allowed a judicial determination of avoidability, and thus the application of § 502(d), to be obtained "in the context of a claim objection, a declaratory judgment action or an adversary proceeding."[24]

In *Vivaro*, the court suggested that even if a final judgment on avoidability has been required, as long as the estate is seeking no affirmative recovery from the creditor, § 502(d) may be raised as a claims objection rather than an adversary proceeding. Noting the cost savings, the court stated that a "decision by the estate or the estate representative to file a claim objection rather than an adversary proceeding to recover an avoidable transfer [might] be a rational economic decision."[25] Since the entire claim must be disallowed under § 502(d) if the creditor is liable for an avoidable transfer in any amount, the court found that it only needed to determine that the creditor received "a preference in some amount that has not been repaid to the estate."[26]

Conclusion

Existing law under § 57(g) of the Bankruptcy Act, which Congress did not indicate an intention to change (the alternative means for enforcing final judgments), along with § 502(d)'s importance in promoting an equitable distribution to creditors and the avoidance of unnecessary litigation costs in administering a bankruptcy estate leads the authors to suggest the following proposed statutory change:

> (d) Notwithstanding subsections (a) and (b) of this section, **sections 546(a), 549(d), and 550(f) or the absence of a final judgment**, the court shall disallow any claim of any entity from which property is recoverable under section 542, 543, 550, or 553 of this title or that is a transferee of a transfer avoidable under section 522(f), 522(h), 544, 545, 547, 548, 549, or 724(a) of this title, unless **and until** such entity or transferee has paid the amount, or turned over any such property, for which such entity or transferee is liable under section 522(i), 542, 543, 550, or 553 of this title, **at which time the disallowance of such claim may be reconsidered for cause under section 502(j)**. abi

21 736 F.3d 247 (3d Cir. 2013).

22 *Id.* at 252.

23 *Id.* at 253. Cases decided under § 57(g) of the Bankruptcy Act support the defensive use of § 502(d), even when time-barred.

24 *In re Metiom Inc.*, 301 B.R. 634, 642 (Bankr. S.D.N.Y. 2003).

25 541 B.R. at 147.

26 *Id.* at 148.

AMERICAN BANKRUPTCY INSTITUTE

Preference May Be Offset by an Unpaid Administrative Claim, Judge Carey Rules

"Automatic disallowance under Section 502(d) held not applicable to administrative claims."

Ruling on an important issue in cases of administrative insolvency, Bankruptcy Judge Kevin J. Carey of Delaware concluded that a supplier can offset an unpaid administrative claim against preference liability.

Were the decision otherwise, a supplier in a failed reorganization would be required to pay a preference judgment in full without receiving payment on an allowed administrative claim.

From one point of view, the decision allows unequal treatment among holders of administrative claims. On the other hand, disallowing setoff would discourage a supplier from shipping goods after a chapter 11 filing if the supplier has preference exposure.

The case involved a failed chapter 11 reorganization. The supplier had almost $14 million in preference exposure. After filing, the supplier provided another $2.6 million in goods but was not paid. On motion, the bankruptcy court granted the supplier an allowed $2.6 million administrative claim that was not paid because the debtor was administratively insolvent.

The creditors' committee sued the supplier for preferences. The supplier denied liability and counterclaimed for the right to offset the unpaid administrative claim against preference liability. The committee filed a motion to dismiss the supplier's setoff counterclaim. Judge Carey denied the motion in his opinion on July 25, thus allowing setoff.

Judge Carey said that setoff is permitted only when "'opposing obligations arise on the same side of the . . . bankruptcy petition date.'" Setoff is allowed, he said, because a preference claim does not exist before the filing date.

Judge Carey also rejected the committee's argument that Section 502(d) prohibits setoff until the preference is paid in full. That section disallows "any claim" until the creditor pays its liability arising from an avoidance action.

"By its terms," Section 502(d) does not cover administrative expense claims, Judge Carey said. He cited cases holding that administrative claims are given "special treatment" and are not subject to Section 502(d).

Opinion Link: Opinion Link

Judge Name: Kevin J. Carey

Case Citation: Official Committee v. Tyson Foods LLC (In re Quantum Foods LLC), 15-50254 (Bankr. D. Del. July 25, 2016)

Case Name: In re Quantum Foods LLC

Case Type: Business

Court: 3rd Circuit

Delaware

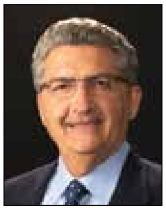
Bankruptcy Tags: Administrative Expense Claims
Claims
Bankruptcy Litigation

Feature

By Ali M.M. Mojdehi, Janet Dean Gertz and Allison M. Rego

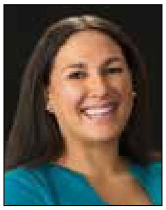
Hope for a "Cure"?

Entz-White Was Superseded by Enactment of § 1123(d)



Ali M.M. Mojdehi
Cooley, LLP
Los Angeles

Janet Dean Gertz
Cooley, LLP
Los Angeles



Allison M. Rego
Cooley, LLP
Los Angeles

Ali Mojdehi is a partner, Janet Dean Gertz is a senior associate and Allison Rego is an associate with Cooley, LLP in Los Angeles.

'"Cure' is one of the most precious words in the English language. It's a short word. A clean and simple word. But it isn't so easy a thing as it sounds...."[1]

The U.S. Supreme Court has consistently held that "property interests are created and defined by state law."[2] Yet for almost three decades, under *Great Western Bank and Trust v. Entz-White Lumber & Supply Inc. (In re Entz-White Lumber & Supply Inc.)*,[3] the law in the Ninth Circuit eschewed state law, adopting instead a bankruptcy-specific definition of "cure" that did not require a debtor to pay the contractually prescribed default rate of interest if the debtor proposed a cure and reinstatement of defaulted debt under a plan implemented under 11 U.S.C. § 1123(a)(5)(G).

The Ninth Circuit Changes Direction

In *Pacifica L 51 LLC v. New Investments Inc. (In re New Investments Inc.)*,[4] a Ninth Circuit panel has held that *Entz-White* was overruled by the 1994 amendments to § 1123(d), which provides that if a plan proposes to cure a default, "the amount necessary to cure the default shall be determined in accordance with the underlying agreement and applicable nonbankruptcy law." *In re New Investments Inc.* holds that if state law and the parties' agreement require payment of a default rate of interest, any "cure" under a chapter 11 plan must provide for the same default rate of interest and/or any fees or penalties that must be paid under state law to cure and reinstate the loan.

The negotiated terms and conditions of a commercial loan agreement generally reflect a carefully crafted balance and form part of the consideration for the bargained-for interest rate and other terms for the financing offered to the borrower. Terms providing consequences for the borrower's default of a material condition of the loan agreement (such as late penalties, default interest or acceleration of the maturity date) reflect the real economic cost to a lender that is caused by the borrower's default and by the initiation of foreclosure proceedings. Likewise, state foreclosure laws, as well as local enactments of Article 9 of the Uniform Commercial Code, although providing a means for the borrower's cure of the defaults and restoring the parties to their predefault condition, also require the borrower to make cure payments to stave off the foreclosure and other consequences of default.

The Ninth Circuit under *Entz-White*

The Bankruptcy Code "incorporates the concept of cure,"[5] but the manner by which a cure must be made under § 1123(a)(5)(g) and whether a cure requires the borrower to pay default interest has resulted in significant circuit splits that have significant impact on the recovery of lenders, in particular commercial real estate lenders, in a bankruptcy proceeding. The amount of default interest can be quite significant in cases that linger in chapter 11 for many months or years prior to a confirmed plan. On the other hand, debtors in chapter 11 have utilized so-called "cure plans" under *Entz-White* to facilitate their reorganizations, denying the lender millions of dollars in interest that would have been payable but for the bankruptcy proceeding. That dichotomy between state law and bankruptcy law is no longer valid in the Ninth Circuit.

Pursuant to § 1123(a), a reorganization plan must "provide adequate means for the plan's implementation." Section 1123(a)(5) provides a series of nonexclusive examples of the practical means by which a plan might be implemented. Among these examples is § 1123(a)(5)(G), which provides for implementation by "the curing or waiving of any default." *Entz-White* was decided prior to addition to the Bankruptcy Code of § 1123(d), which directs that the *amount* of the cure must be determined in accordance with the "underlying agreement and applicable nonbankruptcy law." In *Entz-White*, the Ninth Circuit took note of the fact that Congress did not provide any definition of what it meant to "cure."[6] As such, it incorporated language from a Second Circuit case, *Di Pierro v. Taddeo (In re Taddeo)*[7]:

> A default is an event in the debtor-creditor relationship which triggers certain consequences. Curing a default commonly means taking case of the triggering event and returning to pre-default conditions. The consequences are thus nullified. This is the concept of "cure" used throughout the Bankruptcy Code.[8]

1 Lauren DeStefano, *Server* (Simon & Schuster 2013).
2 *Butner v. United States*, 440 U.S. 48, 99 S. Ct. 914, 59 L. Ed. 2d 136 (1979).
3 850 F.2d 1338 (9th Cir. 1988).
4 840 F.3d 1137 (9th Cir. 2016).
5 *Id.* at *1.
6 850 F.2d at 1340.
7 685 F.2d 24 (2d Cir. 1982).
8 850 F.2d at 1340 (quoting *In re Taddeo*, 685 F.2d at 26-27).

From this, the Ninth Circuit in *Entz-White* concluded that the power to cure under the Bankruptcy Code "nullifies ... default penalties such as higher interest."[9] In other words, a debtor's cure of its default returned the parties to the *status quo ante*, meaning that creditors lost any contractual right to recover default-rate interest.[10]

Six years later, Congress amended § 1123 to add subsection (d). Subsequently, numerous bankruptcy courts and two courts of appeals[11] have expressed the view that the addition of § 1123(d) to the Bankruptcy Code in 1994 overruled *Entz-White*'s denial of default interest. Somewhat surprisingly, however, the continued vitality of *Entz-White* has not been directly confronted by the Ninth Circuit in the 22 years since Congress amended the statute.[12] The only hint given by the Ninth Circuit that *Entz-White* may no longer be good law appeared in *GE Capital Corp. v. Future Media Prods.*[13]

In *Future Media*, the issue was whether the "cure" provisions of § 1123(a)(5)(G) applied outside of a plan. Ruling that they did not, the Ninth Circuit did not have to determine whether *Entz-White* was still good law. Nonetheless, in a curious footnote (which was changed three times in subsequent amended decisions), the Ninth Circuit stated, in *obiter dicta*, that the "plain language of § 1123(d) as promulgated in the 1994 amendments" requires that "[t]he bankruptcy court should apply a presumption of the allowability for the contracted for default rate, provided that the rate is not unenforceable under applicable nonbankruptcy law."[14]

In re New Investments Explained

In *In re New Investments*, the borrower had taken out a mortgage to finance a hotel property in Kirkland, Wash. The loan agreement was governed by Washington law and provided for a default interest rate of 5 percent. The borrower defaulted on the note, and, after the lender commenced non-judicial foreclosure proceedings, the debtor filed for chapter 11. The debtor's plan proposed to sell the property to a third party for significantly more than the outstanding amount of the loan, then use the proceeds to pay the outstanding amount of the loan balance minus the default interest, giving the balance of the proceeds to the debtor's equityholders. After the bankruptcy court confirmed the plan over the lender's objection, the lender appealed. The only issue on appeal was "whether *Entz-White*'s rule that a debtor may nullify a loan agreement's requirement of post default interest remains good law in light of 11 U.S.C. § 1123(d)."[15]

The Ninth Circuit first reviewed the language of § 1123(d) and determined that it was not ambiguous. Then, the Ninth Circuit proceeded to interpret the statute in accordance with its plain meaning — that a debtor "cannot nullify a preexisting obligation in a loan agreement to pay post-default interest solely by proposing a cure."[16] In the alternative, the Ninth Circuit noted that the legislative history would also require overruling *Entz-White*. The Ninth Circuit noted that the legislative history of § 1123(d) expresses that Congress's concern was to overrule the Supreme Court's decision in *Rake v. Wade*,[17] which had imposed a noncontractual default rate of interest on a chapter 13 debtor who had proposed to cure a default.

Relying upon the Supreme Court's opinion in *Union Bank v. Wolas*,[18] which holds that "[t]he fact that Congress may not have foreseen all of the consequences of a statutory enactment is not a sufficient reason for refusing to give effect to its plain meaning," the Ninth Circuit also rejected the argument that the purpose behind Congress's enacting § 1123 should limit the effect of the text.[19] The text of § 1123(d) required it to look to Washington law and the promissory note. Thus, it looked first to the state of Washington's deed of trust law, which provides that a cure required the payment of "[t]he entire amount then due under the terms of the deed of trust and the obligation secured thereby, other than such portion of the principal as would not then be due had no default occurred."[20] Thus, "it is *only once these penalties are paid* that the debtor can return to pre-default conditions as to the remainder of the loan obligation."[21]

Next, it looked at the note. Since the note provided that the interest on the *loan* would increase by 5 percent upon default, the Ninth Circuit found that the debtor was required to pay the default interest rate on the entirety of the note — not just on the amount in arrears — in order to cure the default.[22]

The Ninth Circuit also analyzed the relationship of § 1123(d) to the provisions of § 1124 of the Bankruptcy Code that define the treatment that is required under a reorganization plan to leave a creditor "unimpaired." The Ninth Circuit noted that a "common law treatment of cure is consistent" with the requirements of § 1124(2)(E), which provides that a creditor is impaired unless the cure under the plan does not "otherwise alter the legal, equitable, or contractual rights" of that creditor. Much to the contrary, the Ninth Circuit in *Entz-White* had reasoned instead that "[t]he natural reading of these sections is that plans may cure all defaults without impairing the creditor's claim" and that "[t]he more natural reading of [§ 1124] is that the interest awarded should be at the market rate or at the pre-default rate provided for in the contract."[23] As such, the holding in *In re New Investments* not only revises the Ninth Circuit's construction of the amount needed to cure under § 1123(a)(5)(G), it also works a significant repudiation of *Entz-White*'s formulation of the interrelationship of §§ 1123 and 1124 relating to impairment and a creditor's right to vote on the plan. The decision significantly revises not only the meaning of cure, but also the meaning of "impairment." Therefore, the decision should have a significant impact on chapter 11 practice in the Ninth Circuit.[24]

9 *Id.* at 1342.

10 In *Entz-White*, the loan fully matured pre-petition, so "[i]t makes no sense to reinstate the maturity of a claim that has already matured." *In re Ace-Texas Inc.*, 217 B.R. 719 (Bankr. D. Del. 1998) (Walsh, J.). Cure of a matured loan also would not generally be allowed under state law.

11 *See In re Southland Corp.*, 160 F.3d 1054, 1059 n.6 (5th Cir. 1998) ("Congress, in bankruptcy amendments enacted in 1994, arguably rejected the *Entz-White* denial of contractual default interest rates."); *In re Sagamore Partners Ltd.*, No. 14-11106, 620 Fed. App'x. 864, 867 (11th Cir. Aug. 31, 2015).

12 In *Platinum Capital Inc. v. Sylmar Plaza LP (In re Sylmar Plaza LP)*, 314 F.3d 1070, 1075 (9th Cir. 2002), the Ninth Circuit determined that the use of a cure plan to eliminate default interest was in good faith. However, there was no analysis of whether *Entz-White* was still good law in light of 11 U.S.C. § 1123(d).

13 547 F.3d 956 (9th Cir. 2008).

14 *Id.* at 961 and n.3. The footnote containing this observation was revised three times by the Ninth Circuit before the decision was made final.

15 *In re New Invs.*, 2016 WL 6543520 at *2.

16 *Id.* at *3.

17 508 U.S. 464 (1993) (citing H.R. Rep. No. 103-835, at *55 (1994)).

18 502 U.S. 151, 158 (1991). The Ninth Circuit also pointed to similar language in *Entz-White.* 2016 WL 6543520 at *4.

19 2016 WL 6543520 at * 4.

20 *Id.* at *3 (citing Wash. Rev. Code Ann. § 61.24.090(1)(a)).

21 *Id.* at *4 (emphasis added).

22 *Id.* The Ninth Circuit did not opine on whether this might constitute an unenforceable penalty.

23 850 F.2d at 1341.

24 For example, *In re New Investments* also overrules *Florida Partners Corp. v. Southeast Co. (In re Southeast Co.)*, 868 F.2d 335 (9th Cir. 1989), which interpreted § 1124 to require payment of only interest on overdue installments at the contract nondefault rate.

continued on page 68

Hope for a "Cure"? Entz-White *Was Superseded by Enactment of § 1123(d)*

from page 17

The Ninth Circuit did not discuss the import of the debtor's solvency. Some courts make a distinction between a solvent debtor and an insolvent debtor in respect to the lender's entitlement to default interest, both under a cure plan and generally as part of the allowance of a secured creditor's claim.[25] The rationale of *In re New Investments* and the text of § 1123(d) would suggest that the debtor's solvency should have no bearing on the lender's entitlement to default interest, at least in the context of a cure effected under § 1123 or 1124. Rather, the only factors that should determine the lender's entitlement to be paid a default rate of interest under these statutes is the language of the parties' agreement and the payment that is required under applicable state law, including whether such is a legal rate of interest under state law.

Conclusion

The decision in *In re New Investments* finally brings the law of the Ninth Circuit into conformity with Supreme Court precedents, such as *Butner v. United States*[26] and *Travelers Casualty & Surety Co. of America v. Pacific Gas and Electric Co.*[27] In *Travelers*, the Supreme Court reversed the Ninth Circuit, reiterating its holding in *Butner* that "the determination of property rights in the assets of a bankruptcy's estate [is left] to state law." In *Travelers*, the question presented was whether the "*Fobian* rule," which denied fees incurred in litigating issues governed by federal bankruptcy law, should be struck down.

The Supreme Court initially noted that the *Fobian* rule had no support in the Bankruptcy Code, nor did it have any support in state law, but was instead federal common law. As a result, the Court held that the absence of textual support was "fatal for the *Fobian* rule."[28] The principle here is the same: The Bankruptcy Code does not provide a definition of "cure." Moreover, § 1123(d) requires that the amount needed to cure must be determined in accordance with applicable state law and the parties' agreement, *not* federal common law. The Ninth Circuit finally got it right. abi

25 *See, e.g., In re Sagamore Partners Ltd.*, 2012 Bankr. LEXIS 3224 (Bankr. S.D. Fla. July 10, 2012) (holding that plan was unconfirmable because it failed to provide payment of default interest as element of cure where lender was oversecured, debtor was solvent and unsecured creditors would be paid in full in any event).

26 440 U.S. 48.

27 549 U.S. 443 (2007).

28 *Id.* at 444.

AMERICAN BANKRUPTCY INSTITUTE

Membership

Why Join Join Renew Update Profile Committees Member Directory

Committees:
Ethics and Professional Compensation

Ninth Circuit Bankruptcy Appellate Panel Holds that Trustee Can Liqui Debtor's Pre-Paid Advance Fee Retainer by Rejecting Agreement and Terminating Legal Services

Help Center

Keith L. Kleinman
Cozen O'Connor; Wilmington, Del.

Date Created: Fri, 08/19/2016 - 15:27

2

A critical issue for all attorneys who represent debtors in bankruptcy is how to ensure payment for services performed both prior to and after a bankruptcy filing. One way that attorneys seek to secure payment for post-petition services is by obtaining an "advance fee retainer" that is earned in full upon receipt and thus arguably never becomes property of the debtor's estate and can be used to fund post-petition services.

However, in *Ulrich v. Schian Walker, P.C.* (*In re Boates*), [1] the Ninth Circuit Bankruptcy Appellate Panel (BAP) held that a flat-fee, advance-payment retainer, fully paid pre-petition, was an executory contract that could be rejected by a chapter 7 trustee. In addition, the court found that upon rejection, the trustee could exercise the debtor's pre-petition right to terminate the contract and obtain a refund of any portion of the retainer that is unused at the time of termination.

Facts

The debtor was a defendant in state court litigation commenced by a bank against the debtor. In the suit, the bank asserted claims against the debtor for negligence, misrepresentation and fraud. After communicating his intent to file for bankruptcy, the bank told the debtor that it would file a nondischargeability adversary proceeding in his bankruptcy case. In response, the debtor retained the services of a law firm to defend him in the anticipated nondischargeability action.

The debtor and law firm entered into an advance payment retainer (retainer agreement) that provided the following:

> The Flat Fee ($60,000) will cover the value of all work we will perform through the conclusion of the Adversary Proceeding. The Flat Fee will be paid by you directly to us, and will be deposited in our business account. The Flat Fee is not an advance against any hourly rate, and the Flat Fee will not be billed against an hourly rate. You agree that the Flat Fee becomes the property of our firm upon receipt, and will be deposited into our business account.

Days before he filed for bankruptcy, the debtor signed the retainer agreement and paid the $60,000 retainer to the law firm. Thereafter, the debtor filed.

Post-petition, the chapter 7 trustee sued the law firm seeking the return of the $60,000 retainer. In the complaint, the trustee asserted that the retainer should be returned because the retainer agreement had been rejected by operation of law under § 365(d)(1) of the Code. The trustee also alleged that he had demanded the return of the retainer from the law firm prior to any litigation in the nondischargeability action. The trustee premised his argument on a previous BAP decision that stated that a "trustee can liquidate the debtor's [prepaid] right to legal services by rejecting the contract with the attorney and demanding a refund of the unearned fees." [2]

Notwithstanding the BAP's previous decision, the bankruptcy court granted the law firm's motion for summary judgment based on a finding that, among other things, the retainer agreement was not an executory contract because the debtor's pre-petition payment of the flat-fee retainer constituted substantial performance of the debtor's obligations. The trustee appealed.

The Decision

The BAP determined that a threshold issue was whether the retainer agreement was an executory contract subject to rejection under § 365 of the Code. In evaluating the retainer agreement, the court rejected the trustee's argument that the debtor's agreement to cooperate in his own defense created an executory contract. If anything, "the [debtor's] cooperation was a mere condition to [the law firm's] performance," the breach of which *would not* result in breach of the contract. [3] Nonetheless, the court held that the retainer agreement *was* executory based on the debtor's continuing obligation to pay out-of-pocket costs incurred by the law firm in the process of defending the debtor. As the court stated, the debtor's "obligation to pay [the law firm's] costs was a material contractual duty that could result in breach and could excuse the [law firm] from further performance." [4]

The court went on to explain that the rejection of the retainer agreement did not terminate, rescind or relinquish any rights of the debtor in the contract as of the petition date. "[T]he real issue the bankruptcy court [] needed to resolve was the nature and extent of the [debtor's] contract rights on the date of the bankruptcy filing if [the debtor] were considered to have breached the contract on that date." [5] As a matter of Arizona law (the applicable law), the debtor's "Retainer Agreement rights on the date of bankruptcy filing necessarily included a right to terminate [the law firm] and a right to a refund of the fees previously prepaid based on the value of services provided before termination." [6] The court remanded the case back to the bankruptcy court with instructions to determine when the trustee exercised his right to terminate the law firm, [7] as the summary judgment record presented no evidence on this issue.

Takeaway

With its holding, the Ninth Circuit BAP makes advance payment retainers a risky option for counsel attempting to secure funding for post-petition services to debtors. In light of this, attorneys should consider the three forms of retainers — classic, advance payment and security — and the relative rights afforded to an attorney under applicable state law. If an advance fee retainer is used, counsel should be careful to ensure that the agreement does not include any term that could cause the agreement to be executory, including any provision regarding the debtor/client's payment of out-of-pocket costs and expenses. Attorneys should also review a client's rights under applicable state law to obtain the return of an advance-payment retainer to assess potential liability if the retainer agreement is later determined to be executory.

From a trustee's perspective, the *Boates* decision serves as a cautionary tale that rejection of an executory advance-payment retainer agreement, in and of itself, may not be enough to enable the trustee to obtain a return of the retainer. An explicit termination letter may also be required t(right to the return of any unused advance-payment retainer.

Help Center

[1] --- B.R. ----, 2016 WL 3213665 (B.A.P. 9th Cir. June 9, 2016).

[2] *Gordon v. Hines* (*In re Hines*), 147 F.3d 1185, 1189 (B.A.P. 9th Cir. 1998).

[3] *Boates*, 2016 WL 3213665 at *5.

[4] *Id.*

[5] *Id.* at *6.

[6] *Id.* at *7.

[7] Also notable is the court's rejection of the trustee's argument that he never retained the law firm under §§ 327 and 330 of the Code and therefore the firm had no right to any of the retainer. The court explained that the advance-payment retainer never became property of the estate because under the terms of the retainer agreement, the entire retainer was earned pre-petition upon receipt. Rather, the question is when the trustee gave notice of termination to the law firm, which triggered the right to a refund of the unused portion of the retainer.

American Bankruptcy Institute | 66 Canal Center Plaza, Suite 600 | Alexandria, VA 22314

Tel. (703)-739-0800 | Fax. (703) 739-1060

CIRCUIT COURT OPINION FIRST RESPONDER

OUR KEYWORDS SEARCH

Home » Ulrich v. Walker (In re Boates)

View Edit

Ulrich v. Walker (In re Boates)

Summarized by DAVID HERCHER , Miller Nash Graham & Dunn LLP

1 year 1 month ago

Citation: In re Boates, No. AZ-15-1279-KuJaJu (9th Cir. B.A.P. July 8, 2016). Published.

Ruling: A chapter 7 debtor's rights arising from a prepetition payment to a lawyer are estate property, even if the engagement agreement isn't executory.

Procedural context: The chapter 7 trustee sued the debtor's lawyer to recover a flat fee paid by the debtor to the lawyer before the petition date for defense of an anticipated nondischargeability action. The bankruptcy court dismissed the trustee's action against the lawyer. In the BAP's 6/9/16 opinion (previously summarized at http://volo.abi.org/ulrich-v-schian-walker-plc-in-re-boates), it reversed and remanded. In an order entered on 7/8/16, the BAP denied the lawyer's motion for rehearing.

Facts: Even if the agreement is not executory, the debtor's rights under the agreement included the right to terminate the lawyer and receive a refund of the prepaid fee based on the value of the services provided before termination, and those rights became estate property upon the filing of the petition, exercisable by the trustee.

Judge(s): Christopher D. Jaime, Bankruptcy Judge for the Eastern District of California, sitting by designation, and Meredith A. Jury and Frank L. Kurtz, Bankruptcy Appellate Panel Judges.

Tag(s):

FILED

ORDERED PUBLISHED

JUL 08 2016

SUSAN M. SPRAUL, CLERK
U.S. BKCY. APP. PANEL
OF THE NINTH CIRCUIT

UNITED STATES BANKRUPTCY APPELLATE PANEL

OF THE NINTH CIRCUIT

In re:	BAP No. AZ-15-1279-KuJaJu
CRAIGHTON THOMAS BOATES, Debtor.	Bk. No. 2:14-bk-17115-GBN
	Adv. No. 2:15-ap-00269-GBN
DALE D. ULRICH, Chapter 7 Trustee, Appellant,	
v.	**ORDER ON MOTION FOR REHEARING**
SCHIAN WALKER, P.L.C., Appellee.	

Before: KURTZ, JAIME[1] and JURY, Bankruptcy Judges.

This panel has received and reviewed appellee Schian Walker's motion for rehearing filed pursuant to Rule 8022. In the motion, Schian Walker raises a single point it claims this Panel misapprehended. Contrary to this Panel's ruling, Schian Walker contends that, under the adversary proceeding retainer agreement it entered into with Boates, the $60,000 flat fee was supposed to constitute full advance payment not only for services to be rendered but also for all litigation costs to be incurred.

Schian Walker has admitted that its form statement of Billing Policies and Procedures is incorporated into every

[1]Hon. Christopher D. Jaime, United States Bankruptcy Judge for the Eastern District of California, sitting by designation.

representation agreement it enters into, including the November 5, 2014 letter agreement it entered into with Boates. Indeed, the letter agreement (prepared by Schian Walker) contains a provision in which Boates is required to acknowledge that he has read both the letter agreement and the Billing Policies and Procedures statement and that he has agreed to both of them.

Along similar lines, the Billing Policies and Procedures statement contains the following introductory paragraph:

> It is the policy of Schian Walker, P.L.C. (the "Firm") to provide this statement of Billing Policies and Procedures (the "Policy") to each of its clients, together with a cover letter that defines the scope of the representation and reflects any **other** agreed terms that may be unique to a particular client or representation (the "Engagement Letter").

(Emphasis added.)

The Billing Policies and Procedures statement contains a paragraph specifying that Boates is liable "for all out-of-pocket costs incurred in connection with the matter." Meanwhile, the letter agreement never refers to costs at all. Instead, it focuses exclusively on the services Schian Walker was promising to provide in exchange for a flat fee of $60,000. For instance, the letter agreement stated that Schian Walker was willing to defend Boates in the anticipated nondischargeability litigation for a flat fee of $60,000 and that the flat fee would cover "the value of all work we will perform through the conclusion of the Adversary Proceeding." To reiterate, the letter agreement says absolutely nothing about costs.

In our June 9, 2016 Opinion, we construed the parties' contract as including an obligation by Boates to pay all litigation costs. This construction was based on the seemingly unequivocal language on the face of the contract. This construction also was based on the argument included in Ulrich's appeal brief that the legal services contract between Boates and Schian Walker was an executory contract, in part, because of the costs provision. Schian Walker's responsive appeal brief cursorily addressed the costs aspect of Ulrich's executory contract argument, but Schian Walker never explained how the seemingly unequivocal language of the letter agreement could be interpreted to address litigation costs when the letter agreement never mentions them.

In its rehearing motion, Schian Walker in essence contends that, when it referred in its letter agreement to a flat fee for services to be rendered, it really meant a flat fee for services to be rendered and for all litigation costs to be incurred. To support this alternate construction of the parties' contract, Schian Walker relies for the first time upon extrinsic evidence, which it claims demonstrates the parties' true intent – that Boates' $60,000 advance payment would cover both fees and costs.

It is not necessary for us to resolve the question of contract interpretation raised by Schian Walker's rehearing motion. Even if we were to conclude that Boates did not owe Schian Walker any costs under the retainer agreement and even if we were to conclude, based thereon, that the retainer agreement was not an executory contract, this would not change the ruling we made in our June 9, 2016 Opinion.

Contract rights held by the debtor on the date of his or her petition filing are property of the bankruptcy estate regardless of whether the rights are associated with an executory or non-executory contract. See Gordon v. Hines (In re Hines), 147 F.3d 1185, 1189 (9th Cir. 1998) (stating that a prepaid contractual right to future legal services that "exists at the outset of the bankruptcy case . . . becomes property of the debtor's estate").

In re Hines's statement regarding the scope of bankruptcy estate property, and the inclusion of contract rights within it, is by no means novel. As early as 1984, the Ninth Circuit held that prepetition contract rights are included within the Bankruptcy Code's definition of bankruptcy estate property. Rau v. Ryerson (In re Ryerson), 739 F.2d 1423, 1425 (9th Cir. 1984); see also Sliney v. Battley (In re Schmitz), 270 F.3d 1254, 1258 (9th Cir. 2001) (listing additional Ninth Circuit cases); Johnson v. Taxel (In re Johnson), 178 B.R. 216, 218-19 (9th Cir. BAP 1995) (holding that proceeds of contracts rights arising from prepetition sales contract were estate property).

The Ninth Circuit's more recent decisions dealing with contract rights in bankruptcy are consistent with In re Hines, In re Ryerson and In re Johnson. See, e.g., Gladstone v. U.S. Bancorp, 811 F.3d 1133, 1136 (9th Cir. 2016) (holding that debtor's rights arising from prepetition life insurance policies were estate property); First Ave. W. Bldg., LLC v. James (In re Onecast Media, Inc.), 439 F.3d 558, 563 (9th Cir. 2006) (opining that trustee's rejection of lease did not divest the bankruptcy estate of whatever lease rights debtor was entitled to under the lease and under applicable nonbankruptcy law as of the date of the petition filing).

In our June 9, 2016 Opinion, we did not address the status in bankruptcy of contract rights arising from non-executory contracts because we did not consider it necessary to our resolution of the appeal. However, Schian Walker's rehearing motion has opened the door to our considering whether the result would be the same for both executory contracts and non-executory contracts. We hold that the result is the same based on the Ninth Circuit case law set forth above.

Accordingly, to the extent we might have erred in holding that the retainer agreement was executory, any such error was harmless error, and we must ignore harmless error. Van Zandt v. Mbunda (In re Mbunda), 484 B.R. 344, 355 (9th Cir. BAP 2012), aff'd, 604 F. App'x 552 (9th Cir. 2015).

For the reasons set forth above, Schian Walker's motion for rehearing is hereby ORDERED DENIED.