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2017 Northeast Bankruptcy Conference

PLENARY SESSION

What's Your Favorite? Supreme Court Decisions that Will Impact (and Already Have Impacted) Bankruptcy Practice

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2017

How Supreme Court Decisions Affect Bankruptcy Practice

ABI 24th Annual Northeast Conference
Sunday, July 23, 2017, 8:30 A.M.
Newport, Rhode Island

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Table of Contents

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

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

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

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

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to do so by the debt collector, the majority did not rule that the later adoption of the Bankruptcy Code impliedly repealed aspects of the FDCPA.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

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

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

The Facts

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

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

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

The Majority Opinion

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

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

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

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

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

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

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

Justice Sotomayor's Dissent

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

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

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

The opinion is *Midland Funding LLC v. Johnson*, 16-348 (Sup. Ct. May 15, 2017).

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

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

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

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

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

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

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

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

Justice Gorsuch then launched into a complex statutory and grammatical analysis, focusing largely on the word "owed." He cited two grammar books alongside the Oxford English

Dictionary to debunk the notion that "owed," a past participle, means a debt previously owed to another.

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

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

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

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

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

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

The opinion is *Henson v. Santander Consumer USA Inc.*, 16-349 (Sup. Ct. June 12, 2017).

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

Delaware District Judge Issues Important Opinion on Third-Party Releases

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

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

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

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

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

The Millennium Plan

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

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

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

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

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

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

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

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

Judge Stark's Opinion

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

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

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

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

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

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

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

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

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

Judge Stark denied the equitable mootness motion without prejudice.

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

Confirmation Becomes Two-Step Process

Assuming Judge Stark is correct and plan releases are not core issues, plans like Millennium's will require two-step confirmation, first in the bankruptcy court, followed by *de*

novo review in district court of non-consensual releases. Consequently, a plan could not be consummated until after district court review of proposed findings and conclusions about the releases. Presumably, the district court would review the merits of the appeal at the same time.

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

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

First Circuit narrowly interprets 'arising in' jurisdiction.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

The opinion is *Gupta v. Quincy Medical Center*, 15-1183 (1st Cir. June 2, 2017).

Marrama ***permits relief that's not explicitly prohibited by the Code, even if policies shown in the statute suggest otherwise.***

Third Circuit Harmonizes *Law v. Siegel* with *Marrama*

In a case involving a debtor's right to dismiss a chapter 13 case, the Third Circuit harmonized the Supreme Court's decision in *Law v. Siegel*, 134 S. Ct.1188 (2014), with *Marrama v. Citizens Bank of Mass.*, 549 U.S. 365 (2007).

Interpreting a chapter 7 debtor's right to convert under Section 706(a), the Supreme Court in *Marrama* allowed the bankruptcy court to attach conditions to the right of conversion when the statute arguably allows no exercise of discretion. *Marrama* was a 5/4 decision, with the dissenters accusing the majority of departing from the language of the statute.

Seven years later, in *Law*, the Supreme Court unanimously held in an opinion by Justice Antonin Scalia that exemptions are sacrosanct, even in the face of compelling equitable arguments to the contrary. The Court barred bankruptcy judges from exercising discretion where the statute authorizes none.

Law narrowed *Marrama* or, arguably, silently overruled the prior decision.

In the Third Circuit, the debtor and his wife had filed three chapter 13 petitions to forestall foreclosure. In the husband's second case, the lender filed a motion to dismiss or convert to chapter 7. If the court decided to dismiss, the lender asked the judge to bar the husband from filing again for 180 days or provide that there be no automatic stay blocking foreclosure if the husband or wife were to file again.

Before the lender's motion came up for hearing, the husband filed a motion to dismiss under Section 1307(b). At the hearing on the lender's motion, the bankruptcy judge dismissed with prejudice and granted relief more broad than the lender requested by barring the husband from filing again without the court's permission. The district court upheld the lower court's rulings.

In the Third Circuit, the husband argued that a debtor's right to dismiss precluded the bankruptcy court from imposing a filing injunction. The June 6 opinion by Circuit Judge Thomas I. Vanaskie upheld the bankruptcy court's ability to issue a filing injunction alongside a debtor's voluntary dismissal "because nothing in the Bankruptcy Code's express terms says otherwise."

If a case has not previously been converted from chapters 7, 11, or 12, Section 1307(b) provides that the "court shall dismiss" a chapter 13 case "[o]n request of the debtor at any time."

The circuits are split on whether a chapter 13 debtor's right to dismiss is absolute. Some say it is, while other courts permit the bankruptcy court to weigh the debtor's bad faith by first addressing a creditor's competing motion to convert. Judge Vanaskie avoided taking sides in the split, saying that the bankruptcy court could have attached a filing injunction to a dismissal order.

Addressing the debtor's argument, Judge Vanaskie interpreted *Law* to mean that a "bankruptcy court's general authority" under Section 105(a) "does not extend to actions that conflict with 'specific,' 'explicit,' and 'express' terms of the Bankruptcy Code." Citing *Marrama*, he said that whether a filing injunction undermines the "purposes" of other sections of the Code "is not the question." He cited the earlier Supreme Court opinion as brushing "back an argument that its decision would undermine the purpose of other Code provisions."

Harmonizing the two high court decisions, Judge Vanaskie said that *Marrama* focused on whether there was anything in the statute "that prohibited the bankruptcy court's order." *Law*, he said, prevents the court from issuing an order that conflicts "with the 'explicit mandates' and 'express terms'" of the statute.

Judge Vanaskie held that a filing injunction was permissible since the case was more like *Marrama* than *Law*, because nothing in Section 1307(b) "prohibits the entry of a filing injunction."

The Third Circuit nonetheless reversed and remanded to the bankruptcy court because the bankruptcy court had abused its discretion in tailoring the filing injunction by giving no reasons explaining why the debtor's conduct warranted an order that was broader than the creditor had requested.

Because the debtor was appealing *pro se*, the appeals court appointed William H. Burgess to serve as *amicus curiae* on behalf of the debtor. The circuit court thanked Burgess, a former Third Circuit clerk, for his "valuable assistance." Burgess is a partner in the Washington, D.C., office of Kirkland & Ellis LLP.

The opinion is *In re Ross*, 15-2222 (3d Cir. June 6, 2017).

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

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

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

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

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

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

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

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

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

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

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

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

Seventh Circuit won't immunize an LBO from fraudulent transfer just by using a bank conduit.

Circuits Split on Invoking Safe Harbor Whenever a Bank Serves as Conduit

The Seventh Circuit deepened an existing split among the courts of appeals by holding that a transfer through a financial institution as a conduit does not by itself invoke the safe harbor in Section 546(e) and immunize the entire transaction from avoidance as a fraudulent transfer.

The July 28 opinion by Chief Circuit Judge Diane P. Wood stands for the proposition that routing consideration for a leveraged buyout of a non-public company through a financial institution cannot preclude a fraudulent transfer attack if it turns out that the seller was rendered insolvent. It is less clear what the decision means for LBOs of public companies.

Judge Wood cited the Second, Third, Sixth, Eighth and Tenth Circuits as applying the safe harbor when a financial institution is nothing more than a conduit. She noted that the Eleventh Circuit "agrees with us."

Since Circuit Judge Richard A. Posner was on the panel along with Circuit Judge Ilana D. Rovner, the chances of persuading the court to hold rehearing *en banc* are remote.

If there is a petition for *certiorari*, the Supreme Court will have a chance to decide whether the safe harbors should be interpreted broadly, like the Second Circuit opinions in *Enron, Quebecor, Madoff* and, recently, *Tribune*.

The case in the Seventh Circuit was similar to a leveraged buyout. One company bought another, in part with money borrowed from a bank. Another bank served as escrow agent, holding the purchase price before passing it along to the seller.

Employing a constructive fraudulent transfer theory, the litigation trust established in the buyer's bankruptcy sued the 30% owner of the seller for $16.5 million, representing its share of the $55 million purchase price. Invoking Section 546(e), the district court dismissed the suit, holding that the safe harbor applied because the transfer was "made by or to" a financial institution.

The safe harbor precludes a trustee from attacking a transfer of a "settlement payment" that is "made by or to" a "financial institution," or a transfer "by or to" a "financial institution . . . in connection with a securities contract." Since the purchaser was buying stock, it was clear to

Judge Wood that the transfers were either a settlement payment or a payment in connection with a securities contract.

Judge Wood said it was therefore only necessary to decide whether the safe harbor protects transactions "simply [because they were] conducted through financial institutions." In typical Seventh Circuit fashion, the opinion is an exploration of the judges' understanding of the purpose of the statute, largely unaided by citation to authorities.

Although the Seventh Circuit previously had held that the safe harbor should be interpreted "broadly," that "does not mean that there are no limits," Judge Wood said. She declined to "interpret the safe harbor so expansively that it covers any transaction involving securities that uses a financial institution or other named entity as a conduit for funds." Instead, she said "it is the economic substance of the transaction that matters."

Judge Wood analyzed the purpose of the avoidance and safe harbor statutes because there are "multiple plausible interpretations" of the statutory language "made by or to." She also said the parenthetical "for the benefit of," added in 2006, "is also ambiguous."

Invoking the safe harbor simply because the parties used a bank conduit would "render any transfer non-avoidable unless it were done in cold hard cash, and that conflicts with Section 548(c)'s good faith exception," the opinion says. Instead, the safe harbor applies "only where the debtor incurred an actual obligation" to the financial institution that received the transfer.

Judge Wood also found support in the history of the safe harbor, which was designed to prevent a domino effect "'rippling through the securities industry.'" She said the safe harbor applies when the transferor or transferee is a financial institution. Tagging the selling shareholder with liability "will not trigger bankruptcies of any commodity or securities firm," the opinion says.

The opinion is *FTI Consulting Inc. v. Merit Management Group LP*, 15-3388 (7th Cir. July 28, 2016).

Creditors, not just trustees, are also barred from suing by Section 546(e).

Second Circuit Closes Loopholes in 'Safe Harbor' to Protect Selling LBO Shareholders

[Note: The opinion, originally issued on March 24, 2016, was "filed in error and stricken from the record" by a docket entry on March 28. The next day, the appeals court reissued the opinion with immaterial changes.]

Broadly interpreting the safe harbor for "settlement payments" provided by Section 546(e) of the Bankruptcy Code, the Second Circuit triple-locked the door against individual creditors trying to sue shareholders for the recovery of payments received in a leveraged buyout before the company filed bankruptcy.

In a March 24 opinion by Circuit Judge Ralph K. Winter Jr., the appeals court foreclosed virtually any argument that creditors individually or collectively can sue shareholders on a constructive fraudulent transfer theory seeking recovery of payments received in a leveraged buyout for stock in a company that later files bankruptcy.

The case arose in the chapter 11 reorganization of newspaper publisher Tribune Co. and centered around Section 546(e), which provides that "the trustee may not" sue for recovery of a "settlement payment," unless the suit is brought under Section 548(a)(1)(A) for recovery of a fraudulent transfer within two years of bankruptcy made with actual intent to hinder, delay or defraud creditors.

The Second Circuit in substance was called on to decide whether there are any loopholes allowing creditors to sue for recovery of constructive fraudulent transfers when an LBO goes sour. The district court in the opinion on appeal had opened the door a crack, and a bankruptcy judge in the reorganization of Lyondell Chemical Co. had also found loopholes.

In Tribune's reorganization, the official creditors' committee was authorized to sue selling shareholders for allegedly receiving fraudulent transfers with "actual intent." Prosecuted after plan confirmation by a creditors' trust, that suit remains pending in bankruptcy court in Manhattan.

When the two-year statute of limitations was about to expire, Tribune's bankruptcy judge modified the automatic stay by allowing company retirees, along with pre-LBO unsecured bondholders, to sue selling shareholders using constructive fraudulent transfer theories. In modifying the stay, the bankruptcy judge did not rule on whether individual creditors had standing or whether a suit would be barred by Section 546(e)'s safe harbor. The individual

creditors' suit ended up in district court in Manhattan, where the selling shareholders moved to dismiss.

Granting the motion to dismiss, the district court held that individual creditors lacked standing because the creditors' trust was simultaneously suing on fraudulent transfer grounds, albeit on a different theory. The judge also held that the safe harbor only bars suits by a trustee and does not preclude creditors from suing under state law.

Judge Winter reversed the district court on both scores, with dismissal still the result. He made short shrift of the district court's holding that the automatic stay deprived individual creditors of standing when the creditors' trust was suing to recover the same transfers as fraudulent transfers with "actual intent." The judge pointed out how the bankruptcy court on at least three occasions had modified the stay so individual creditors could sue.

Although he gave them back the right to sue, Judge Winter nonetheless knocked them out of the box under Section 546(e) on a theory of implied preemption. He said that implied preemption results when "state law stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress."

He rejected the argument that only trustees are barred from suing by the safe harbor. Although the meaning of Section 546(e) is not "plain," Judge Winter said the creditors' arguments rely on "adhering to statutory language only when opportune and resolving various ambiguities in a way convenient to that theory." Ultimately, he said that the creditors' theory was in "outright conflict" with the section.

The creditors contended that fraudulent transfer claims revert to creditors if the trustee does not file suit within the two-year statute of limitations or if the automatic stay is lifted to allow suing. Judge Winter said that a reversion of fraudulent transfer claims "is not based on the language of the Code."

Although he conceded that Section 546(e) is ambiguous, Judge Winter said in his 53-page opinion that "unwinding settled securities transactions" would "seriously undermine" the markets. For reasons developed at length about the congressional policy shown in the safe harbor, the appeals court held that state law constructive fraudulent transfer claims are preempted.

The *Tribune* opinion cuts the ground from underneath a decision by the *Lyondell* bankruptcy judge in January 2014 holding that the safe harbor does not preclude fraudulent transfer suits based on state law, nor does it protect selling shareholders who ultimately received proceeds from allegedly fraudulent transfers.

Judge Winter's opinion contains a useful discussion of how to determine whether a statute's meaning is plain.

The opinion is *Note Holders v. Large Private Beneficial Owners (In re Tribune Co.)*, 13-3992 (March 24, 2016).

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

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

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

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

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

The Tribune LBO and Bankruptcy

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

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

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

In *Tribune*, the creditors filed a petition for *certiorari* in September from the Second Circuit's dismissal, but the Supreme Court has yet to schedule a conference for the justices to

consider allowing a final appeal. To read ABI's discussion of the March *Tribune* decision, click here.

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

Lyondell

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

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

Judge Sullivan Takes on Judge Cote

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

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

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

It was another matter, Judge Sullivan said, to impute fraudulent intent to the company based on the intent of company executives. Disagreeing with Judge Cote and following Judge Gerber, Judge Sullivan said that the intent of executives mattered only if they were in a position to

"control" decision making by the board. In other words, executives must have "formidable voting and managerial power" that rises to the level of "majority voting control."

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

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

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

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

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

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

The *Tribune* decision is *Kirschner v. Fitzsimons (In re Tribune Co. Fraudulent Conveyance Litigation)*; 11-md-2296, 12-mc-2296 and 12-cv-2652 (S.D.N.Y. Jan. 6, 2017).

***Test case on preferences deepens a circuit split and lays the groundwork for* certiorari.**

Wages Garnished Before Bankruptcy Are Voidable Preferences, Circuit Rules

The Fifth Circuit handed down an important garnishment decision on March 13 following the *Collier* treatise and saying that opinions from three other circuit courts were either wrongly decided or did not survive *Barnhill v. Johnson*, 503 U.S. 393 (1992).

The case involved a judgment creditor who served a garnishment order on a debtor's employer before the debtor filed bankruptcy. The bankruptcy court awarded a preference judgment to the trustee for recovery of wages garnished within 90 days of bankruptcy.

The district court affirmed, and so did the Fifth Circuit in an opinion by Circuit Judge James L. Dennis.

Do not be surprised if there is a petition for *certiorari*. The appeal was a test case because it entailed the recovery of a $1,750 preference.

Judge Dennis explained that a preference resulting from garnishment is governed by two subsections in Section 547.

First, Section 547(e)(2)(B) provides that a transfer is "perfected" when a creditor on a simple contract could not obtain a lien superior to the interest of the transferee. Because the garnishment order was served on the employer before bankruptcy, the creditor argued that no other creditor could acquire a judicial lien superior to the garnishor's interest.

Judge Dennis said that would be true, except for the fact that it ignores the second relevant subjection, Section 547(e)(3), which says that the debtor must have an interest in the property before a transfer can occur.

On that topic, the Supreme Court ruled in *Barnhill* that the time of a transfer is governed by federal law, not state law.

The Supreme Court had ruled earlier in *Local Loan v. Hunt*, 292 U.S. 234 (1934), that the earning power of an individual is not "translated into property" until the earnings come into "existence."

Thus, Judge Dennis said that the Sixth Circuit was correct when it said in *In re Morehead*, 249 F.3d 445 (6th Cir. 2001), that a debtor cannot obtain rights in future wages until the services have been performed. Therefore, the Sixth Circuit held that garnished wages earned during the preference period are recoverable preferences.

Judge Dennis agreed with the Sixth Circuit. He went on to say that contrary decisions from the Eleventh, Seventh and Second Circuits were all decided before *Barnhill* and are therefore no longer good law. He noted that the Seventh Circuit has disavowed its pre-*Barnhill* case, which had held that wages garnished before bankruptcy are not preferential.

Those three cases, Judge Dennis said, have been "roundly criticized" by the Sixth Circuit in *Morehead* and by lower courts. He noted that the *Collier* treatise says those three circuit cases are "wrong."

In short, Judge Dennis said, there is no property a creditor can garnish or that a debtor can transfer until wages are earned. Therefore, the "creditor's collection of garnished wages earned during the preference period is an avoidable transfer made during the preference period even if the garnishment was served prior to that period."

The opinion is *Tower Credit Inc. v. Schott (In re Jackson)*, 16-30274 (March 13, 2017).

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

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

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

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

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

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

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

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

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

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

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

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

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

The opinion is *Town Center Flats LLC v. ECP Commercial II LLC (In re Town Center Flats LLC)*, 16-1812 (6th Cir. May 2, 2017).

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

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

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

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

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

Valuation of an Affordable Housing Project

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

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

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

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

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

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

Rash and Cramdown Valuation

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

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

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

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

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

The Proper Interest Rate on Cramdown

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

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

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

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

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

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

No Second 1111(b) Election

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

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

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

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

The Dissent

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

Practical and Curious Aspects of the Opinions

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

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

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

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

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

The opinion is *First Southern National Bank v. Sunnyslope Housing LP (In re Sunnyslope Housing LP)*, 12-17241 (9th Cir. May 26, 2017).

Circuit split widens on an issue the Supreme Court has been ducking.

Third Circuit Joins the Majority in the Split Over Late-Filed Tax Returns

The split widens on the one-day-late rule, where the First, Fifth and Tenth Circuits hold that a tax debt never can be discharged under Section 523(a)(1)(B)(i) if the underlying tax return was filed even one day late.

The Fourth, Sixth, Seventh, Eighth and Eleventh Circuits, on the other hand, employ the four-part test resulting from a 1984 Tax Court decision known as *Beard*. Addressing the question, the Third Circuit joined the majority in a May 5 opinion by adopting the *Beard* test.

Deepening the controversy over late-filed tax returns, the Third Circuit weighed in on a subordinate split by differing with the Eighth Circuit and considering the timing of the late-filed return as relevant to the question of dischargeability.

The Supreme Court has been ducking the split. Columbia University Law Professor Ronald J. Mann attempted to take a one-day-late case to the Supreme Court in 2015 in *In re Mallo*. The high court denied *certiorari*.

In February, the justices denied *certiorari* in *Smith v. IRS*, where the petitioner's counsel raising the same issue was Prof. John A.E. Pottow from the University of Michigan Law School.

The Third Circuit Case

The Third Circuit dealt with a case where the debtor did not file three years' worth of tax returns until after the Internal Revenue Service made assessments. The bankruptcy court held that the tax debt was not dischargeable and was upheld in district court.

On appeal to the Third Circuit, the debtor argued that his late-filed returns nonetheless qualified as "returns," making the tax debt dischargeable under Section 523(a)(1)(B)(i). That section excepts a debt from discharge "for a tax . . . with respect to which a return . . . was not filed . . . ."

Added to Section 523(a) along with the amendments in 2005, the so-called hanging paragraph defines "return" to mean "a return that satisfies the requirements of applicable nonbankruptcy law (including applicable filing requirements)."

The opinion by Third Circuit Judge Jane R. Roth declined to employ the one-day-late rule followed by three circuits and instead adopted the *Beard* test used by five others. She tersely alluded to the fact that the IRS does not endorse the one-day-late rule.

Among the four parts to the *Beard* test, only the fourth element was at issue: whether the debtor's late-filed return "represent[ed] an honest and reasonable effort to comply with the tax law."

Citing other circuits, Judge Roth said that a return filed after an IRS assessment will "rarely, if ever, qualify as an honest or reasonable attempt to satisfy the tax law."

The debtor relied on the Eighth Circuit's *Colsen* decision focusing "on the content of the form, not the circumstances of its filing." Judge Roth declined to follow the sister circuit but instead agreed "with the weight of authority that the timing of the filing of a tax form is relevant" in deciding whether the late-filed return was an "honest and reasonable attempt to comply with tax law."

Judge Roth therefore ruled that tax debts were not dischargeable under the *Beard* test because they did not qualify as "returns."

The opinion is *Giacchi v. U.S. (In re Giacchi)*, 15-3761 (3d Cir. May 5, 2017).