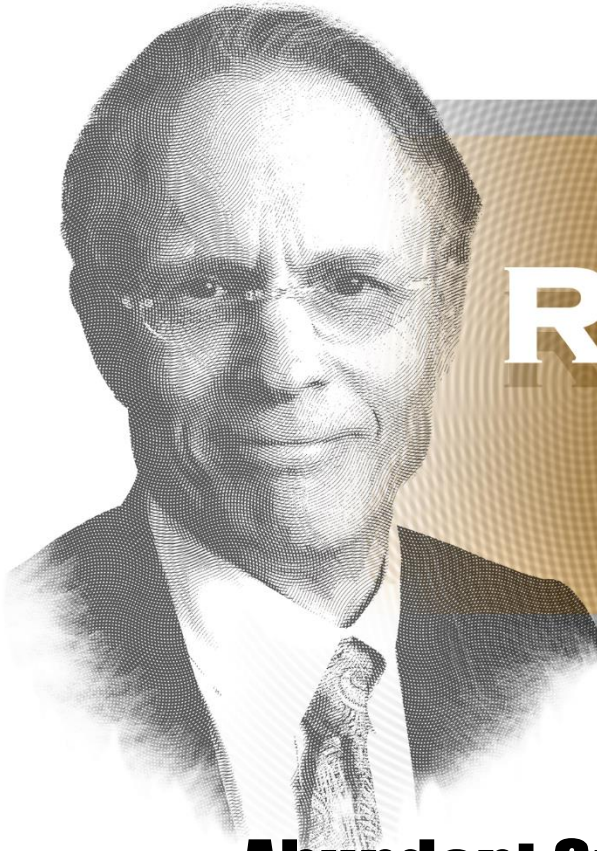




AMERICAN  
BANKRUPTCY  
INSTITUTE



# ROCHELLE'S DAILY WIRE

## **Abundant Splits and Other Significant Bankruptcy Decisions**

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### **38<sup>th</sup> Annual Commercial Law & Bankruptcy Seminar**

**McCall, Idaho**

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## Supreme Court



# ROCHELLE'S DAILY WIRE

## *Decided Last Term*



*Supreme Court says that activities not required by state law in nonjudicial foreclosure may be covered by the FDCPA.*

## **Nonjudicial Foreclosure Is *Not* Subject to the FDCPA, Supreme Court Rules**

The Supreme Court ruled unanimously today that nonjudicial foreclosure is not subject to regulation by the federal Fair Debt Collection Practices Act, known as the FDCPA, 15 U.S.C. § 1692-1692p.

The opinion for the Court by Justice Stephen G. Breyer contained an important caveat: Nonjudicial foreclosure is exempt from the FDCPA only with regard to actions *required* by state law.

### The Circuit Split

After a homeowner defaulted on his mortgage, the lender hired a law firm, which gave notice that it was retained to conduct nonjudicial foreclosure under Colorado law. The homeowner responded with a letter purporting to invoke rights under Section 1692(g) of the FDCPA, which obliges a debt collector to halt collection activities until it provides the debtor with a “verification of the debt.”

However, the law firm proceeded to initiate nonjudicial foreclosure. The homeowner then filed suit alleging violation of the FDCPA. The district court dismissed the suit, finding that the law firm was not a “debt collector” within the purview of the FDCPA. The Tenth Circuit affirmed, holding that merely enforcing a security interest through nonjudicial foreclosure is not governed by the FDCPA.

The circuits were split. The Fourth, Fifth and Sixth Circuits held that the FDCPA applies to nonjudicial foreclosure, while the Ninth and Tenth Circuits concluded that it does not. The Supreme Court granted *certiorari* on June 28, 2018, to resolve the split and heard oral argument on January 7.

### The Statutory Provisions

The FDCPA applies to “debt collectors,” defined in the first sentence of 15 U.S.C. § 1692a(6) as someone who “regularly collects or attempts to collect, directly or indirectly, debts owed . . . or due another.” The definition makes the statute applicable to a law firm pursuing *judicial* foreclosure when the lender is entitled to a deficiency judgment.



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The case turned on the meaning of the third sentence in Section 1692a(6), which applies to enforcement of security interests. “For the purpose of section 1692f(6) [governing the conduct of someone repossessing property nonjudicially],” the third sentence of Section 1692a(6) says that the “term [debt collector] also includes any person who uses [the mail or interstate commerce] in any business the principal purpose of which is the enforcement of security interests.”

The third sentence applies to nonjudicial foreclosure. However, Section 1692f(6) does not impose all of the FDCPA’s regulations on those who only enforce security interests. Section 1692f(6) only prohibits certain activities, such as threatening to repossess when there is no intention of repossessing or there is no right to repossess. The law firm was not alleged to have violated the proscriptions in Section 1692f(6).

## The Unanimous Opinion

Writing for the Court, Justice Breyer said that the FDCPA would apply to nonjudicial foreclosure if the statute contained only the primary definition in the first sentence of Section 1692a(6). If the third sentence did not contain the reference to someone whose principal business “is the enforcement of security interests,” he said that a person engaged in nonjudicial foreclosure proceedings “would qualify as a debt collector for all purposes,” because foreclosure “is a means of collecting a debt.”

Justice Breyer said that the primary definition of “debt collector” in the first sentence in Section 1692a(6) does not apply only to someone who attempts to collect from a debtor. Even if nonjudicial foreclosure were not a direct attempt to collect a debt, he said, “it would be an *indirect* attempt to collect a debt.” [Emphasis in original.]

The third sentence in Section 1692a(6) changed the result, however. The phrase “[f]or the purpose of section 1692f(6),” Justice Breyer said, “strongly suggests that one who does no more than enforce security interests does *not* fall within the scope of the general definition. Otherwise why add this sentence at all?” [Emphasis in original.]

Justice Breyer also surmised that Congress did not intend for the FDCPA to be generally applicable to nonjudicial foreclosure “to avoid conflicts with state nonjudicial foreclosure schemes.”

For “those of us who use legislative history to help interpret statutes,” he said that “the history of the FDCPA supports our reading.” He alluded to how competing versions of the bill would or would not have made nonjudicial foreclosure subject to regulation. The third sentence, he said, “has all the earmarks of a compromise: The prohibitions contained in Section 1692f(6) will cover security-interest enforcers, while the other ‘debt collector’ provisions of the Act will not.”





## Caveats in the Opinion

Justice Breyer added two caveats to say that specific acts in connection with nonjudicial foreclosure could conceivably be subject to the FDCPA, although nonjudicial foreclosure generally is not.

The homeowner argued that the third sentence applies only to a “repo man,” meaning someone who repossesses personal property and has no interaction with the debtor. Judge Breyer rejected this contention, saying, “if Congress meant to cover only the repo man, it could have said so.”

In the same paragraph, Justice Breyer went on to say it is “at least plausible that ‘threatening’ to foreclose on a consumer’s home without having legal entitlement to do so is the kind of ‘nonjudicial action’ without ‘present right to possession’ prohibited by that section.” He went on to say parenthetically, “We need not, however, decide precisely what conduct runs afoul of Section 1692f(6).”

Of greater significance, Justice Breyer said near the end of his 14-page opinion, “This is not to suggest that pursuing nonjudicial foreclosure is a license to engage in abusive debt collection practices like repetitive nighttime phone calls . . . .”

Because the case before the Court involved “only steps required by state law, we need not consider what *other* conduct (related to, but not required for, enforcement of a security interest) might transform a security-interest enforcer into a debt collector subject to main coverage of the Act.” [Emphasis in original.]

## The Concurring Opinion

Justice Sotomayor concurred in the opinion. Calling it “a close case,” she said that Justice Breyer made “a coherent whole of a thorny section of statutory text.” She was persuaded to concur because the third sentence would be superfluous “if all security-interest enforcement is already covered” by the first sentence.

Justice Sotomayor made two points: (1) “[T]oday’s opinion does not prevent Congress from clarifying today’s opinion if we have gotten it wrong,” and (2) enforcing a security interest does not confer blanket immunity from the FDCPA.

“I would see as a different case one in which the defendant went around frightening homeowners with the threat of foreclosure without showing any meaningful intention of ever actually following through.” In such a case, she said, there would be a question of whether the person was actually in the business of enforcing a security interest or “was simply using that label as a stalking horse for something else.”



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The case is *Obduskey v. McCarthy & Holthus LLP*, 139 S. Ct. 1029, 203 L. Ed. 2d 390 (Sup. Ct.).



*Supreme Court gets around to  
overruling Lubrizol almost 35 years later.*

## **Licensee May Continue Using a Trademark after Rejection, Supreme Court Rules**

Today, the Supreme Court handed down its decision in [\*Mission Product Holdings Inc. v. Tempnology LLC\*](#), 17-1657 (Sup. Ct.), reversed the First Circuit and held that rejection of an executory trademark license does not bar the licensee from continuing to use the mark. As Justice Elena Kagan said, “A rejection breaches a contract but does not rescind it.”

The opinion was almost unanimous, with Justice Neil M. Gorsuch dissenting; he believes the petition for *certiorari* should have been dismissed as improvidently granted. In his view, the Court could not grant effective relief.

Justice Sonia Sotomayor wrote a concurring opinion to say that nondebtor parties to rejected trademark licenses may have more rights following rejection than parties to other types of intellectual property licenses whose rights are limited by Section 363(n).

The Court granted *certiorari* in October to resolve a split of circuits.

### The Circuit Split

It took decades, but the Supreme Court ruled on May 20 that the Fourth Circuit was wrong almost 35 years ago when it held that rejection of an executory license for intellectual property precludes the nonbankrupt licensee from continuing to use the license. *Lubrizol Enterprises Inc. v. Richmond Metal Finishers Inc.*, 756 F.2d 1043 (4th Cir. 1985).

*Lubrizol* was subjected to withering criticism, prompting Congress three years later to adopt Section 365(n) and the definition of “intellectual property” in Section 101(35A). Together, they allow a nondebtor to continue using patents, copyrights and trade secrets despite rejection of a license.

Congress did not mention trademarks, leading most lower courts to interpret the omission as meaning that rejection cuts off the right to use trademarks.

In 2012, the Seventh Circuit differed with *Lubrizol* when it handed down *Sunbeam Products Inc. v. Chicago American Manufacturing LLC*, 686 F.3d 372 (7th Cir. 2012), and held that rejection does not preclude the continued use of a mark. According to Circuit Judge Frank Easterbrook, “nothing about this process [of rejection] implies that any other rights of the other contracting party have



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been vaporized.” If a licensor’s breach outside of bankruptcy would not bar continued use of the mark, the same would hold true in bankruptcy after rejection by the licensor, he said.

In Tempnology’s chapter 11 case, the debtor had granted the licensee a nonexclusive, nontransferable, limited license to use the debtor’s trademarks. Following *Lubrizol*, the bankruptcy court rejected the license and ruled that the licensee could not continue using the license. The Bankruptcy Appellate Panel reversed, following *Sunbeam*.

The First Circuit reversed the BAP in January 2018. *Mission Product Holdings Inc. v. Tempnology LLC (In re Tempnology LLC)*, 879 F.3d 389 (1st Cir. Jan. 12, 2018).

In a 2/1 opinion, the First Circuit majority in *Tempnology* sided with *Lubrizol* and criticized *Sunbeam* for “largely [resting] on the unstated premise that it is possible to free a debtor from any continuing performance obligations under a trademark license even while preserving the licensee’s right to use the trademark.” The majority favored “the categorical approach of leaving trademark licenses unprotected from court-approved rejection, unless and until Congress should decide otherwise.” To read ABI’s discussion of the First Circuit’s opinion in *Tempnology*, [click here](#).

As it had done in the First Circuit, the debtor argued in the Supreme Court that allowing the licensee to continue using the trademark would force the debtor to continue shouldering the onerous burden of policing the quality of the licensee’s use of the mark. Absent quality control, the debtor contended, the licensor abandons the mark, and it reverts to the public domain. Rejection frees the debtor from the burden of policing the mark and is thus a necessary adjunct to the power of rejection, according to the debtor.

## Justice Kagan’s Opinion

### *Mootness*

Joined by all justices except Justice Gorsuch, Justice Kagan began by holding that the appeal was not moot.

Initially, the bankruptcy judge had only granted a plain, vanilla motion to reject the trademark license. Following rejection, the debtor returned to court, where the bankruptcy judge issued a declaration saying that rejection terminated the licensee’s use of the mark. Later still, the license terminated by its own terms.

To counter the notion of mootness, the licensee contended that it had a claim for damages resulting from its inability to use the mark. The debtor responded by saying that the bankruptcy court had authorized distribution of the last funds in the estate. The licensee countered by saying it might prevail on the bankruptcy court to compel other creditors to disgorge distributions.





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Justice Kagan held that the appeal remained “a live controversy.” “If there is any chance of money changing hands, [the licensee’s] suit remains alive.” Citing the Court’s precedent, she said that “courts often adjudicate disputes whose ‘practical impact’ is unsure at best, as when ‘a defendant is insolvent.’”

## *The Merits: Rejection Isn’t Rescission*

Justice Kagan said that the text of Section 365 and “fundamental principles of bankruptcy law” lead to a conclusion that rejection is not rescission. In particular, she relied on Section 365(g), which provides that rejection “constitutes a breach of such contract” immediately before the filing of the bankruptcy petition.

Or “more pithily for current purposes,” Justice Kagan said that “rejection is a breach.” In turn, breach “means in the Code what it means in contract law outside bankruptcy.”

As an example, Justice Kagan supposed that a debtor had leased a copy machine to a law firm. Were the debtor to reject the lease, she said the debtor could stop servicing the machine, but the debtor “cannot take it back.”

Applying the same notion to trademarks, Justice Kagan said that “breach does not revoke the license or stop the licensee from doing what it allows.”

Justice Kagan also bought into the idea that the power to reject does not convey the same remedies as avoidance actions, which, she said, are “exceptional cases in which trustees . . . may indeed unwind pre-bankruptcy transfers.”

## *No Negative Inference from Section 365(n)*

The debtor argued that the omission of trademarks from Section 365(n) meant that Congress intended for rejection to cut off use of a mark.

“Still,” Justice Kagan said, “Congress’s repudiation of *Lubrizol* for patent contracts does not show any intent to *ratify* that decision’s approach for almost all others. Which is to say that no negative inference arises. Congress did nothing in adding Section 365(n) to alter the natural reading of Section 365(g) — that rejection and breach have the same results.” [Emphasis in original.]

## *Aiding Reorganization*

The debtor argued that it would be better able to reorganize if the court relieved it of the burden of policing the use of the mark. To that, Justice Kagan said, “The Code of course aims to make



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reorganization possible. But it does not permit anything and everything that might advance that goal.”

Justice Kagan said that Section 365 therefore does not “relieve the debtor of the need . . . to invest the resources needed to maintain a trademark. . . . The resulting balance may indeed impede some reorganizations, of trademark licensors and others.”

For the Court, Justice Kagan held that rejection “has the same effect as a breach outside of bankruptcy. Such an act cannot rescind rights that the contract previously granted. Here, that construction of Section 365 means that the debtor-licensor’s rejection cannot revoke the trademark license.”

Danielle Spinelli, a former Supreme Court law clerk, represented the licensee. Douglas Hallward-Driemeier, a former Assistant Solicitor General, argued for the debtor. Assistant Solicitor General Zachary D. Tripp argued on behalf of the government in favor of reversing *Lubrizol*.

## Justice Sotomayor’s Concurrence

Justice Sotomayor said she concurred “in full.” She wrote “to highlight two potentially significant features of today’s holding.”

First, Justice Sotomayor said the opinion does not mean that “every trademark licensee has the unfettered right to continue using licensed marks post rejection.” The opinion may not apply, she said, if provisions in the license or “state law” might “bear” on continued use of the mark.

Second, and of greater significance, Justice Sotomayor said that the “holding confirms that trademark licensees’ postrejection rights and remedies are more expansive in some respects than those possessed by other types of intellectual property.” For instance, she said that licensees of patents, copyrights and four other types of intellectual property (which are covered by Section 365(n)) “must make all [their] royalty payments.”

## The Dissent

Dissenting, Justice Gorsuch said nothing about the merits. He would have dismissed the *certiorari* petition for having been improvidently granted.

The case should have been considered moot, Justice Gorsuch said, because the licensee “hasn’t come close to articulating a viable legal theory on which a claim for damages could succeed. And where our jurisdiction is so much in doubt, I would decline to proceed to the merits . . . . [T]here is no need to press the bounds of our constitutional authority . . . .”



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## The Irony, Import and Utility of the Decision

For appellate jurisprudence, the inability of Justice Gorsuch to prevail in his view about mootness seems to mean that the Court can reach the merits even when the existence of a live controversy is in doubt.

James M. Wilton of Ropes & Gray LLP in Boston, one of the counsel for the debtor, told ABI that “the decision will enhance the negotiating leverage of trademark licensees vis a vis secured lenders and other creditors and make it more difficult for debtor-licensors to rebrand their businesses and reorganize.”

In the very hypothetical that Justice Kagan mentioned, the bankruptcy of a lessor of personal property will not enable the debtor to use rejection as a means for recovering the equipment for lease to someone else at a higher price.

Ironically, some non-debtor third parties would now be better off had Congress not come to their aid. Section 365(n) is not the only Code provision where a party to a rejected contract or lease would have greater rights after *Mission Product*.

Judge Kagan mentioned real property leases, contracts for the sale of real property and time-share interests in Sections 365(h) and (i). Having balanced the interests of debtor and creditors in those sections, Congress could have given third parties fewer rights and remedies than they might otherwise have been found to have following *Mission Product*. Nonetheless, the certainty provided by Sections 365(h) and (i) is perhaps a fair trade-off.

[The opinion is](#) *Mission Product Holdings Inc. v. Tempnology LLC*, 139 S. Ct. 1652, 203 L. Ed. 2d 876 (Sup. Ct.).



*'No objectively reasonable basis' is the high court standard to find civil contempt for violating the discharge injunction.*

## **Court Rejects Strict Liability for Discharge Violations**

Today, the Supreme Court rejected a strict-liability standard for the imposition of contempt for violating the discharge injunction. Instead, the justices held unanimously that the bankruptcy court “may impose civil contempt sanctions when there is no objectively reasonable basis for concluding that the creditor’s conduct might be lawful under the discharge order.”

The opinion for the Court by Justice Stephen G. Breyer also rejected the Ninth Circuit’s idea that a subjective, good faith belief about the inapplicability of the discharge injunction is a defense to contempt. It is unclear from the opinion whether the Court’s standard for a discharge violation also applies to violations of the automatic stay under Section 362.

### **A Discharge Violation Was Unclear**

The procedural history of the case in the lower courts was exceptionally complex. Suffice it to say that the debtor had transferred his interest in a closely held corporation. After the debtor received his chapter 7 discharge, two other shareholders sued him in state court for transferring his interest without honoring their contractual right of first refusal. They also sued the transferee of the stock.

After the debtor raised his discharge as a defense in state court, the parties agreed he would not be liable for a monetary judgment. The state court eventually ruled in favor of the creditors and unwound the transfer.

The creditors then sought attorneys’ fees as the prevailing parties, invoking a fee-shifting provision in the shareholders’ agreement. The state court ruled that the debtor “returned to the fray” and thereby made himself liable for post-discharge attorneys’ fees.

Meanwhile, the debtor reopened his bankruptcy case, seeking to hold the creditors in contempt for violating the discharge injunction. The bankruptcy judge sided with the debtor and imposed sanctions. The Bankruptcy Appellate Panel reversed the finding of contempt, ruling that the creditors’ good faith belief that their actions did not violate the injunction absolved them of contempt.

Meanwhile, the state appellate court and a federal district court in related litigation both ruled that the debtor’s participation in the litigation did not constitute returning to the fray, thus taking





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away the grounds for imposing attorneys' fees and lending credence to the notion that the creditors did technically violate the injunction.

In sum, judges disagreed over whether the discharge injunction applied to the litigation to recover attorneys' fees.

The debtor appealed the BAP's opinion to the Ninth Circuit, where Circuit Judge Carlos T. Bea upheld the BAP in April 2018 and found no contempt. However, he expanded the defense available to someone charged with contempt of a discharge injunction. The appeals court held that "the creditor's good faith belief that the discharge injunction does not apply to the creditor's claim precludes a finding of contempt, even if the creditor's belief is unreasonable."

The debtor filed a petition for *certiorari*, which the Supreme Court granted in January. Oral argument was held on April 24.

## The Standard Borrowed from Equity

In his 11-page opinion, Justice Breyer said the outcome was informed by Section 524(a)(2), the statutory discharge injunction, and by Section 105(a), the bankruptcy version of the All Writs Act.

Those two sections, according to Justice Breyer, "bring with them the 'old soil' that has long governed how courts enforce injunctions." The "old soil," he said, includes "the traditional standards in equity practice for determining when a party may be held in civil contempt for violating an injunction."

Justice Breyer cited Supreme Court precedent from 1885 holding that civil contempt should not be found "where there is [a] *fair ground of doubt* as to the wrongfulness of the defendant's conduct." *California Artificial Stone Paving Co. v. Molitor*, 113 U.S. 609, 618 (1885) (emphasis added by Justice Breyer).

Justice Breyer then cited *Schmidt v. Lessard*, 414 U.S. 473, 476 (1974) (*per curiam*), for the notion that "principles of 'basic fairness requir[e] that those enjoined receive explicit notice' of 'what conduct is outlawed' before being held in civil contempt."

Although subjective intent is not "always irrelevant," Justice Breyer said, "This standard is generally an *objective* one." [Emphasis in original.] Again citing high court precedent, he said that "a party's good faith, even where it does not bar civil contempt, may help determine an appropriate sanction."

Given that the "typical discharge order entered by a bankruptcy court is not detailed," Justice Breyer held that civil contempt "therefore may be appropriate when the creditor violates a



discharge order based on an objectively unreasonable understanding of the discharge order or the statutes that govern its scope.”

## The Rejected Standards

Justice Breyer rejected the Ninth Circuit’s “good faith belief” standard. Recognizing the realities of life for debtors, he said that the rule proposed by the circuit court “may too often lead creditors who stand on shaky legal ground to collect discharged debts, forcing debtors back into litigation (with its accompanying costs) to protect the discharge that it was the very purpose of the bankruptcy proceeding to provide.”

On the other hand, he also rejected a strict-liability standard that would authorize a contempt finding “regardless of the creditors’ subjective beliefs about the scope of the discharge order, and regardless of whether there was a reasonable basis for concluding that the creditor’s conduct did not violate the order.”

In support of strict liability, the debtor argued that a creditor can turn to the bankruptcy court for a so-called comfort order declaring that a proposed action would not violate the discharge injunction. To that, Justice Breyer said that a “risk averse” creditor would seek a comfort order “even when there is only a slight doubt” about a violation of discharge. Often, he said, there will “be at least some doubt as to the scope of” the discharge.

Frequent use of comfort orders, Justice Breyer said, would run contrary to Section 523(c)(1), where only three categories of debts require advance determinations of dischargeability.

Frequent resort to comfort orders, according to Justice Breyer, would “alter who decides whether a debt has been discharged, moving litigation out of state courts, which have concurrent jurisdiction over such questions, and into federal courts.”

Because the Ninth Circuit had not employed the proper standard, the Justice Breyer vacated the judgment of the appeals court and remanded “the case for further proceedings consistent with this opinion.”

## What About the Automatic Stay?

Does the Supreme Court’s standard for contempt of the discharge injunction also apply to violations of the automatic stay under Section 362(a)?

Justice Breyer said that the language in Section 362(k)(1) “differs from the more general language in Section 105(a).” Section 362(k)(1) allows an individual to recover actual damages, costs, attorneys’ fees and even punitive damages (in “appropriate circumstances”) for “any willful violation” of the automatic stay.



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The debtor argued that lower courts have often imposed strict liability for violating the automatic stay. Coupled with the different purpose of the automatic stay, the absence of the word “willful” in the discharge context prompted Justice Breyer to reject the idea of importing lower courts’ standards for violation of the automatic stay to contempt of the discharge injunction.

Parenthetically, Justice Breyer noted that the use of “willful” in Section 362(k)(1) is “a word the law typically does not associate with strict liability.” However, he ducked the question, saying that “[w]e need not, and do not, decide whether the word ‘willful’ supports a standard akin to strict liability.”

Although the Court made no holding about automatic stay violations, Justice Breyer’s parenthetical observation can lay the foundation for contending there is also no strict liability for stay violations.

So, the question remains: Is the contempt standard different for automatic stay violations?

Craig Goldblatt of Wilmer Cutler Pickering Hale & Dorr LLP in Washington, D.C., observed that “the Code sets out a standard for the stay but not the discharge injunction. Bankruptcy lawyers think they serve a similar role and so read them to be parallel. But there is no textual basis for that.”

“In the absence of text,” Goldblatt said in a message to ABI, “the Court says you read the discharge injunction just like you would any injunction outside of bankruptcy. That is all that he needed to say to resolve this case. Because it is not a case about the automatic stay, it presented no basis to opine on how the automatic stay works.”

Goldblatt therefore concluded, “*Taggart* has nothing at all to do with the automatic stay.” He has argued three bankruptcy cases in the Supreme Court.

Assuming the Court said nothing about automatic stay violations with respect to individuals, what about violations of the stay protecting corporate debtors where there is no statutory standard like 362(k)(1)? Does the absence of a statutory standard for corporate debtors throw the issue back to common law regarding injunctions?

However, the standards may be different, because, as Justice Breyer observed, the automatic stay has a shorter duration and a different purpose in preventing disruptions in the administration of bankruptcy cases.

The high court’s ruling on discharge violations may touch off decades of litigation over the standard for deciding whether someone violated the automatic stay.



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The opinion is *Taggart v. Lorenzen*, 139 S. Ct. 1795, 204 L. Ed. 2d 129 (Sup. Ct. June 3, 2019).





*Bankruptcy needs blanket judicial immunity from the Federal Arbitration Act after the Supreme Court's Schein decision.*

## **Supreme Court Decision on Arbitration Has Ominous Implications for Bankruptcy**

Justice Brett M. Kavanaugh wrote his first opinion for the Supreme Court in what *The New York Times* called a “minor arbitration case.”

If Justice Kavanaugh’s ruling in *Henry Schein Inc. v. Archer & White Sales Inc.* is applied rigorously in bankruptcy, it’s a “really big deal,” because bankruptcy judges will not be able to bar creditors from initiating arbitrations over “core” issues such as allowance of claims, objections to dischargeability of debts, and even adequate protection.

Indeed, *Schein* could be interpreted to mean that the bankruptcy court cannot bar a creditor from initiating arbitration against an individual or corporate debtor, even if the call for arbitration was frivolous.

‘Wholly Groundless’

*Schein* was argued on October 29 and decided for the unanimous Court by Justice Kavanaugh on January 8. By contract, the parties agreed to arbitrate before the American Arbitration Association and according to AAA rules.

Later, the plaintiff filed suit under federal and state anti laws, seeking damages and an injunction. The contract called for arbitration “except for actions seeking injunctive relief . . . .” The rules of the AAA call for the arbitrator to decide issues of arbitrability.

Invoking the Federal Arbitration Act, 9 U.S.C. § 2, the defendant responded to the complaint by asking the district judge to refer the case to arbitration. Adopted in 1925, the FAA provides that a contract calling for arbitration “shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.”

Following Fifth Circuit authority, the district court refused to compel arbitration, finding that the demand for arbitration was “wholly groundless” because the plaintiff was seeking an injunction. The Fifth Circuit affirmed.

The Circuit Split



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The circuits were split. The Fourth, Fifth, Sixth and Federal Circuits have held that a federal court could refuse to compel arbitration if the demand was “wholly groundless.”

The Tenth and Eleventh Circuits ruled to the contrary, holding that the arbitrator alone is entitled to rule on the arbitrability of the dispute, if the contract so provides.

To resolve the split, the Court granted *certiorari* on June 25.

## Justice Kavanaugh's Rationale

In substance, Justice Kavanaugh said the Court had already decided the question. In 2010, the high court ruled that the parties may agree by contract that an arbitrator, not the court, will resolve threshold arbitrability questions, not just the merits of the dispute. *Rent-A-Center West Inc. v. Jackson*, 561 U. S. 63, 68–70 (2010).

Justice Kavanaugh said that “some federal courts nonetheless will short-circuit the process” by deciding the arbitrability question if the demand for arbitration is “wholly groundless.” Those courts, he said, adopted the “wholly groundless” exception to *Rent-A-Center* “to block frivolous attempts to transfer disputes from the court system to arbitration.”

Reversing the Fifth Circuit, Justice Kavanaugh held that the “court possesses no power to decide the arbitrability issue” if “the parties’ contract delegates the arbitrability question to an arbitrator.”

Justice Kavanaugh reaffirmed the principle that a court can decide whether there was a valid arbitration agreement before referring a dispute to arbitration. “But,” he said, “the court may not decide the arbitrability issue” if “a valid agreement exists, and if the agreement delegates the arbitrability issue to an arbitrator.”

Justice Kavanaugh rejected the policy argument that the “wholly groundless” exception is “necessary to deter frivolous motions to compel arbitration.” He said that arbitrators can quickly and efficiently dispose of frivolous cases, imposing costs and attorneys’ fees on the movant “under certain circumstances.”

Because the lower courts had not considered the issue, Justice Kavanaugh remanded the case for the Fifth Circuit to rule on whether the agreement “in fact delegated the arbitrability question to an arbitrator.” He said the judge “should not assume that the parties agreed to arbitrate arbitrability unless there is clear and unmistakable evidence that they did so,” quoting *First Options of Chicago Inc. v. Kaplan*, 514 U.S. 938, 944 (1995).

## Fewer and Fewer Exceptions to Arbitration



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The implications of Justice Kavanaugh's opinion for bankruptcy cases are better understood in the context of the progression of recent Supreme Court authority.

In 1987, the Supreme Court ruled that a court could decline to enforce an arbitration agreement if there was an inherent conflict between arbitration and the statute's underlying purpose. *Shearson/American Express Inc. v. McMahon*, 482 U.S. 220, 227 (1987).

Building on *McMahon*, the Second, Fourth, Fifth and Ninth Circuits have held in bankruptcy cases that the court may decline to compel arbitration if the issue is "core" and arbitration would represent a "severe conflict" with the Bankruptcy Code.

Last year, the Second Circuit utilized that concept to override an arbitration agreement when a debtor mounted a class action contending that the creditor had violated the discharge injunction. *One Bank NA v. Anderson (In re Anderson)*, 884 F.3d 382 (2d Cir. March 7, 2018), *cert. denied* Oct. 1, 2018.

*Anderson* and the other circuit decisions overriding arbitration agreements in bankruptcy cases were all decided before *Epic Systems Corp. v. Lewis*, 138 S. Ct. 1612, 1624 (May 21, 2018), where the Supreme Court held last term that the language of a statute must be "clear and manifest" before a court can disregard an arbitration agreement. In *Epic*, the Supreme Court nixed a class action and required individual arbitration of a former employee's claim that the employer's failure to pay overtime violated the Fair Labor Standards Act.

*Epic* was a 5/4 decision, with the justices divided on ideological grounds.

## Applying *Epic* and *Schein* to Bankruptcy Cases

Assume that a debtor and a creditor had a prebankruptcy agreement to arbitrate all disputes, including any arising in bankruptcy, such as the allowance of claims, counterclaims, preferences, and adequate protection. Further assume that the agreement called for the arbitrator to decide whether the dispute was arbitrable, even following bankruptcy.

If *Epic* and *Schein* were applied rigorously, the bankruptcy judge arguably would have no right to bar the creditor from initiating arbitration. If the dispute raised a core issue — such as the allowance of a claim, dischargeability or adequate protection — the bankruptcy judge might have no power to bar arbitration even if there was a "severe conflict" with bankruptcy law.

A chapter 11 debtor could find itself defending dozens of arbitrations, giving the bankruptcy judge little ability to confirm a plan or avoid liquidation. Or, an individual debtor might be fighting dischargeability in several arbitrations.



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The prospect of arbitrating dischargeability is not fanciful. *See Williams v. Navient Solutions LLC (In re Williams)*, 564 B.R. 770 (Bankr. S.D. Fla. 2017) (debtor compelled to arbitrate student loan dischargeability); *but see Golden v. JP Morgan Chase Bank NA (In re Golden)*, 587 B.R. 414 (Bankr. E.D.N.Y. 2018), and *Roth v. Butler University (In re Roth)*, 18-50097, 2018 BL 427188 (Bankr. S.D. Ind. Nov. 16, 2018) (arbitration of dischargeability of student loan not permitted). For ABI's discussion, [click here](#).

Supreme Court authority on arbitration seems headed to a pivotal case for the justices to decide whether bankruptcy represents a general exception to the enforceability of arbitration agreements.

In that regard, bankruptcy cases have an element not present in *Epic* and *Schein*. The underpinning of the Bankruptcy Code is centrality of administration. Bankruptcy law has always recognized that an individual cannot win a fresh start and a company cannot reorganize if issues related to bankruptcy must be litigated in several forums. Bankruptcy is designed so one judge decides all core disputes. Even if there is a *Stern* problem, the case goes to a district judge in the same courthouse.

*Epic*'s requirement of a statute's "clear and manifest" exception to arbitration may be found in the centrality of administration of bankruptcy cases. And if that's not enough, the most conspicuous feature of bankruptcy is the automatic stay.

Surely, a creditor cannot continue or initiate arbitration without relief from the automatic stay. If the automatic stay is not a "clear and manifest" exception to arbitration, it's hard to imagine what is.

Justice's Kavanaugh's opinion reaffirms the power of courts to determine in the first instance whether an arbitration agreement is valid. An arbitration clause purportedly enforceable in bankruptcy could be viewed as an invalid agreement, just like an agreement is invalid if it waives the automatic stay or precludes the filing of bankruptcy.

But the question remains: Is a contract calling for arbitration of bankruptcy issues an invalid contract that the bankruptcy court can override, or does *Schein* require the bankruptcy court to refer the dispute to an arbitrator who will decide whether bankruptcy questions are arbitrable?

To read ABI's discussion of *Anderson*, [click here](#), [here](#) and [here](#).

The Supreme Court opinion is *Henry Schein Inc. v. Archer & White Sales Inc.*, 139 S. Ct. 524, 202 L. Ed. 2d 480 (Sup. Ct. Jan. 8, 2019).



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## *Decided This Term*





*Building on Bullard, the Supreme Court rules unanimously that a lift-stay motion is a “procedural unit” that’s appealable if the bankruptcy court “conclusively” denies the motion.*

## **Supreme Court Rules that ‘Unreservedly’ Denying a Lift-Stay Motion Is Appealable**

The Supreme Court ruled unanimously today in *Ritzen v. Jackson Machinery* that an order denying a motion to modify the automatic stay is a final, appealable order “when the bankruptcy court unreservedly grants or denies relief.”

In her unanimous opinion for the Court, Justice Ruth Bader Ginsburg said that a lift-stay motion is a “procedural unit” separate from the remainder of the bankruptcy case, even though the decision to retain the stay may be “potentially pertinent to other disputes.”

The decision in *Ritzen* may contain a trap for creditors: A bankruptcy court could deny a creditor the right to appeal, perhaps for an extended time, by denying a lift-stay motion without prejudice or offering to reexamine the result in light of subsequent events.

### The Facts

Before bankruptcy, the creditor had a contract to buy land from the debtor. The deal never closed, and the creditor sued in state court for breach of contract. Before trial, the debtor filed a chapter 11 petition.

In bankruptcy, the creditor moved to modify the stay so that the state court could decide who breached the contract. The bankruptcy court denied the motion. The creditor did not appeal.

The creditor filed a proof of claim, but the bankruptcy court disallowed the claim, ruling that the creditor, not the debtor, had breached the contract. Without objection from the creditor, the bankruptcy court confirmed the debtor’s plan.

The creditor then filed an appeal from denial of the lift-stay motion and from disallowance of the claim. The district court dismissed the stay appeal as untimely and upheld the claim ruling on the merits.



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The Sixth Circuit affirmed. *Ritzen Group Inc. v. Jackson Masonry LLC (In re Jackson Masonry LLC)*, 906 F.3d 494 (6th Cir. Oct. 16, 2018). To read ABI's analysis of the Sixth Circuit's opinion, [click here](#).

The creditor filed a petition for *certiorari*, contending there was a split of circuits. The Supreme Court granted *certiorari* in May. The case was argued on November 13.

## Bankruptcy Isn't Like Ordinary Litigation

Appealability is governed by 28 U.S.C. § 158(a), which gives district courts jurisdiction over appeals from “final judgments, orders, and decrees . . . in cases and proceedings referred to bankruptcy judges . . . .”

Justice Ginsburg acknowledged that ordinary rules of finality are “not attuned to the distinctive character of bankruptcy litigation.” Bankruptcy, she said, is “an aggregation of individual controversies,” quoting the *Collier* treatise. She explained why appeals from individual controversies cannot await resolution of the entire bankruptcy case.

The outcome was guided, if not controlled, by *Bullard v. Blue Hills Bank*, 575 U.S. 496 (2015), where the Supreme Court held that denial of confirmation of a chapter 13 plan is not a final, appealable order. She paraphrased *Bullard* as holding that bankruptcy court orders are final when they “definitively dispose of discrete disputes within the overarching bankruptcy case.”

To be final under *Bullard*, an order must alter the *status quo* and fix the rights and obligations of the parties, Justice Ginsburg said.

Justice Ginsburg framed the question as whether denial of a lift-stay motion is a “distinct proceeding” that terminates “when the bankruptcy court rules dispositively on the motion.” She said that a majority of courts and leading treatises say that denial of a lift-stay motion is immediately appealable.

Addressing the facts of the case on appeal, Justice Ginsburg said that the lift-stay motion was “a procedural unit anterior to, and separate from, claim-resolution proceedings.” Stay relief, she said, “occurs before and apart from proceedings on the merits of creditors’ claims.”

Of potential significance in the future on questions about the finality of other types of orders, Justice Ginsburg said that resolution of a stay motion “can have large practical consequences.” For example, leaving the stay in place may “delay collection of a debt or cause collateral to decline in value.”

The decision by Justice Ginsburg is a categorical ruling. She saw “no good reason to treat stay adjudication as the relevant ‘proceeding’ in only a subset of cases.” Quoting Supreme Court



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authority in another context, she said that finality “should ‘be determined for the entire category to which a claim belongs.’ *Digital Equipment Corp. v. Desktop Direct Inc.*, 511 U.S. 863, 868 (1994).”

Justice Ginsburg left little room for contending that denial of a lift-stay motion can sometimes be non-final. She said it “does not matter whether the court rested its decision on a determination potentially pertinent to other disputes in the bankruptcy case, so long as the order conclusively resolved the movant’s entitlement to the requested relief.”

In a footnote at the end of the opinion, Justice Ginsburg said the Court was not deciding whether denial of a motion without prejudice would be final if the bankruptcy court was awaiting “further developments [that] might change the stay calculus.”

Affirming the judgment of the Sixth Circuit, Justice Ginsburg held that the stay-relief motion was the “appropriate ‘proceeding.’” The order “conclusively denying” the motion was final, she said, because the “court’s order ended the stay-relief adjudication and left nothing more for the Bankruptcy Court to do in that proceeding.”

## Observation

At first blush, the opinion seems beneficial for creditors by assuring them of their right to appeal denials of lift-stay motions. In practice, however, *Ritzen* can be used against creditors.

Suppose the bankruptcy court denies a lift-stay motion without prejudice, saying that unfolding events might persuade the court to modify the stay. Denial of a motion without prejudice could therefore cut off the ability to appeal, exerting leverage in favor of the debtor and persuading the creditor to settle.

In upcoming years, courts may be called upon to grapple with the question of whether denial without prejudice may sometimes have the trappings of a final order.

[The opinion is](#) *Ritzen Group Inc. v. Jackson Masonry LLC*, 18-938, 2020 BL 11881 (Sup. Ct. Jan. 14, 2020).



*The 'fraud-specific discovery rule' might permit FDCPA suits filed more than one year after the occurrence that gives rise to the claim.*

## **Supreme Court Might Allow FDCPA Suits More than a Year After Occurrence**

While closing one door, the Supreme Court opened another door today for debtors to argue that the statute of limitations does not begin to run until discovery of the existence of a claim under the federal Fair Debt Collection Practices Act, or FDCPA, 15 U.S.C. § 1692-1692p.

In 2008, a debt collector filed suit on a defaulted credit card debt. Later that year, the debt collector withdrew the suit because the complaint had been served on someone who was not the debtor at a home where the debtor was no longer living.

In 2009, the debt collector sued a second time, again serving someone not the debtor at the same address where the debtor was no longer living. There being no answer, the debt collector got a default judgment.

The debtor did not learn about the second suit until 2014, when he was denied a mortgage on account of the default judgment. Less than one year after discovery, the debtor filed suit, raising a claim under the FDCPA because the debt was allegedly time-barred. He contended that the one-year statute of limitations under the FDCPA was equitably tolled because the debt collector used a manner of service designed to ensure that the debtor would not receive service.

### The Circuit Split

The district court dismissed the suit under the statute of limitations and was upheld in the Third Circuit. The Supreme Court granted *certiorari* to resolve a split of circuits.

In 2009, the Ninth Circuit had applied the so-called discovery rule in holding that limitations periods in federal practice generally begin to run when the plaintiff knows or has reason to know of the injury. *Mangum v. Action Collection Serv., Inc.*, 575 F.3d 935 (9th Cir. 2009).

*En banc*, the Third Circuit rejected the Ninth Circuit's holding by ruling that the statute begins to run when the violation occurs.

### The Majority Opinion



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Ostensibly, the case was governed by Section 1692k(d) of the FDCPA, which provides that suit must be brought “within one year from date on which the violation occurs.”

Justice Clarence Thomas upheld the judgment of the Third Circuit in an opinion on December 10. Based on “dictionary definitions” of the words “violation” and “occurs,” he said that the statute “unambiguously sets the date of the violation as the event that starts the one-year limitations period.”

Justice Thomas described the Ninth Circuit’s “discovery rule” as a “bad wine of recent vintage,” citing a concurring opinion by the late Justice Antonin Scalia. According to Justice Thomas, “A textual judicial supplementation is particularly inappropriate when, as here, Congress has shown that it knows how to adopt the omitted language or provision.”

In his brief, the debtor argued for the Court to follow a fraud-specific discovery rule with roots in 19th century Supreme Court precedent. *Bailey v. Glover*, 21 Wall. 342 (1875).

Justice Thomas did not reach the fraud-specific discovery rule. He said the debtor had not preserved the issue in the Ninth Circuit and did not raise the question in his petition for *certiorari*.

## The Ginsburg Dissent

Justice Ruth Bader Ginsburg dissented from the judgment affirming the Third Circuit. She believes the debtor had preserved the issue in the appeals court and adequately raised the question in the *certiorari* petition.

Justice Ginsburg described the debt collector as having “employed fraudulent service to obtain and conceal the default judgment that precipitated [the debtor’s] FDCPA claim.”

“That allegation, if proved,” she said, “should suffice under the fraud-based discovery rule, to permit adjudication of [the debtor’s] claim on its merits.”

## The Sotomayor Concurrence

For future litigation on the FDCPA’s statute of limitations, the concurring opinion by Justice Sonia Sotomayor is the most significant.

Justice Sotomayor agreed with the majority that the statute “typically” begins to run when the violation occurs, not when the debtor discovers the violation.

Unlike Justice Ginsburg, Justice Sotomayor also agreed with the majority that the debtor had not preserved the “equitable, fraud-specific discovery rule” in the Third Circuit. She therefore concurred in the judgment.





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Justice Sotomayor wrote separately, she said, “to emphasize that this fraud-specific equitable principle is not the ‘bad wine of recent vintage’ of which my colleagues speak.” Rather, she said, “the Court has long ‘recogni[zed]’ and applied this ‘historical exception for suits based on fraud.’”

Justice Sotomayor ended her concurrence by telling future litigants that “[n]othing in today’s decision prevents parties from invoking that well-settled doctrine.”

[The opinion is](#) *Rotkiske v. Klemm*, 205 L. Ed. 2d 291 (Sup. Ct. Dec. 10, 2019).



## *Cases Argued So Far This Term*



*Circuits are split on whether a tax refund presumptively goes to the subsidiary that created the losses giving rise to the refund.*

## **Supreme Court to Tackle a Bankruptcy Tax Refund Circuit Split**

To resolve a split of circuits, the Supreme Court has granted *certiorari* to decide whether state or federal law governs the ownership of tax refunds when a subsidiary generated the losses but the government pays the refund to the bankrupt corporate parent.

The issue came to the fore in the wake of the banking crisis beginning some 10 years ago. A bank would fail and be taken over by the Federal Deposit Insurance Corporation, or FDIC. The bank's parent holding company often would end up in bankruptcy.

The parent and subsidiary typically would have a prebankruptcy tax allocation agreement, or TAA, calling for the parent holding company to file a consolidated tax return for the corporate group. Usually, the failed bank would have incurred the losses giving rise to a tax refund. However, the Internal Revenue Service would pay the refund to the parent corporation as the entity that filed the tax return.

When the tax refund arrives from the IRS, does the bankrupt parent keep the cash, or does it go to the FDIC as receiver for the failed bank? That's where the courts are split.

### The Two Results

Courts resolved the question by employing two conflicting methodologies leading to different results.

The first group of courts employ state law to decide who keeps the refund. Sometimes, the TAA would create a valid or agency arrangement under state law. In those cases, the refund would not be property of the bankrupt estate of the parent holding company. Consequently, the refund would end up in the hands of the FDIC.

When the TAA did not create a or agency relationship, the first group of courts would conclude that the TAA resulted in a debtor/creditor relationship between the parent and the subsidiary. In those cases, the first group of courts would conclude that the FDIC had nothing more than an unsecured claim against the bankrupt parent. Creditors of the bankrupt parent, sometimes



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bondholders, would benefit because the parent might otherwise have precious few assets aside from the tax refund.

The second group of courts employ the so-called *Bob Richards* rule, derived from a Ninth Circuit opinion in 1973. *In re Bob Richards Chrysler-Plymouth Corp.*, 473 F.2d 262 (9th Cir. 1973). Those courts adopted a presumption — evidently a creation of federal common law — that the subsidiary with the losses is presumptively entitled to the refund absent a TAA that clearly gives the refund to the parent.

Under the same set of facts, the FDIC would come out on top in courts following the *Bob Richards* presumption.

The split worked out like this: The Fifth, Ninth and Tenth Circuits follow *Bob Richards*. Naturally, the FDIC does too.

The Second, Third, Sixth and Eleventh Circuits reject *Bob Richards* and employ state law to decide who owns the refund and whether the TAA creates an unsecured debtor/creditor relationship.

## The Case on *Certiorari*

In the case to be heard in the Supreme Court, the parent holding company ended up in chapter 7 with a ee. The bank subsidiary was taken over by the FDIC, as receiver. The bank subsidiary's losses resulted in a \$4 million tax refund payable to the parent under a TAA.

The bankruptcy court in Colorado granted summary judgment in favor of the holding company's trustee. Finding that the TAA did not create a or agency under Colorado law, the bankruptcy court believed the parent and subsidiary had a debtor/creditor relationship under the TAA, meaning that the parent was the owner of the tax refund.

The district court reversed, believing that the Tenth Circuit had previously adopted *Bob Richards*. The Tenth Circuit affirmed, ruling that the case was governed by federal common law, not state law, unless the TAA unambiguously specified where the refund would go. Because the TAA did not unambiguously favor the holding company, the refund went to the FDIC as receiver.

Citing the split of circuits, the bankruptcy trustee filed a petition for *certiorari* in April. The justices of the Supreme Court considered the petition at two conferences and granted *certiorari* on June 27. The case will be argued in the term to begin in October. The date for argument has not been set as yet.

## How Will the Justices Rule?



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In recent years, the Supreme Court has often resolved bankruptcy cases based on textualism, limitations on the powers of federal courts or deference to state law.

In *Butner v. U.S.*, 440 U.S. 48 (1979), the Supreme Court ruled that state law determines the nature and extent of a debtor's property interests. If the justices adhere to *Butner*, they may invoke state law, reverse the Tenth Circuit, overrule *Bob Richards*, and reinstate the judgment of the Colorado bankruptcy court giving the refund to the parent holding company.

The bankruptcy trustee also argues that courts adopting *Bob Richards* disregarded the rules for creating federal common law. According to the trustee, the Supreme Court requires a "significant conflict between some federal policy or interest and the use of state law" before a court is entitled to create federal common law. *O'Melveny & Myers v. FDIC*, 512 U.S. 79, 87 (1994).

Of course, the bankruptcy trustee sees no significant conflict with federal policy and thus no reason to adopt the *Bob Richards* presumption.

It is not entirely clear to this writer that the Supreme Court will reach the *Bob Richards* issue. Arguing on behalf of the FDIC, the U.S. Solicitor General contends that the Tenth Circuit applied Colorado law in concluding that the refund belonged to the FDIC. If the justices are persuaded that the Tenth Circuit invoked state law and did not rely on the *Bob Richards* presumption, the Court might dismiss the *certiorari* petition as having been improvidently granted.

## The Significance of the Outcome

Obviously, the outcome in the Supreme Court will be significant in the liquidation of banks by the FDIC. In chapter 11 reorganizations of large non-bank companies with multiple debtors, the ruling by the high court will affect valuations underpinning the treatment of creditor classes under chapter 11 plans.

[The case in the Supreme Court is \*Rodriguez v. Federal Deposit Insurance Corp.\*, 18-1269.](#) *cert. granted* June 27, 2019 (Sup. Ct.).





*At oral argument, the justices seemed to recognize that Rodriguez v. FDIC does not raise the question of whether the lower courts relied on federal common law in deciding the ownership of a tax refund.*

## **The Supreme Court May Duck a Case Involving Federal Common Law vs. State Law**

To resolve a split of circuits, the Supreme Court granted *certiorari* in *Rodriguez v. Federal Deposit Insurance Corp.*, 18-1269 (Sup. Ct.), to decide whether state law or federal common law decides who owns a tax refund when a parent holding company files a tax return but a subsidiary generated the losses giving rise to the refund.

The case was an opportunity for the justices to lay down rules prescribing limits on the ability of federal courts to create federal common law in derogation of state law. As it turned out at oral argument on December 3, the Court may never reach the question for which the justices granted *certiorari*.

Why duck an important question? Because neither side defended federal common law, known as the *Bob Richards* rule. Instead, the case boils down to a question of whether the Tenth Circuit correctly applied state law, and the Supreme Court is not in the business of ruling on disputes about the application of state laws.

As Justice Ruth Bader Ginsburg said a few minutes into oral argument, the question of the validity of federal common law “has vanished from the case.” She and several other justices suggested that the Court may end up dismissing the *certiorari* petition as having been improvidently granted.

### The Facts

The holding company for a bank ended up in chapter 7 with a trustee. The bank subsidiary was taken over by the Federal Deposit Insurance Corp. as receiver. The bank subsidiary’s losses resulted in a \$4 million tax refund payable to the parent under a pre-bankruptcy tax allocation agreement, or TAA, between the parent and the bank subsidiary.

The refund arrived after the holding company’s bankruptcy, thus raising the question of whether the holding company owned the refund, leaving the FDIC with nothing more than an unsecured claim.



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The bankruptcy court in Colorado granted summary judgment in favor of the holding company's trustee. Finding that the TAA did not create a trust or agency under Colorado law, the bankruptcy court believed the parent and subsidiary had a debtor/creditor relationship under the TAA, meaning that the parent was the owner of the tax refund. In the opinion of the bankruptcy court, the FDIC only had an unsecured claim for the refund.

On appeal, the district court concluded that the Tenth Circuit had previously adopted the *Bob Richards* rule, first enunciated by the Ninth Circuit in *In re Bob Richards Chrysler-Plymouth Corp.*, 473 F.2d 262 (9th Cir. 1973). *Bob Richards* adopted a presumption — evidently a creation of federal common law — that the subsidiary with the losses is presumptively entitled to the refund absent a TAA that clearly gives the refund to the parent.

The district court, however, went on to analyze the TAA and found provisions supporting a ruling in favor of the holding company and other provisions where the bank subsidiary would come out on top. The district court ended up relying on tie-breaking language in the TAA that resolves ambiguity in favor of the bank subsidiary. The district court therefore reversed and awarded the refund to the FDIC.

The Tenth Circuit affirmed the district court, first saying that the appeals court had adopted *Bob Richards* in handing down *Barnes v. Harris*, 783 F.3d 1185 (10th Cir. 2015).

Unlike *Barnes* and *Bob Richards*, the Tenth Circuit said that the case on appeal had a written agreement, namely, the TAA. Construing the TAA, the appeals court ruled that the tie-breaking provision had the effect of creating an agency relationship. The holding company was only an agent for the bank, thus giving ownership of the refund to the FDIC.

Upholding the district court, the Tenth Circuit created ambiguity about the basis for its ruling by saying at the end of the opinion that the result did not differ from the rule in *Barnes* and *Bob Richards*.

The holding company's trustee filed a petition for *certiorari* in April. The Court granted the petition at the end of June to answer the one question presented: Does federal common law (*Bob Richards*) or state law determine the ownership of a tax refund?

On the question presented, the circuits are split 3/4. The Fifth, Ninth and Tenth Circuits follow *Bob Richards*, while the Second, Third, Sixth and Eleventh Circuits reject *Bob Richards* and employ state law to decide who owns a refund and whether the TAA creates an unsecured debtor/creditor relationship.

## Oral Argument



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Speaking first, the attorney for the holding company's trustee correctly stated that the FDIC abandoned any defense of *Bob Richards*. The first among the justices to speak, Justice Ginsburg observed that the Tenth Circuit decided the case based on state law, not *Bob Richards*.

Given that the case below was decided on state law and the FDIC was not defending *Bob Richards*, Justice Ginsburg said that the question presented "has vanished from the case." Likewise, Justice Stephen G. Breyer said that the question of federal common law "seems to have evaporated."

Justice Sonia Sotomayor was on the same page, observing that the case had become a question of whether the lower courts correctly applied state law. With no one defending *Bob Richards*, she said, "we need adversarial testing before we reach questions that are implicated by the issues before us."

Similarly, Justice Ginsburg said, "we usually don't decide an abstract" question when there is a lack of "adversarial confrontation." Justice Elena Kagan said there was a "good probability" that the Court would have appointed an *amicus* had the justices known no one would defend *Bob Richards*.

Arguing for the FDIC, the U.S. Solicitor General said the Court would be issuing an "advisory opinion" were it to rule on *Bob Richards*.

It is not clear whether the Court will dismiss the petition as improvidently granted, or DIG in the parlance of Court observers. Several justices seemed primed to strike down *Bob Richards*. Justice Brett M. Kavanaugh said the federal common law was "patently indefensible." Similarly, Justice Neil M. Gorsuch said the outcome should be determined by state law, without "any thumb on the scale by federal common law."

The Solicitor General agreed, saying that *Bob Richards* is not "a correct rule of federal common law."

Justice Gorsuch appeared inclined to reach the merits. He said, "it would be of material benefit" if courts around the country knew that *Bob Richards* is not good law. However, Justice Gorsuch recently demonstrated a disinclination to rule on theoretical issues.

Last term in *Mission Product Holdings Inc. v. Tempnology LLC*, 587 U.S. \_\_\_, 203 L. Ed. 2d 876 (May 20, 2019), he dissented and said the petition should have been dismissed for having been improvidently granted. In his view, the case was moot because effective relief could not be granted in the event of reversal.

Procedurally, the Court has several options. The justices could 'DIG' the petition, in which event the decision below will stand, and the circuit split will theoretically endure. Or, the Court



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could overrule *Bob Richards* and remand for the Tenth Circuit to review the case without reliance on *Bob Richards*.

Naturally, the FDIC would wish for the Court to affirm. In that instance, the Court would be ruling that the Tenth Circuit properly applied state law.

Or, without passing on *Bob Richards*, the Court could remand for the Tenth Circuit to clarify whether it was relying on federal common law.

Mitchell P. Reich, a senior associate with Hogan Lovells US LLP in Washington, D.C., argued for the trustee. It was his first argument in the Supreme Court. Reich was a clerk for Justice Kagan. Assistant to the Solicitor General Michael R. Huston argued for the FDIC.

*The case is [Rodriguez v. Federal Deposit Insurance Corp.](#), 18-1269 (Sup. Ct.).*



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*Case Still to Be Argued This Term*





*Virginia case highlights the damage that will be done to debtor protections if affirmative action is required for a stay violation.*

## **Supreme Court Grants 'Cert' to Decide Whether Inaction Violates the Automatic Stay**

Yesterday, the Supreme Court granted *certiorari* in *City of Chicago v. Fulton*, [19-357](#) (Sup. Ct.), to resolve a circuit split and decide whether inaction can violate the automatic stay under Section 362(a). The case will likely be argued and decided before the high court's term ends in late June.

An opinion by Bankruptcy Judge Brian F. Kenney of Alexandria, Va., demonstrates how the Supreme Court could dramatically impair the efficacy of bankruptcy by ruling that creditors are not required to unwind actions they have already taken when notified of bankruptcy.

### The Prebankruptcy Garnishment

Former matrimonial counsel had a judgment against the debtor for more than \$10,000. The law firm had obtained a garnishment order under which \$1,000 was being held by the clerk of the state court after having been deducted from the debtor's wages. A hearing was scheduled in state court to rule on turning the garnished funds over to the firm as the judgment creditor.

One month before the hearing in state court, the debtor filed a chapter 7 petition, listed the judgment as a debt, gave notice of the filing to the judgment creditor, claimed an exemption in the \$1,000, and filed a suggestion of bankruptcy in the state court.

Claiming to have performed legal research, the judgment creditor responded to the debtor by saying he was unaware of any obligation to take affirmative action to terminate the garnishment. The judgment creditor said he would appear in state court on the return date, where he expected the state court judge would rule "as the Court deems appropriate."

[N.B. The judgment creditor's research must have been incomplete, because there was a prior ruling by a district court in that district imposing an affirmative duty on a creditor to discontinue an action after the defendant's bankruptcy filing.]

Prior to the return date in state court, the debtor filed a motion for the creditor to be held in contempt for willful violation of the automatic stay under Section 362(k)(1). Before the hearing on the contempt motion, the clerk of the state court returned the garnished funds to the debtor's



employer. In his December 16 opinion, Judge Kenney said the money would “presumably” be returned to the debtor in her next paycheck.

## The Circuit Split

On the question of contempt, Judge Kenney said that “the issue of a refusal to release seized property upon a bankruptcy filing is now the subject of some controversy in the case law,” citing, among others, *In re Fulton*, 926 F.3d 916 (7th Cir. June 19, 2019), and *In Denby-Peterson*, 941 F.3d 115 (3d Cir. Oct. 28, 2019).

Judge Kenney explained how the circuits are split when it comes to deciding whether a secured creditor must turn over repossessed property immediately or face a contempt citation. Led by *Fulton*, the Second, Seventh, Eighth, Ninth and Eleventh Circuits impose an affirmative duty on creditors to turn over repossessed property after a filing. With *Denby-Peterson* as the most recent authority to the contrary, the Third, Tenth and District of Columbia Circuits have held that the retention of property only maintains the *status quo*. For those three circuits, a stay violation requires an affirmative action. Simply holding property is not an affirmative act, in their view.

To resolve the circuit split, the Supreme Court granted *certiorari* to review *Fulton*. To read ABI’s discussion of the Seventh Circuit decision, [click here](#). For ABI’s report on *Denby-Peterson*, [click here](#).

## Judge Kenney Sides with the Majority

Judge Kenney was persuaded to follow the majority and *Fulton*. He ruled that the creditor “violated Section 362(a)(3) by continuing to exercise control over the garnished funds post-petition.” He prominently relied on *U.S. v. Whiting Pools, Inc.*, 462 U.S. 198 (1983), where the Supreme Court held that the estate has a “possessory interest in certain property of the debtor that was not held by the debtor at the commencement of reorganization proceedings.” *Id.* at 207.

Compared to *Fulton*, Judge Kenney said that the case before him was more easily resolved in favor of the debtor because the law firm did not claim to have either an ownership interest in or lien against the garnished funds in the hands of the clerk of the state court. He understood “the ordinary and plain reading of the phrase ‘to exercise control’ to preclude the creditor’s refusal to release the Debtor’s funds from a pre-petition garnishment.”

Judge Kenney decided that the debtor was entitled to damages because there was a stay violation committed willfully. He declined to impose punitive damages under Section 362(k)(1), since the stay violation was neither egregious nor malevolent.

In terms of damages, the debtor claimed none other than the \$2,400 in attorneys’ fees incurred in prosecuting the motion to recover garnished wages. Judge Kenney awarded the \$2,400 because



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the fees were incurred “in enforcing the Debtor’s legal right to the release of her property.” He noted that the contempt motion was not brought merely to “or even primarily” to recover attorneys’ fees.

## Inaction as a Stay Violation

Judge Kenney was surely correct in one respect: His case presented more persuasive facts for a stay violation because the creditor claimed neither ownership nor a lien on the garnished funds. However, it is possible that the Supreme Court will rule in *Fulton* that mere inaction violates neither the automatic stay nor the command to turn over estate property under Section 542(a). The case before Judge Kenney was a classic example of inaction.

If the Supreme Court rules that inaction does not violate the stay, a debtor in a case like Judge Kenney’s could not or would not pursue a turnover of \$1,000 in garnished wages when her counsel fees would be \$2,400.

In deciding *Fulton*, one hopes the justices will grasp the implications of their ruling. If a stay violation requires an affirmative action by a creditor, many debtors will be unable to enforce rights given them by the Bankruptcy Code because (1) lawyers will not take cases on a contingency, or (2) the debtors will be unable to pay counsel fees.

## The *Fulton Certiorari* Petition

The creditor in *Fulton* filed a petition for *certiorari* in September. The justices considered the petition at a conference on December 16 and issued an order on December 18 granting the petition.

The creditor who lost in *Denby-Peterson* could also file a petition for *certiorari* in upcoming weeks. Conceivably, the Court could hear *Denby-Peterson* alongside *Fulton*. More likely, however, the Court will defer action on a *Denby-Peterson* petition until the justices decide *Fulton*.

Any opinions are those of the writer, not ABI.

[The Virginia opinion is](#) *In re Nimitz*, 19-12741 (Bankr. E.D. Va., Dec. 16, 2019).



*Disagreeing with the Tenth and D.C. Circuits and siding with four other circuits, the Seventh Circuit rules that passively holding estate property violates the automatic stay.*

## **Seventh Circuit Solidifies a Circuit Split on the Automatic Stay**

Solidifying a split of circuits, the Seventh Circuit ruled that the City of Chicago must comply with the automatic stay by returning impounded cars immediately after being notified of a chapter 13 filing.

The decision lays the foundation for the Supreme Court to grant *certiorari* and decide whether violation of the automatic stay requires an affirmative action or whether inaction amounts to control over estate property and thus violates the stay.

The Second, Seventh, Eighth, Ninth and Eleventh Circuits hold that a secured creditor or owner must turn over repossessed property immediately or face a contempt citation. The Tenth and the District of Columbia Circuits have ruled that passively holding an asset of the estate in the face of a demand for turnover does not violate the automatic stay in Section 362(a)(3), which prohibits “any act . . . to exercise control over property of the estate.”

The same issue was argued on May 23 in the Third Circuit, where the lower courts were siding with the minority. See *Denby-Peterson v. NU2U Auto World*, 18-3562 (3d Cir.). For ABI’s report on *Denby*, [click here](#).

### The Impounded Cars in Chicago

Four cases went to the circuit together. The facts were functionally identical.

The chapter 13 debtors owed between \$4,000 and \$20,000 on unpaid parking fines. Before bankruptcy, the city had impounded their cars. Absent bankruptcy, the city will not release impounded cars unless the fines are paid. If the cars are not redeemed by their owners, most of them are scrapped.

In 2016, Chicago passed an ordinance giving the city a possessory lien on impounded cars.

After filing their chapter 13 petitions, the debtors demanded the return of their autos. The city refused to release the cars unless the fines and other charges were paid in full.





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The debtors mounted contempt proceedings in which four different bankruptcy judges held that the city was violating the automatic stay by refusing to return the autos. After being held in contempt, the city returned the cars but appealed.

In all four cases, the owners confirmed chapter 13 plans treating the city as holding unsecured claims. The city did not object to confirmation or appeal.

In the four cases, the city never sought adequate protection for its alleged security interests under Section 363(e).

## *Thompson Controls*

Circuit Judge Joel M. Flaum was not writing on a clean slate in his June 19 opinion, given the circuit's controlling precedent in *Thompson v. General Motors Acceptance Corp.*, 566 F.3d 699 (7th Cir. 2009). *Thompson*, he said, presented "a very similar factual situation."

Although *Thompson* came down only 10 years ago, Judge Flaum nonetheless wrote a comprehensive, 27-page opinion, perhaps sensing that the case will go to the Supreme Court on *certiorari*.

In *Thompson*, Judge Flaum said, "we held that a creditor must comply with the automatic stay and return a debtor's vehicle upon her filing of a bankruptcy petition. We decline the City's request to overrule *Thompson*." He also agreed with the bankruptcy courts "that none of the exceptions to the stay apply."

Quoting extensively from *Thompson*, Judge Flaum said that the Seventh Circuit had already "rejected" the city's contention that "passively holding the asset did not satisfy the Code's definition of exercising control." He noted that Congress amended Section 362 in 1984 by adding subsection (a)(3) and making the automatic stay "more inclusive by including conduct of 'creditors who seized an asset pre-petition,'" citing *U.S. v. Whiting Pools Inc.*, 264 U.S. 198, 203-204 (1983).

Again citing *Whiting Pools*, Judge Flaum said that Section 362(a)(3) "becomes effective immediately upon the filing of the petition and is not dependent on the debtor first bringing a turnover action." He added, the "creditor . . . has the burden of requesting protection of its interest in the asset under Section 363(e)."

Judge Flaum found support for his conclusion in Section 542(a). Again quoting *Thompson*, he said the section "indicates that turnover of a seized asset is compulsory." *Thompson, supra*, at 704.





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“Applying *Thompson*,” Judge Flaum held “that the City violated the automatic stay . . . by retaining possession . . . after [the debtors] declared bankruptcy.” The city, he said, “was not passively abiding by the bankruptcy rules but actively resisting Section 542(a) to exercise control over the debtors’ vehicles.”

Telling Chicago how to proceed in the future, Judge Flaum said the city must turn over the car and may seek adequate protection on an expedited basis. The burden of seeking adequate protection, he said, “is not a reason to permit the City to ignore the automatic stay and hold captive property of the estate, in contravention of the Bankruptcy Code.”

In sum, Judge Flaum declined the city’s invitation to overrule *Thompson*. He said, “Our reasoning in *Thompson* continues to reflect the majority position and we believe it is the appropriate reading of the bankruptcy statutes.”

## Exceptions to the Automatic Stay

Judge Flaum devoted the last third of his opinion to explaining why Chicago was not eligible for any of the exceptions to the automatic stay.

Section 362(b)(3), allowing acts to perfect or continue perfection of liens, does “not permit creditors to retain possession of debtors’ property,” Judge Flaum said. Rather, it allows creditors to file notices to continue or perfect a lien when bankruptcy has intervened. The city, he said, could perfect its possessory lien by a filing with the Secretary of State.

Judge Flaum cited Illinois decisions holding that giving up possession involuntarily does not destroy a possessory lien. The notion that turning over cars would abrogate the possessory lien was one of Chicago’s primary arguments on appeal.

Judge Flaum held that Section 362(b)(4), excepting police or regulatory powers from the automatic stay, did not apply. On balance, he said, the municipal machinery to impound cars “is an exercise of revenue collection more so than police power.”

## Is *Certiorari* Next?

In the term that ends this month, the Supreme Court denied a petition for *certiorari* raising the same question. See *Davis v. Tyson Prepared Foods Inc.*, [18-941](#) (Sup. Ct.) (cert. denied May 20, 2019).

*Davis*, from the Tenth Circuit, was a challenge to the Tenth Circuit’s holding in *WD Equipment v. Cowen (In re Cowen)*, 849 F.3d 943 (10th Cir. Feb. 27, 2017). In *Cowen*, the Tenth Circuit ruled that passively holding an asset of the estate in the face of a demand for turnover does not violate



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the automatic stay in Section 362(a)(3) as an act to “exercise control over property of the estate.” To read ABI’s discussion of the denial of *certiorari*, [click here](#).

In this writer’s opinion, the Chicago parking ticket cases are a better vehicle for *certiorari* because they raise the issue more cleanly. *Davis* was a step or two removed from the question of whether overt action is required to violate the automatic stay.

Given the recent change in administration in Chicago, it is not certain that the city will pursue *certiorari*.

Eric Brunstad told ABI, “The issue is certainly not going away. I predict that eventually the Supreme Court will grant *certiorari* in a case involving the issue and resolve the conflict among the courts of appeals.” Brunstad represented the debtor who unsuccessfully sought Supreme Court review in *Davis*.

[The opinion is](#) *In re Fulton*, 926 F.3d 916 (7th Cir. June 19, 2019).



*Third Circuit also holds that turnover in Section 542(a) is not automatic. The debtor must mount an adversary proceeding to obtain a turnover of property.*

## **Circuit Split Widens on the Automatic Stay and Turnover of Repossessed Cars**

Taking sides with the minority in a circuit split, the Third Circuit held that the automatic stay in Section 362(a) does not require a secured creditor to turn over repossessed property immediately or face a contempt citation.

The Philadelphia-based appeals court went on to hold that a creditor is not required to turn over property under Section 542(a) unless the debtor has mounted an adversary proceeding and filed a complaint demanding turnover.

The appeals court found the answers in the language and purpose of the statute.

The identical issue is now before the Supreme Court on a pending petition for *certiorari* to the Seventh Circuit in *City of Chicago v. Fulton*, 19-357 (Sup. Ct.). The petition was filed in September. The response is due November 18. We may know before the year's end whether the justices will take the case and resolve the split. As it now stands, five circuits hold that a creditor violates the automatic stay by not turning over property on request after notice of filing. Three circuits believe that inaction does not violate the stay.

### The Facts

The facts in the Third Circuit case were typical. The debtor had purchased a car but defaulted on payments to the lender. Before bankruptcy, the lender repossessed the car.

After filing, the debtor demanded that the lender turn over the car. When the lender did not comply, the debtor filed a turnover motion in bankruptcy court and sought the imposition of sanctions under Section 362(k) for willful violation of the automatic stay.

Bankruptcy Judge Andrew B. Altenburg, Jr., of Camden, N.J., directed the lender to turn over the auto, assuming the debtor could show proof of insurance. Predicting how the Third Circuit would rule, he followed the minority and denied the motion for sanctions, holding that the lender had not violated the automatic stay.



Also predicting how the Third Circuit would come down, District Judge Noel L. Hillman, also of Camden, upheld Judge Altenburg in an opinion in November 2018. To read ABI's report, [click here](#).

## Stay Violation Requires an Affirmative Act

In his October 28 opinion, Circuit Judge Fuentes Julio M. Fuentes was answering a case of first impression in the circuit. He said that the Second, Seventh, Eighth, Ninth and Eleventh Circuits would find a stay violation in the circumstances, while the Tenth and District of Columbia Circuits would not.

The case turned on Section 362(a), which “operates as a stay . . . of . . . (3) any act . . . to exercise control over property of the estate.” Applied to the case at hand, Judge Fuentes found no ambiguity in the statute.

For Judge Fuentes, the critical words were “control” and “exercise.” From dictionary definitions, he deduced that Section 362(a)(3) “prohibits creditors from taking any affirmative act to exercise control over property of the estate.” In other words, he said, “the text of Section 362(a)(3) requires a post-petition affirmative act to exercise control over property of the estate.”

In the case on appeal, Judge Fuentes said that retaining possession of the car was not a post-petition affirmative act.

Beyond the language of the statute, Judge Fuentes said that his conclusion was in accord with “the legislative purpose and underlying policy goals of the automatic stay.” The “primary purpose” of the stay, he said, is “to maintain the *status quo*.”

By retaining possession of the car, Judge Fuentes said that the lender was maintaining the *status quo*. Holding otherwise, he said, “would directly contravene the *status quo* aims of the automatic stay.” Congress, in his view, “did not intend passive retention to qualify” as an act to exercise control of estate property.

Judge Fuentes rejected the debtor's argument based on the 1984 amendments, which added the “exercise control” language. The amendment carried no weight, he said, because there was no legislative history explaining the intent of Congress.

## Section 542(a) Doesn't Help

The debtor argued that Section 362(a)(3) operates hand in glove with Section 542(a), which says that someone in possession or control of estate property “shall deliver” the property to the trustee. To the debtor's way of thinking, the word “shall” means the person in control of property must turn it over automatically, without court compulsion.



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To the contrary, Judge Fuentes said that turnover under Section 542(a) “is not self-effectuating; in other words, a creditor’s obligation to turn over estate property to the debtor is not automatic.”

“Rather,” Judge Fuentes said, “the turnover provision requires the debtor to bring an adversary proceeding in Bankruptcy Court in order to give the Court the opportunity to determine whether the property is subject to turnover under Section 542(a).”

As it was with the automatic stay, Judge Fuentes said that “the plain language” of Section 542(a) “also shows that the provision is not self-effectuating.” That is to say, the “shall” language, he said, “is mandatory in the context of an adversary proceeding presided over by the Bankruptcy Court.”

Because the lender elected not to participate in the appeal, the Third Circuit tapped Craig Goldblatt of Wilmer Cutler Pickering Hale & Dorr LLP in Washington, D.C., to submit a brief and argue on behalf of the lender. Coincidentally or not, Mr. Goldblatt is counsel for the petitioner for *certiorari* in *Fulton*. Mr. Goldblatt has argued three cases in the Supreme Court.

## Observations

This writer interprets the opinion to mean that a debtor must initiate an adversary proceeding, pay the filing fee, file a complaint, and submit a motion for summary judgment or a motion for a temporary or preliminary injunction before securing possession of a car or other estate property.

In addition to delay, mounting an adversary proceeding will add measurably to the debtor’s costs and attorneys’ fees. On the other hand, the increased cost and delay may end the practice of filing a chapter 13 petition in the Third Circuit only to regain possession of a car.

The Third Circuit’s discussion of Section 542(a) is a curious interpretation of “shall.” In substance, the court says that turnover is mandatory only after the bankruptcy court has directed the creditor to turn over property. In that sense, the use of “shall” seems superfluous because court orders are always mandatory.

To read ABI’s discussion of the Seventh Circuit’s *Fulton* decision, which is the subject of a petition for *certiorari*, [click here](#).

The opinion is *In Denby-Peterson*, 18-3562 (3d Cir. Oct. 28, 2019).





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*'Cert' Pending*



*The Supreme Court wants the government's opinion about comity and the extraterritorial application of Sections 548 and 550.*

## **No Decision Soon on Extraterritorial Fraudulent Transfers**

At the earliest, the Supreme Court will not decide until 2021 whether the subsequent recipient of a fraudulent transfer can be sued in the U.S. when the transfer occurred abroad.

In a broadly worded opinion in February in the *Madoff* liquidation, the Second Circuit held that Sections 548 and 550 can be applied extraterritorially to recover fraudulent transfers even if subsequent transfers occurred abroad. *In re Picard, Trustee for the Liquidation of Bernard L. Madoff Investment Securities LLC*, 917 F.3d 85 (2d Cir. Feb. 25, 2019). To read ABI's report, [click here](#).

The appeals court was reversing District Judge Jed Rakoff, who had ruled in July 2014 that Section 550 does not permit recovering from a subsequent foreign recipient of stolen funds, given comity and the presumption against extraterritorial application of U.S. statutes.

Picking up on an argument made by the Madoff trustee, the Second Circuit said it was closing a "loophole," because the district court's decision would have enabled a fraudster to transfer property to a "foreign entity," thereby rendering the "property recovery-proof." *Id.* at 100.

The Second Circuit's decision had put deep-pocket defendants back on the hook for perhaps \$4 billion in fraudulent transfers. They filed a petition for *certiorari* in late August. The Madoff trustee responded at the end of October, opposing *certiorari* because there is no circuit split.

The justices of the Supreme Court considered the *certiorari* petition at a conference on December 6. On December 9, the Court asked the U.S. Solicitor General "to file a brief in this case expressing the views of the United States." Presumably, the justices are seeking the opinion of the U.S. government because the case deals with comity and a possible effect on international relations.

The Solicitor General is not likely to proffer his opinion on granting *certiorari* until late in the winter or spring of 2020. Even if the Court grants the petition at that time, the case would not be argued until the term to begin in October 2020. At the earliest, we cannot realistically expect a decision from the Supreme Court on the merits until 2021.



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Although there is ostensibly no circuit split, the *Madoff* case does involve billions of dollars. Should the Supreme Court deny the petition or uphold the Second Circuit, the trustee's \$4 billion in suits will spring back to life. If the Madoff trustee in turn prevails against or settles with the offshore defendants, he has a chance of paying creditors in full for the \$17 billion they lost in the world's largest Ponzi scheme. The Madoff trustee has already recovered about \$14.3 billion.

Because there is no circuit split, the views of the Solicitor General may be the pivotal factor in the Court's disposition of the *certiorari* petition, and particularly so if the government believes that the Second Circuit was wrong.

The case boils down to the following question: Does the U.S. have the primary interest in recovering fraudulent transfers that originated in the U.S., even if subsequent transfers occurred abroad?

[The case is](#) *HSBC Holdings PLC v. Picard*, 19-277 (Sup. Ct.).



*Neither comity nor the presumption against extraterritorial application of U.S. statutes bars trustees from suing to recover subsequent transfers made abroad.*

## **Second Circuit Allows Extraterritorial Application of Sections 548 and 550**

In a broadly worded opinion in the *Madoff* liquidation, the Second Circuit held that Sections 548 and 550 can be applied extraterritorially to recover fraudulent transfers even if subsequent transfers occurred abroad.

The appeals court reversed District Judge Rakoff, who had ruled in July 2014 that Section 550 does not permit recovering from a subsequent foreign recipient of stolen funds, given comity and the presumption against extraterritorial application of U.S. statutes.

As Circuit Judge Richard C. Wesley was careful to say in his February 25 opinion, the ruling by the appeals court closed a “loophole,” because the district court’s decision would have enabled a fraudster to transfer property to a “foreign entity,” thereby rendering the “property recovery-proof.”

The opinion avoided a split of circuits with the Fourth Circuit and lower courts that have given extraterritorial effect to Section 548.

The opinion has practical significance for the victims of Bernie Madoff’s Ponzi scheme, who have already received distributions representing about 67% of what they invested. The revival of the trustee’s lawsuits means the victims have a realistic shot at recovering 100%. Reinstatement of the lawsuits may convince some defendants to settle, because they face the possibility of liability for 10 years of prejudgment interest on top of a judgment for the stolen money they received.

“The opinion has a broad application, and we think the court got it 100% right,” Stephen P. Harbeck, the president and chief executive of the Securities Investor Protection Corp., told ABI.

### The Fraudulent Transfers

Some of the largest investors in the Madoff Ponzi scheme were so-called offshore feeder funds, located in places like the Cayman Islands. Many of the feeder fund investors were foreigners, or at least nominally so.



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Some of the feeder funds reinvested virtually everything with Madoff. The feeder fund investors seemingly made out very well until the fraud came crashing down. When it did, some of the feeder funds had taken more cash out of the Madoff firm than the cash they had invested.

The feeder funds were called “net winners” if they had taken out more cash than they invested. Under prior Second Circuit decisions in the *Madoff* case, net winners are recipients of fraudulent transfers with “actual intent,” making them liable to disgorge fictitious profits received within two years of bankruptcy under Sections 548(a)(1)(A) and 550(a)(1).

Madoff’s bankruptcy in 2008 put many of the feeder funds into liquidation abroad. The feeder funds’ bankruptcies left the Madoff trustee unable to claw back fraudulent transfers made to the feeder funds themselves. Undeterred, the Madoff trustee sued feeder fund investors as subsequent transferees under Section 550(a)(2), because the feeder funds had paid out their fictitious Madoff profits to the feeder funds’ investors. The payments were fictitious profits because they represented money stolen from other investors, not legitimate income from investments.

The Madoff firm is being liquidated under the Securities Investor Protection Act, which incorporates large swaths of the Bankruptcy Code, including the avoiding and recovery powers under Sections 548 and 550.

## Judge Rakoff’s Ruling

Before the bankruptcy judge could rule on the liability of the feeder funds’ investors as subsequent recipients of fraudulent transfers, they banded together and persuaded Judge Rakoff to withdraw the reference.

The feeder fund investors contended that U.S. fraudulent transfer law does not apply to them abroad. Judge Rakoff heard argument in September 2012 and handed down his opinion in July 2014. *Securities Investor Protection Corp. v. Bernard L. Madoff Investment Securities LLC (In re Bernard L. Madoff Investment Securities LLC)*, 513 B.R. 222 (S.D.N.Y. 2014).

Reciting black letter law, Judge Rakoff said that U.S. statutes do not apply extraterritorially absent contrary intent by Congress. For him, the origination of the fraudulent transfers in the U.S. was insufficient to transform “these otherwise thoroughly foreign subsequent transfers” into a “domestic application” of bankruptcy law. He also found no “clearly expressed” congressional intent to allow application of the law abroad.

Even if Congress had intended to allow suits against foreigners, Judge Rakoff said he would still dismiss the suits on a second ground: international comity. He said that foreigners “had no reason to expect that U.S. law would apply to their relationships with the feeder funds.”





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After ruling, Judge Rakoff sent the lawsuits back to bankruptcy court. Implementing Judge Rakoff's mandate, the bankruptcy court on remand dismissed suits seeking \$4 billion from feeder fund investors. Because Judge Rakoff had already ruled on the issues, the Second Circuit permitted the trustee to take a direct appeal in 88 consolidated appeals.

## The Second Circuit Opinion

Reversing Judge Rakoff, the Second Circuit could have rested its decision on the unique provisions of SIPA giving special powers to trustees liquidating brokerage firms. Instead, Judge Wesley found the result entirely within the four corners of the Bankruptcy Code, meaning that the decision is equally applicable to ordinary bankruptcies, not merely brokerage liquidations under SIPA.

Judge Wesley agreed with Judge Rakoff about the presumption against extraterritoriality, saying that the lawsuits could go ahead "if either the statute indicates its extraterritorial reach or the case involves a domestic application of the statute." From there on, however, Judge Wesley knocked the props out from under Judge Rakoff's theories.

## Extraterritoriality

Following Supreme Court authority, Judge Wesley said the court looks to the statute's "focus" to decide "whether a case involves a domestic application of that statute."

Where the district court focused on Section 550, Judge Wesley said the proper focus was Section 548, because Section 550 merely provides a remedy for a fraudulent transfer.

Judge Wesley said the harm to the estate resulted from the initial transfer, which was made in the U.S. He said that Section 550 is a "utility provision" helping to execute the policy in Section 548. Paraphrasing the Supreme Court, he said that Section 550 is merely the means by which the statute achieves its ends of "regulating and remedying the fraudulent transfer of property."

Judge Wesley thus held that a fraudulent transfer emanating from the U.S. "is a domestic activity for the purposes of Sections 548(a)(1)(A) and 550(a)." Consequently, "the presumption against extraterritoriality therefore does not prohibit the debtor's trustee from recovering, . . . regardless of where any initial or subsequent transferee is located." Mimicking the Supreme Court's terminology, he said the "relevant conduct in these actions is the debtor's fraudulent *transfer* of property, not the transferee's *receipt* of property." [Emphasis in original.]

## Comity

Having decided that the presumption against extraterritoriality did not bar the lawsuits, Judge Wesley next dealt with international comity as grounds for dismissal. His opinion is a ringing



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endorsement of a trustee's ability to chase defendants around the world when the fraudulent transfer initiated in the U.S.

Comity, Judge Wesley said, comes into play only when there is a "true conflict" between American law and that of a foreign jurisdiction. Assuming without deciding that there was such a conflict, he said that the U.S. nevertheless "has a compelling interest in allowing domestic estates to recover fraudulently transferred property."

There would be a better argument for comity were Madoff also in liquidation abroad. The absence of any parallel Madoff proceeding abroad "seriously diminishes the interest of any foreign state in our resolution of the trustee's claims," Judge Wesley said. Even where the initial recipient of the fraudulent transfer is in liquidation abroad, he said, the foreign "interests are not compelling."

Even if the foreign liquidators were trying to recover the same funds from the same subsequent recipients, Judge Wesley said "those are not comity concerns," nor are they "compelling enough to limit the reach of a federal statute that would otherwise apply here."

Judge Wesley saw no reason to believe that "Congress would have decided that trustees looking to recover property in domestic proceedings are out of luck when trustees in foreign proceedings may be interested in recovering the same property." Indeed, he saw the "opposite": "Congress wanted the claims resolved in the U.S., rather than through piecemeal proceedings around the world."

Judge Wesley said the district court erroneously focused on the subsequent transfer. He held that "[p]roscriptive comity poses no bar to recovery when the trustee of a domestic debtor uses Section 550(a) to recover property from a foreign subsequent transferee on the theory that the debtor's initial transfer of that property from within the U.S. is avoidable under Section 548(a)(1)(A)."

Judge Wesley ended by debunking the district court's theory that the feeder fund investors had no reason to believe that U.S. law would apply to their relationship with the offshore feeder funds. "When these investors chose to buy into feeder funds that placed all or substantially all of their assets with Madoff Securities," he said, "they knew where their money was going."

## An Important Footnote and an Omission

The conclusion on extraterritoriality was based on two factors: The Madoff firm was a domestic entity, and the fraud occurred when Madoff transferred funds from a U.S. bank account.

In a footnote, Judge Wesley expressed "no opinion on whether either factor standing alone would support a finding that a transfer was domestic." Thus, the Second Circuit left the door open



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for the trustee of a domestic corporation to pursue a fraudulent transfer made from a bank account abroad.

Judge Rakoff found significance in *FDIC v. Hirsch (In re Colonial Realty)*, 980 F.2d 125 (2d Cir. 1992), where the Second Circuit said that fraudulently transferred property is not estate property until it has been recovered. The Second Circuit's *Madoff* opinion did not mention *Colonial Realty*, implying that the pursuit of estate property is not a necessary factor to overcome the presumption against extraterritoriality involving a fraudulent transfer emanating from the U.S.

[The opinion is](#) *In re Picard, Trustee for the Liquidation of Bernard L. Madoff Investment Securities LLC*, 917 F.3d 85 (2d Cir. Feb. 25, 2019).



## Reorganization



## *Fraudulent Transfers*





*The Supreme Court's Merit Management opinion fails to persuade the Second Circuit to change the result in Tribune.*

## **Second Circuit Again Applies the 'Safe Harbor' to Protect Selling Shareholders in an LBO**

The Supreme Court ruled in February 2018 that the so-called safe harbor under Section 546(e) only applies to “the transfer that the trustee seeks to avoid.” *Merit Management Group LP v. FTI Consulting Inc.*, 138 S. Ct. 883, 200 L. Ed. 2d 183, 86 U.S.L.W. 4088 (Sup. Ct. Feb. 27, 2018).

The high court opinion had the effect of abrogating one of the Second Circuit's principal holdings in *Note Holders v. Large Private Beneficial Owners (In re Tribune Co. Fraudulent Conveyance Litigation)*, 818 F.3d 98 (2d Cir. 2016).

*Tribune* included two rulings by the Second Circuit that precluded creditors of a bankrupt company from bringing suit on their own behalf based on state fraudulent transfer law. First, the circuit court ruled that the safe harbor in Section 546(e) applies even if a bank only serves as a conduit for money paid to selling shareholders in a leveraged buyout that turns out to be a fraudulent transfer. The appeals court said that the safe harbor protects transactions, not just financial institutions.

Second, the appeals court held that the Section 546(e) safe harbor impliedly preempts state law on fraudulent transfers anytime there is a bankruptcy of a company that was the subject of a leveraged buyout. As a consequence of preemption, the Second Circuit said that individual creditors cannot mount a fraudulent transfer suit on their own behalf. In the opinion of the Second Circuit, the safe harbor blocked lawsuits not only by trustees and debtors but also by creditors asserting claims of their own in a non-bankruptcy court.

The creditors in *Tribune* had filed a petition for *certiorari* before the Supreme Court handed down *Merit Management*. With the Supreme Court authority in hand, the creditors prevailed on the Second Circuit in May 2018 to withdraw the mandate in *Tribune* and revisit the issue.

Without further briefing on the merits, the Second Circuit issued a revised *Tribune* opinion on December 19, reaching the same result by dismissing the creditors' constructive fraudulent transfer claims. In substance, the Second Circuit found a loophole in *Merit Management*.

By employing a “financial institution” as its “agent,” an entity that is not otherwise covered by the Section 546(e) safe harbor can immunize a transaction from attack as a constructive fraudulent



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transfer under Section 548(a)(1)(B), the Second Circuit held in the opinion, which will likely be called *Tribune II*.

## The First *Tribune* Opinion

The case arose in the chapter 11 reorganization of newspaper publisher Tribune Co. and focused on Section 546(e), which provides that “the trustee may not” sue for recovery of a “settlement payment” that was made “by or to (or for the benefit of) a . . . financial institution” unless the suit 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.

Tribune’s official creditors’ committee was authorized to sue selling shareholders for allegedly receiving fraudulent transfers with “actual intent.” 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. 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.

Writing for the three-judge panel in March 2016, Circuit Judge Ralph K Winter, Jr. reversed the district court on both scores, with dismissal still the result. First, he ruled that the creditors had standing.

Judge Winter nonetheless ruled that Section 546(e) impliedly preempted state fraudulent transfer law, under which the creditors were suing.

Following existing Second Circuit precedent, he ruled that the involvement of a financial institution as a mere conduit did not obviate the applicability of the Section 546(e) safe harbor. In the context of a leveraged buyout, he said that allowing fraudulent transfer suits to unwind “settled securities transactions” would “seriously undermine” the markets. For reasons Judge Winter 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.

To read ABI’s report on the first *Tribune* opinion, [click here](#).

## *Merit Management* and the Withdrawal of the Mandate



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Already pending in the Supreme Court, *Merit Management* raised the question of whether the presence of a financial institution as a mere conduit in the chain of payments in a leveraged buyout was sufficient to invoke Section 546(e). Before the decision from the high court came down, the *Tribune* creditors filed a petition for *certiorari*.

*Merit Management* abrogated one of the grounds on which the Second Circuit had dismissed the creditors' lawsuit in *Tribune*. Where the Second Circuit said that the safe harbor protects transactions, the Supreme Court held that the protection is for "financial institutions."

Evidently, several justices of the Supreme Court were recused from considering the *Tribune certiorari* petition. So, Justices Anthony M. Kennedy and Clarence Thomas issued a "Statement" on April 3, 2018, saying that the Second Circuit could recall the *Tribune* mandate and "decide whether relief from judgment is appropriate given the possibility that there might not be a quorum in this Court. *See* U.S.C. § 2109." On May 15, 2018, the Second Circuit recalled the mandate to reconsider the *Tribune* decision in light of *Merit Management*. To read ABI's report, [click here](#).

## The New *Tribune* Opinion

The Second Circuit did not hold oral argument anew, nor did the court call for additional briefing on the merits. Rather, Circuit Judges Winter and Christopher F. Droney filed a revised opinion on December 19 based on papers filed in connection with withdrawal of the mandate. (Judge Droney retired this month. District Judge Alvin K. Hellerstein sat on the original panel by designation. His name does not appear on the revised opinion from December 19.)

For the most part, the new opinion is a verbatim restatement of the original opinion, with significant additions. The appeals court acknowledged the Supreme Court's holding that the safe harbor does not apply if a financial institution is a mere conduit, therefore abrogating one of the holdings in the original *Tribune* opinion.

The revised opinion added a new section explaining why the Section 546(e) safe harbor still applies, although the new theory was not argued or decided in the original opinion.

The appeals court adhered to its original holding that the safe harbor in the Bankruptcy Code preempts state law. To uphold dismissal once again, the two circuit judges on the panel were tasked with deciding whether the safe harbor still applied. The judges framed the question as whether *Tribune* was subsumed within the definition of a "financial institution" as defined in Section 101(22)(A).

A "financial institution" in Section 201(22)(A) is defined to be a bank or "trust company, . . . and when any such . . . entity is acting as agent . . . for a customer . . . in connection with a securities contract . . . such customer." In other words, a customer of a financial institution itself becomes a "financial institution" if the financial institution is acting as the customer's agent.



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Relying on information that was arguably not in the record on the motion to dismiss in district court, the appeals court ruled that a depository used for making payments to selling shareholders in the leveraged buyout was an agent for Tribune.

In essence, Tribune fell within the definition of a “financial institution,” thus making the safe harbor applicable and compelling dismissal of the suit.

In that regard, the Second Circuit held that “Section 546(e)’s language is broad enough under certain circumstances to cover a bankrupt firm’s LBO payments even where, as here, that firm’s business was primarily commercial in nature.”

The panel ended its new opinion by distinguishing and limiting *Merit Management’s* holding to the facts and issues before the Supreme Court.

The panel said the Supreme Court was “was not tasked with assessing Section 546(e)’s preemptive force, and it did not address preemption.” Therefore, the circuit court said that *Merit Management* did not “control our disposition of the preemption issue.” Furthermore, the circuit judges found nothing “in *Merit Management’s* reasoning that contradicts our assessment of Congress’s preemptive intent.”

## Observations

When structuring a transaction that might later be attacked as a constructive fraudulent transfer, it still seems possible in the Second Circuit to sanitize the transaction by using a financial institution in the role of agent.

The creditors have filed a petition for rehearing *en banc*. Principally, the creditors are attacking the appeals court’s conclusion that the depository was an agent for Tribune.

[The new opinion is](#) *In re Tribune Co. Fraudulent Conveyance Litigation*, 13-3992 (2d Cir. Dec. 19, 2019).





*Long Island's Judge Grossman follows the Third Circuit by finding limitations on the Rooker-Feldman doctrine.*

## **Trustee Allowed to Sue for Fraudulent Transfer on an Unenforceable Contract**

Even if a contract is unenforceable under state law, a bankruptcy trustee still has the ability to recover the value provided by the debtor as a constructive fraudulent transfer, according to Bankruptcy Judge Robert E. Grossman of Central Islip, N.Y.

The corporate debtor had a contract with a municipality to build sidewalks and curbs for the city. To be enforceable under state and municipal law, the original contract had been subjected to competitive bidding and was approved by the town board.

About two weeks after the original contract expired, the debtor agreed to build more sidewalks and curbs for a price of about \$450,000. Once the new job was completed and the time for payment arrived, the city refused to pay, citing state law and the lack of approval of the new agreement by the town board. According to the city, the local laws are designed to prevent corruption and favoritism.

Before bankruptcy, the debtor sued in state court, seeking a money judgment for the \$450,000 called for in the new agreement. Before the suit was resolved, the debtor filed a chapter 11 petition and removed the action to bankruptcy court. The bankruptcy court granted the city's motion for mandatory abstention, returning the suit to state court.

Back in state court, the judge granted the city's motion to dismiss because the agreement was unenforceable under local and state law. The state judge said that the public interest in preventing collusion precluded the debtor from enforcing the contract.

Meanwhile, the chapter 11 case had been converted to chapter 7, and a trustee was appointed. The trustee commenced an adversary proceeding in bankruptcy court against the town under Section 544, seeking the same \$450,000 and alleging that the debtor's uncompensated work was a constructive fraudulent transfer under the New York Debtor & Creditor Law. (The transfers occurred more than two years before filing, preventing the trustee from suing under Section 548. Thus, the trustee used his status as a creditor under Section 544 to sue under state fraudulent transfer law.)

The city filed a motion to dismiss the adversary proceeding, contending that the state's interest in preventing corruption and collusion was superior to the right of a trustee to recover avoidable





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transfers under Section 544. The city also contended that the *Rooker-Feldman* doctrine was the death knell of the suit in bankruptcy court.

On several grounds — including federal preemption and the inapplicability of *Rooker-Feldman* — Judge Grossman denied the motion to dismiss in an opinion on July 10.

## Preemption

The city argued that Congress did not intend for trustees to violate state law by relying on the Bankruptcy Code. Judge Grossman countered by saying that the suit would not compel the city to violate state law. Rather, he said that the suit was designed to recover property for which the city gave no consideration.

Judge Grossman then ruled that the Bankruptcy and Supremacy Clauses in the U.S. Constitution meant that the Bankruptcy Code and Section 544 preempted state law under the rubric of “conflict preemption.” He said that “the interests protected by these state laws must be subservient to [the avoidance powers in Section 544], which promote the objectives of protecting a debtor’s creditors from harm as a result of transfers made by a debtor for less than fair consideration.”

He went on to say that “the public’s health and safety is not at risk if the trustee is permitted to recover the value of the materials and labor provided to the town” under Section 544 and New York’s fraudulent transfer law.

## *Rooker-Feldman*

Next, the city argued that the trustee’s suit should be dismissed for lack of jurisdiction under the *Rooker-Feldman* doctrine. Named for two Supreme Court decisions, *Rooker-Feldman* stands for the proposition that federal courts lack subject matter jurisdiction to review judgments by state courts. It means that a plaintiff cannot appeal a state court judgment in federal court.

Judge Grossman rejected the *Rooker-Feldman* argument, wrapping himself in the flag sewn last year by the Third Circuit in *In re Philadelphia Entertainment & Development Partners*, 879 F.3d 492 (3d Cir. 2018). To read ABI’s report on *Philadelphia Entertainment*, [click here](#).

For starters, Judge Grossman said that *Rooker-Feldman* might not even apply because courts “routinely” hold that the doctrine is not relevant when the Bankruptcy Code is modifying or avoiding a state court judgment under Sections 544 or 548.

Even if it were applicable, Judge Grossman explained why *Rooker-Feldman* did not kick in: The bankruptcy court would not be disturbing the findings by the state court. Citing *Philadelphia*



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*Entertainment*, he said that the “ee was not inviting review and rejection” of the ruling in state court.

Instead, the trustee is seeking “recovery for the materials and labor provided by the Debtor without the benefit of a contract.”

## Issue and Claim Preclusion

Next, Judge Grossman dismissed the city’s contentions based on issue and claim preclusion, which he referred to as collateral estoppel and *res judicata*.

Judge Grossman “easily rejected” collateral estoppel because the Section 544 claim could not have been asserted in state court. Moreover, the state court did not consider the “identical issue” of dealing with fraudulent transfer law and the trustee’s right to sue under Section 544.

Likewise, *res judicata* did not apply, because the lawsuit in state court was not between the same parties and did not entail the same causes of action. Even if the trustee were in privity with creditors whose claims he was asserting under Section 544, the suit in state court did not concern fraudulent transfer claims.

## Substantive Law

The city contended that New York law on fraudulent transfer does not allow recovery for personal services.

Because the debtor was a corporation, Judge Grossman said the suit sought to recover for materials and labor provided by third parties, not personal services.

Judge Grossman denied the motion to dismiss. The gist of the opinion implies that the city will have few defenses when there is a trial on the merits of the fraudulent transfer claim. Because the trustee is not suing under contract, the trial may boil down to a dispute about damages.

Observation: A mediated settlement would be a good idea, unless the city is intent on taking federal preemption and *Rooker-Feldman* to the Second Circuit.

[The opinion is](#) *Pryor v. Town of Smithtown (In re Jadeco Construction Corp.)*, 18-08013, 2019 Bankr Lexis 2076 (Bankr. E.D.N.Y. July 10, 2019.)



## *Executory Contracts & Leases*



*Over a dissent, the Sixth Circuit holds that FERC may offer its opinion but may not bar a bankruptcy court from rejecting a power purchase agreement after considering the public interest.*

## **Sixth Circuit Gives Primacy to the Bankruptcy Court in Rejecting Power Contracts**

Reversing the bankruptcy court, the Sixth Circuit ruled 2/1 that the bankruptcy court shares jurisdiction with FERC, the Federal Energy Power Commission, when a chapter 11 debtor moves to reject a power purchase agreement, or PPA. Nonetheless, the Sixth Circuit held that FERC may not bar the bankruptcy court from ordering the rejection of a PPA.

In deciding whether the debtor may reject a PPA, the appeals court adapted the standard from *Bildisco* in ruling that the bankruptcy court must consider the public interest alongside the traditional business judgment test. *NLRB v. Bildisco & Bildisco*, 465 U.S. 513 (1984).

The dissenter would not have permitted rejection without approval from regulators.

### The Bankruptcy Court's Injunction

The appeal arose from the reorganization of FirstEnergy Solutions Corp. and affiliates. The companies generated, purchased and sold electric energy to retail and wholesale customers. Immediately after filing their chapter 11 petitions, the debtors filed motions to reject several PPAs with renewable energy sources that FERC had previously approved under the Federal Power Act, 16 U.S.C. § 791a, *et. seq.*

The debtors also initiated an adversary proceeding where they asked the bankruptcy judge to declare that FERC has no jurisdiction over the rejection of PPAs and to enjoin FERC from taking any action regarding rejection of the PPAs.

The bankruptcy court entered a temporary restraining order, followed in May 2018 by a preliminary injunction under the Section 362 automatic stay and Section 105(a), the bankruptcy version of the All Writs Act.

The injunction barred FERC from commencing or continuing any proceedings regarding rejection of the PPAs or requiring the debtors to continue performing. The order also enjoined FERC from interfering with the bankruptcy court's "exclusive jurisdiction" with regard to the rejection motions.



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The Sixth Circuit accepted a direct appeal.

## The Majority Opinion

In the December 12 opinion for herself and Circuit Judge Bernice B. Donald, Circuit Judge Alice M. Batchelder began her legal analysis by emphasizing how the bankruptcy case was a reorganization, not a liquidation. Were it a liquidation, she said that “neither FERC nor anyone else could compel the defunct debtor to keep performing the contracts or prevent the debtor from breaching the contracts by nonperformance.”

With regard to the power of a bankruptcy court in a reorganization, FERC and the power producers contended that filed-rate contracts are equivalent to regulations or statutes that a court has no power to overturn. Judge Batchelder agreed that several circuit courts have said that filed rates have the force of a regulation or statute, “at least insofar as to keep a district court or a state court from messing with them.” But she did not go that far.

Instead, Judge Batchelder said that “the public necessity of available and functional bankruptcy relief is generally superior to the necessity of FERC’s having complete or exclusive authority to regulate energy contracts and markets. This means,” she said, that “the PPAs are . . . ordinary contracts susceptible to rejection in bankruptcy.”

Consequently, Judge Batchelder held that FERC and the bankruptcy court exercise concurrent jurisdiction. Still, she decided that the bankruptcy court is the top dog with the power to decide whether a debtor can reject a PPA. Once the debtor receives “proper bankruptcy court approval,” Judge Batchelder said that “FERC cannot independently prevent it.”

Next, Judge Batchelder said the bankruptcy court “went too far” under Section 105(a) by enjoining FERC from doing anything at all.

To apportion power between FERC and the bankruptcy court, Judge Batchelder examined the “two apparently conflicting federal statutes” and decided how to “harmonize” them.

Judge Batchelder recognized that a reorganization must “be expeditious and possibly unfair or harmful to other concerned parties, even including the general public. It would not be reasonable in all cases to permit public-interest concerns to overrule a restructuring decision, or even to wait for FERC to conduct a full hearing to identify, assess, and opine on those concerns.” She added that “bankruptcy judges are capable of comprehending public interests, particularly when FERC has provided an opinion.”

Giving veto power to both the bankruptcy court and FERC “is not the only way . . . to harmonize the two statutes,” Judge Batchelder said.





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To harmonize the two statutes, Judge Batchelder held that “the bankruptcy court may, based on the particular facts and circumstances before it, enjoin FERC from issuing an order (or compelling an action) that would directly conflict with the bankruptcy court’s orders or interfere with its otherwise-authorized authority, but the bankruptcy court may not enjoin FERC from risking its own jurisdictional decision, conducting its (otherwise regulatory mandated) business, or issuing orders that do not interfere with the bankruptcy court.”

In other words, the bankruptcy court erred by enjoining FERC from doing anything at all, including holding hearings to advise the bankruptcy court where the public interest lay.

Finally, Judge Batchelder confronted the question of the standard the bankruptcy court must employ in ruling on the rejection of a PPA. Naturally, the debtor contended that the bankruptcy court should use the ordinary business judgment standard.

Judge Batchelder adopted the Supreme Court’s *Bildisco* standard for dealing with the rejection of labor contracts. She quoted the high court as saying that a debtor carries the burden of showing “that after careful scrutiny, the equities balance in favor of rejecting” the contract. *Id.* at 526.

Adapting the *Bildisco* standard to the case at hand, Judge Batchelder remanded the matter for the bankruptcy court to “reconsider its decision under this higher standard, considering and deciding the impact of the rejection of these contracts on the public interest — including the consequential impact on consumers and any tangential contract provisions concerning such things as decommissioning, environmental management, and future pension obligations — to ensure that the ‘equities balance in favor of rejecting the contracts,’” citing *Mirant Corp. v. Potomac Electric Power Co. (In re Mirant Corp.)*, 378 F.3d 511, 525 (5th Cir. 2004).

At the end of her opinion, Judge Batchelder again said in substance that the bankruptcy has primacy. The bankruptcy court, she said, need only give FERC a “reasonable accommodation” and suffer only a “reasonable delay” while FERC is deciding on its recommendation to the bankruptcy court about the public interest in a PPA rejection.

To recap, Judge Batchelder said that the “bankruptcy court must consider the public interest and ensure that the equities balance in favor of rejecting the contract, and it must invite FERC to participate and provide an opinion in accordance with the ordinary FPA approach (*e.g.*, under the *Mobile-Sierra* doctrine), within a reasonable time.”

## The Dissent

Circuit Judge Richard Allen Griffin dissented. He said that chapter 11 “provides a shield against an insolvent company’s creditors, not its regulators.” He therefore believes that the



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“Bankruptcy Code does not authorize a debtor to violate its obligations under the FPA or a filed rate any more than the criminal code or securities laws.”

Judge Griffin did agree with the majority’s holding that the bankruptcy court erred in applying only the business judgment standard. Of course, he also agreed that the bankruptcy court’s injunction was too broad.

Because the automatic stay does not apply to the enforcement of police or regulatory powers under Section 362(b)(4), Judge Griffin would have held that the bankruptcy court “exceeded its jurisdiction and infringed on FERC’s exclusive jurisdiction to decide whether to modify or abrogate a filed rate.” Conversely, he said that FERC would have no power under the FPA to enjoin a bankruptcy court from rejecting executory contracts.

Procedurally, Judge Griffin would have the debtor file a rejection motion to be evaluated under the “heightened standard.” In addition, he would require the debtor to petition FERC for relief from the filed rate.

Judge Griffin believes that a filed rate has the force of law, and the bankruptcy court has no authority to decide whether a rate is “just and reasonable.” Instead, he saw the FPA as giving FERC the exclusive power to modify or abrogate a filed rate on public-necessity grounds, subject to appellate review.

## Observations

The majority endeavored to craft a decision in accord with *Mirant* from the Fifth Circuit. The New Orleans-based appeals court gave the bankruptcy court power to reject a PPA under a heightened standard, together with the power to bar FERC from preventing rejection.

The majority attempted to distinguish *In re Calpine Corp.*, 337 B.R. 27 (S.D.N.Y. 2006), where the court held that FERC’s authority over filed rates is superior to the bankruptcy court’s power over executory contracts. The majority noted that *Calpine* dealt with a debtor who moved to reject just because power could be purchased more cheaply. FirstEnergy, on the other hand, simply did not need the power.

In dissent, Judge Griffin was not persuaded by *Mirant*. He said that the Fifth Circuit adopted “an unreasonably narrow view of the powers granted to FERC by the FPA.”

The vigorous dissent may give rise to a petition for rehearing *en banc*, but the lack of a clearly defined circuit split does not bode well for a successful *certiorari* petition, unless the Sixth Circuit rejects *Mirant en banc* by holding that FERC has the power to bar rejection of a PPA.



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The opinion is *FERC v. FirstEnergy Solutions Corp. (In re FirstEnergy Solutions Corp.)*, 18-3787 (6th Cir. Dec. 12, 2019).



*Fifth Circuit leaves the door open to preventing automatic rejection if the existence of an executory contract is intentionally undisclosed.*

## **Executory Contracts Are Automatically Rejected Even if Unscheduled, Fifth Circuit Holds**

On a topic where there is scant appellate authority, the Fifth Circuit held that a trustee cannot assume and assign an executory contract after the deadline for assumption has passed, even if the contract had not been scheduled and was unknown to the trustee.

The case involved a corporate debtor who knew it owned a patent license but failed to list the license in its schedules. However, there was no effort to conceal the license, Circuit Judge Patrick E. Higginbotham said in his October 29 opinion.

After the case converted from chapter 11 to chapter 7, the trustee sold all of the estate's property. The sale occurred more than 60 days after conversion. Section 365(d)(1) provides in effect that an executory contract not assumed within 60 days of conversion "is deemed rejected."

The sale agreement transferred all of the debtor's property and listed the assets by category. Although the license fell within a category of transferred property, the license was not specifically listed because the trustee was unaware of the existence of the license. The sale-approval order provided that all executory contracts were assumed and assigned to the purchaser.

A year after the sale, a lawsuit ended up in bankruptcy court where the licensor of the patent license contended that the license was rejected and had not been sold to the purchaser. The bankruptcy judge agreed with the licensor and held that the license had been rejected automatically and could not have been sold. The district court agreed.

The Fifth Circuit affirmed, first holding that the license was an executory contract because material, reciprocal obligations remained outstanding on both sides. The erstwhile purchaser argued that there is an implicit exception to automatic rejection under Section 365(d)(1) when an executory contract is not scheduled and the trustee is unaware of the existence of the asset.

With one exception, there is no authority at the circuit level about exceptions to automatic rejection. In the lower courts, Judge Higginbotham said there is "sparse authority" and "no clear consensus." He said some lower courts hold that a contract is not deemed rejected if the debtor has intentionally concealed the existence of the asset. That was not the state of facts in the case on appeal, he said.



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When there has been no intentional concealment, Judge Higginbotham said that “some courts” have held that failure to schedule a contract does not prevent its automatic rejection. However, he cited a district court for holding that failure to schedule a contract tolls the deadline for assumption.

Judge Higginbotham followed a 1985 Ninth Circuit opinion decided under the former Bankruptcy Act: *Cheadle v. Appleatchee Riders Association (In re Lovitt)*, 757 F.2d 1035 (9th Cir. 1985).

In *Cheadle*, the Ninth Circuit said that a trustee has an affirmative duty to investigate for unscheduled assets. Therefore, the appeals court found a conclusive presumption that unscheduled contracts are rejected in 60 days.

Because the Bankruptcy Code likewise imposes a duty on a trustee to investigate the debtor’s affairs, Judge Higginbotham decided that the reasoning of *Cheadle* “still applies.” “More to the point,” he said, Section 365(d)(1) “does not impose an actual or constructive notice requirement for when the sixty-day deadline applies.” He declined to “read such a requirement into the statute.”

“At a minimum,” Judge Higginbotham therefore held that “the statutory presumption of rejection after sixty days is conclusive where there is no suggestion that the debtor intentionally concealed a contract from the estate’s trustee.”

The purchaser argued that setting aside the sale amounted to a collateral attack on the sale-approval order.

On rejection, Judge Higginbotham said, the license ceased to be property of the estate, and there was nothing in the purchase contract or sale-approval order to suggest that the trustee was selling anything other than estate property. Therefore, the decision by the bankruptcy court was not a collateral attack on the prior sale-approval order but was “merely an interpretation of the bankruptcy court’s orders.”

[The opinion is](#) *RPD Holdings LLC v. Tech Pharmacy Services (In re Provider Meds LLC)*, 17-11113 (5th Cir. Oct. 29, 2018).





# ROCHELLE'S DAILY WIRE

## *Sales*



*Section 363(o) claims nonetheless must be counted in deciding whether a chapter 11 plan passes the best interests test.*

## **Section 363 Doesn't Apply to Asset Sales in a Chapter 11 Plan, Judge Garrity Rules**

Although he held that consumer protections in Section 363(o) do not apply to asset sales in chapter 11 plans, Bankruptcy Judge James L. Garrity, Jr. of Manhattan ruled that a plan cannot cut off a homeowner's defenses and rights of recoupment against someone who purchases his or her mortgage.

In a 134-page opinion with the most exhaustive case law analysis you may ever read, Judge Garrity nonetheless held that the Ditech chapter 11 plan failed the so-called best interests test because it did not provide consumers with a recovery equal to what they would realize in chapter 7, where Section 363(o) would apply and where their claims would survive against a purchaser.

The August 28 opinion revolved around Section 363, where subsection (f) allows the sale of estate property "free and clear of any interest in such property," so long as one of five conditions is met.

"Notwithstanding subsection (f)," subsection 363(o) says that someone who purchases "any interest in a [specified type of] consumer credit transaction . . . or consumer credit contract . . . shall remain subject to all claims and defenses that are related to such consumer credit transaction or consumer credit contract, to the same extent as such person would be subject to such claims and defenses of the consumer had such interest been purchased at a sale not under this section."

### **Ditech's (Attempted) Second Reorganization**

Ditech is a servicer and originator of home mortgage loans and a servicer of reverse mortgages. In early 2018, Ditech confirmed and consummated a prepackaged chapter 11 plan that extinguished more than \$800 million in debt for borrowed money but did not impair unsecured creditors, including homeowners who might have claims regarding their mortgages.

Once again lacking liquidity, the company and affiliates filed another chapter 11 petition in February 2019 accompanied by a restructuring support agreement with some but not all creditor groups.

In May, the U.S. Trustee appointed an additional official committee to represent consumer creditors, principally meaning homeowners with mortgages that Ditech originated or serviced.



# ROCHELLE'S DAILY WIRE

The consumers' committee came into being after the official unsecured creditors' committee agreed on a global settlement that did not preserve consumers' claims and defenses regarding their mortgages. Consumers had not participated in negotiations leading up to the global settlement that formed the foundation for the revised chapter 11 plan.

The revised plan called for selling the assets to two purchasers who were selected after an exhaustive auction process. The buyers are among the country's largest mortgage servicers.

Briefly stated, the agreements with the buyers required Ditech to sell the assets in a chapter 11 plan free and clear of consumers' claims, including those covered by Section 363(o). The buyers' obligations were conditioned upon sales free and clear, but one of the buyers agreed to a price reduction if the sale did not strip off homeowners' claims.

According to Judge Garrity, consumers' claims covered a "wide range of alleged misconduct" by Ditech relating to the "ownership, origination, and/or servicing of mortgages, including, among other things, overstating and failing to correct borrower accounts, improperly servicing borrower accounts . . . , demanding payments barred by confirmed plans or the discharge injunction . . . , improperly foreclosing on borrowers' properties, and violation of state and federal consumer protection and debt collection laws . . . ."

Although the plan would have barred homeowners from suing the purchasers, it provided \$5 million to cover consumers' claims. In a chapter 7 liquidation, Ditech contended that consumers would recover nothing. Ditech therefore believed that Judge Garrity could cram down the plan on consumers under Section 1129(b).

The official consumers' committee opposed confirmation, raising multiple objections. The U.S. Trustee also objected.

After Ditech brought the plan to court for confirmation, Judge Garrity found only two flaws, but they were enough to deny confirmation.

## Act I: Section 363(o) Doesn't Apply to Chapter 11 Plans

The consumers' committee contended that the preservation of consumers' claims in Section 363(o) applies to chapter 11 plans, thus barring confirmation.

Judge Garrity disagreed. His meticulous analysis of the inapplicability of Section 363 to chapter 11 cases merits reading in full text.

Judge Garrity extensively analyzed legislative history and found that "Congress intended to limit Section 363(o)'s effect to pre-plan sales, not chapter 11 reorganizations, including those



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effectuated through plan sales.” He therefore decided that “plan sales can be free and clear of claims without invoking Section 363(f)” and that “complying with Section 363(f) is not necessary to confirm a plan that provides for a sale free and clear of claims upon confirmation” under Section 1123(a)(5)(D).

Judge Garrity thus concluded that the plan was not required to comply with Section 363(o), but that wasn't the end of the story.

Caution: Don't forget about Section 363(o). It will return in the third act to drive a stake through the heart of the plan.

## Act II: Setoff and Recoupment

Next, Judge Garrity dealt with setoff and recoupment, which, generally speaking, are not affected in bankruptcy by virtue of Section 533 and common law. With regard to setoff, the debtors tweaked the plan to the satisfaction of the consumers' committee. Recoupment was another issue.

Judge Garrity held that the plan must not disturb consumers' “defenses or rights of recoupment under applicable non-bankruptcy law.” He added a proviso, however. He said that defenses and rights of recoupment “do not require the Buyers . . . to pay money damages, refund amounts paid by, or pay monies (except escrow advances) on behalf of or for the account of, the Borrower.”

Again, Judge Garrity's detailed examination of case law is worthy of analysis in full text.

## Act III: Plan Flunks Best Interests Test

Judge Garrity found that the plan was filed in good faith, but it failed the best interests test under Section 1129(a)(7). The section requires a plan to give each creditor “not less” than what the creditor “would so receive or retain if the debtor were liquidated under chapter 7 . . . .”

The debtors argued that consumers would receive nothing on their claims in a chapter 7 liquidation. They contended that Section 363(o) was irrelevant, because best interests only measures claims recoverable from the debtor, not from third-party purchasers. Judge Garrity disagreed.

Indisputably, Judge Garrity said, Section 363(o) would apply were the debtors liquidated in chapter 7, “notwithstanding that the Court has determined that Sections 363(f) and (o) are not applicable” to a sale under a chapter 11 plan.

In chapter 7, Judge Garrity said, consumers “would retain their claims and defenses pursuant to Section 363(o).” The debtors' liquidation analysis of consumers' recoveries in chapter 7 “did not account for these Consumer Claims, but should have,” he said.



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“As such,” Judge Garrity said, the debtors “have failed to satisfy the ‘best interests’ test of Section 1129(a)(7)” because the plan did not assure consumers of a recovery commensurate with claims that would be preserved in chapter 7 under Section 363(o).

## Act IV: Settlement Disapproved

At the confirmation hearing, the debtors were also seeking approval of the global settlement that underlay the plan and would have given \$5 million to a trust for consumer creditors.

The debtor contended that \$5 million was a reasonable settlement because the consumers’ claims were speculative at best. Judge Garrity declined to approve the settlement because the debtors’ valuation did not “attempt to place a value on those claims.”

## Valuation

Is Judge Garrity’s decision just about valuation? Would he have confirmed the plan had the debtors produced competent evidence to show that \$5 million was more than the consumers’ collective claims, thus giving the plan a passing grade under the best interests test?

A more thorough liquidation analysis may not have been enough. Judge Garrity also ruled that the plan could not cut off defenses and rights of recoupment. Will the buyers be willing to go forward in the face of recoupment?

## Appeal

Judge Garrity’s ruling would have given rise to an intriguing appeal were it not for *Bullard v. Blue Hills Bank*, 135 S. Ct. 1686, 191 L. Ed. 2d 621 (2015), which held that denial of confirmation of a chapter 13 plan is not a final, appealable order. Presumably, the same principle will prevent Ditech from appealing denial of confirmation in chapter 11.

Perhaps Judge Garrity would authorize an interlocutory appeal, but is the ice cube melting too quickly?

The consumers are not out of the woods. *Bullard* permits Ditech to confirm an amended plan that preserves consumers’ claims and then ask the appellate court to reinstate the plan that Judge Garrity nixed on August 28. Respectfully, the *Ditech* case shows that *Bullard* is an uncomfortable fit in a complex chapter 11 case.

[The opinion is](#) *In re Ditech Holding Corp.*, 19-10412 (Bankr. S.D.N.Y. Aug. 28, 2019).





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## *Estate Property*



*As his parting shot, Judge Carey requires turnover of almost everything in the files of professionals for an independent audit committee.*

## **The Debtor or Trustee Control the Privileges of an Independent Audit Committee**

Writing what may be his last opinion, Bankruptcy Judge Kevin J. Carey of Delaware parsed a split of authority before concluding that a liquidating trustee may compel counsel for an independent audit committee to turn over almost all of its files.

Judge Carey is stepping down from the bench on August 31 after 19 years of service as a bankruptcy judge. He was a bankruptcy judge in Philadelphia for five years before transferring his flag to Delaware.

### The Audit Committee's Investigation

Before bankruptcy, the debtor corporation formed an independent audit committee that hired a law firm and forensic accountants. The committee was tasked with investigating senior management's financial reporting. Later, the company filed a chapter 11 petition when the inability to produce audited financial statements caused a default on secured credit facilities.

Before bankruptcy, shareholders commenced a class action lawsuit alleging the issuance of false or misleading financial statements. The audit committee's professionals presented their conclusions to the debtor and the Securities and Exchange Commission several months into the chapter 11 case. The debtor paid the audit committee's professionals \$6.3 million for their work.

The company confirmed a liquidating chapter 11 plan that conveyed all of the debtor's claims and rights of action to a liquidating trustee. The liquidating trustee demanded that the audit committee's professionals turn over their files. The law firm declined to turn over documents that it claimed to be covered by the attorney/client and work-product privileges.

### The Split of Authority

In his June 20 opinion, Judge Carey began the analysis with *C.F.T.C. v. Weintraub*, 471 U.S. 343, 105 S. Ct. 1986 (1985), where the Supreme Court held that a corporation's bankruptcy trustee has the power to waive the corporation's attorney/client privilege. He explained why the high court "determined that the trustee's control of the corporate debtor's attorney-client privilege would be



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consistent with the policies of the bankruptcy laws.” Were it otherwise, a trustee could not carry out the duty of investigation if former management controlled the privilege.

However, the law firm contended that the audit committee was a separate, independent body with its own privileges to which the trustee did not succeed.

There is a split of authority among district judges in the Southern District of New York, Judge Carey said. The more recent case allowed a trustee to recover privileged documents from an audit committee, while an earlier case did not.

Judge Carey adopted the reasoning of the more recent Southern District case, saying that “it is appropriate to extend the Supreme Court’s analysis in *Weintraub* and recognize that the trustee appointed as the representative of a corporate debtor controls the privileges belonging to the independent committee established by the corporate debtor.”

The analysis was not over. Did the transfer of the privileges extend to the work-product privilege, not just the attorney/client privilege?

Judge Carey followed a third decision from the Southern District of New York holding that a firm may not invoke the work-product doctrine to withhold documents from a client or former client, given that the client paid for the creation of the materials.

But wait, there’s more! Judge Carey cited the Delaware Chancery Court for pointing out a split of authority about a firm’s duty to release files to a client or former client. The majority require production of the entire file, while the minority require the lawyer to produce only the end product.

Judge Carey decided to follow the Delaware Chancery Court’s policy of requiring the production of everything, subject to limited exceptions for documents intended for internal law office review and use.

Judge Carey therefore directed the audit committee’s counsel to turn over everything “except for those items that are firm documents intended for internal law office review and use.” He only allowed the firm to withhold documents with “counsel’s mental impressions.” He required the firm to turn over draft legal and factual memoranda, even if they were only circulated within the firm. He also required counsel to turn over communications between the lawyers and individual audit committee members.

[The opinion is](#) *In re Old BPSUSH Inc.*, 16-12373, 2019 BL 231071, 2019 Bankr Lexis 1867 (Bankr. D. Del. June 20, 2019).



*In a large 'prepack,' the debtor was required to spend \$80,000 a month for its depository bank to obtain a bond required by Section 345(b).*

## **New York Judge Refuses to Waive Collateralization for Debtors' Bank Accounts**

A large company in chapter 11 must ensure that its depository banks comply with Section 345(b), even if it means the bank charges the debtor \$80,000 a month for providing a bond to collateralize the deposits, according to Bankruptcy Judge James L. Garrity, Jr. of New York.

The debtors constituted a major mortgage originator and servicer that filed a prepackaged chapter 11 petition in February intended for confirmation in August. The debtors' operations utilized more than 1,000 bank accounts, including over 500 accounts at Citibank N.A. with aggregate daily balances of some \$95 million.

Section 345(b) requires debtors to maintain their accounts at authorized depositories that are required to maintain collateral at the U.S. Treasury amounting to 115% of aggregate bankruptcy funds on deposit in excess of FDIC insurance limits. Or, the bank can obtain a surety bond.

Although Citibank is an authorized depository, the debtors discovered that the bank had not collateralized its accounts as required by Section 345(b). After negotiations, Citibank agreed to obtain a bond, at a monthly cost to the debtors of \$80,000.

The debtors nonetheless filed a motion asking Judge Garrity to waive the requirement that the bank post security. In an opinion on June 24, Judge Garrity declined to grant the waiver and stuck the debtors with the \$80,000 monthly cost.

Judge Garrity explained that Congress amended Section 345(b) in 1994 by allowing the court to waive the security requirement "for cause." He analyzed *In re Service Merchandise Co., Inc.*, 240 B.R. 894 (Bankr. M.D. Tenn. 1999), where the court found cause for waiving the collateral requirement based on 10 factors.

Without adopting *Service Merchandise*, Judge Garrity evaluated the facts before him that weighed in favor of a waiver. Among other factors, moving the accounts to another bank would take nine months and cost \$500,000. The U.S. trustee conceded that the risk of loss was "minimal" because Citibank enjoyed a long-term deposit rating by Standard & Poor of A+.



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On the other hand, Citibank was giving the debtors a “favorable” interest rate of 2.6% on its deposits. Judge Garrity estimated that the \$80,000 monthly fee would be a “small fraction” of earnings on interest.

Evaluating the factors for and against granting a waiver, Judge Garrity concluded “on balance” that the debtors “failed to establish ‘cause’ to excuse them from collateralizing the Citibank Accounts, as required by Section 345(b) of the Bankruptcy Code.” Providing a bond, he said, “clearly ensures the safety of the funds on deposit . . . and, under the facts of this case, the payment of a monthly fee to do so, does not ‘handcuff’ the Debtors.”

[The opinion is](#) *In re Ditech Holding Corp.*, 19-10412, 2019 BL 235032, 2019 Bankr Lexis 1892 (Bankr. S.D.N.Y. June 24, 2019).





*Like physics, bankruptcy searches for a unified theory to explain claims by and against the estate.*

## **Different Rules Govern When Claims Accrue By or Against an Estate**

Recently, courts have been holding that the accrual of claims by and against an estate are not governed by the same rules. An appeal on the way to the Sixth Circuit will perhaps give some clarity to the issue.

### *Frenville*

To determine whether a claim accrued before bankruptcy and was therefore discharged, there is no longer a circuit split.

In *Avellino & Bienes v. M. Frenville Co. (In re M. Frenville Co.)*, 744 F.2d 332 (3d Cir. 1984), the Third Circuit had held that a claim was not discharged in bankruptcy if it had not arisen *under state law* before bankruptcy. Third Circuit sat *en banc* in 2010, overruled *Frenville* and sided with seven other circuits. See *Jeld-Wen Inc. v. Van Brunt (In re Grossman's Inc.)*, 607 F.3d 114 (3d Cir. 2010).

In *Grossman's*, the Third Circuit held that an asbestos claim is presumptively discharged if exposure occurred before bankruptcy, even though injury was not manifest until years later. The *en banc* court reasoned that *Frenville* was contrary to the broad definition given to the word "claim" in the Bankruptcy Code.

When the tables are turned, the rules recently are different in deciding whether a claim belongs to the estate or to the debtor. In those cases, the result has turned on whether the claim by the debtor accrued *under state law* before or after filing. In other words, the discredited *Frenville* concept still holds water in deciding whether a claim is property of the estate.

### Legal Malpractice Claims

In April, we reported *Church Joint Venture LP v. Blasingame (In re Blasingame)*, 598 B.R. 864 (B.A.P. 6th Cir. April 5, 2019). There, the Bankruptcy Appellate Panel for the Sixth Circuit held that a legal malpractice claim leading to the loss of the debtors' discharges belonged to the debtors, not to the estate.



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Because there was no pre-petition injury, the BAP held that “the malpractice cause of action arose post-petition and is not property of the bankruptcy estate.” The case is on appeal to the Sixth Circuit. *Church Joint Venture LP v. Blasingame (In re Blasingame)*, 19-5505 (6th Cir.). To read ABI’s discussion of the BAP’s *Blasingame* opinion, [click here](#).

In June, Bankruptcy Judge Elizabeth D. Katz of Worcester, Mass., dealt with a case where the debtor’s pre-bankruptcy attorney advised his client to make a transfer of valuable property before filing. The attorney advised the client that the transfer might be attacked as a fraudulent transfer.

That’s exactly what happened. The chapter 7 trustee sued the transferees to set aside the pre-bankruptcy transfer. The trustee also sued the debtor’s pre-bankruptcy counsel, contending that the advice was malpractice.

In her June 28 opinion, Judge Katz held that the legal malpractice claim belonged to the debtor, not to the trustee. She therefore dismissed the malpractice suit in bankruptcy court for lack of jurisdiction.

Judge Katz held that the “plain language” of Section 541(a) required dismissal, because the claim did not arise under state law until after bankruptcy when the debtor suffered injury. Knowledge of potential injury before bankruptcy was “not dispositive,” she said.

The opinion by Judge Katz raises a question: Did *Segal v. Rochelle*, 382 U.S. 375 (1966), decided under the former Bankruptcy Act, survive adoption of the Bankruptcy Code? *Segal* held that a claim by the debtor belonged to the estate if it was “sufficiently rooted in the prebankruptcy past.”

Judge Katz followed Thomas L. Perkins of Peoria, Ill., who held in May that *Segal* no longer determines whether an asset is estate property. The two judges are of the view that property of the estate is governed by state law, following *Butner v. U.S.*, 440 U.S. 48 (1979), which, by the way, was also decided under the former Bankruptcy Act.

Judge Perkins’ opinion is *In re Brown*, 18-81242, 2019 BL 168813 (Bankr. C.D. Ill. May 9, 2019). *Brown* was not appealed. To read ABI’s discussion of *Brown*, [click here](#).

## The Search for a Unified Theory

The concept of the accrual of property interests is evidently different when dealing with claims by the estate, as opposed to claims against the estate. The difference makes sense in terms of viewing the Bankruptcy Code as a statute primarily for debtor relief.



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*Grossman's* ensures that more, not fewer, claims will be discharged. Decisions like those by Judges Katz and Perkins let debtors keep more intangible property. The decisions by those two judges make even more sense when the debtors have malpractice claims.

In the case of malpractice leading to the loss of discharge, debtors would suffer twice if malpractice claims belong to the trustee. The debtors will have lost their discharges and also find themselves without a suit against the lawyer who caused the damage in the first place.

So, the diverging rules make sense when the debtors are individuals. But what if the debtor is a corporation?

Assume that a chapter 7 corporate debtor has a claim that will not accrue under state law until after filing. If accrual is the only test, then the chapter 7 trustee will be unable to pursue the claim on behalf of creditors. Instead, the claim will remain property of the corporate debtor.

But the corporate debtor in chapter 7 does not receive a discharge.

So, what happens with a corporate chapter 7 debtor? Will shareholders pursue the claim and hope the trustee and creditors never find out? Will the target of the late-accruing claim escape liability? Can a creditor pursue the claim? Can the chapter 7 trustee somehow use strong-arm powers to lay claim to the lawsuit?

Perhaps *Segal* and *Frenville* reflect a policy that answers this hypothetical question. In the case of a corporate debtor, maybe the claim is sufficiently rooted in the prebankruptcy past so that the trustee could bring the claim on behalf of all creditors. Perhaps the rules are the same for claims by and against a corporate debtor in chapter 7. But does it make sense if the results are different for corporate chapter 7 debtors than for individual debtors?

If any of our readers have answers to these questions, please pass them along. We are flummoxed.

[The opinion is](#) *White v. Gaffney (In re Lloyd)*, 18-4027, 2019 Bankr Lexis 1982 (Bankr. D. Mass. June 28, 2019).



## *Jurisdiction & Power*



*Fifth Circuit rejects the 'recodification canon' to divest bankruptcy courts of jurisdiction over Social Security suits.*

## **Circuits Split on Bankruptcy Jurisdiction for Social Security, Medicare Suits**

Deepening an existing split of circuits, the Fifth Circuit held that the recodification canon does not divest the bankruptcy court of subject matter jurisdiction to hear Social Security claims.

In a revised opinion on July 25 by Circuit Judge Edith Brown Clement, the Fifth Circuit joined the Ninth Circuit. On the other side of the fence, the Third, Seventh, Eighth and Eleventh Circuits held there is no bankruptcy or diversity jurisdiction over Social Security claims.

The issue is important because the same jurisdictional question looms over Medicare and Medicaid claims. As a result of the Eleventh Circuit's opinion in *Florida Agency for Health Care Administration v. Bayou Shores SNF LLC (In re Bayou Shores SNF LLC)*, 828 F.3d 1297 (11th Cir. July 11, 2016), the bankruptcy court, for example, lacks jurisdiction to force the government to continue funding a hospital or nursing facility that files a chapter 11 petition. To read ABI's report on *Bayou Shores*, [click here](#).

It remains to be seen whether judges following the Fifth Circuit will conclude that the bankruptcy court has jurisdiction to force the government into funding hospitals and nursing homes in chapter 11.

### The Fifth Circuit Case

A debtor allegedly received an overpayment of Social Security benefits. According to the debtor, the Social Security Administration, or SSA, was improperly withholding a portion of his Social Security benefits to recover the overpayment.

Before bankruptcy, the debtor appealed to an administrative law judge from the agency's denial of a refund. The appeal was pending when the debtor filed a chapter 7 petition.

In bankruptcy court, the debtor sued the SSA to recover the benefits. The bankruptcy court granted the SSA's motion to dismiss and was upheld in district court on jurisdictional grounds.

The debtor appealed to the Fifth Circuit and won a reversal reinstating the suit in bankruptcy court. The debtor was represented in the circuit by Prof. John A. E. Pottow, the John Philip Dawson Collegiate Professor of Law at the University of Michigan Law School.





## The Recodification

Section 405(h) of Title 42 provides that no one may sue the government “under section 1331 or 1346 of Title 28 to recover on any claim arising under” the Social Security, Medicare or Medicaid laws until there is an exhaustion of remedies in the agency. Because jurisdiction in the bankruptcy court was based on Section 1334 — not Sections 1331 or 1346 — the plain language of the statute would seem to allow the suit in bankruptcy court. But it’s not so simple.

From 1939 to 1984, bankruptcy courts lacked jurisdiction over SSA claims because Section 405(h), as adopted in 1939, deprived federal courts of jurisdiction “under section 26 of the Judicial Code.” At the time, Section 26 contained virtually all of the grants of jurisdiction to federal courts, including bankruptcy and diversity jurisdiction.

In 1948, Congress recodified Section 26, establishing jurisdictional grants in Section 1331 for federal questions, Section 1332 for diversity, Section 1346 for suits against the government, and Section 1334 for bankruptcy. However, Congress did not get around to correcting Section 405(h) until 1984. In the intervening years, Section 405(h) continued referring to “section 26 of the Judicial Code” and was interpreted to mean there was no bankruptcy or diversity jurisdiction over Social Security, Medicare and Medicaid disputes.

Congress eventually recodified Section 405(h) in a technical corrections bill in 1984, resulting in the statute as it now reads, depriving federal courts of jurisdiction over Social Security, Medicare and Medicaid disputes under Sections 1331 and 1346. Pointedly, the recodification did not list Section 1334, the grant of bankruptcy jurisdiction, or 1332, for diversity jurisdiction.

The legislative history said that the bill was intended only to correct “technical errors.” The bill itself contained a provision saying that none of the amendments “shall be construed as changing or affecting any right, liability, status, or interpretation which existed (under the provisions of law involved) before” the amendments’ effective date.

## The Doctrine of Recodification Error

In the late nineteenth century, the Supreme Court pronounced the doctrine of recodification error, proclaiming that a recodification does not effect a substantive change without a clear expression of congressional intent.

The Third, Seventh, Eighth and Eleventh Circuits held that the omission of Sections 1332 and 1334 from Section 405(h) was a mistake in recodification and continued to hold that there was no bankruptcy or diversity jurisdiction.



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A circuit split arose in 1991 when the Ninth Circuit handed down *In re Town & Country Home Nursing Services Inc.*, 963 F.2d 1146 (9th Cir. 1991), and held that Section 405(h) did not prohibit the exercise of bankruptcy jurisdiction.

## The Fifth Circuit Heeds Justice Scalia

Writing for the Fifth Circuit, Judge Clement didn't buy the notion that there is "a hidden jurisdictional bar" resulting from a mistake in recodification. She said the doctrine only applies "in the absence of a clear indication from Congress that it intended to change the law's substance." She said that the clear indication of congressional intent is contained in the "actual words" of the statute.

Judge Clement cited *Reading Law: The Interpretation of Legal Texts*, a book by the late Justice Antonin Scalia. He said that the "new text is the law . . . even when the legislative history . . . expresses the intent to make no change."

Judge Clement interpreted Section 405(h) "to mean what it says. And it says nothing about Section 1334." Given the language of the statute, she said that the recodification canon cannot "trump the clear text."

The debtor did not win outright, however. A different sentence in Section 405(h) provides, "No findings of fact or decision of the Commissioner of Social Security shall be reviewed by any person, tribunal, or governmental agency except as" provided in Section 405(g). She went on to say that channeling into Section 405(g) "applies only where the would-be plaintiff is challenging a decision regarding his entitlement to benefits."

Judge Clement remanded for the bankruptcy court to determine whether there is jurisdiction. She said there would not be jurisdiction if the debtor's claims were "primarily about his entitlement to benefits." The bankruptcy court would have jurisdiction, she said, if the debtor was making a "claim for money because the [Social Security Administration] failed to comply with its own regulations in recouping the overpayment."

## Prof. Pottow's Observations

Prof. Pottow told ABI, "This is an area of flux.

"Earlier decisions were more confident brushing away the text. We now live in a different world of statutory interpretative methodology, so the [Eleventh Circuit's *Bayou Shores* opinion] had to do much heavier lifting to combat the text, resorting gamely to something called the recodification canon.



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“The Fifth Circuit has just taken the wind out of those sails, holding that properly applied, the recodification canon cannot bear such weight, and the text is the text.” With regard to Medicare, he said “it’s not obvious how their standard applies there.”

## The Modified Opinion

Judge Clement handed down her original opinion on May 10, prompting the government to file a motion for rehearing *en banc* on July 15. The rehearing motion led Judge Clement to issue her modified opinion on July 25. The new opinion did not alter the original version except with regard to the description of the issue for the bankruptcy court to decide on remand.

The government could file another petition for rehearing *en banc* or a petition for *certiorari* to the Supreme Court. ABI will report if the government takes another bite at the apple.

[The revised opinion is](#) *Benjamin v. U.S. (In re Benjamin)*, 18-20185, 2019 BL 275779 (5th Cir. May 10, 2019).



*Judge Sontchi declines to rule that 28 U.S.C. § 157 is unconstitutional by denominating fraudulent transfer suits as 'core' proceedings.*

## **Reading *Stern* Narrowly, Delaware Judge to Issue Final Order in Fraudulent Transfer Suit**

Narrowly interpreting Supreme Court authority, Chief Bankruptcy Judge Christopher S. Sontchi of Delaware disagreed with the Ninth Circuit and several district courts by holding that the bankruptcy court has constitutional authority to enter a final judgment in a fraudulent transfer suit against a defendant who neither filed a claim nor consented to final adjudication in bankruptcy court.

Judge Sontchi concluded that the Supreme Court has not explicitly ruled that Sections 157(b)(1) and (b)(2)(H) are unconstitutional when applied to fraudulent transfer suits against defendants who have not filed proofs of claim. Absent high court authority, he declined to find the statute to be unconstitutional.

When thinking about Judge Sontchi's opinion, consider this question: Did he ignore an obvious implication of *Stern v. Marshall*, 564 U.S. 462 (2011)?

### The Suit by the Creditors'

The Paragon Offshore PLC chapter 11 plan created a to pursue claims on behalf of creditors. The filed suit after confirmation to recover allegedly fraudulent transfers that occurred before Paragon's chapter 11 filing.

The defendants filed a motion asking Judge Sontchi to declare that he could only enter proposed findings of fact and conclusions of law. Judge Sontchi denied the motion in a scholarly March 11 opinion that surveys the ups and downs (mostly downs) of bankruptcy courts' powers following *Northern Pipeline Construction Co. v. Marathon Pipe Line Co.*, 458 U.S. 50 (1982) (plurality opinion).

Judge Sontchi laid out the statutory framework, beginning with 28 U.S.C. § 157(b)(1), where Congress gave bankruptcy courts power to "hear and determine . . . all core proceedings." Section 157(b)(2)(H) lists fraudulent transfer suits among "core proceedings." Thus, the statute permits bankruptcy courts to enter final judgments in fraudulent transfer suits.



By contending that he could not issue a final judgment in a fraudulent transfer suit, Judge Sontchi said that the defendants were asking him to rule that parts of 28 U.S.C. § 157 are unconstitutional.

## *Granfinanciera* and *Stern*

Judge Sontchi parsed the Supreme Court's bankruptcy decisions to identify what the justices held and how they limited their opinions. After *Marathon Pipe Line*, he examined *Granfinanciera S.A. v. Nordberg*, 492 U.S. 33 (1989), which, he said, was closely related but not binding, even though the facts were "closely analogous." Like the case at bar, *Granfinanciera* involved a fraudulent transfer suit against a defendant who had not filed a claim. The high court ruled that the defendant was entitled to a jury trial.

Judge Sontchi said that *Granfinanciera* at bottom was a Seventh Amendment case involving the right to a jury trial, not an Article III case regarding the constitutional limitations on the powers of bankruptcy judges. He said that *Granfinanciera* "alone" did not compel him to rule that Section 157(b)(2) violates Article III of the Constitution.

Judge Sontchi said that *Granfinanciera* "intentionally and explicitly refrained from extending its opinion to the constitutionality of the entry of final orders by bankruptcy courts pursuant to [Section 157] — the very issue before this Court today."

Next, Judge Sontchi turned to *Stern*. Like *Granfinanciera*, he said that *Stern* "does not bind lower courts on issues that were not directly before it."

While "its rhetoric may have been at points, sweeping," Judge Sontchi said that *Stern*'s "ultimate holding was not." Rather, he alluded to how the Chief Justice said that *Stern* should little affect the distribution of work between district and bankruptcy judges.

*Stern*, Judge Sontchi said, "included a crystal-clear statement that 'Congress, in one isolated respect, exceeded' its Article III power when passing the 1984 Amendments — and that 'isolated' issue is not the issue before this Court today."

Nodding to the Ninth Circuit and other courts that have ruled otherwise, Judge Sontchi said, "Perhaps *Stern* provides compelling evidences of how the Supreme Court *would* rule on this issue if it were to address it directly, but it does not decide it." [Emphasis in original.]

Since neither *Stern* nor *Granfinanciera* were controlling, Judge Sontchi said that the defendants "are not asking this Court to apply controlling precedent to the matter at hand. Instead, Movants are asking this court to *extend* the holdings of those cases, in order to find that 28 U.S.C. § 157(a) is unconstitutional to the extent it directs bankruptcy judges to enter final orders in





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fraudulent transfer claims against parties who have not filed claims against the bankruptcy estate. The Court decline to make that leap.” [Emphasis in original.]

Judge Sontchi made two other notable rulings. First, he held that a claim for unjust enrichment is noncore even when the claim is based on the same facts as a fraudulent transfer claim that is core. He also held that the defendants had not waived their objections to the final adjudicatory power of the bankruptcy court by participating in the formulation of the plan.

## Observations

*Stern* found a constitutional infirmity insofar as Section 157 lodged final adjudicatory authority in the bankruptcy court over a counterclaim based on a tortious interference claim under state law. *Stern* did not deal with a fraudulent transfer counterclaim.

So, the question is: Given the 5/4 ruling in *Stern* that Section 157(b)(2)(C) was unconstitutionally applied to the facts of the case before the Supreme court, does it follow ineluctably that Section 157(b)(2)(H) is also unconstitutional when the defendant has not filed a claim or consented to final adjudication in bankruptcy court?

In this writer’s view, *Stern* does imply that Section 157(b)(2)(H) is also unconstitutional on the facts of a case like that before Judge Sontchi. However, keep in mind that *Stern* was a 5/4 decision. Also recall that none of the opinions in *Marathon Pipe Line* commanded a majority of the justices.

It is therefore not a foregone conclusion that the Supreme Court will assuredly rule that Section 157(b)(2)(H) is unconstitutional when and if the question is squarely presented. It is possible that the high court will draw a line and say that the Court has gone far enough in eroding the powers of bankruptcy judges. However, don’t hold your breath.

[The opinion is](#) *Paragon Litigation v. Noble Corp. PLC (In re Paragon Offshore PLC)*, 598 B.R. 761 (Bankr. D. Del. March 11, 2019).



*Following dicta in Bellingham, Judge Collins finds no power to enter a final order in a fraudulent transfer suit against a defendant who did not consent.*

## **Final Orders Allowed in Preference Suits Against Defendants Who Didn't File Claims**

Constrained by the logic of *In re Bellingham Ins. Agency Inc.*, 702 F.3d 553, 565 (9th Cir. 2012), although not by its holding, Bankruptcy Judge Daniel P. Collins of Phoenix went as far as he could toward holding that bankruptcy courts have constitutional authority to issue final orders in preference and fraudulent transfer suits.

The March 15 opinion by Judge Collins is strikingly similar to a decision four days earlier by Chief Bankruptcy Judge Christopher S. Sontchi of Delaware in *Paragon Litigation v. Noble Corp. PLC (In re Paragon Offshore PLC)*, 17-51882, 2019 BL 81418, 2019 WL 1112298 (Bankr. D. Del. March 11, 2019).

Judge Sontchi held in *Paragon* that a bankruptcy court has constitutional authority to enter a final judgment in a fraudulent transfer suit against a defendant who neither filed a claim nor consented to final adjudication in the bankruptcy court. To read ABI's discussion of *Paragon*, [click here](#).

### The Fiduciary Duty Claims

The case before Judge Collins involved an adversary proceeding against multiple defendants asserting claims for breach of fiduciary duty, preference, and intentionally fraudulent transfer. Some of the defendants had filed proofs of claim, but others had not.

In what it described as a "narrow" holding, the Supreme Court ruled in *Stern v. Marshall*, 564 U.S. 462 (2011), that the bankruptcy court lacks constitutional authority to issue a final judgment on a state law counterclaim for tortious interference that would not be resolved in ruling on the creditor's proof of claim. In view of *Stern*, the plaintiff in the case before Judge Collins conceded that the bankruptcy court could not enter a final judgment on the fiduciary duty claims.

### The Preference Claims

The defendants argued that the bankruptcy court could not enter final orders on preference claims against those who had not filed proofs of claim.



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Judge Collins disagreed. He said that preference claims only exist as a matter of bankruptcy law and are “not independent of federal bankruptcy law.” He cited *Paragon* approvingly for the proposition that fraudulent transfer defendants are subject to the bankruptcy court’s final adjudicatory power, even if the defendant has not filed a proof of claim.

The “narrow scope of *Stern*,” together with the nature of preference claims as a “creature of the Bankruptcy Code,” led Judge Collins “to determine that preferential transfer avoidance claims are the type of ‘core proceedings’ over which this Court has the authority to enter final orders, regardless of whether a given Defendant has filed a proof of claim in this case.”

## Fraudulent Transfer Claims

On his final authority regarding fraudulent transfer claims, Judge Collins was constrained by *Bellingham*, whereas Judge Sontchi was not. *Bellingham* is generally understood to mean that the bankruptcy court has no final adjudicatory power over a fraudulent transfer defendant who did not file a claim or otherwise submit to the bankruptcy court’s power.

However, Judge Collins parsed *Bellingham* further. He said the case was “entirely resolved” by the determination that the defendant has “implicitly consented to the bankruptcy court’s authority by failing to challenge the court’s authority until the bankruptcy court’s decision was appealed.” *Bellingham* was *dicta*, he said, for the idea that defendants who had not filed proofs of claim are not subject to the bankruptcy court’s final adjudicatory power.

Finding *Bellingham*’s logic nonetheless “compelling,” Judge Collins held that a bankruptcy court cannot enter a final order against a fraudulent transfer defendant absent consent or the filing of a claim.

Judge Collins devoted the remainder of his opinion to describing what is or is not consent.

## Consent

One defendant had made a setoff argument to counter a fraudulent transfer claim. By raising setoff, Judge Collins said that the defendant had waived objections to the court’s power by invoking the claims-allowance process, even though he had found there was no valid setoff.

None of the defendants had demanded a jury trial. Consent did not result, Judge Collins said, because “failing to request a jury trial . . . is not indicative of Defendants’ consent to entry of final orders by a non-Article III Court.”

The plaintiff argued that some of the defendants consented to the bankruptcy court’s power by having participated in administrative aspects of the bankruptcy case before they were sued. Judge Collins found no waiver.



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While not having filed a claim, participating in “the administrative portion” of the case “does not waive the participant’s right to adjudication by an Article III court in a subsequent adversary proceeding brought against them.”

[The opinion is](#) *Morris Anderson & Associates Ltd. v. Redeye II LLC (In re Swift Air LLC)*, 14-00534, 2019 BL 94442, 2019 Bankr Lexis 852 (Bankr. D. Ariz. March 15, 2019).



*Even though subject matter jurisdiction persists when there is no longer an effect on the estate, the court may exercise discretion to dismiss, the Fifth Circuit says.*

## **'Related To' Jurisdiction Is Measured When the Suit Is Filed, Not Later, Circuit Says**

If “related to” jurisdiction exists at the outset of a lawsuit, the court retains personal and subject matter jurisdiction even if the basis for “related to” jurisdiction disappears later, the Fifth Circuit held on August 26.

Although subject matter jurisdiction continues to exist as a technical matter, the district court may still dismiss the suit as a matter of discretion, the circuit said.

Based on “related to” jurisdiction under 28 U.S.C. § 1334(b), a chapter 11 debtor brought a contract action in federal district court against two defendants. Later, the debtor assigned the claim to a creditor.

On motion by the defendants, the district court dismissed the suit for lack of personal and subject matter jurisdiction. The district court reasoned that jurisdiction ceased to exist when there was no longer a basis for “related to” jurisdiction once prosecution of the suit would no longer affect the chapter 11 estate.

In a five-page opinion, Fifth Circuit Judge Gregg Costa reversed the district court.

In a suit based on “ordinary” diversity or federal question jurisdiction, Judge Costa recited “hornbook law” for the proposition that jurisdiction is tested by the “time-of-filing rule.” In other words, jurisdiction for the duration of a suit “is determined when a federal court’s jurisdiction is first invoked.”

Judge Costa held that the rule also governs “related to” jurisdiction. The district court, he said, “erred by failing to apply the time-of-filing rule to Section 1334(b)” because the principle “applies to bankruptcy jurisdiction no less than it applies to diversity or federal question jurisdiction.”

“Indeed,” he said, “even the closing of a bankruptcy case does not divest federal courts of Section 1334(b) jurisdiction.”

Similarly, the time-of-filing rule resulted in the continuation of personal jurisdiction.





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In an ordinary case based on federal question or diversity jurisdiction, personal jurisdiction over a defendant is based on F.R.C.P. 4, which requires the defendant to have sufficient contacts with the state where the suit is brought.

But when jurisdiction is based on Section 1334(b), Judge Costa described how Bankruptcy Rule 7004 allows “nationwide service of process without limitation to the reach of the forum state’s courts.” When service of process is made under Rule 7004, minimum contacts with the state “are beside the point,” he said, because minimum contacts with the U.S. “suffice.”

Judge Costa therefore held that “Section 1334(b) jurisdiction that existed when the case was filed thus means there is both subject matter and personal jurisdiction” even after there is no longer an effect on the estate.

That wasn’t the end of the story. In the Fifth Circuit and elsewhere, Judge Costa cited the “general rule” that “strongly” favors discretionary dismissal if the bankruptcy case has been dismissed.

Judge Costa remanded the case for the district court to decide whether discretionary dismissal would be appropriate. He also called on the district court to consider the forum selection clause in the parties’ contract and the possibility of “a venue transfer” rather than dismissal.

[The opinion is](#) *Double Eagle Energy Services LLC v. Markwest Utica EMG LLC*, 19-30207 (5th Cir. Aug. 26, 2019).



*Seventh Circuit splits with other circuits on basis for jurisdiction to determine the amount of a tax.*

## **Section 505(a) Doesn't Confer Jurisdiction to Determine Amount of a Tax, Circuit Says**

A September 20 opinion from the Seventh Circuit reads like a suspense novel: For nine pages, Circuit Judge Frank H. Easterbrook sounded as though he was rejecting a test for “related to” jurisdiction adopted by nine other circuits.

Then, on page 10, Judge Easterbrook abruptly announced that the Seventh Circuit would adopt the position taken everywhere else. He found “related to” jurisdiction when there appears to be a conceivable effect on a bankruptcy estate *at the time the proceeding commences*.

Despite finding jurisdiction, Judge Easterbrook ended his opinion by directing the bankruptcy court to abstain because resolution of the tax dispute would have no effect on creditors or the estate *at the time the appeal was decided*. The ruling in that regard is curious because an abstention decision is not reviewable in the court of appeals under 28 U.S.C. § 1334(d).

The case was argued in May 2017; the appeals court took 28 months to issue a decision.

### The Tax Dispute

Although Judge Easterbrook did not say so directly, the debtors may have committed tax fraud and were forum-shopping, facts that may have influenced the outcome.

The Internal Revenue Service had assessed \$107,000 in taxes plus \$80,000 in penalties for fraud. The debtors sought review in the Tax Court and later agreed with the IRS that they owed \$100,000 in taxes. However, they did not agree on the amount of penalties.

The IRS was seeking 75% in penalties for fraud, while the debtors thought \$20,000 was the correct amount for negligence. On the day of trial in Tax Court, the husband and wife debtors filed a chapter 13 petition. After the bankruptcy court denied a motion by the IRS to modify the automatic stay, the debtors converted the case to chapter 7.

The IRS did not appeal denial of a stay modification. However, the IRS did file a priority proof claim for the taxes and penalties, alleging that the penalties were nondischargeable. The debtors filed an objection to the claim. Contending that they were not liable for fraud penalties, the debtors



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filed a motion about three months into the bankruptcy case, asking the bankruptcy court to determine the amount of the debt under Section 505(a)(1).

The IRS moved to dismiss the Section 505 proceeding, contending there was no subject matter jurisdiction to determine the amount of the tax debt. The bankruptcy court denied the motion to dismiss and declined to abstain about 10 months into the bankruptcy case.

The IRS sought and obtained permission for an interlocutory appeal. The district court disagreed with the bankruptcy court and found no subject matter jurisdiction. Because the district court's order was final, the debtors were entitled to appeal to the circuit.

The trustee did not sell the largest chunk of estate property until almost two years after the bankruptcy court's ruling on jurisdiction, about the same time that the jurisdiction appeal was being argued in the Seventh Circuit. The trustee did not file the final report until about two years after the appeal was argued in the circuit court.

## Section 505 Isn't Jurisdictional

The debtors argued that Section 505 grants jurisdiction. The section provides that the court “may determine the amount or legality of any tax . . . .”

Judge Easterbrook said it was “unfortunate” that other circuits have referred to Section 505 as jurisdictional. He said, “we do not see what Section 505 has to do with jurisdiction, a word it does not use.” Provisions in the Bankruptcy Code like Section 505 “are unrelated to jurisdiction,” he said.

Instead, Judge Easterbrook said, grants of jurisdiction appear in Title 28, the Judicial Code. Quoting Section 105(c) of the Bankruptcy Code, he ruled that the jurisdiction depends on 28 U.S.C. § 1334, the statute granting general bankruptcy jurisdiction.

## Jurisdiction under Section 1334

Having won round one, the IRS next argued there was no jurisdiction under Section 1334(b).

Judge Easterbrook found no “arising in” jurisdiction because a “proceeding to determine taxes and penalties does not arise in bankruptcy in this sense,” because “[m]ost tax disputes are resolved outside of bankruptcy.”

Similarly, Judge Easterbrook said there was no “arising under” jurisdiction because there was no “substantive question of bankruptcy law.” Rather, the dispute turned on the IRS Code.



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Turning to “related to” jurisdiction, Judge Easterbrook found no constitutional constraints of the *Stern* variety because concerns about “jurisdiction for state-law disputes are not salient for federal tax disputes.” If the bankruptcy court did not fix the amount of tax owing, the dispute would be resolved by a judge in Tax Court, another Article I tribunal.

## The Effect on Creditors

The government contended there was no “related to” jurisdiction given the lack of an effect on creditors or the estate.

In response, Judge Easterbrook asked whether “related-to jurisdiction really depends on how things look at the end of the bankruptcy.” On the other hand, he said, “one of the most fundamental rules of federal jurisdiction is that judicial authority depends on the state of affairs when a case begins . . . rather than on how things turn out.”

When the debtors filed their motion for the bankruptcy judge to determine their tax liability, Judge Easterbrook said there could have been an effect on creditors.

Nonetheless, the IRS contended that there was no effect on creditors at the later time when the bankruptcy court would have ruled on tax liability. In other words, Judge Easterbrook asked, is jurisdiction decided “in light of how things turn out”?

To answer the question, Judge Easterbrook cited *Celotex Corp. v. Edwards*, 514 U.S. 300, 308 n.6 (1996), where he said the Supreme Court “favorably quoted” a rule adopted in nine circuits to the effect that “related to” jurisdiction turns on a conceivable effect on the estate. He said that *Celotex* “avoids making a jurisdictional decision only after the merits have been resolved and the effect can be known with certainty.”

“Under [the *Celotex*] approach,” Judge Easterbrook said, the debtor’s motion to determine tax liability “is within the related-to jurisdiction.”

Judge Easterbrook observed that nine circuits addressing the question “unanimously conclude that *ex ante* perspective is the right one,” not “*ex post* perspectives.” The Seventh Circuit, he said, has not ruled on the issue.

To “align this circuit with the view widely held by our colleagues elsewhere,” Judge Easterbrook ruled that “related-to jurisdiction must be addressed at the outset of the dispute, and is satisfied when the resolution has a potential effect on other creditors.”

Judge Easterbrook therefore reversed the district court because the bankruptcy court did have subject matter jurisdiction over the tax dispute.



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## Abstention

Although the bankruptcy court did have subject matter jurisdiction, Judge Easterbrook said that the “exercise [of] that authority was “a distinct question.”

By the time the Seventh Circuit issued its decision, Judge Easterbrook gleaned from the bankruptcy court’s docket that the estate’s assets had been distributed, the final report had been filed, and the automatic stay had “lapsed by its own terms.” He therefore found “no reason why this residual dispute about tax penalties should stick with the bankruptcy judge, who otherwise is done with the case, rather than the specialized judges in the Tax Court.”

Judge Easterbrook vacated the district court’s finding of no jurisdiction but remanded the case with instruction for the bankruptcy court to abstain under Section 1334(c)(1).

## Observations

Beyond the holding that Section 505(a) is not jurisdictional, courts elsewhere might disagree with other aspects of the opinion.

Judge Easterbrook tersely rejected the idea of “arising in” or “arising under” jurisdiction. But even though tax disputes are ordinarily decided in Tax Court under the IRS Code, is there an argument that Section 505(a) results in a contested matter that arises in the bankruptcy case or arises under the Bankruptcy Code?

At the time of oral argument in the Seventh Circuit, May 2017, the bankruptcy case was active. The trustee would not file the final report until February 2019, showing that the priority claim of the IRS would consume all assets after payment of administrative expenses.

Would abstention have been the proper result if the appeals court had issued its opinion soon after argument when it was unclear whether unsecured creditors would receive a distribution?

And how could the appeals court in substance overturn the bankruptcy judge’s ruling on abstention when Section 1334(d) provides that a decision to abstain or not to abstain “is not reviewable by appeal or otherwise by the court of appeals . . . .”?

[The opinion is](#) *Bush v. U.S.*, 16-3244, 2019 BL 354488 (7th Cir. Sept. 20, 2019).





*W.R. Grace makes more law on channeling injunctions.*

## **Another Court Limits 'Related To' Jurisdiction Based on Indemnification Claims**

In the context of mass tort bankruptcies like *Johns Manville*, *W.R. Grace* and *Quigley*, the Second and Third Circuits have prescribed limits on the extent to which so-called channeling injunctions can bar creditors from asserting their own claims against insurers that provided coverage for debtors.

The Third Circuit issued a seminal decision in August 2018 in the W.R. Grace bankruptcy. *Continental Casualty Co. v. Carr (In re W.R. Grace & Co.)*, 900 F.3d 126 (3d Cir. Aug. 14, 2018).

Reversing and remanding the case to bankruptcy court, the Third Circuit explored the outer limits of channeling injunctions by defining when creditors cannot sue insurance companies and must collect their claims only from a trust created as part of a chapter 11 plan. Basically, the appeals court said that a channeling injunction can go only so far as Section 524(g) allows in protecting non-debtor third parties like insurers. To read ABI's report on last year's opinion, [click here](#).

In the lawsuit that the Third Circuit remanded to bankruptcy court, the plaintiffs are asserting claims against W.R. Grace's insurers under Montana law, contending that the insurers were negligent and failed to warn about the dangers of exposure to asbestos.

After the case was remanded to the Delaware bankruptcy court, the Third Circuit tapped Bankruptcy Judge Ashely M. Chan of Philadelphia to take over for a bankruptcy judge who was retiring.

On September 23, Judge Chan handed down a 56-page opinion where she concluded that the claims were not based on derivative liability and therefore were not enjoined. She authorized the plaintiffs to continue litigation against the insurers in Montana state court.

Judge Chan's opinion reads like a treatise, tracing the evolution of the law on derivative claims and channeling injunctions principally from the Second and Third Circuits. As mandated by the Third Circuit, she explored Montana law to decide whether the injunction in the W.R. Grace plan stopped the plaintiffs from prosecuting claims against the insurers. In substance, she concluded that the negligence and failure-to-warn claims were not derivative in nature and were therefore not subject to the channeling injunction.



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There is a novel aspect to Judge Chan's decision regarding subject matter jurisdiction. In the appeal last year, the parties did not seriously contest subject matter jurisdiction. Essentially, the Third Circuit tersely said there was "related to" jurisdiction entitling the bankruptcy court to decide whether the injunction was properly imposed under Section 524(g).

Judge Chan took a step back and said there was no subject matter jurisdiction in the first place because the broad "conceivable effect" test for "related to" jurisdiction is more narrow when based on indemnification obligations.

In the course of the W.R. Grace reorganization, the debtor reached a settlement with insurers where they paid \$84 million. In return, the debtor agreed, among other things, to indemnify the insurers up to \$13 million for any payments they might make on account of asbestos claims that were not channeled through the trust.

Judge Chan recognized that "related to" jurisdiction can result from the effect on the trust stemming from the indemnification obligation. Critical to her decision on jurisdiction, she said that the insurers had no right of indemnification absent the settlement agreement made years before.

Judge Chan parsed *In re Combustion Engineering Inc.*, 391 F.3d 190 (3d Cir. 2004), as amended (Feb. 23, 2005), where the Third Circuit said there is no "related to" jurisdiction when a third party's claim "did not directly result in liability for the debtor." *Id.* at 231.

Judge Chan also analyzed *Feld v. Zale Corp. (In re Zale Corp.)*, 62 F.3d 746 (5th Cir. 1995), where the creditors' bad faith tort claims against the insurer were based on the misconduct of the insurer, not the debtor. The only connection between the bad faith claims and the debtor's estate was the debtor's settlement agreement to indemnify the insurer for claims that could not be brought against the debtor.

Judge Chan quoted the Fifth Circuit as holding "that the settlement agreement did not 'provide the basis for jurisdiction over the bad faith claims.'" *Id.* at 756.

Applying the law to the facts, Judge Chan said that neither the debtor nor the trust would have any liability for the Montana claims aside from the settlement and its indemnification agreement. "In other words," she said, the Montana litigation "does not, in and of itself, give rise to *any* claims in favor of [the insurers] against Grace or the Trust." [Emphasis in original.]

Judge Chan returned to *Combustion Engineering*. When the court lacks subject matter jurisdiction, the Third Circuit said that "the parties cannot create it by agreement even in a plan of reorganization." *Combustion Engineering*, 391 F.3d at 228. In other words, the settlement agreement could not confer subject matter jurisdiction when the debtor otherwise would have had no indemnification obligations.



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Judge Chan ended her discussion of subject matter jurisdiction by saying that she was “constrained to respectfully observe that the Bankruptcy Court did not have jurisdiction over the Montana Claims.”

Ordinarily, a finding of a lack of jurisdiction would end the discussion, and the court would not explore the merits, like Section 524. Of course, Judge Chan did rule on the merits in accordance with the mandate from the Third Circuit. Her discussion of jurisdiction may be helpful in the future when other courts face similar questions regarding indemnification as a basis for “related to” jurisdiction.

*In re Imerys Talc America Inc.*, 19-mc-103, 2019 BL 267734, 2019 U.S. Dist. Lexis 120572, 2019 WL 3253366 (D. Del. July 19, 2019), is another Delaware case parsing the more limited reach of “related to” jurisdiction based on indemnification claims. To read ABI’s discussion, [click here](#).

The opinion is *Continental Casualty Co. v. Carr (In re W.R. Grace & Co.)*, 15-50766 (Bankr. D. Del. Sept 23, 2019).



*Judges Pappas and Teel permit avoidance actions for small amounts to be prosecuted in the debtors' bankruptcy courts.*

## **Courts Divided on Venue for Small-Dollar Avoidance Actions**

When a trustee pursues an avoidance action for less than \$12,850, is the debtor's bankruptcy court the proper venue?

The courts are divided, but Bankruptcy Judges Jim D. Pappas of Pocatello, Idaho, and S. Martin Teel, Jr., of Washington, D.C., concluded that venue is proper in the debtor's court, even if their conclusions were based on a drafting error that Congress may have committed in adopting 28 U.S.C. § 1409(b).

The facts in both cases were typical of a small-dollar avoidance actions. The trustees were seeking to recover about \$11,000 and \$12,000, respectively. In Idaho, the trustee was pursuing a constructively fraudulent transfer under Section 548 and Idaho law. In Washington, D.C., the trustee was after a preference under Section 547.

Claiming that venues in the debtors' courts were improper under Section 1409(b), both defendants filed motions to dismiss under Rule 12(b)(3).

Saying that the courts do not agree, Judges Pappas and Teel relied on the plain meaning of Section 1409(b) in concluding that venue was proper in the debtors' courts.

Section 1409 governs venue in bankruptcy cases. Subsection (a) says that "a proceeding arising under title 11 or arising in or related to a case under title 11 may be commenced in the district court in which such case is pending."

Subsection (b) provides that a trustee "may commence a proceeding arising in or related to such a case to recover a money judgment of or property worth less than \$1,300 or a consumer debt of less than \$19,250, or a debt (excluding a consumer debt) against a noninsider of less than \$12,850, only in the district court for the district in which the defendant resides."

The two subsections use notably different language. Subsection (a) applies to proceedings arising under, arising in, or related to a title 11 case. Subsection (b) only refers to proceedings "arising in or related to" a title 11 case. Is the distinction significant, or is the absence of "arising under" in subsection (b) a distinction without a difference?



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Because the suits sought less than \$12,850, the defendants contended that they could only be sued where they resided, not in the debtors' home courts.

Like Judge Teel, Judge Pappas pointed out that subsection (b) “makes no mention of cases ‘arising under’ title 11.” For both judges, the distinction was important, given the parties’ concessions that the avoidance actions — based on Sections 547, 548, 544(b) and 550 — were proceedings arising under title 11.

If subsection (a) alone was applicable, venue in the debtor’s bankruptcy court was proper because the proceedings arose under title 11. However, the defendants made several arguments contending that subsection (b) applied, but both judges knocked them all down.

Judge Pappas said that the “plain language interpretation” of subsection (b) “has led many courts to conclude that it applies only to claims ‘arising in’ and ‘related to’ under title 11, but not to those ‘arising under’ title 11.” Other courts, including the Bankruptcy Appellate Panel for the Ninth Circuit, held otherwise, he said, believing “that Congress unintentionally omitted ‘arising under’ from subsection (b).”

Citing *Lamie v. U.S.*, 540 U.S. 526 (2004), both judges said that the Supreme Court nixed the idea that a court may disregard the plain language of a statute by presuming that Congress made a mistake. Even if the BAP opinion were binding, Judge Pappas said it was not good law because it preceded *Lamie*.

Finding no absurd result, Judge Pappas held that the monetary limitations of subsection (b) did not apply because the avoidance action arose under title 11. Because subsection (a) applied, Judge Pappas concluded that venue was proper in the debtor’s court.

Likewise, Judge Teel agreed with decisions concluding “that Section 1409(b) does not apply to a proceeding ‘arising under title 11.’”

Cases to the contrary, according to Judge Teel, were “unpersuasive.” Similarly, Judge Pappas declined to follow a pair of bankruptcy court decisions that had invoked the \$12,850 threshold for avoidance actions, saying they gave “terse treatment” to the question.

Judge Teel pointed out several “odd results” that would occur if “arising under” cases were included in subsection (b). A trustee could avoid a transaction in the debtor’s home court under subsection (a) but then be forced to obtain a money judgment for the value of the property in the defendant’s hometown under subsection (b).





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Judge Teel came up with another odd result: Subsection (b) only applies to trustees. Thus, a debtor could always sue in the debtor's home court, but a trustee seeking the same relief on the same claim could not.

Another question: If subsection (b) did apply, which part governed? Was the suit (1) "a case to recover a money judgment of or property worth less than \$1,300," where venue would be proper in the debtor's bankruptcy court, or was it (2) a case to recover "a debt . . . of less than \$12,850," in which event venue would be improper, Judge Pappas asked?

Employing a "practical reading" of the statute, Judge Pappas said that the "real effect" of the suit was "to recover money judgments or property" for more than \$1,300, making the \$12,850 threshold inapplicable and meaning that venue was proper.

Judges Pappas and Teel denied the motions to dismiss for improper venue.

The opinions are *Klein v. ODS Technologies LP (In re J & J Chemical Inc.)*, 596 B.R. 704 (Bankr. D. Id. Jan. 11, 2019); and *Webster v. Republic National Distributing Co. LLC (In re Tadich Grill of Washington DC LLC)*, 598 B.R. 65 (Bankr. D. D.C. March 12, 2019).



*Ninth Circuit says that Section 158(d)(1) isn't an appeals court's jurisdiction over a 'Stern' matter.*

## **'Stern' Disputes Invoke a Circuit Court's General Jurisdiction Under 28 U.S.C. § 1291**

In a nonprecedential opinion, the Ninth Circuit identified one of the finer points of an appeals court's jurisdiction over a noncore dispute falling under the ambit of *Stern v. Marshall*, 564 U.S. 462 (2011).

The Ninth Circuit said it was “visiting an old friend,” because the case involved the deceased Anna Nicole Smith, her similarly deceased husband, J. Howard Marshall II, and E. Pierce Marshall, J. Howard's son. You guessed it! They are the litigants whose disputes resulted in the *Stern* decision defining constitutional limits on a bankruptcy court's power to enter final orders.

Long after the Supreme Court ruled in *Stern*, Anna Nicole's estate appealed the denial of a motion in district court for relief from a judgment under Rule 60(b)(5)-(6) of the Federal Rules of Civil Procedure. The district court ruled that it did not have jurisdiction for several reasons. The Ninth Circuit reversed.

For bankruptcy nerds, one aspect of the Ninth Circuit's January 31 opinion is significant.

The genesis of the dispute, as the Supreme Court said in its landmark *Stern* decision, was a noncore matter where the bankruptcy court could only issue proposed findings under 28 U.S.C. § 157(c)(1).

The Rule 60(b) motion was therefore made in a noncore dispute, but the district court said it was exercising bankruptcy appellate jurisdiction.

The Ninth Circuit disagreed, saying the district court was not exercising bankruptcy appellate jurisdiction under 28 U.S.C. § 158(a)(1). Rather, the appeals court said the district court “entered judgment pursuant to its original jurisdiction in bankruptcy matters. *See* 28 U.S.C. § 1334(b).”

Consequently, the Ninth Circuit ruled that it had jurisdiction “under 28 U.S.C. § 1291, our general grant of jurisdiction to hear appeals from ‘final decisions of the district courts of the United States.’”



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Appellate jurisdiction therefore did not rest in the circuit court under 28 U.S.C. § 158(d)(1), the Ninth Circuit said, “because that provision only authorizes appeals from district court orders entered under 28 U.S.C. § 158(a).”

[The opinion is](#) *Marshall v. Stern (In re Marshall)*, 754 Fed. Appx. 566 (9th Cir. Jan. 31, 2019).



*'Conceivable effect' test for 'related to' jurisdiction continues to apply to liquidating trusts after confirmation of a chapter 11 plan.*

## **'Close Nexus' Test Doesn't Apply to Liquidating Trusts After Confirmation**

A district judge in Colorado predicted that the Tenth Circuit would follow the First Circuit by holding that “related to” jurisdiction does not narrow after confirmation when the plaintiff is a liquidating debtor (or liquidating trust) that has not returned to the marketplace.

In his September 10 opinion, District Judge R. Brooke Jackson of Denver cited the so-called *Pacor* test for the proposition that federal courts have “related to” jurisdiction under 28 U.S.C. § 1334(b) if the proceeding could have a “conceivable effect” on the estate in bankruptcy. *Pacor Inc. v. Higgins*, 743 F.2d 984, 994 (3d Cir. 1984), overruled on other grounds by *Things Remembered v. Petrarca*, 516 U.S. 124 (1995)).

Judge Jackson went on to say that “most courts” hold that “related to” jurisdiction “narrows” after confirmation of a chapter 11 plan. Like *Pacor*, the leading case in that regard comes from the Third Circuit, where the Philadelphia-based appeals court requires a “close nexus” after confirmation to the “implementation, consummation, execution, or administration of the confirmed plan.” *Binder v. Price Waterhouse & Co. LLP (In re Resorts International Inc.)*, 372 F.3d 154, 167 (3d Cir. 2004).

Although the Tenth Circuit has not done so formally, he said that the Second, Fourth and Ninth Circuits have adopted *Resorts International*.

However, the case before Judge Jackson was not an ordinary chapter 11 reorganization where the debtor corporation continued doing business after confirmation and consummation of a plan.

The debtor corporation had confirmed a liquidating chapter 11 plan in 2008 that created a liquidating trust authorized to take any actions necessary to pay creditors. After confirmation, the trust sued insiders, alleging that they had fraudulently transferred company property to themselves.

The trust settled with the insiders for a nominal amount because they represented that they had no substantial assets. The settlement agreement provided that the trust could have a \$15 million nondischargeable judgment if the insiders had misrepresented their financial condition.



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In 2018 (10 years after confirmation), the trust sued the insiders in district court in a complaint based on “related to” jurisdiction. The complaint alleged that the insiders had substantial assets they had not disclosed. The suit included claims for fraudulent transfer under Section 548 and state law.

The insiders moved to dismiss, contending that the court lacked “related to” jurisdiction so long after confirmation. Judge Jackson denied the motion.

When a liquidating plan is involved, Judge Jackson said that “most courts have not narrowed post-confirmation jurisdiction.” At the circuit level, he cited *Boston Regional Medical Center Inc. v. Reynolds (In re Boston Regional Medical Center Inc.)*, 410 F.3d 100 (1st Cir. 2005). The Boston-based appeals court said that “narrowing interpretations have been invoked only with respect to actions involving reorganizing debtors that have reentered the marketplace.” *Id.* at 105-106.

In the liquidations of *Delphi* and *Lehman Brothers*, Judge Jackson said that district courts in the Southern District of New York followed the First Circuit. The *Lehman* court found “related to” jurisdiction because the suit “could impact the amounts available to be paid to [Lehman’s] creditors.” *Fried v. Lehman Brothers Real Estate Associates III LP*, 496 B.R. 706, 710 (S.D.N.Y. 2013).

Judge Jackson conceded that the Ninth Circuit is an “outlier” by continuing to apply the “close nexus” test to a liquidating trust after confirmation.

Judge Jackson found *Boston Regional*, *Lehman* and *Delphi* to be “more persuasive.” In his case, he said the claims were “related to the ongoing bankruptcy” for several reasons.

The defendants, Judge Jackson said, allegedly had “squirreled away tens of millions of dollars” of the bankrupt company’s assets. The suit had the necessary relationship to the bankruptcy case because the liquidating trust was charged with collecting the debtor’s assets and filing lawsuits to recover property. He found the required relationship to the bankruptcy case because the “sole purpose [of the liquidating trust] is to implement and execute the confirmed Plan.”

In short, Judge Jackson found subject matter jurisdiction because the recovery in the suit “will directly impact [the debtor’s] creditors making this lawsuit more closely related to the bankruptcy.” The judge said he was not laying down a rule where bankruptcy jurisdiction would continue endlessly because the debtor was no longer in business.

[The opinion is](#) *Centrix Financial Liquidating Trust v. Sutton*, 18-02769 (D. Colo. Sept. 10, 2019).





*A divided panel of the Sixth Circuit holds that Section 106 does not waive sovereign immunity for Indian tribes.*

## **Creating a Split, Sixth Circuit Holds: No Waiver of Immunity for Indian Tribes**

In a 2/1 decision, the Sixth Circuit created a split of circuits by holding that Sections 106 and 101(27) do not waive sovereign immunity with respect to Indian tribes.

The majority on the appeals court also held that the tribe's filing of a bankruptcy petition for one of its businesses did not waive sovereign immunity when creditors later filed a fraudulent transfer suit against the tribe.

The opinion appears to mean that a tribe can loot a business it owns, put the business in bankruptcy, then escape liability for its pre-bankruptcy conduct, unless the tribe has waived immunity under the tribe's internal governing rules.

### The Facts

A tribe was part owner of a casino in Michigan that filed a chapter 11 petition and confirmed a plan, creating a creditors' . In bankruptcy court, the sued the tribe for \$180 million, contending that the tribe had been the recipient of a pre-bankruptcy fraudulent transfer.

In a prior appeal, the district court ruled that Congress had not waived a tribe's sovereign immunity in Section 106. However, the district court remanded the case for the bankruptcy court to determine whether the tribe's conduct waived sovereign immunity.

The bankruptcy court found no waiver by conduct. District Judge Paul D. Borman upheld dismissal of the suit in January 2018, ruling that the tribe had not waived sovereign immunity. The trustee appealed to the Sixth Circuit. To read ABI's report on the district court opinion, [click here](#).

### The Circuit's Opinion

Writing for himself and Circuit Judge Richard A. Griffin, Circuit Judge Eric L. Clay recited black letter law for the notion that Congress must "unequivocally" express intent to waive sovereign immunity. Do Sections 106 and 101(27) "express such an intent," he asked?



Section 106(a) abrogates sovereign immunity “as to a governmental unit” with respect to enumerated sections of the Bankruptcy Code, including Sections 544 and 550, under which the trustee was suing the tribe.

In turn, Section 101(27) defines “government unit” to “mean” (not “include”), among other things, the U.S., states, municipalities, foreign states or “other foreign or domestic government.”

## Waiver by Statute

Judge Clay said that only two circuits have dealt with tribal sovereign immunity under the Bankruptcy Code. The Ninth Circuit found a waiver in *Krystal Energy Co. v. Navajo Nation*, 357 F.3d 1055 (9th Cir. 2004), holding that Congress did express an unequivocal intent to waive immunity.

On the other hand, Judge Clay cited *Meyers v. Oneida Tribe of Indians of Wisconsin*, 836 F.3d 818 (7th Cir. 2016), where the Seventh Circuit found no waiver under a different statute. In *dicta*, the Seventh Circuit said its reasoning would apply to Section 106.

Judge Clay was persuaded by *Meyers*, not by the Ninth Circuit. Although a tribe is both “domestic” and a “government,” “that is not the real question,” he said.

For Judge Clay, the “real question” is “whether Congress . . . unequivocally expressed an intent to abrogate tribal sovereign immunity.”

Judge Clay said there was not one instance where the Supreme Court had found a waiver of tribal immunity when the statute did not expressly mention “Indian tribes somewhere in the statute.” He found only one instance at the circuit level, and that was the Ninth Circuit in *Krystal*.

Judge Clay did not hold that Congress can only waive immunity by specific reference to tribes. Rather, he held that Sections 106 and 101(27) “lack the requisite clarity of intent to abrogate tribal sovereign immunity.”

## Waiver by Conduct

Next, Judge Clay dealt with the question of whether the tribe had waived immunity by conduct.

The tribe’s casino had waived immunity by contract. However, the tribe’s board had not authorized the waiver of immunity. Consequently, the waiver was not binding on the tribe.

Still, could the tribe waive immunity by litigation conduct? Although the Supreme Court has held that litigation conduct can be a waiver for non-tribal governments, Judge Clay said that only a few courts had found a litigation waiver by tribes.



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Judge Clay cited two circuit courts holding that intervention in a lawsuit constitutes waiver and three that found a waiver by filing a lawsuit. He therefore held that “Indian tribes can waive their tribal sovereign immunity through sufficiently clear litigation conduct, including by filing a lawsuit.”

However, he went on to hold on the next page that “litigation conduct by alter egos or agents of Indian tribes cannot be attributed to the tribes for the purpose of waiving tribal sovereign immunity.”

Therefore, the majority upheld dismissal, ruling that “the filing of a bankruptcy petition does not waive tribal sovereign immunity as to separate, adversarial fraudulent transfer claims.”

## The Dissent

Sitting by designation from the Northern District of Ohio, District Judge Jack Zouhary dissented.

In Section 101(27), Judge Zouhary said that Congress “chose to speak broadly” by abrogating immunity “of any government, of any type, anywhere in the world.” For him, the statute was a “clear” waiver. Next, he said that a tribe is a “domestic government.”

Judge Zouhary concluded that the Bankruptcy Code waived sovereign immunity as to tribes because immunity is abrogated “as to all governments[, and] Indian tribes are governments.”

Judge Zouhary disputed the idea that there is an extant circuit split. The Seventh Circuit, he said, dealt with a different statute where the waiver as to tribes was “ambiguous.” The statute before the Seventh Circuit made “no mention of sovereign immunity, [while] the [Bankruptcy] Code targets it directly,” he said.

Judge Zouhary criticized the idea that a statutory waiver must mention Indian tribes. He pointed to Justice Antonin Scalia, who provided the fifth vote in an immunity case and said that a congressional waiver is not required to make explicit reference to any particular terms.

Courts could also look to the “larger statutory scheme,” Judge Zouhary said. To enforce an equitable distribution, he said that Sections 106 and 101(27) have a broad abrogation of sovereign immunity, where “all governments must play by the rules.”



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The opinion is *Buchwald Capital Advisors LLC v. Sault Ste. Marie Tribe of Chippewa Indians (In re Greektown Holdings LLC)*, 917 F.3d 451 (6th Cir. Feb. 26, 2019).



*Appeals court insinuates that denial of a lift-stay motion without prejudice is not appealable.*

## **Sixth Circuit Pronounces a Two-Prong Test to Determine 'Finality'**

Appointed to the appeals court last year, Circuit Judge Amul Thapar attempted what no court or commentator has so far accomplished successfully: He formulated a test for deciding when an order is “final” and therefore appealable in the bankruptcy context.

It is unclear, however, whether Judge Thapar’s test can predictably and fairly discriminate between appealable and non-appealable orders in all circumstances.

The appeal to the Sixth Circuit involved a motion to lift the automatic stay, which was denied in bankruptcy court. The creditor who lost the motion did not appeal within 14 days.

Instead, the creditor filed an appeal from the denial of the lift-stay motion months later when the bankruptcy judge sustained the debtor’s objection to the creditor’s claim. In his October 16 opinion, Judge Thapar upheld the district judge who had dismissed the appeal for being untimely.

In his 15-page opinion, Judge Thapar cited five circuits and the *Collier* treatise for saying that courts “almost uniformly” hold that denial of a lift-stay motion is an appealable order. Rather than cite those authorities and be done with it, he searched for a principled standard to discern “finality.”

Judge Thapar cited *Bullard v. Blue Hills Bank*, 135 S. Ct. 1686, 1692 (2015), for the proposition that orders are appealable in bankruptcy “if they dispose of discrete disputes within the larger case.” He went on to say that “courts have taken the loose finality in bankruptcy as license for judicial invention. The result: a series of vague tests that are impossible to apply consistently.”

According to Judge Thapar, some courts do not articulate a general test at all. They “simply treat the finality of the specific order before them as a case-by-case question and do not look to or articulate principles that can be applied to other types of orders.”

For guidance in formulating a test, Judge Thapar took counsel from the statute governing appealability, 28 U.S.C. § 158(a), which grants appellate jurisdiction to district courts from “final judgments, orders, and decrees . . . of bankruptcy judges entered in cases and proceedings” under the Bankruptcy Code. “These extra words [cases and proceedings] have meaning,” he said. For 100 years, “courts have viewed ‘proceeding’ as the relevant ‘judicial unit’ for bankruptcy finality,” Judge Thapar said.





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For Judge Thapar, the statute provides “a clear test for courts to apply: a bankruptcy court’s order may be immediately appealed if it is (1) ‘entered in [a] . . . proceeding’ and (2) final — terminating that proceeding.”

Applying the two-part test to the case at hand, Judge Thapar first analyzed whether the lift-stay motion was a “proceeding.” He said that a “proceeding” under Section 158(a) is “a discrete dispute within the overall bankruptcy case.” He concluded that a lift-stay motion “fits this description,” because “there is a discrete claim for relief, a series of procedural steps, and a concluding decision.”

Judge Thapar buttressed his conclusion by referencing 28 U.S.C. § 157(b)(2)(G), where lift-stay motions are listed among “core proceedings.”

Turning to the second part of the test and the question of “finality,” Judge Thapar quoted *Bullard’s* statement that a final order “alters the status quo and fixes the rights and obligations of the parties.” *Bullard*, 135 S. Ct. at 1692. He quoted a commentator on the idea that “a bankruptcy order is final ‘if it is both procedurally complete and determinative of substantive rights.’”

Applying the definition to conclude that the order was appealable when entered, Judge Thapar ruled that denial of a lift-stay motion was “final” because it was procedurally complete and precluded the creditor from pursuing its claim against the debtor outside of bankruptcy court.

Judge Thapar then claimed that denial of a lift-stay motion *without* prejudice is an exception that “helps prove the rule.” Insinuating that denial of a motion without prejudice is non-final, he said that courts “may deny stay-relief motions without prejudice if it appears that changing circumstances could change the stay calculus.”

Having dangled the prospect that denial *without* prejudice is non-final, Judge Thapar said that “we need not determine now whether a stay-relief denial without prejudice is ‘final,’” because denial with prejudice in the case at hand was the “final word on the matter.”

Observation: This writer questions whether “finality” is susceptible to hard-and-fast rules applicable in all circumstances, much like the concept of an executory contract, on which scholars disagree.

Denial of a lift-stay motion without prejudice is a situation where application of Judge Thapar’s test is problematic, because denial without prejudice raises additional considerations beyond the two prongs of his test.

In decades past, some bankruptcy judges often, if not routinely, denied lift-stay motions without prejudice, leading appellate courts to rule that the orders were not appealable because they



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were not final. For the duration of the bankruptcy case, the creditor would not have recourse to appellate review, thus giving the debtor leverage in negotiations with the creditor.

Over time, some courts came to the view that denial without prejudice did not destroy finality, because dismissing an appeal would be manifestly unfair to the creditor when there was no realistic possibility of appellate review.

Perhaps decisions on finality are circumstances where judges should apply their experience and judgment rather than search for a blanket answer in the skeletal words of a statute. Perhaps case-by-case analysis of finality is not such a bad idea after all. Perhaps the underlying facts of a case will affect finality and defy categorizing specific types of orders as always either final or non-final.

The opinion is *Ritzen Group Inc. v. Jackson Masonry LLC (In re Jackson Masonry LLC)*, 18-5157 (6th Cir. Oct. 16, 2018), *cert.* granted May 20, 2019, in *Ritzen Group Inc. v. Jackson Masonry LLC*, 18-938 (Sup. Ct.).



*The Third Circuit's new opinion on 'finality' will be cast in doubt depending on how the Supreme Court rules in Ritzen.*

## **Third Circuit Expands the Flexible Notion of 'Finality' on Bankruptcy Appeals**

The Third Circuit further expanded the notion of a final order to include seemingly interlocutory rulings that will become essentially unreviewable because subsequent events will render them moot.

For example, the opinion will mean that an order denying a stay pending appeal from approval of a settlement will be appealable because consummation of the settlement will ordinarily make the appeal moot. In that regard, the Third Circuit and the Second Circuit disagree on appealability.

### **The Appeal from Denial of a Stay Pending Appeal**

The appeal involved a law firm that had litigated successfully before bankruptcy under the Sarbanes Oxley Act of 2002, 15 U.S.C. § 7243.1. The firm was entitled to a fee award for creating a common fund by clawing back compensation paid to company executives whose misconduct required the restatement of financial statements.

Later, the bankruptcy court set aside \$5 million to cover the fee award that the court might ultimately grant. Having sought a \$15 million set-aside, the firm appealed. The appeal remains pending in district court.

Next, the firm sought a stay of distributions from the common fund created when the target of the clawback agreed in settlement to pay about \$150 million. The bankruptcy court denied the law firm's motion for a stay of the distributions.

Appealing the denial of a stay, the law firm asked the district court for a stay of distributions until the district court decided the prior appeal from the refusal to set aside \$15 million.

The law firm appealed to the Third Circuit when the district court denied the stay.

In a June 25 opinion, Circuit Judge Joseph A. Greenaway, Jr. ruled that the district court's denial of a stay pending appeal was a final, appealable order under 28 U.S.C. § 158(d)(1), which gives appellate jurisdiction to the circuits over appeals from final orders entered by district courts on appeal from bankruptcy courts.



## The *Revel* Decision in 2015

Judge Greenaway followed *dicta* in an analogous Third Circuit opinion from 2015. *In re Revel AC, Inc.*, 802 F.3d 558 (3d Cir. 2015). To read ABI's discussion of *Revel*, [click here](#).

*Revel* involved an appeal from denial of a stay of an order authorizing a sale of property. Writing for the Third Circuit in *Revel*, Circuit Judge Thomas L. Ambro conceded that the denial of a stay was “not technically a final judgment.” He went on to say that the appeal was final in a “practical sense” because a statute, Section 363(m), would have rendered the appeal moot and prevented the court from later reaching the merits if there were no stay.

In the case on appeal, there was no statute to render the appeal moot. Consequently, Judge Greenaway said that *Revel* was not on point. However, he said that “this appeal . . . does fit within *Revel's dicta*, to which we give teeth today.”

The imminent distribution of the \$150 million, Judge Greenaway said, would “effectively” moot the law firm's appeal from the bankruptcy court's order refusing to set aside \$15 million. Once the money was out the door, there would be no way to take the distributions back from creditors if the law firm were awarded more than \$5 million.

In bankruptcy, where the Third Circuit takes a “relaxed, pragmatic, and functional view of finality,” Judge Greenaway said that treating the stay denial as a final order is a “mere logical application of *Revel*.”

Having found appellate jurisdiction, Judge Greenaway next ruled on the merits. The denial of a stay was proper because the law firm had not shown that a \$5 million set-aside was inadequate. On the merits, he used the sliding-scale approach adopted by *Revel* to judge whether a stay pending appeal would be appropriate.

Judge Ambro was on the panel alongside Judge Greenaway.

## Observations

*Revel* and the new Third Circuit opinion are arguably in conflict with the Supreme Court's decision in *Bullard v. Blue Hills Bank*, 135 S. Ct. 1686, 191 L. Ed. 2d 621 (2015), holding that denial of confirmation of a chapter 13 plan is not a final, appealable order.

The Third Circuit is also in apparent conflict with an unreported opinion from the Second Circuit in 2014. There, the Second Circuit dismissed an application for a stay pending appeal, saying the creditors “have not shown that the district court's order denying a stay should be treated as a denial of injunctive relief.” *BOKF NA v. Momentive Performance Materials Inc. (In re MPM Silicones LLC)*, 14-3531 (2d Cir. Oct. 31, 2014).



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Finality in the bankruptcy context will come before the Supreme Court in the new term to begin in October 2019. See *Ritzen Group Inc. v. Jackson Masonry LLC*, [18-938](#) (Sup. Ct.) (*cert. granted* May 20, 2019).

The creditor who took *Ritzen* to the Supreme Court contends that the Sixth Circuit deepened an existing circuit split by erroneously holding that an order denying a motion to modify the automatic stay is always a final order that must be appealed immediately. However it comes down, the Supreme Court is likely to tell us whether finality is formulaic and immutable in bankruptcy or whether there is a more relaxed, pragmatic approach to finality in bankruptcy cases.

The propriety of the new opinion from the Philadelphia-based appeals court will be in doubt if the Supreme Court goes against the Third Circuit's flexible approach to finality.

[The opinion is](#) *S.S. Body Armor I. Inc.*, 18-2558, 2019 BL 234018 (3d Cir. June 25, 2019).





## *Plans & Confirmation*



*The Third Circuit wrote an important decision on distributing collateral under an intercreditor agreement, but it wasn't precedential.*

## **Intercreditor Agreement Didn't Apply to Plan Distributions, Third Circuit Holds**

In a typical chapter 11 reorganization, distributions to secured creditors are not distributions of collateral, at least when there is no sale, according to the Third Circuit. Furthermore, undersecured creditors are not entitled to post-petition interest when calculating the distributions among creditors secured by the same collateral, the appeals court held.

Although rulings are critical for corporate reorganizations in Delaware, the June 19 decision by Circuit Judge Stephanos Bibas was nonprecedential. The opinion puts Delaware firmly in line with New York.

### The Energy Future Noteholders

Two groups of Energy Future noteholders had liens on the same collateral. The notes were issued four years apart, and the more recently issued notes carried a higher rate of interest. The two noteholder groups were undersecured.

The issuer, Energy Future, filed a chapter 11 petition and confirmed a reorganization plan that distributed cash, stock and the right to tax benefits to the noteholders. In deciding how to split up the plan distribution, the holders of the more recently issued notes contended that the intercreditor agreement called for calculating how much would be owed to the two noteholder groups at the time of distribution.

If hypothetical post-petition interest accruals were included in the calculation, the holders of the more recently issued notes would receive a larger distribution by \$90 million.

The two noteholder groups duked it out before Bankruptcy Judge Christopher S. Sontchi of Delaware, who ruled on a motion to dismiss in favor of the holders of the older notes and held that the holders of the newer notes were not entitled to the additional \$90 million. To read ABI's reports on Judge Sontchi's opinions, [click here](#) and [here](#).

The district court upheld Judge Sontchi, prompting the holders of the recently-issued notes to appeal to the Third Circuit.



## The Intercreditor Agreement Didn't Apply

The intercreditor agreement between the noteholder groups contained a waterfall provision that would arguably give the additional \$90 million to the holders of the newer notes because it allegedly required the inclusion of hypothetical post-petition interest in the calculation.

Judge Bibas explained that the waterfall “does not govern every asset the creditors receive.” Quoting the waterfall provision, he said it applies to “Collateral or any proceeds thereof received in connection with the sale or other disposition of . . . Collateral upon the exercise of remedies . . . by the Collateral Agent.”

The noteholders were fighting over two types of distributions: The consideration handed out by the plan and adequate protection payments made throughout the course of the reorganization. Neither fell under the waterfall, Judge Bibas said.

“The waterfall provision would apply to the adequate protection payments and plan distributions if they were collateral. But they are not,” Judge Bibas ruled.

Conceding that the noteholders held liens on essentially all of the debtor's assets, Judge Bibas nonetheless said that “not every payment from the subsidiary's assets is a payment of collateral.” A payment of collateral reduces the debt, but neither the plan distribution nor the adequate protections payments reduced debt.

The adequate protection payments were for the use of collateral, but did not reduce the debt, Judge Bibas said. Judge Sontchi therefore correctly held, according to Judge Bibas, that the adequate protection payments were not payments of collateral.

With regard to the plan distributions, they were not made from assets on which the noteholders held liens. Instead, they derived from assets created by the plan over which the noteholders did not hold liens. Judge Bibas said, “plan distributions are not distributions of collateral,” citing Section 552(a), which generally cuts off the attachment of prepetition liens to property acquired after filing.

Even if the distributions were collateral, the waterfall still would not apply for a second reason, Judge Bibas explained.

For the waterfall to kick in, the intercreditor agreement imposed two requirements: (1) The proceeds must arise from the sale or disposition of collateral; and (2) The sale or disposition of collateral must result from a remedy implemented by the collateral agent.

The adequate protection payments and plan distributions were neither, Judge Bibas held.



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Referring to the adequate protection payments, Judge Bibas said, “Proceeds cannot be from a sale when there is no sale.”

Although plan distributions might come from a sale or distribution, Judge Bibas said they did not stem from the collateral agent’s remedy. Even if the plan distributions were equivalent to a disposition of collateral, the distribution “was not part of a remedy implemented by the collateral agent.”

Even if the collateral agent’s participation in the chapter 11 process was seen as exercising a remedy, Judge Bibas said that “the restructuring was not part of a remedy implemented by the collateral agent.” The noteholders, not the collateral agent, voted for the plan, and the bankruptcy court confirmed it. “This corporate restructuring . . . is a far cry from a collateral agent’s typical remedy: selling the collateral at a foreclosure sale.”

Judge Bibas therefore held that “the plan distributions are not proceeds under the waterfall provision” because “the restructuring was not a remedy implemented *by the collateral agent.*” [Emphasis in original.]

Holding that the waterfall did not apply, Judge Bibas upheld the lower courts and ruled that the plan distributions must be made according to the debts owing to the noteholder groups on the filing date.

## Observations

In this writer’s opinion, the result could have gone either way, depending on the prejudices of the presiding judge. However, the intercreditor agreement was negotiated between well represented, sophisticated parties. When an agreement like this is vague, the better result is one providing equal treatment. Giving \$90 million in preferential treatment doesn’t seem right when parties could have written with clarity but didn’t. In other words, uncertainty demands equal treatment.

An intercreditor agreement could be drafted to achieve the opposite result, but we believe it must be very, very specific to evade the breadth of the ruling by Judge Bibas. Of course, the decision by Judge Bibas is not binding on later Third Circuit panels, because the opinion was nonprecedential.

Beyond the interpretation of a typical intercreditor agreement, the opinion is important for a second reason: The outcome will not lead to forum shopping because the result is the same in Delaware as it is in New York. Bankruptcy Judge Robert Drain of White Plains, N.Y. held that distribution under a plan are not distributions of collateral. *BOKF NA v. JPMorgan Chase Bank NA (In re MPM Silicones LLC)*, 518 B.R. 740 (Bankr. S.D.N.Y. 2014).



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[The opinion is](#) *Delaware Co. v. Morgan Stanley Capital Group Inc. (In re Energy Future Holdings Corp.)*, 18-1957. 2019 BL 226740 (3d Cir. June 19, 2019).





*Fifth Circuit upholds its prior ruling that disallowing part of a claim under the Bankruptcy Code does not render the claim 'impaired' to allow voting on a chapter 11 plan.*

## **Fifth Circuit Revokes a Controversial Opinion with *Dicta* on the Solvent-Debtor Exception**

Granting a petition for panel rehearing, the Fifth Circuit vacated a controversial opinion from January that included reams of *dicta* about the allowance of so-called makewhole premiums and the survival of the solvent-debtor exception after adoption of the Bankruptcy Code.

Among other things, the panel had said in January that a makewhole is allowable only if the solvent-debtor exception survived the adoption of Section 502(b)(2), the provision that disallows claims for unmatured interest. With regard to whether the exception survived, Circuit Judge Andrew S. Oldham in January said, “We doubt it did.” *Ultra Petroleum Corp. v. Ad Hoc Committee of Unsecured Creditors (In re Ultra Petroleum Corp.)*, 913 F.3d 533, 547 (5th Cir. Jan. 17, 2019). Despite ruling almost definitively on the question, Judge Oldham had remanded for “the bankruptcy court to answer the question in the first instance.” *Id.*

The creditors claiming the makewhole premium filed a petition in late January for panel rehearing or rehearing *en banc*. They argued that the panel should not have reached the question of whether a makewhole amounts to unmatured interest, principally because the bankruptcy court had not ruled on the issue.

Granting panel rehearing, the same three circuit judges vacated the earlier opinion and handed down a substitute opinion on November 26, chopping the 27-page January decision down to 12 pages. In the new opinion, the panel this time limited its ruling to a declaration that disallowance of portions of a claim by the operation of provisions of the Bankruptcy Code does not amount to “impairment” of the claim entitling the creditor to vote for or against confirmation of a chapter 11 plan.

The 15 deleted pages surveyed 300 years of English and U.S. legal history about the solvent-debtor exception to the general rule that unsecured creditors are not entitled to interest on their claims in bankruptcy. In other words, if the debtor is solvent, the exception allows an unsecured creditor to claim interest.



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The new opinion also omits speculation about the allowance of makewholes, but with a curious hint about how the bankruptcy court should rule on remand. To read ABI's discussion of the January opinion, [click here](#).

## The Facts Remain the Same

In the new opinion, also by Judge Oldham, the facts and the discussion of impairment remained the same.

The debtors were oil and gas producers plunged into chapter 11 in 2016 after the price of petroleum collapsed. The companies were insolvent on filing, but they became solvent after the price of oil rose.

The bondholders' loan agreement included provisions calling for the payment of makewhole premiums. In substance, a makewhole compensates a lender for being forced to reinvest at lower interest rates if the loan is paid before maturity.

The debtors proposed a chapter 11 plan where none of the creditors were impaired, thus theoretically barring them from voting on the plan. Allegedly unimpaired creditors included holders of unsecured bonds, whose loan agreement contained the makewhole premiums. The plan did not propose to pay the makewholes.

The debtors also proposed to pay revolving credit lenders in full. However, the plan offered post-petition interest at the federal judgment rate, not the higher default rate imposed by the loan agreement.

Because the plan did not pay the makewhole or the higher default interest rate, the creditors objected to the plan. To permit confirmation, the debtors set aside almost \$400 million to compensate the bondholders and the revolving credit lenders if their claims for the makewhole and the default rate must be paid to render their claims unimpaired.

## The Decision in Bankruptcy Court

Both sides agreed that the makewhole and the default interest rate were enforceable under state law. Bankruptcy Judge Marvin Isgur of Houston ruled after confirmation that the creditors must receive everything under state law to render their claims unimpaired, including the makewhole and the higher default rate.

The debtors appealed, and Judge Isgur certified the questions for direct appeal to the Fifth Circuit. The Court of Appeals accepted the direct appeal.

## Judge Oldham's Original Opinion and New Opinion on Impairment



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In the opinion handed down after granting panel rehearing, Judge Oldham in substance issued the same opinion holding that a claim is not impaired just because some portion of the claim is disallowed under the Bankruptcy Code.

He agreed with *In re PPI Enterprises (U.S.) Inc.*, 324 F.3d 197 (3d Cir. 2003), where the cap in Section 502(b)(6) of the Bankruptcy Code reduced the allowed claim of a landlord to an amount lower than it would have been outside of bankruptcy under state law. The Third Circuit held that the landlord's claim was not impaired, because the amount of the claim outside of bankruptcy "is not the relevant barometer for impairment." *Id.* at 204.

Judge Oldham said that the *Collier* treatise and every reported decision all agree that impairment arises from what the plan does, not from disallowance of a portion of a claim under the Bankruptcy Code. Thus, he held for a second time this year that the bondholders were unimpaired, and thus not entitled to vote, because the Bankruptcy Code reduced the amount of their claims, not the plan.

Judge Oldham said his conclusion was based on the plain language of the statute, Section 1124(a), which says that a claim is not impaired "if the plan . . . leaves unaltered the [claimant's] legal, equitable, and contractual rights." The focus, he said, is on whether "'the plan' itself alters a claimant's 'legal, equitable [or] contractual rights.'"

## Allowance of the Makewhole?

Ruling that the bondholders' claim was not impaired did not end the inquiry. Two questions remained: (1) Does the Bankruptcy Code disallow makewhole premiums; and (2) are the lenders entitled to interest at the higher default rate contained in the loan agreements?

The lenders argued that the solvent-debtor exception permitted the allowance of both the makewhole and the higher post-petition default rates.

At that point in the January opinion, Judge Oldham launched into pages and pages of speculation about the answers to both questions. This time, he didn't.

Instead, Judge Oldham said in his new opinion that the "bankruptcy court never reached either question."

Quoting a treatise, Judge Oldham said that courts disagree about the allowance of makewholes. Although he did not, he could have cited the disagreement between the Second and Third Circuits regarding the allowance of makewholes. The New York-based appeals court disallowed a makewhole, while the circuit court in Philadelphia allowed a makewhole claim to stand. *See Delaware Trust Co. v. Energy Future Intermediate Holding Co. LLC (In re Energy Future*



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*Holdings Corp.*), 842 F.3d 247 (3d Cir. 2016), and *BOKF NA v. Momentive Performance Materials Inc. (In re MPM Silicones LLC)*, 874 F.3d 787 (2d Cir. 2017). For some of ABI's coverage of those cases, click [here](#) and [here](#).

Judge Oldham said that the bankruptcy court was “best able” to rule in the first instance on the allowance of the makewholes and default interest. Nonetheless, he went on to say, “Our review of the record reveals no reason why the solvent-debtor exception could not apply.”

But mindful of the circuit court’s role as a court of review, he said that “we will not make the choice ourselves or weigh the equities on our own.”

Judge Oldham therefore reversed the bankruptcy court’s ruling on impairment and remanded for the bankruptcy court to consider the allowance of the makewhole and the higher default rate.

[The opinion is](#) *Ultra Petroleum Corp. v. Ad Hoc Committee of Unsecured Creditors (In re Ultra Petroleum Corp.)*, 943 F.3d 758 (5th Cir. Nov. 26, 2019).



*Appeals court laudably provides guidance for lower courts by ruling on the merits of a chapter 11 plan and not dismissing an appeal for being equitably moot.*

## **Eighth Circuit Upholds Backstopped Rights Offerings for Chapter 11 Plans**

The Eighth Circuit joined three other circuits by holding that a plan with better treatment for creditors who backstop a rights offering does not violate the “same treatment” requirement in Section 1123(a)(4).

On an appeal challenging confirmation, the circuit court did not rule on whether the plan was equitably moot. By reaching on the merits and not taking the easy way out, the Eighth Circuit provided valuable guidance for lower courts regarding a frequently used device in major reorganizations.

### **The Peabody Coal Reorganization**

The appeal arose following confirmation of a chapter 11 plan for coal producer Peabody Energy Corp. The plan included two \$750 million, backstopped rights offerings. A group of creditors who had proposed an alternative reorganization plan opposed one of the offerings, a backstopped private placement of \$750 million in new preferred stock.

The plan was overwhelmingly approved by all classes of creditors. Bankruptcy Judge Barry G. Schermer of St. Louis overruled the objection and confirmed the plan. Following confirmation, the debtor consummated the plan by taking in \$1.5 billion under the rights offerings, issuing new common and preferred stock, and distributing \$3.5 billion to creditors under the plan.

On appeal, the district court held that the appeal was equitably moot. However, the district court went on to visit the merits and concluded that the plan did not offend Section 1123(a)(4) and had been proposed in good faith.

The objecting creditors appealed a second time. In an August 9 opinion for the Eighth Circuit, Circuit Judge Michael J. Melloy did not consider whether the appeal was equitably moot because he found no error on the merits. Judge Melloy was a bankruptcy judge in Iowa before his appointment to the district court in 1992 and then to the Eighth Circuit in 2002.

### **Equal Treatment**





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Judge Melloy summarized the allegedly unequal treatment. He said that holders of second-lien notes and unsecured notes could buy significant amounts of new stock at a discount in the private placement and receive “significant premiums” in return for backstopping the rights offerings and agreeing to support the plan. Regardless of whether they participated in the private placement, second-lien noteholders had a projected recovery of 52.4% while the return on unsecured notes was an anticipated 22.1%.

The so-called equal treatment requirement for chapter 11 plans appears in Section 1123(a)(4). The statute provides that the plan must “provide the same treatment for each claim or interest of a particular class,” unless the holder agrees “to a less favorable treatment.” The statute does not define “same treatment,” nor has the Supreme Court provided a definition.

Judge Melloy described the Second, Fifth and Ninth Circuits as having ruled that a plan “may treat one set of claim holders more favorably than another so long as the treatment is not for the claim but for distinct, legitimate rights or contributions from the favored group separate from the claim.”

Analyzing the Peabody plan, Judge Melloy said that the ability to participate in the private placement was not treatment for the creditors’ claim. Rather, he said, it was “consideration for valuable new commitments . . . to support the plan, buy preferred stock that did not sell in the Private Placement, and backstop the Rights Offering.” In exchange, he said they “received the opportunity to buy preferred stock at a discount as well as premiums designed to compensate them for shouldering significant risks.”

The objecting creditors relied on *Bank of America National & Savings Ass’n v. 203 North LaSalle Street Partnership*, 526 U.S. 434 (1999). Judge Melloy said that *North LaSalle* was distinguishable “in at least three ways.”

In *North LaSalle*, the Supreme Court ruled that the plan violated the absolute priority rule because prebankruptcy shareholders had the exclusive right to buy stock in the reorganized company. Unlike *North LaSalle*, Judge Melloy said that the participating creditors “gave something of value up front.” Furthermore, the objecting creditors had the ability to participate in the rights offerings, which was not true of creditors in *North LaSalle*, who had no ability to purchase new equity.

In short, Judge Melloy said that the plan did not offend Section 1123(a)(4) because “the right to participate in the Private Placement was not ‘treatment for’ a claim.”

N.B.: Judge Melloy said that his court has not ruled on whether review of a “same treatment” ruling is *de novo* or clearly erroneous. The judge said he would have reached the same conclusion under either standard.



## Good Faith

Next, Judge Melloy upheld the bankruptcy court's finding that the plan was proposed in good faith, as required by Section 1123(a)(3). To determine good faith, he used the clear error test to evaluate whether the bankruptcy judge properly analyzed the "totality of the circumstances."

The objecting creditors argued that the plan was not proposed in good faith because the alternative plan they proffered was superior. Judge Melloy said that the court could not rely on the "potential virtues" of the alternative plan "while ignoring the potential risks involved."

The objectors complained that seven holders of second-lien and unsecured notes received disproportionate ability to participate in the private placement. The seven creditors were responsible for negotiating the plan with the debtor and the official creditors' committee.

Judge Melloy said the seven were entitled to disproportionate treatment because they "took on more obligations than other members of the class: They put themselves on the hook to buy more of the preferred stock if it did not sell."

Observation: Backstopped rights offerings, like those sanctioned by Judge Melloy, seem to be a method developed by Wall Street for allowing subordinate creditors to realize a greater recovery under a chapter 11 plan without offending *North LaSalle*.

[The opinion is](#) *Ad Hoc Committee of Non-Consenting Creditors v. Peabody Energy Corp. (In re Peabody Energy Corp.)*, 18-1302, 2019 BL 296906 (8th Cir. Aug. 9, 2019).



*Bankruptcy Judge Wiles explains the jurisdictional, statutory and constitutional reasons why nonconsensual releases are improper in the Second Circuit except in exceptional circumstances.*

## **New York Judge Gives Reasons for Nixing Nonconsensual, Third-Party Releases**

Bankruptcy Judge Michael E. Wiles of Manhattan refused to approve broadly worded, nonconsensual, third-party releases in the chapter 11 plan for Aegean Marine Petroleum Network Inc.

Judge Wiles said that “third-party releases are not a merit badge that somebody gets in return for making a positive contribution to a restructuring. They are not a participation trophy, and they are not a gold star for doing a good job.”

Instead, Judge Wiles said, third-party releases are appropriate “only when they are actually important and necessary to the accomplishment of the transaction before the court.” They “are not supposed to be imposed involuntarily just to make people feel better.”

Explaining the limited circumstances when non-consensual, third-party releases are proper in the Second Circuit, Judge Wiles drew together statutory, constitutional and caselaw authorities in his published bench opinion on March 8.

### Approved Releases in the Aegean Plan

In plain English, Judge Wiles laid out the release and exculpation provisions in the Aegean plan.

There being no objections, Judge Wiles explained why he was approving consensual releases and broad releases of the debtor’s own claims. Releasing the debtor’s claims, he said, would result in barring derivative claims. He also approved exculpation provisions, which he restricted in scope.

As written, Judge Wiles said the broadly worded exculpation would bar enforcement of contracts approved by the court. He said that an “appropriate exculpation” would protect “people from claims based on their negotiation, execution and implementation of transactions that I approved.”



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However, the Securities and Exchange Commission and the U.S. Trustee objected to broadly worded, third-party, *nonconsensual* releases.

## The Circuit Split

Judge Wiles explained how the Fifth, Ninth, and Tenth Circuits have held that bankruptcy courts lack power to grant nonconsensual, third-party releases of the type he was being asked to approve.

On the other hand, he said, the Second, Fourth, Sixth and Eleventh Circuits permit nonconsensual, third-party releases in “rare” or “unusual” cases. In the Second Circuit, he said, releases of this type are proper only when “a particular release is essential and integral to the reorganization itself,” citing *In re Metromedia Fiber Network, Inc.*, 416 F.3d 136, 141-43 (2d Cir. 2005).

## The Proposed Nonconsensual Releases

Judge Wiles explained that he was also being asked to approve releases “even if the releasing parties did not agree to provide such releases. These proposed releases do not involve claims against the Debtors [nor] are they limited to claims that are derivative in nature . . . . They are also not limited to transactions that occurred during the bankruptcy case.”

Instead, Judge Wiles said, the involuntary releases would immunize “certain parties” from claims by creditors, stockholders or parties in interest that relate “in any way” to the debtors, “with no exceptions for claims alleging fraud or willful misconduct.”

The parties intended to receive nonconsensual releases fell into two categories: (1) The prepetition lender who was also the DIP lender and will be the acquiring party under the plan; and (2) three individuals on the debtor’s audit committee.

## Jurisdictional Limitations on Releases

Judge Wiles disagreed with the idea that the contested releases were “no big deal.” Rather, he said, they were “an extraordinary thing [that is different] from what courts ordinarily do.”

The claims to be released belonged to third parties in circumstances where the bankruptcy court lacks *in rem* jurisdiction, Judge Wiles said.

Even though the claims might fall under “related to” jurisdiction, Judge Wiles said he was being “asked to exercise power over a potential claim for which no actual proceeding exists.” Even if there were a proceeding, he said the court needed personal jurisdiction over the parties to be bound by the releases.



To obtain personal jurisdiction, there must be formal service of process. Although the Supreme Court has recognized several exceptions, Judge Wiles said none applied.

## Limitations on the Court's Power

Even if there were subject matter and personal jurisdiction, Judge Wiles said, “that would not mean that I would have the power to impose an involuntary release.” For example, he said, the Supreme Court has “held that a court has no power to dictate settlement terms or to force parties to release their claims.”

Rather, Judge Wiles said, a claim belonging to a third party “may only be resolved through litigation on the merits, or on terms to which the third party agrees,” again citing the Supreme Court.

In addition, there are constitutional limitations, because the court cannot “take a third party’s property without any hearing on the merits and without any of the discovery or other rights that a litigant usually would have.”

Typically, Judge Wiles said, the releases are granted in return for contributions to the reorganization, “rather than the benefits to be provided directly to the persons whose claims are being released.”

Finally, Judge Wiles said that the third-party releases are also improper because they would be broader than the released parties could obtain in their own bankruptcies, citing securities law claims as an example.

## Second Circuit Restrictions

Judge Wiles said that involuntary releases are “often” justified by “the contention that anybody who makes a contribution to the case has earned a third-party release.” If this were enough, he said, “releases would never be limited to the ‘rare’ and ‘unusual’ circumstances that the [Second Circuit] required in *Metromedia*.”

The teaching of *Metromedia*, Judge Wiles said, “is that releases should be given only when they are an important part of a reorganization.” In the case at bar, he said he was “at a loss to understand what claim is left as to which [the lender-buyer] needs protection,” given the scope of the consensual leases he was approving.

To approve a third-party release, Judge Wiles said he should consider “not only” the contribution by the released parties, “but also the particular claims that are to be released, whether





the releasing parties are otherwise getting recoveries on the released claims, and the fairness of the releases from the point of view of the people upon whom the releases are to be imposed.”

Judge Wiles could not approve the nonconsensual releases because he was given none of the factual predicate, outlined above, that he interpreted the Second Circuit to require.

## Indemnification of Directors

Having declined to approve nonconsensual releases in favor of the lender-buyer, Judge Wiles also disapproved releases designed to protect members of the audit committee.

The possibility that directors on the audit committee might assert indemnification claims against the reorganized debtor was given as a reason for the nonconsensual releases. In that respect, Judge Wiles said that some courts justify releases “to protect the debtor from indemnification claims.”

“I fail to see how the possibility of an indemnification claim is a proper justification to take away the rights that claimants may have to pursue claims that they own directly against the officers and directors,” Judge Wiles said.

N.B.: If anyone suspects that Judge Wiles slipped his opinion through because the debtor was not well represented, think again. The debtor, the creditors’ committee, and the lender-buyer were represented by some of the country’s most renowned bankruptcy counsel.

[The opinion is](#) *In re Aegean Marine Petroleum Network Inc.*, 599 B.R. 717 (Bankr. S.D.N.Y. April 8, 2019).



*Extinguishing contingent environmental claims doesn't comply with the Sixth Circuit's Dow Corning test, Judge Koschik says.*

## **Another Judge Clamps Down on Third-Party Releases in a Major Reorganization**

Saying that he agrees with an opinion handed down three months ago by Bankruptcy Judge Michael E. Wiles of Manhattan, Bankruptcy Judge Alan M. Koschik of Akron, Ohio, refused to approve broadly worded, nondebtor, third-party releases in a reorganization plan proposed by FirstEnergy Solutions Corp., the owner of two fossil-fuel electric generating plants and three nuclear power generating facilities.

In his August 29 opinion, Judge Koschik described the “broad and nearly even circuit split on the issue of whether bankruptcy courts can, under any circumstances, release nondebtors from claims held by nonconsenting parties in connection with a debtor’s reorganization plan.”

In the case before him, Judge Koschik explained that the “most substantial class” of claims to be extinguished by the nonconsensual releases would have been “environmental cleanup and maintenance claims held by the Governments.”

Judge Koschik’s opinion explained why he had signed an order in April rejecting the debtors’ disclosure statement. Since then, the debtors revised the plan several times and held a confirmation hearing in August. Judge Koschik sustained one of the objections to the plan, and the confirmation hearing was adjourned.

Judge Wiles had similarly refused to approve broadly worded, nonconsensual, third-party releases in a chapter 11 plan. *In re Aegean Marine Petroleum Network Inc.*, 599 B.R. 717 (Bankr. S.D.N.Y. April 8, 2019). To read ABI’s report on *Aegean Marine*, [click here](#).

### The FirstEnergy Plan

The FirstEnergy debtors are part of a family of companies, but not all were in chapter 11. Judge Koschik said that the “intent” of the plan was for the debtors and their nondebtor affiliates to “wash [their] hands of any liability flowing from [their] historical ownership of the properties and operation of the businesses and facilities now or at any time owned and operated by the Debtors.”

The proposed third-party releases emanated from a settlement earlier in the case where nondebtors committed substantial assets to the plan. The settlement called for the releases to be



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incorporated into a chapter 11 plan, but ultimate approval of the releases was not a condition to the settlement. Consequently, Judge Koschik's prior approval of the settlement did not tie his hands when the disclosure statement came to court for approval.

The releases, Judge Koschik said, made the plan "patently unconfirmable." He therefore declined to approve the debtors' disclosure statement.

## The Circuit Split

Judge Koschik went beyond the Sixth Circuit to survey law throughout the country. "The circuit split occupies the spectrum between 'impossible' and 'very rare,'" he said.

In the Fifth, Ninth and Tenth Circuits, he said, nondebtor releases "are categorically outside the power of the bankruptcy courts." "Other circuits are not so strict," he said.

Adopting standards laid down by the Sixth Circuit in *Class Five Nevada Claimants v. Dow Corning Corp.* (*In re Dow Corning Corp.*), 280 F.3d 648, 658 (6th Cir. 2002), Judge Koschik said that the Fourth Circuit allows releases "when the affected creditors of the nondebtor approved of and accepted the terms of the plan."

The Second and Seventh Circuits, according to Judge Koschik, "allow for the possibility of nonconsensual third-party releases . . . , but always in rare and exceptional circumstances." The Third Circuit, he said, "may be willing to allow for such releases as well."

Although the rules vary, Judge Koschik found it "striking that each circuit that has considered nondebtor releases either rejects them absolutely or approves them only reluctantly." He described the leading cases of *Detroit, A.H. Robbins* and *Johns-Manville* as "essentially class action settlements releasing a debtor and its co-obligors, ensuring that no claims of contribution or indemnity against the debtor survive plan confirmation, and directing substantial compensation to the class of claimants voting to accept the settlement incorporated into the plan of reorganization."

## The *Dow Corning* Standard Applied to FirstEnergy Plan

Naturally, Judge Koschik applied the *Dow Corning* standard to the FirstEnergy plan. While "possible within the Sixth Circuit," he said that "the nonconsensual release of third-party claims against nondebtors remains an exception, not the rule."

Judge Koschik analyzed how the seven *Dow Corning* factors applied to the FirstEnergy plan. The factors include an identity of interest between the debtor and the nondebtor (usually an indemnity relationship), the contribution of substantial assets by the nondebtor, an overwhelming vote in favor of the plan by affected classes, and the opportunity for a full recovery by those who elect not to settle.



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FirstEnergy failed the *Dow Corning* test, in Judge Koschik's opinion. The releases were "extraordinarily broad or at least potentially so." The debtors, he said, would "impose [the releases] upon all of its creditors, including those who do not consent." The releases would bar "a wide array of potential claims, including all claims that have anything to do with the historic operation of the business."

Judge Koschik heard "impassioned pleas" by governmental authorities. He noted that most of their claims for environmental cleanup and other damages would "lie *solely* against the [nondebtors], and *not at all* against the Debtors." [Emphasis in original.] Furthermore, he said, the plan had no recovery for holders of claims against nondebtors that "would nevertheless be released."

Judge Koschik declined to approve the disclosure statement because the releases in the plan were "not justified by unusual circumstances as required by *Dow Corning*."

The opinion is [In re FirstEnergy Solutions Corp.](#), 18-50757 (Bankr. N.D. Ohio Aug. 29, 2019).



## *Stays & Injunctions*





*Fifth Circuit should decide en banc whether nonddebtor releases are permissible in receiverships but not in bankruptcy cases.*

## **Divided Fifth Circuit Again Permits Third-Party Injunctions in Stanford Receivership**

Granting a motion for panel rehearing, the Fifth Circuit held for a second time, again by a 2/1 vote, that third parties who paid more than \$130 million to the receiver in the R. Allen Stanford Ponzi scheme are entitled to an order barring creditors from suing on the creditors' own claims.

The new opinion stands in contrast to the Fifth Circuit's long-held ruling that bankruptcy courts lack power to grant nonconsensual, third-party releases in chapter 11 plans. *See, e.g., Bank of N.Y. Trust Co. v. Official Unsecured Creditors' Comm. (In re Pacific Lumber Co.)*, 584 F.3d 229, 251 (5th Cir. 2009).

As before, the dissenter in the Fifth Circuit would have held that the receivership court lacked subject matter jurisdiction to bar creditors from suing on their own claims.

Exactly where the Fifth Circuit stands on third-party releases, either in receiverships or in bankruptcy, may not be clear unless the appeals court hears the *Stanford* appeal *en banc*. As it now stands, a receiver in federal court in the Fifth Circuit has a shot at imposing a nonconsensual, third-party release, while a chapter 11 debtor or trustee does not.

### **The Stanford Ponzi Scheme and the Settlement**

The Securities and Exchange Commission put Stanford International Bank into a federal receivership in Dallas after discovering that the business in reality was a Ponzi scheme where hundreds of defrauded investors lost some \$5 billion. The receiver brought lawsuits generating recoveries for distribution to all creditors *pro rata*. Stanford himself is serving a 110-year prison sentence.

The receiver sued two insurance brokers who provided policies that were advertised as providing investors with complete protection against loss and assured investors that Stanford was running a legitimate business. As it turned out, the policies were almost as illusory as the Stanford business.

After years of litigation and discovery, the two brokers agreed to settle and pay the receiver more than \$130 million. At the time, the brokers were also defendants in lawsuits in state court



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brought by defrauded Stanford investors complaining about the representations made to them. In return for paying \$130 million, the brokers therefore insisted that the receivership court enter a bar order precluding investors from pursuing their own claims.

## The Original Panel Split Opinion

The district court approved the settlement and the bar order. Objecting investors appealed. For himself and Circuit Judge James E. Graves, Jr., Circuit Judge Patrick E. Higginbotham upheld the settlement and the bar order in a July 22 opinion. *Zacarias v. Stanford International Bank Ltd.*, 931 F.3d 382 (5th Cir. July 22, 2019).

Circuit Judge Don R. Willett dissented. While he said he appreciated the “settlement’s practical value,” the district court, in his view, “lacked jurisdiction to grant the bar orders.” For ABI’s report on the July opinion and dissent, [click here](#).

In early August, the dissenting investors filed a petition for rehearing *en banc*. They contended that the majority opinion was inconsistent and irreconcilable with another Fifth Circuit opinion just weeks earlier, also arising from the Stanford Ponzi scheme. *See SEC v. Stanford International Bank Ltd.*, 927 F.3d 830 (5th Cir. June 17, 2019). To read ABI’s discussion of the June decision, [click here](#).

In the June opinion, a different panel of Fifth Circuit judges had held, among other things, that receivers do not have greater powers than bankruptcy trustees to settle claims and enter bar orders based on the receivership court’s *in rem* jurisdiction.

The two Stanford cases were distinguishable, but, of course, the question remains whether the distinction makes a difference.

In the June opinion, the Fifth Circuit set aside an injunction barring insureds from suing the insurance companies, which had settled with the receiver. The insureds who were barred from suing the insurers included former Stanford employees who had claims under the policies to cover defense costs and potential judgments. The insureds were also barred from having claims in the Stanford receivership. Were it not for the reversal in the Fifth Circuit, the former employees would have had no protection from claims against them.

The July opinion, in contrast, dealt with the claims of defrauded investors who could receive distributions, unlike the insureds in the earlier case.

## The Revised Opinions



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On rehearing, the same three-judge panel from July treated the *en banc* petition as a petition for panel rehearing and withdrew their earlier opinion. In its place, the majority published a more lengthy opinion.

Again writing for the majority, Judge Higginbotham reached the same result, this time focusing more on the differences in the two Stanford appeals. He trotted out more facts to show that the brokers were in cahoots with Stanford and allowed their representations to attract new investors. He also stressed how the estate's claims were identical to those of the defrauded investors.

Judge Higginbotham conceded that the receivership "cannot reach claims that are independent and non-derivative and that do not involve assets claimed by the receivership." On the other hand, he said the dissenting investors' "claims are derivative of and dependent on the receiver's claims, and their suits directly affect the receiver's assets."

Judge Higginbotham stressed that the dissenting investors' claims competed with the receiver's for the same dollars from the settling defendants. Analyzing the facts, he said that the objectors in the June Fifth Circuit opinion were additional insureds who were not "active co-conspirators" who were left with no ability to collect on their claims against the insurance companies.

Judge Willett again dissented, this time in a shorter, two-page opinion. Again, he shared "the majority's appreciation for this settlement's practical value." In his view, the dissenting investors' and the receiver's claims were not identical. He emphasized how the settling brokers had made representations directly to the investors.

Because the objecting investors had "distinct" claims, Judge Willett concluded that the receivership court "lacked jurisdiction to adjudicate them, or to enjoin them."

Judge Willett said he "would thus vacate the bar orders."

## Observations

Panel rehearing enabled the majority to sharpen their arguments. The brevity of Judge Willett's dissent could be interpreted as a sign that he believes the Fifth Circuit will hear the case *en banc*.

Another petition for rehearing *en banc* seems likely. If rehearing is granted once more, the outcome will determine whether receivers in the Fifth Circuit can confer nonconsensual, third-party releases even though they are unavailable in chapter 11 plans.

In the new Stanford opinion, the majority and the dissent both framed the question around the existence or lack of subject matter jurisdiction. *En banc*, the Fifth Circuit should examine the jurisdictional, prudential or statutory basis for permitting or barring third-party releases.



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In a similar bankruptcy case, there could be subject matter jurisdiction if the need for a third-party injunction fell within the bankruptcy court's "related to" jurisdiction under 28 U.S.C. § 1334(b). In this writer's view, there would be subject matter jurisdiction in bankruptcy, on the theory that there is a conceivable effect on the estate because (1) there might be no settlement without a third-party junction, and (2) the individual plaintiffs were pursuing claims that belonged to the bankrupt estate.

However, the presence of subject matter jurisdiction does not mean that a bankruptcy court is at liberty to impose a third-party injunction. There must also be a statutory basis giving the court power to grant the equivalent of a discharge to a nondebtor. In that regard, courts disagree on whether Section 524(e) precludes the issuance of third-party injunctions.

In an SEC receivership like *Stanford*, subject matter jurisdiction is equally broad. Under 15 U.S.C. §§ 77v(a) and 78aa(a), district courts have jurisdiction over "all suits in equity" to "enforce any liability or duty created by" the securities laws. Again, the existence of subject matter jurisdiction does not mean that a court can or should issue a nondebtor injunction. Assuming there is jurisdiction, the question then becomes: Do the securities laws confer statutory power for the issuance of a third-party injunction?

In this writer's view, courts should analyze third-party injunctions in terms of statutory power. Even if there is power, a court may still believe as a prudential matter that such injunctions are inappropriate.

The lack of subject matter jurisdiction has another implication: If a third-party injunction is beyond a court's subject matter jurisdiction, dismissal of an appeal for equitable mootness may not be available.

One final thought. The trustee cleaning up the Madoff Ponzi scheme has been successful in the Second Circuit in enjoining defrauded investors from suing on claims based on the same facts as claims belonging to the estate. In that sense, the Fifth and Second Circuit cases are identical. If the Fifth Circuit sits *en banc* and reverses, there will arguably be a split of circuits.

[The new opinion is \*Zacarias v. Stanford International Bank Ltd.\*, 17-11073, 2019 BL 486611, 2019 US App Lexis 37892 \(5th Cir. Dec. 19, 2019\).](#)





*Third Circuit emphasizes the limitation of nonconsensual, third-party releases to 'exceptional' cases.*

## **Third Circuit Finds Constitutional Power to Grant Releases in Confirmation Orders**

Given the “exceptional facts” of the case, the Third Circuit upheld the constitutional power of a bankruptcy court to grant nonconsensual, third-party releases.

Indeed, the circumstances were exceptional. The chapter 11 plan of Millennium Lab Holdings II LLC gave nonconsensual releases to shareholder defendants in return for their \$325 million contribution. In his December 19 opinion, Circuit Judge Kent A. Jordan said, “we are not broadly sanctioning the permissibility of nonconsensual third-party releases in bankruptcy reorganization plans.”

Rightly or wrongly, the opinion will give ammunition to those who oppose releases broadly granted for simply participating in a reorganization. Having focused on the constitutional authority of bankruptcy courts to grant nonconsensual releases, the appeals court did not reach the merits, because Judge Jordan ruled that the appeal was equitably moot once he had resolved the constitutional issue.

Strictly speaking, the appeals court therefore did not define circumstances when third-party releases are appropriate, nor did it opine on whether the releases in the particular case were permissible under the Bankruptcy Code or Third Circuit precedent.

### The Facts

The case has gone up on appeal, down, and back up again, each time adding more definition to the propriety of third-party releases in Delaware and the Third Circuit.

The debtor had obtained a \$1.825 billion senior secured credit facility and used \$1.3 billion of the proceeds before bankruptcy to pay a special dividend to shareholders.

Indebted to Medicare and Medicaid for \$250 million that it could not pay, the debtor filed a chapter 11 petition along with a prepackaged plan calling for the shareholders to contribute \$325 million in return for releases of any claims that could be made by the lenders who financed the \$1.825 million loan. The plan did not allow the lenders to opt out of the releases.





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

Over objection, Bankruptcy Judge Laurie Selber Silverstein of Delaware confirmed the plan in late 2015 and approved the third-party releases. The dissenting lenders appealed.

The debtor filed a motion to dismiss the appeal on the ground of equitable mootness, because the plan had been consummated in the absence of a stay pending appeal.

## District Judge Stark's Remand

On the first appeal in district court, the objecting lenders contended that the bankruptcy court lacked constitutional power to enter a final order granting third-party releases. The decision by Chief District Judge Leonard P. Stark of Delaware in March 2017 could have been read to imply, without holding, that granting the releases was beyond the bankruptcy court's constitutional power to enter a final order because the releases were "tantamount to resolution of those claims on the merits against" the lender.

Rather than rule on the constitutional issue, Judge Stark remanded the case for Judge Silverstein to decide whether she had final adjudicatory authority, either as a matter of constitutional law or as a consequence of the lender's waiver. To read ABI's discussion of Judge Stark's opinion, [click here](#).

## Judge Silverstein's Opinion Following Remand

In October 2017, Bankruptcy Judge Silverstein wrote an impassioned, 69-page opinion concluding that the limitations on the constitutional power of a bankruptcy court under *Stern v. Marshall*, 564 U.S. 462 (2011), are inapplicable to granting third-party releases because a confirmation order exclusively implicates questions of federal bankruptcy law and raises no issues under state or common law.

Judge Silverstein also analyzed the record and concluded that the objecting lender never raised the constitutional question during or even after confirmation. Citing the prohibition of sandbagging in *Wellness International Network, Ltd. v. Sharif*, 135 S. Ct. 1932 (2015), Judge Silverstein said that the lender could not lie in the weeds and raise constitutional infirmities for the first time on appeal. On the ground of waiver alone, Judge Silverstein found that she was entitled to enter a final order. To read ABI's discussion of Judge Silverstein's opinion, [click here](#).

The objecting lender appealed again to Judge Stark.



## Judge Stark's Second Opinion

In an opinion in September 2018, District Judge Stark abandoned the insinuation he made 18 months earlier, adopted the analysis of Bankruptcy Judge Silverstein, and held that the principles of *Stern* do not apply because confirming a reorganization plan with releases is not tantamount to a final judgment on the merits of non-bankruptcy claims.

Alternatively, Judge Stark held that the appeal from the confirmation order was equitably moot because the plan had been consummated and releases could not be revoked without upsetting the plan as a whole. Judge Stark also reached the merits and held that the releases were proper because Judge Silverstein correctly applied Third Circuit criteria. To read ABI's discussion of Judge Stark's second opinion, [click here](#).

The dissenting lenders appealed to the Third Circuit. The appeal was argued in September.

## Constitutional Power

Judge Jordan did not reach the merits in his 36-page opinion for the Third Circuit. He dealt with two issues: (1) the constitutional authority of a bankruptcy court to grant third-party releases, and (2) whether the appeal was equitably moot.

On the constitutional issue, Judge Jordan dissected *Stern* and offered insights into the Supreme Court's opinion. He observed that the high court did not decide whether a bankruptcy restructuring entails a public right that by itself would vest authority in an Article I tribunal.

Instead, Judge Jordan focused on what he characterized as a "two-part disjunctive test" from *Stern*. The bankruptcy court would have power to grant nonconsensual releases if the action "stems from the bankruptcy itself or *would necessarily be resolved in the claims allowance process*." *Stern*, 564 U.S. 462 at 499. [Emphasis added by Judge Jordan].

Focusing on the case at hand, Judge Jordan said that the releases would pass constitutional muster if they involved "a matter integral to the restructuring of the debtor-creditor relationship."

Turning to the facts, Judge Jordan said the releases were constitutionally appropriate because there would have been no reorganization and no plan confirmation absent the \$325 million contributed by the shareholders in return for releases.

Judge Jordan admitted that the dissenting lender's argument about opening the floodgates to third-party release was "not without force." He said that demands for releases by "reorganization financiers . . . could lead to gamesmanship."



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Judge Jordan said that the decision “should not be read as expanding bankruptcy court authority” nor as “permitting or encouraging . . . hypothetical gamesmanship.” The appeals court, he said, was “not broadly sanctioning the permissibility of nonconsensual third-party releases in bankruptcy reorganization plans.”

Judge Jordan went on to say that the opinion should not “be construed as reducing a court’s obligation to approach the inclusion of nonconsensual third-party releases or injunctions in a plan of reorganization with the utmost care and to thoroughly explain the justification for any such inclusion.”

In sum, Judge Jordan upheld the bankruptcy court’s constitutional power because “the release provisions were integral to the restructuring [and the bankruptcy court’s conclusion] was well-reasoned and well-supported by the record.”

## Equitable Mootness

Having found that the bankruptcy court had power to grant releases, Judge Jordan turned to the question of equitable mootness. He recited the familiar two-part test: (1) Has the plan been substantially consummated, and (2) would granting relief to the appellant fatally unscramble the plan or significantly harm third parties who justifiably relied on confirmation?

Judge Jordan quickly concluded that granting relief to the dissenting lenders “would certainly unscramble the plan,” because the releases were “central” to the plan and represented consideration for the shareholders’ \$325 million contribution. Even exposing the shareholders to the lenders’ \$100 million claim, he said, “would completely undermine the purpose of the release provision.”

Capping off his discussion of mootness, Judge Jordan said that the dissenting lenders want “all of the value of the restructuring and none of the pain. That is a fantasy and upends the purpose of the equitable mootness doctrine, which is designed to prevent inequitable outcomes.”

Consequently, Judge Jordan did not reach the merits because he decided that the district court did not abuse its discretion in ruling that the appeal was equitably moot.

## Observations

There are two questions the Supreme Court has not answered: (1) Is equitable mootness a viable doctrine in bankruptcy, and (2) do bankruptcy courts have constitutional or statutory power to grant nonconsensual, third-party releases? With regard to third-party releases, there is a longstanding circuit split.



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The Fifth, Ninth and Tenth Circuits hold that third-party releases are categorically impermissible. Other circuits — like the Second, Third, Fourth and Seventh Circuits — permit releases under differing standards.

The dissenting lenders could file a petition for *certiorari* to raise the viability of equitable mootness, but there is not an evident circuit split. The Supreme Court has shown a reluctance to tackle chapter 11 issues in the absence of a split when the system is otherwise functioning smoothly.

On third-party releases, the dissenting lenders could pursue Supreme Court review on two issues: (1) Did the bankruptcy court have constitutional power under *Stern*, and (2) even if there was power, does the Bankruptcy Code authorize such releases, and if so, under what circumstances?

It is arguable whether there is a split on the first question, but there surely is on the second.

However, the Third Circuit did not squarely rule on the propriety of third-party releases under the Bankruptcy Code or the appeals court's existing authority. The case is therefore not a particularly good vehicle for a *certiorari* petition to raise the circuit split where some appeals courts categorically bar non-debtor releases.

Nonetheless, we will report if the dissenting lenders file a petition for *certiorari*.

[The opinion is](#) *Opt-Out Lenders v. Millennium Lab Holdings II LLC (In re Millennium Lab Holdings II LLC)*, 18-3210, 2019 BL 487907 (3d Cir. Dec. 19, 2019).



*Saying she is in the minority in her district, a new Delaware judge ruled that allowing creditors to opt out won't permit a plan to impose nonconsensual, third-party releases.*

## **Opting Out Won't Justify Imposing Third-Party Releases, Delaware Judge Says**

Disagreeing with some of her colleagues in Delaware, a newly appointed bankruptcy judge refused to approve third-party releases binding creditors and equity holders who receive no distribution in a chapter 11 plan but had been given the option of opting out from the releases.

In her December 5 opinion, Bankruptcy Judge Karen B. Owens could not conclude that the failure to opt out represented consent to granting the releases, under the circumstances of the case. Judge Owens was appointed to the bankruptcy bench in Delaware in June.

The debtor mined and produced sand used for hydraulic fracturing in the oil and gas industry. The case was a typical prepackaged chapter 11 reorganization.

The plan called for refinancing the pre-bankruptcy revolving credit and secured loans incurred by the debtor in possession. In return for their debt, secured noteholders were to receive all of the equity in the reorganized debtor.

The plan presumed that the reorganized business was worth less than the approximately \$320 million owed to secured creditors. Therefore, unsecured creditors and equity holders were out of the money and entitled to no distribution.

As an incentive for unsecured creditors to vote in favor of the reorganization, the plan contained a so-called deathtrap. If the unsecured creditor class were to vote in favor of the plan by the requisite majorities, they would receive 5% of the new equity and warrants for 10% more. Existing equity holders would be given warrants for 5% of the new equity if the unsecured creditor class were to approve the plan.

The plan contained broad third-party releases barring everyone – creditors and equity holders included – from bringing claims against non-debtor participants in the reorganization, such as the secured noteholders and revolving credit lenders.





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In the ballots they were given, unsecured creditors had the option of opting out from the releases. Equity holders were given a form for them to sign and return if they did wish to grant releases.

The unsecured creditor class voted against the plan, meaning neither they nor equity holders would receive any distribution. The unsecured creditors' committee, the U.S. Trustee, and the Securities and Exchange Commission objected to confirmation of the plan on a variety of grounds.

Judge Owens devoted most of her decision to placing a value on the debtor's business and assets. Analyzing valuation opinions given by experts for the debtor and the unsecured creditors' committee, Judge Owens concluded that unsecured creditors were entitled to no distribution. She also concluded that the plan satisfied the best interests and fair and equitable tests.

Having failed to win the war on valuation, the unsecured committee argued that the deathtrap meant the plan was not filed in good faith.

Although the deathtrap "may have seemed unsavory," Judge Owens said it "was intended to encourage consensus." Given the circumstances, she ruled that the deathtrap was neither "impermissible [nor] indicative of a lack of good faith." Thus, she concluded that the plan was proposed in good faith.

With regard to the third-party releases, the debtor did not fare so well.

The debtor argued that the releases were consensual because creditors and equity holders were given the opportunity of opting out. Judge Owens disagreed, holding that "consent cannot be inferred by the failure of a creditor or equity holder to return a ballot or Opt-Out Form."

Judge Owens could not say "with certainty" that a creditor or equity holder who failed to opt out "did so intentionally to give the third-party release."

To evaluate the significance of failing to opt out, Judge Owens employed what she called "basic contract principles." She concluded that failing to opt out did not "manifest [an] intent to provide a release." She believed that "[c]arelessness, inattentiveness, or mistake are three reasonable alternative explanations."

Judge Owens conceded that the conclusion put her in "a minority amongst the judges in this District." She cited bankruptcy judges in New York and Bankruptcy Judge Mary F. Walrath in Delaware who take the same position as she.

Nonetheless, Judge Owens did not proscribe third-party releases altogether. First, she said that "silence or inaction" may be indicative of consent if "special circumstances are present." She did not give examples of special circumstances.



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Second, nonconsensual releases, she said, can be permissible in the Third Circuit under *Gillman v. Continental Airlines (In re Continental Airlines)*, 203 F.3d 203, 212-14 (3d Cir. 2000), when there is an appropriate bankruptcy justification.

The debtor had not proffered a bankruptcy justification, so Judge Owens declined to confirm the plan, while suggesting that the debtor may confirm the plan by omitting the third-party releases.

Judge Owens had been a law clerk for a Delaware bankruptcy judge and was a partner at a prominent Delaware firm before ascending to the bench.

[The opinion is](#) *In re Emerge Energy Services LP*, 19-11563 2019 BL 465924 (Bankr. D. Del. Dec. 5, 2019).



## *Compensation*



*Another bankruptcy judge rules that the increase in U.S. Trustee fees does not apply to pending chapter 11 cases.*

## **Fifth Circuit to Rule on Whether Increased U.S. Trustee Fees Are Retroactive**

Bankruptcy Judge Mark X. Mullin of Fort Worth, Tex., joined the parade of judges holding that the increase in U.S. Trustee fees in 2018 does not apply to chapter 11 cases that were already pending and is unconstitutional if it does apply.

The issue will soon be tested in the Fifth Circuit.

In February, Bankruptcy Judge Ronald B. King of San Antonio ruled that the increase in fees does not apply to pending cases because the amended statute, 27 U.S.C. § 1930(a)(6)(B), is not retroactive. He went on to hold that the statute violates the Bankruptcy, Uniformity, and Due Process Clauses of the Constitution. *In re Buffets LLC*, 597 B.R. 588 (Bankr. W.D. Tex. 2019). To read ABI's discussion of *Buffets*, [click here](#).

Judge King authorized a direct appeal to the Fifth Circuit. The appeals court accepted the direct appeal on August 16.

The new case before Judge Mullin also involved a chapter 11 debtor whose plan was confirmed and consummated before the U.S. Trustee fee increase became effective. Principally following *Buffets*, he ruled that the statute was not retroactive by its terms and would violate the Due Process Clause if it were. He also held that the higher fee violates the Uniformity and Bankruptcy Clauses for cases pending when the increase was adopted on October 26, 2017.

The fee increase had a major effect on the debtor in Judge Mullin's court. For all of 2017, before the increase went into effect, total U.S. Trustee fees were \$56,000. Following the increase, the debtor was paying almost \$655,000 just for the first three quarters of 2018.

Judge Mullin ruled that the debtor is liable to pay U.S. Trustee fees at the rate in effect before the 2017 amendment. However, the decision is not ripe for appeal, because Judge Mullin still must determine the amount of the debtor's liability and whether the debtor is entitled to a refund.

Judge Mullin also followed the reasoning of Bankruptcy Judge Kevin R. Huennekens of Richmond, Va. Judge Huennekens held that the increased fee violates the Uniformity Clause if the fee is seen as a tax, and violates the Bankruptcy Clause if the fee is considered



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a user fee. In a case pending when the fee rose, he ruled that the debtor was only liable to pay the lower rate under the prior version of the statute. *In re Circuit City Stores Inc.*, 08-35653, 2019 BL 264824, 2019 Bankr. Lexis 2121 (Bankr. E.D. Va. July 15, 2019).

Judge Huennekens adopted Judge King's rationale in *Buffets*. To read ABI's discussion of *Circuit City*, [click here](#).

The opinion by Judge Mullin is *In re Life Partners Holdings Inc.*, 15-40289 (Bankr. N.D. Tex. Aug 22, 2019).





*Parting with some other bankruptcy courts, Judge Walrath upholds the constitutionality of the major increase in U.S. Trustee fees that was imposed on pending cases in early 2018.*

## **Delaware Judge Upholds U.S. Trustee Fee Increase in Pending Cases**

Delving into a controversy where the courts are divided, Bankruptcy Judge Mary F. Walrath of Delaware held that the increased fees payable by chapter 11 debtors for the U.S. Trustee system are not impermissibly retroactive and do not violate the Due Process and Bankruptcy Clauses of the U.S. Constitution.

The increased fees, which became effective in January 2018, are no small matter. Exide Technologies, the debtor in Judge Walrath's case, had been paying \$30,000 a quarter. After the increase, the quarterly fee rose to \$250,000.

The questions confronted by Judge Walrath will likely be decided this year in a direct appeal to the Fifth Circuit. *Hobbs v. Buffets LLC (In re Buffets LLC)*, 19-50765 (5th Cir.). The reply briefs in *Buffets* will be filed in early February. A date for argument has not been set.

In *Buffets*, Bankruptcy Judge Ronald B. King of San Antonio held that the increase in fees must not apply to pending cases because the amended statute increasing the fees, 27 U.S.C. § 1930(a)(6)(B), is not retroactive. Judge King went on to hold that the statute violates the Bankruptcy, Uniformity, and Due Process Clauses of the Constitution. *In re Buffets LLC*, 597 B.R. 588 (Bankr. W.D. Tex. 2019).

In addition, a class action was filed in April 2019 in the U.S. Court of Claims seeking a refund of increased U.S. Trustee fees paid by chapter 11 debtors whose cases were pending when the increase came into effect. *Acadiana Management Group LLC v. U.S.*, 19-496 (Ct. Cl.). The complaint alleges that the increased fees are unconstitutional as applied. The government filed a motion to dismiss and is scheduled to submit its reply brief at the end of January.

### Judge Walrath's Case

Exide, the debtor in Judge Walrath's case, confirmed a chapter 11 plan in March 2015. The statute, Section 1930(a)(6)(B), was amended more than two years later, compelling Exide to increase its quarterly fee payments in the first calendar quarter of 2018.



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The debtor filed a motion asking Judge Walrath to lower the fee to the amount the company was paying at the time of confirmation. In her 34-page opinion on January 9, Judge Walrath denied the motion.

Judge Walrath said there is a split, citing *Buffets* for barring imposition of the increase retroactively. She also cited *In re Life Partners Holdings Inc.*, 15-40289, 2019 BL 482329, 2019 WL 3987707 (Bankr. N.D. Tex. Aug. 22, 2019), for holding that retroactive application of the increase violates due process. To read ABI's reports on *Buffets* and *Life Partners*, click [here](#) and [here](#).

Unlike the two judges in Texas, Judge Walrath found no fault with the amended statute. In allowing imposition of the increase in pending cases, she made five holdings:

- (1) The 2017 amendment is not a retroactive statute because it applies only to disbursements made after enactment;
- (2) Even though the increase may not have been anticipated by the debtor or its creditors, that's not enough to make the statute a violation of the Due Process Clause;
- (3) Even if the increase is retroactive, the increase does not violate due process because Congress had a legitimate legislative purpose in ensuring that the U.S. Trustee system is self-funded;
- (4) The quarterly fee is a permissible user fee and not an excessive, unconstitutional taking; and
- (5) The increase does not violate the "uniformity" aspect of the Bankruptcy Clause of the Constitution because the increase is applied only to bankruptcy cases. Furthermore, the delay in imposing the increase in the two states with bankruptcy administrators was a result of implementation of the statute, not a consequence of legislative action.

Judge Walrath in substance ruled that the debtor must pay the increase. We will report if the debtor seeks a direct appeal to the Third Circuit.

[The opinion is](#) *In re Exide Technologies*, 13-11482, 2020 BL 6883 (Bankr. D. Del. Jan. 9, 2020).



*Seventh Circuit reverses and imposes the U.S.Trustee fee on 'revolver sweeps,' but Judge Huennekens rules that the fee increase violates two clauses in the Constitution.*

## **Increased U.S. Trustee Fees Stick to 'Revolvers' but Not to Pending Cases**

The struggle to roll back the U.S.Trustee fee is succeeding only with respect to companies whose chapter 11 cases were pending as of October 27, 2017, when the increase came into effect. Conversely, larger companies were dealt a setback when the Seventh Circuit reversed the bankruptcy court by ruling that the daily sweep on a revolving credit is a “disbursement” that must be included in calculating the U.S.Trustee fee.

### Background

To ensure that taxpayers do not finance the U.S.TrusteeProgram, Congress revised the U.S. Trustee fees as part of the Bankruptcy Judgeship Act of 2017. Codified at 27 U.S.C. § 1930(a)(6)(B), the fee increases whenever the balance in the U.S.Trustee System Fund falls below \$200 million at the end of any fiscal year through 2022.

Since the fund balance was below the threshold, the fee increased as of Oct. 27, 2017, when the amendment became effective. With the increase, “the quarterly fee payable for a quarter in which disbursements equal or exceed \$1,000,000 shall be the lesser of 1 percent of such disbursements or \$250,000.”

In other words, if the debtor disburses \$1 million a quarter, the quarterly fee is \$10,000, or \$40,000 a year. Under the prior fee schedule, the quarterly fee would have been \$4,785 if disbursements were \$999,999 in the quarter, or \$6,500 if the quarterly disbursements were \$1 million but less than \$2 million.

If quarterly disbursements are \$25 million or more, the fee is now \$250,000 a quarter. At \$25 million under the old schedule, the fee would have been \$20,000 a quarter. For a company with \$25 million in quarterly disbursements, the fee rose 1,250%

The word “disbursements” is not defined in the statute.



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The increase is hitting middle-market companies, because the fee for large companies in chapter 11 is capped at \$250,000 a quarter. The increase is tough on companies with low margins but high sales volumes.

## 'Revolvers' Are Taxed

Most larger companies in chapter 11 are financed with revolving credits provided by secured lenders. So-called revolvers allow the bank to reduce the debt every day by sweeping the debtor's income. The lender makes new advances if the company is in compliance with the loan agreement. Lenders prefer revolvers because they afford more control than term loans.

A company in Wisconsin persuaded the bankruptcy judge that the daily sweep by the revolver bank was not a "disbursement" because it did not effectively reduce the debt. Omitting the revolver sweep from the calculation of "disbursements" dramatically reduced the debtor's fee for the U.S. trustee system. See *In re Cranberry Growers Cooperative*, 592 B.R. 325 (Bankr. W.D. Wis. 2018). To read ABI's discussion of *Cranberry Growers*, [click here](#).

The bankruptcy judge authorized a direct appeal. The Seventh Circuit reversed on July 17 in a 29-page opinion by Circuit Judge Kenneth F. Ripple.

Since "disbursement" is not defined in the Bankruptcy Code, Judge Ripple looked to the word's "ordinary meaning." The term means money paid out or expenditures, and courts have given the term an "expansive meaning," he said.

Judge Ripple reversed the bankruptcy court, ruling that payments by the debtor's customers that reduced the revolver were "disbursements for the purposes of Section 1930(a)(6) and should have been included in the calculation of [the debtor's] quarterly fees."

On appeal in the circuit, the debtor for the first time latched on to decisions elsewhere holding that the quarterly fees were unconstitutional because they were not uniform throughout the U.S. Judge Ripple declined to reach the constitutional questions because they had not been raised in the bankruptcy court.

Question: Can bank lawyers draft revolvers so that daily sweeps won't look like disbursements, but still give the bank as much protection as traditional revolvers?

## The 'Uniformity' Issue

Alabama and North Carolina never have been part of the U.S. trustee program. Instead, the six federal districts in those states continue using bankruptcy administrators. Originally, debtors in those states did not pay fees to the U.S. trustee system. The exemption was found to violate the Uniformity Clause of the U.S. Constitution, which provides that taxes "shall be uniform



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throughout the United States.” See *St. Angelo v. Victoria Farms, Inc.*, 38 F.3d 1525 (9th Cir. 1994), *amended*, 46 F.3d 969 (9th Cir. 1995).

Consequently, Congress amended the statute to allow imposition of the U.S. trustee fee in non-ee districts. However, the lack of uniformity reemerged.

When Congress increased the U.S. trustee fee, the statute authorized the Judicial Conference of the U.S. to impose the larger fee in Alabama and North Carolina. The Judicial Conference did increase the fee, but not for pending cases.

In an opinion on July 15 dealing with a chapter 11 case that was pending when the larger fee came into effect, Bankruptcy Judge Kevin R. Huennekens of Richmond, Va., held that the increased fee violates the Uniformity Clause, if the fee is seen as a tax, and violates the Bankruptcy Clause, if the fee is considered a user fee. In a case pending when the fee rose, he ruled that the debtor was only liable to pay the lower rate under the prior version of the statute.

In substance, Judge Huennekens adopted rulings by Bankruptcy Judge Ronald B. King of San Antonio in *In re Buffets LLC*, 597 B.R. 588 (Bankr. W.D. Tex. 2019). To read ABI’s discussion of *Buffets*, [click here](#).

Last month, the district court in *Buffets* authorized a direct appeal to the Fifth Circuit.

The [opinion](#) from the Seventh Circuit is *In re Cranberry Growers Cooperative*, 18-3289, 2019 BL 263547 (7th Cir. July 17, 2019); the [Virginia opinion](#) is *In re Circuit City Stores Inc.*, 08-35653, 2019 BL 264824, 2019 Bankr Lexis 2121 (Bankr. E.D. Va. July 15, 2019).





## *Preferences & Claims*



*To avoid liability for an underfunded pension plan, the First Circuit describes a structure for investors to employ when buying a sick company.*

## **First Circuit Explains How to Avoid Liability for an Underfunded Pension Plan**

Reversing the district court, the First Circuit endorsed a structure ensuring that investors will not be liable for withdrawal from a multiemployer pension plan. The guinea pig was two investment funds established by Sun Capital Partners Inc.

On a motion for summary judgment, the district court had found that the two Sun Capital investment funds were jointly and severally liable for more than \$4 million in withdrawal liability when the bankruptcy of a brass company led to withdrawal from a multiemployer pension fund.

In her November 22 opinion, Circuit Judge Sandra L. Lynch laid out the two competing policy considerations: (1) Holding investors liable for withdrawal liability “would likely disincentivize much-needed private investment in underperforming companies with unfunded pension liabilities;” and (2) if investors are not held liable, the Pension Benefit Guaranty Corp. will assume responsibility for paying pensioners, but the maximum annual benefit will be less than \$13,000 for an employee with 30 years of service.

Judge Lynch said she was “reluctant to impose withdrawal liability on the private investors because we lack a firm indication of congressional intent to do so and any formal guidance from the PBGC.”

### The Complex Ownership Structure

The ownership structure was complex but boiled down to this: For an investment of \$2.1 million, one Sun Capital fund bought 70% of the brass company. For 30% ownership, a different Sun Capital fund paid \$900,000.

As investors, the two funds had 124 and 230 limited partners, respectively. Sixty-four of the limited partners invested in both funds. The two funds were both organized as limited liability corporations. The general partner of both was another Sun Capital entity.

The investment funds had no offices and no employees and made nothing on their own. Their organization documents expressly disclaimed being part of any partnerships or joint ventures.



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The two funds bought the brass company with their \$3 million investment and \$4.8 million in debt. The purchase price was a 25% discount to fair market value in view of the brass company's unfunded pension liability. Functionally speaking, decisions for the two funds were made by the same two high-level executives at Sun Capital.

## Liability Under MPPAA

The outcome was governed by the Multiemployer Pension Plan Amendments Act of 1980, or MPPAA. The MPPAA has a two-part test to determine whether the two funds would be liable for the shortfall in funding the pension plan. First, they must have been part of an "implied partnership-in-fact which constituted a control group," Judge Lynch said. Second, the funds had to be engaged in a trade or business.

The opinion by Judge Lynch focused on the first test. The existence of a partnership-in-fact turned on the Internal Revenue Code and the eight-part test in *Luna v. Commissioner*, 42 T.C. 1067 (1964).

Sun Capital used two investment funds with 70%/30% ownership for a simple reason: Treasury regulations provide that an entity with 80% ownership is deemed to have a controlling interest. The issue therefore became a question of whether the two funds met the 80% ownership test because they were functionally a partnership.

Under the eight-part *Luna* test, there were some indicia of a partnership, Judge Lynch said. Sun Capital's control of the two funds by the same two senior executives, she said, was "some evidence of a partnership-in-fact," because the two men "essentially ran things for both" the funds and the brass company.

However, the "consideration of all the factors" led Judge Lynch to "the opposite conclusion." She pointed to the funds' express disclaimer of being in "any sort of partnership." Also, she said, they "did not operate in parallel, that is, invest in the same companies at a fixed or even variable ratio."

Concluding that the two funds had not formed a partnership-in-fact, Judge Lynch reversed the district court. She therefore did not reach the second part of the test: the issue of a trade or business.

[The opinion is](#) *Sun Capital Partners III LP v. New England Teamsters & Trucking Industry Pension Fund*, 16-1376 (1st Cir. Nov. 22, 2019).



*The circuits agree, but the lower courts disagree, on the allowance of post-petition attorneys' fees based on contract.*

## **Another Circuit Allows an *Un*secured Claim for Contractual Attorneys' Fees**

The circuit courts are consistently allowing unsecured claims for post-petition attorneys' fees when the creditor is entitled by contract to recover the costs of collection.

In an opinion on February 8, the Fourth Circuit joined the Second, Seventh and Ninth Circuits. Before the Supreme Court's pivotal decision in *Travelers Casualty & Surety Co. of America v. Pacific Gas & Electric Co.*, 549 U.S. 443 (2007), the First and Eleventh Circuits had reached the same conclusion.

Although the circuit courts agree, some lower courts have the opposite opinion.

The case at bar involved a secured creditor with collateral worth about \$1.7 million. The loan agreement allowed the lender to recover the costs of collection, including attorneys' fees. The chapter 11 plan gave the creditor an allowed, secured claim for \$1.7 million, an amount covering principal, interest, and some of the lender's post-petition attorneys' fees.

The plan permitted the lender to file an unsecured claim for additional post-petition attorneys' fees. Upheld in district court, the bankruptcy court disallowed the lender's unsecured claim for post-petition attorneys' fees.

The lender appealed and won a reversal in an opinion written by Fourth Circuit Judge Pamela Harris.

The lender relied largely on *Travelers*, where the Supreme Court overturned a rule developed in lower courts disallowing attorneys' fees for litigating issues peculiar to bankruptcy law. In a statement being followed in other contexts, the high court said that "claims enforceable under applicable state law will be allowed in bankruptcy unless they are expressly disallowed." *Id.* at 452.

Judge Harris said that bankruptcy and district courts "long have wrestled with this question, disagreeing as to whether creditors may assert unsecured claims for post-petition fees based on pre-petition contracts." She said that *Travelers* requires a determination of whether the Bankruptcy Code "expressly disallows" the claim.



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Turning to the statute, Section 502(b) requires the court to “determine the amount of such claim . . . as of the date of the filing of the petition.” The subsection goes on to list nine specific categories of otherwise valid claims that are disallowed, such as unmatured interest.

Judge Harris framed the question as whether the lender had a claim for post-petition counsel fees as of the filing date. Permitted under the loan agreement, the claim, she said, was “contingent on a future, post-petition event.” She went on to say that the term “claim” is defined broadly in Section 101(5)(A) to include a “right to payment” that is “contingent.”

Because the claim was valid under state law and did not fall into any of the nine categories of disallowed claims, Judge Harris concluded that the claim was allowable because she “found nothing in Section 502(b) that expressly disallows unsecured claims for post-petition attorneys’ fees.”

Judge Harris saw additional support in Section 502(c), which calls on the court to estimate claims that are contingent.

The debtor based an alternative argument on Section 506(b), allowing a secured claim for attorneys’ fees only to the extent there is value in the collateral. The debtor interpreted the section to mean that undersecured claims for attorneys’ fees are not allowed.

Judge Harris rejected the argument, saying that “Section 506(b) never mentions, let alone expressly disallows, unsecured claims for post-petition attorneys’ fees.” She found a second problem with the argument: “Section 506(b) has nothing to do with the allowance or disallowance of claims.” (N.B.: The subsection does say that a claim for attorneys’ fees “shall be allowed” under specified circumstances. However, the subsection may only be referring to the creditor’s secured claim, not an unsecured claim.)

Judge Harris also declined to disallow the claim for “policy considerations.” In that regard, the debtor had argued that allowance of unsecured claims for post-petition attorneys’ fees would dilute the recovery by other unsecured creditors.

Judge Harris said the Bankruptcy Code itself already answered the question of whether the claim is allowable. She said the court “must defer to Congress’ chosen policy” because the debtor’s fairness argument “has no basis in the text of the relevant Code provisions.”

The same issue is on appeal to the Third Circuit in *Tribune Media Co. v. Wilmington Co.* (*In re Tribune Media Co.*), 18-3793 (3d Cir.). In *Tribune*, the district court reversed the bankruptcy court by allowing an unsecured claim for post-petition counsel fees. To read ABI’s discussion of the district court opinion, [click here](#).





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[The opinion is](#) *Summitbridge National Investments III LLC v. Faison*, 915 F.3d 288 (4th Cir. Feb. 8, 2019).



*Policy informs the result when the statutory language is ambiguous.*

## **Fifth Circuit Invokes 'Policies' in Ruling on Subordination under Section 510(b)**

Finding some of the statutory language to be “ambiguous,” the Fifth Circuit prescribed policies to follow when deciding whether a claim is really an interest in securities to be subordinated under Section 510(b).

In her September 3 opinion, Circuit Judge Edith Brown Clement dealt with a set of facts beginning with a trust created 90 years ago, compounded by several complex corporate restructurings in recent years. Fundamentally, the erstwhile creditor had a right to receive payments if the debtor was paying dividends to shareholders. Judge Clement referred to the creditor’s claim as based on a right to receive “deemed dividends.”

Chief Bankruptcy Judge David R. Jones of Houston subordinated the claim under Section 510(b) and was upheld in district court. Judge Clement affirmed a second time, saying that the case dealt with payments “which are not quite dividends but which certainly look a lot like dividends.”

Section 510(b) subordinates “a claim . . . for damages arising from the purchase or sale of . . . a security . . .” Judge Clement said that the policy goals of the section “are clear, but applying the statute is more complex.” Circuit courts agree, she said, that “the ‘arising from’ language is ambiguous.”

Because ambiguity makes a “check-the-box approach . . . impossible,” Judge Clement said that “the policy rationales behind Section 510(b) must always guide its interpretation and application to particular facts.”

Judge Clement first confronted “damages,” a word not defined in the Bankruptcy Code. It connotes “some recovery *other than* a simple recovery of an unpaid debt,” like a claim for fraud or breach of contract. [Emphasis in original.] “All agree,” she said, that the creditor was seeking damages.

Next, Judge Clement analyzed whether the claim was based on a “security,” a word with a long definition in Section 101(49). The definition includes a so-called residual clause characterizing a security as including an “interest commonly known as a ‘security.’” Section 101(49)(A)(xiv).



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Judge Clement concluded that the right to receive “deemed” dividends was a security under the residual clause, because it allowed the creditor to “participate in the success of the enterprise” where the “upside . . . was theoretically limitless.” Conversely, she said, the creditor risked receiving nothing at all if the company went bankrupt.

Last, Judge Clement asked whether the claim arose from the purchase or sale of a security.

A transaction with the creditor a few years before bankruptcy, exhibiting some hallmarks of a purchase or sale, had a “nexus or causal relationship” with the creditor’s claim.

“Finally,” Judge Clement said, the right to receive deemed dividends was “more like an investor’s interest than a creditor’s interest.” Because “arising from” is ambiguous, she concluded that the “policy goals of the statute” supported subordination.

[The opinion is](#) *French v. Linn Energy LLC (In re Linn Energy LLC)*, 18-40369 (5th Cir. Sept. 3, 2019).



*Appeals court holds that a specific request from the debtor isn't required to justify allowance of an 'admin' claim.*

## **Fifth Circuit Clarifies 'Admin' Status for a Drilling Contractor's Post-Rejection Claims**

In a significant opinion for the oil and gas industry, the Fifth Circuit clarified the circumstances when an offshore drilling contractor is entitled to an administrative expense claim after the rejection of a drilling contract. More generally, the appeals courts says that a specific request from the debtor in possession for services is not required for the allowance of an administrative claim.

After remand to make additional findings of fact, the drilling contractor may end up with a larger administrative claim than the bankruptcy court originally allowed.

### **The Drilling Contract**

The debtor was the owner of an offshore drilling and production platform. Before bankruptcy, the debtor hired the drilling contractor to install a drilling rig and associated equipment on the platform and provide workers to drill a new well from the platform.

Before bankruptcy, a worker was killed in an accident on the platform. Federal regulators then shut down the drilling project. Two weeks later, creditors filed an involuntary petition against the owner of the platform.

In chapter 11, the debtor in possession paid the creditor to abandon the well. When abandonment was completed, the debtor filed a motion to reject the contract with the creditor.

The bankruptcy court granted the rejection motion, effective as of the day when abandonment had been completed.

Four months after rejection of the contract, regulators approved a demobilization plan for the drilling contractor to remove the drilling rig and its other equipment from the platform. Six months after rejection, the drilling contractor had removed its equipment from the platform.

The drilling contractor filed an administrative claim for about \$7 million, covering the period from the effective date of rejection until it had removed its equipment from the platform.

The bankruptcy judge allowed an administrative claim for some \$900,000, holding that the contractor was entitled to a priority claim only for services specifically requested by the debtor



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after the effective date of rejection. The district court affirmed in July 2018. To read ABI's report on the district court affirmance, [click here](#).

The drilling contractor appealed and won a remand in a July 26 opinion by Circuit Judge Stephen A. Higginson. Having clerked on the Supreme Court and served as an assistant United States Attorney, Judge Higginson was unanimously confirmed by the Senate in 2011.

## The Law on 'Admin' Claims

Judge Higginson synthesized Fifth Circuit law on the allowance of administrative claims under Section 503(b)(1)(A). To qualify as "actual, necessary costs and expenses of preserving the estate," he said the claim must have arisen post-petition and as a result of actions taken by the debtor in possession that benefitted the estate.

More to the point, Judge Higginson said that the claim must have arisen from a transaction with the debtor in possession, as opposed to the pre-bankruptcy debtor. The creditor, he said, "must show some inducement by the debtor in possession." However, he said there need be no "explicit request by the debtor in possession for specific services."

In line with sister circuits, Judge Higginson said that an administrative claim can be based on a direct request by the debtor or by "the knowing and voluntary post-petition acceptance [by the debtor] of desired goods or services." In addition, the claimed expenses must benefit the estate.

Significantly, Judge Higginson said that a debtor in possession cannot rent equipment and then disclaim liability as an expense of administration "by asserting that it did not end up needing the equipment."

Judge Higginson said that the bankruptcy court drew a "sharp distinction" between being available to provide services and actually providing services. Nonetheless, he said, "conducting business as usual often requires that certain goods or services be available, even if ultimately not used."

## Pre- and Post-Demobilization Claims

Applying the facts to the law, Judge Higginson broke down the claim into two segments: (1) Predemobilization, meaning the four months after rejection up until the contractor was authorized by regulators to begin removing its equipment from the platform, and (2) demobilization, or the two months it took to remove the equipment from the platform after the receipt of regulatory approval.

With regard to the predemobilization, Judge Higginson said that the denial of most of the claim for administrative status "appears to have been influenced by [the bankruptcy court's] stated view





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that [the drilling contractor's] mere availability on the platform did not warrant administrative priority." To the contrary, he said, waiting for regulatory approval "can benefit the debtor in possession," because the debtor asked the contractor to prepare a demobilization plan and wanted the contractor to await regulatory approval before removing its equipment.

Applying the concepts to the facts, Judge Higginson said that the contractor would have a priority claim "for the actual and necessary cost of its presence on the platform for the period of time required to satisfy [the debtor's] logistical and regulatory requirements." On the other hand, he said the contract would not qualify for a priority claim "for the costs of its presence on the platform for any time attributable to its own unnecessary delay."

Judge Higginson remanded the case for the bankruptcy court to determine: (1) whether the debtor induced the contractor to remain on the platform; (2) the length of time the contractor was on the platform "because of [the debtor's] post-petition needs," and (3) "the actual and necessary costs of staying on the platform during this time period." He said that "actual and necessary" includes the costs of "remaining on the platform" and "the full and ordinary costs of providing a service, including overhead costs and other indirect expenses." In a footnote, he said the contractor is not entitled to a double recovery.

On the demobilization costs, the contractor did not fare so well, because Judge Higginson upheld the bankruptcy court by denying administrative status for everything. He said that demobilization "was simply the consequence of [the debtor's] rejection of the contract and did not benefit the estate."

[The opinion is](#) *Nabors Offshore Corp. v. Whistler Energy II LLC (In re Whistler Energy II LLC)*, 18-30940, 2019 BL 277164 (5th Cir. July 26, 2019).



*Although a foreclosure sale can be immune from fraudulent transfer attack, a tax foreclosure not based on the value of the property can be a preference.*

## **New Jersey Tax Foreclosures Can Be Preferences, Third Circuit Rules**

Unlike mortgage foreclosures, which can be immune from attack in bankruptcy court, a tax foreclosure in New Jersey may be set aside as a preference because the process does not entail a public auction related to the value of the property, the Third Circuit held.

Upholding the bankruptcy and district courts, Circuit Judge Jane R. Roth reasoned that *BFP v. Resolution Trust Corp.*, 511 U.S. 531 (1994), was not controlling. In *BFP*, the Supreme Court ruled that a regularly conducted mortgage foreclosure sale cannot be avoided as a fraudulent transfer under Section 548.

Writing for the high court in *BFP*, the late Justice Antonin Scalia focused on the words “reasonably equivalent value” in Section 548 in concluding that the fraudulent transfer statute was not focused on achieving fair market value. He was also concerned that applying fraudulent transfer law to mortgage foreclosures would place foreclosures under a federally created cloud.

In her September 12 opinion, Judge Roth emphasized *BFP*'s focus on fraudulent transfers, while her case dealt with a preference and a different provision in the Bankruptcy Code. She said that the concern with federalism “cannot overcome the plain language” of Section 547.

### **New Jersey's Tax Foreclosure Procedure**

When an owner has not paid real estate taxes, a municipality in New Jersey sells tax certificates. Under state law, prospective purchasers at a sale of tax certificates do not bid on the value of the property. Rather, the winner is the bidder offering the lowest interest rate. In the case on appeal, the winning bidder offered zero percent interest and a bid that was \$13,500 above the unpaid taxes.

After winning the auction, the buyer waited the requisite two years under state law to commence what amounts to a strict foreclosure where there is no sale of the property. The state court entered judgment awarding title to the purchaser. In the intervening two years before foreclosure, the owner could have redeemed the property.

The debtors filed a chapter 13 petition less than 90 days after the foreclosure judgment. They scheduled the property as being worth \$335,000 and listed the tax lien creditor as being owed \$45,000. There were no mortgages on the property, although there was about \$90,000 in other judgment liens.



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The debtors sued to set aside the tax lien foreclosure as a preference. They also filed a chapter 13 plan promising to pay all creditors in full.

Upheld in district court, Bankruptcy Judge Christine M. Gravelle ruled that a tax foreclosure sale in New Jersey can be set aside as a preference under Section 547.

## The Third Circuit Affirmance

The purchaser fared no better in the Third Circuit. Apart from the purchaser's nonstatutory arguments, Judge Roth said that the transaction contained all of the elements of a preference under Section 547.

The purchaser made two arguments, "both sounding in principles of federalism," Judge Roth said. First, the purchaser contended that *BFP* prohibits setting aside a lawfully conducted tax foreclosure as a preference.

Judge Roth said that the case on appeal differed from *BFP* in "two critical ways." She added, "These are not trivial distinctions."

First, *BFP* dealt with a fraudulent transfer, not a preference. Second, a mortgage foreclosure is based on the value of the property, even though a forced sale will not realize market value.

Moreover, the relationship to value of the property is "nonexistent" in a tax foreclosure, Judge Roth said. She rejected the idea that there must be "a clear and manifest intent of Congress" before the Bankruptcy Code can "displace an area traditionally regulated by the states."

Judge Roth distinguished decisions where the Fifth, Ninth and Tenth Circuits immunized tax foreclosure from preference attack. State laws in those cases, she said, called for public auctions.

Judge Roth also rejected the purchaser's argument based on the Tax Injunction Act, 28 U.S.C. § 1341, which precludes federal courts from enjoining the collection of taxes under state law so long as there is a remedy in state court. She said that the "specific edict" of Section 547 "overrides" the general provisions of the Tax Injunction Act.

To read ABI's reports on the bankruptcy and district court opinions, [click here](#) and [here](#). For ABI's report on the Ninth Circuit opinion that Judge Roth declined to follow, [click here](#).

## Observation

Judge Roth's opinion strikes the writer as standing for the proposition that vague notions of federalism cannot overcome the Supremacy and Bankruptcy Clauses of the Constitution.



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The opinion is *Hackler v. Arianna Holdings Co. (In re Hackler)*, 18-15650, 2019 BL 342302, 2019 US App Lexis 27514 (3d Cir. Sept. 12, 2019).



*Delaware district judge reads Supreme Court's Travelers opinion as requiring the allowance of post-petition contractual claims for attorneys' fees.*

## **Delaware Judge Allows Unsecured Claim for Contractual Attorneys' Fees**

If attorneys' fees are disallowed on undersecured claims, it follows, does it not, that contractual claims for post-petition attorneys' fees are also disallowed on *unsecured* claims?

Answer: No, it does not follow.

Reversing the bankruptcy court, District Judge Richard G. Andrews of Delaware interpreted *Travelers Casualty & Surety Co. of America v. Pacific Gas & Electric Co.*, 549 U.S. 443 (2007), to mean that an unsecured claim for post-petition attorneys' fees must be allowed if the contract makes the debtor liable.

Almost ancient history by now, the dispute arose in the reorganization of Tribune Media Co., which began with a chapter 11 filing in late 2008 and concluded on confirmation in 2012.

The indenture for unsecured, subordinated bonds called for Tribune to reimburse the indenture trustee for expenses and attorneys' fees incurred in collecting the debt. The claim by the indenture trustee included a claim for about \$30 million in post-petition attorneys' fees. Were it allowed, the claim for attorneys' fees would receive a partial distribution under Tribune's plan.

The debtor objected to the claim. Bankruptcy Judge Kevin J. Carey disallowed the unsecured claims for attorneys' fees in an opinion on Nov. 19, 2015. To read Judge Carey's decision, [click here](#).

Judge Carey adopted the conclusion of what he said were "some [lower] courts" in the Third Circuit that have held that post-petition attorneys' fees are not recoverable as part of an unsecured claim. Employing the *expressio unis* maxim, he noted that Section 506(b) expressly allows attorneys' fees for oversecured creditors, while no provision in the Bankruptcy Code allows fees for unsecured creditors. He also cited Section 502(b), which fixes the amount of claims as of the petition date.

Saying that the courts have "long been divided," Judge Carey rejected the indenture trustee's reliance on *Travelers*. He said the justices had overruled the so-called *Fobian* rule from the Third Circuit, which disallowed attorneys' fees for litigating issues peculiar to bankruptcy law. He





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quoted the *Travelers* opinion where it said the high court was offering no opinion on whether the claim could have been disallowed on other grounds.

Reversing in a three-page opinion on November 26, Judge Andrews said that three circuit courts after *Travelers* “have allowed unsecured claims for contractual attorneys’ fees that accrued post-filing of the bankruptcy petition.” He added that two circuits had reached the same conclusion before *Travelers*.

Judge Andrews conceded that at least six decisions in 2016 and 2017 agreed with Judge Carey and disallowed contractual claims for post-petition attorneys’ fees. However, Judge Andrews appeared to follow the statement in *Travelers* that “claims enforceable under applicable state law will be allowed in bankruptcy law unless they are expressly disallowed.” *Id.* at 452.

Not able to contribute “anything new . . . to this debate,” Judge Andrews said, “I cannot conclude that Section 506(b) ‘expressly’ disallowed the claims at issue here. Thus, I agree with the position adopted by every court of appeals faced with this question; Section 506(b) does not limit the allowability of unsecured claims for contractual post-petition attorneys’ fees under Section 502.”

[The opinion is](#) *Wilmington Co. v. Tribune Media Co. (In re Tribune Media Co.)*, 15-01116, 2018 BL 432965, 2018 US Dist Lexis 199137 (D. Del. Nov. 26, 2018).



*A failure to distinguish between res judicata and collateral estoppel turned out to be costly.*

## **'Deemed Allowed' Claims Can Be Binding in Subsequent Litigation, Circuit Says**

The validity and amount of a “deemed allowed” claim under Section 502(a) can be binding in a subsequent litigation between the same parties or their privies, according to the Sixth Circuit. Before applying issue preclusion or claim preclusion, however, courts should consider whether the claim was actually or necessarily litigated.

The case involved a trucking company that terminated a union contract and withdrew from a union pension fund. The pension fund sued to recover about \$1.1 million, representing the trucking company’s withdrawal liability.

The trucking company filed a chapter 7 petition, and the pension fund filed a claim for exactly same amount it sought in the pre-petition lawsuit, which had been stayed by bankruptcy. No one objected to the claim, so it was deemed allowed under Section 502(a).

Section 502(a) says that a proof of claim filed under Section 501 “is deemed allowed, unless a party in interest . . . objects.” Eventually, the pension fund received a \$52,000 distribution from the trustee on its deemed allowed claim of \$1.1 million.

Around the time of the bankruptcy filing, the family that owned the bankrupt trucking company set up a new corporation and began the same business with many of the same customers. The pension fund mounted a suit in federal court against the new company, asserting it was an *alter ego* under the National Labor Relations Act, making it liable for the bankrupt’s withdrawal liability.

The district court granted the pension fund’s motion for summary judgment, holding that the new company was the bankrupt’s *alter ego*. With regard to damages, the district court added interest and fees allowed under the NLRA, raising the judgment to some \$3.2 million.

The “new” company appealed, contending that *res judicata* precluded the district court from awarding more than \$1.1 million.

In his March 21 opinion, Circuit Judge Eric L. Clay upheld the district court’s finding that the new company was the *alter ego* of the bankrupt company under the NLRA. He then addressed the



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question of whether the amount of the deemed allowed claim was binding in the new lawsuit under the doctrine of *res judicata*, or claim preclusion.

In the Sixth Circuit, claim preclusion requires proof of four elements: (1) A final decision on the merits by a court of competent jurisdiction; (2) a subsequent litigation between the same parties or their privies; (3) an issue in the later litigation that was actually litigated or should have been litigated; and (4) an identity of the cases of action.

On the first element, Judge Clay said that the Second, Fifth and Ninth Circuits had held between 1993 and 2007 that an uncontested proof of claim is a final judgment on the merits for the purposes of claim preclusion.

Judge Clay agreed with the sister circuits, quoting the Ninth Circuit's comment that it would be "most peculiar" if an uncontested proof of claim "had less dignity" than a claim that someone had contested. *Siegel v. Fed. Home Loan Mortgage Corp.*, 143 F.3d 525, 530 (9th Cir. 1998).

Judge Clay therefore held that "an uncontested proof of claim that was allowed under 11 U.S.C. § 502(a) is a final judgment on the merits for the purposes of *res judicata*, with or without a separate court order specifically allowing the claim."

In one paragraph, Judge Clay said that the new lawsuit involved the same parties or their privies.

On the issue of whether interest and fees under the NLRA could be litigated in bankruptcy court, Judge Clay said yes and held that interest and fees "should have been litigated."

The new company's *res judicata* argument came up short on the fourth and last element: an identity of the causes of action.

The pension fund's proof of claim rested on the bankrupt's failure to pay withdrawal liability. The claim in the new lawsuit dealt with the new company's *alter ego* liability. Thus, Judge Clay said, claim preclusion "does not bar litigation of the amount of [the new company's] liability" because the claim did not arise from the same "operative facts."

In a footnote, Judge Clay insinuated that the new company might have won were its argument based on issue preclusion (collateral estoppel) rather than *res judicata*. He refused to consider collateral estoppel because the new trucking company had not raised the argument until the reply brief.

So, if the new company had argued issue preclusion, the deemed allowed claim would have had preclusive effect regarding the amount of the claim. In other words, the lawyer's failure to distinguish between *res judicata* and collateral estoppel was a \$2 million mistake.



## Observations

The deemed allowance of a claim involves more issues than meets the eye. In a chapter 11 case, a deemed allowed claim logically should be binding in any later litigation involving the debtor or those in privity, such as officers and directors. In those situations, the company and its officers and directors were in control with regard to claim allowance. Even so, a small percentage distribution may not have justified the expense of a claim objection.

But take the case of a corporate debtor in chapter 7. The small size of the estate may not justify objecting to claims. Furthermore, is a trustee in privity with the debtor corporation and its officers and directors for the purpose of claim and issue preclusion? Indeed, the trustee may be the principal adversary of officers and directors. At least with regard to issue preclusion, a deemed allowed claim might not have been actually and necessarily litigated.

[The opinion is](#) *Trustees of Operating Engineers Local 324 Pension Fund v. Bourdow Contracting Inc.*, 18-1491, 2019 BL 229381, 2019 Us App Lexis 18653 (6th Cir. March 21, 2019).



*Seventh Circuit holds that a financing statement is sufficient if it describes collateral by reference to an unattached security agreement.*

## **Seventh Circuit Splits with the First Circuit on Sufficiency of Financing Statements**

The Seventh Circuit held that a financing statement under the Uniform Commercial Code sufficiently describes collateral by referring to an *unattached* security agreement. In other words, no description of the collateral need be contained within the four corners of the financing statement.

Prof. Bruce Markell told ABI that the opinion “neuters the collateral description requirement in Article 9 financing.” Markell is now the Professor of Bankruptcy Law and Practice at the Northwestern Univ. Pritzker School of Law. Before returning to teaching, Prof. Markell was a bankruptcy judge in Nevada and a member of the Ninth Circuit Bankruptcy Appellate Panel.

### The Security Interest in All Assets

The lender had taken a security interest in all of the debtor’s assets. There was no dispute about the adequacy of the security agreement, which granted a security interest in 26 categories of collateral.

The timely filed financing statement described the collateral, in substance, as “all collateral described in the security agreement,” which was not attached to the financing statement. Two years later, the chapter 7 trustee contended that the security interest was unenforceable because the financing statement lacked a sufficient description of the collateral.

The bankruptcy judge agreed with the trustee and ruled that the security interest was voidable because the financing statement itself contained no description of the collateral. The Seventh Circuit accepted a direct appeal.

### Reversal Based on ‘Plain Language’

Circuit Judge Michael B. Brennan reversed the bankruptcy court based on the “plain and ordinary meaning” of Illinois’s version of the UCC.





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In his September 11 opinion, Judge Brennan laid out the UCC's requirements regarding the sufficiency of a financing statement. In pertinent part, Section 9-502 requires the financing statement to "indicate the collateral covered by the financing statement."

Next, Section 9-504 lists six ways in which a financing statement can "sufficiently indicate[]" the collateral. The sixth, catchall provision allows "any other method, if the identity of the collateral is objectively determinable."

Judge Brennan said that the current version of the Illinois UCC no longer requires "the financing statement [to] 'contain' a description of the collateral; after revision [in 2001] the statement must only 'indicate' the collateral."

According to Judge Brennan, the "plain reading of the text" leads to the conclusion that a financing statement may "indicate" the collateral by "pointing or directing attention to a description of that collateral in the parties' security agreement."

To buttress his conclusion that incorporation by reference is sufficient, Judge Brennan cited Seventh Circuit authority for the proposition that Article 9 of the UCC is neither a "minefield" for lenders nor a "windfall" for trustees. He also cited decisions by three bankruptcy judges in Illinois that he interpreted as allowing incorporation by reference.

To Judge Brennan's way of thinking, a financing statement is sufficient if it "puts third parties on notice that a creditor may have an existing security interest."

In short, Judge Brennan held that the "plain and ordinary meaning" of the revised Illinois UCC "allows a financing statement to indicate collateral by reference to the description in the underlying security agreement."

## Observations

Judge Brennan did not cite or discuss contrary decisions from other states, notably the First Circuit's decision in *Altair Global Credit Opportunities Fund (A) LLC v. Financial Oversight and Management Board for Puerto Rico (In re Financial Oversight and Management Board for Puerto Rico)*, 914 F.3d 694, 711-712 (1st Cir. Jan. 30, 2019). There, the First Circuit said that a financing statement is insufficient if it describes collateral by reference to a document not found in the filing office. To read ABI's report on the *Puerto Rico* decision, [click here](#).

"The [Seventh Circuit's] failure to cite, let alone discuss or distinguish, recent similar cases such as the First Circuit's recent *Puerto Rico* case underscores the frailty of its analysis," Prof. Markell said.



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Although the Seventh Circuit is typically not prone to relying on authorities from elsewhere, law under the UCC should be an exception because Section 1-103(a)(3) says it “must be liberally construed and applied . . . to make uniform the law among the various jurisdictions.”

Prof. Markell observed, “Under the [Seventh Circuit’s] reasoning, wouldn’t the mere fact of filing a financing statement ‘indicate’ that there is collateral described somewhere? Otherwise, why file the financing statement in the first place?”

If there is a motion for rehearing, and if possible in Illinois, it might be wise if the circuit were to certify the question for consideration by the Illinois Supreme Court. Otherwise, lenders may begin referring to collateral by reference and thus expose themselves to the danger that an Illinois state court will later rule the description to be inadequate.

[The opinion is](#) *First Midwest Bank v. Reinbold (In re 180 Equipment LLC)*, 18-3291 (7th Cir. Sept. 11, 2019).



## Consumer Bankruptcy



## *Ethics*



*Bankruptcy courts must cooperate before debtors' counsel are assured of being reimbursed for advancing costs and expenses before filing.*

## **Fifth Circuit Facilitates 'No Money Down' Chapter 13s**

The Fifth Circuit opened the door a crack for so-called no-money-down chapter 13s, where debtors' counsel are not required to "eat" the filing fee, the credit counseling fee and the cost of a credit report.

The May 13 opinion by Circuit Judge Jennifer Walker Elrod gives an expansive interpretation to expenses that courts have the discretion to reimburse in fee applications by debtors' counsel. In that regard, the opinion should be applicable in chapter 11, not only chapter 13.

The opinion seems to chip away at *Lamie v. U.S. Trustee*, 540 U.S. 526 (2004), where the Supreme Court held that a chapter 7 debtor's counsel's fees cannot be paid from estate property, and any prepetition obligation for unpaid attorneys' fees is dischargeable.

### The Business Model

By seeming to require the payment of retainers and filing fees before bankruptcy, strict enforcement of cases like *Lamie* had the effect of making bankruptcy unavailable for those most in need of bankruptcy — namely, individuals who are so broke they can't afford the cost of filing.

Last month, we reported a decision by Bankruptcy Judge Kevin R. Anderson of Salt Lake City, who laid down guidelines and disclosure requirements enabling lawyers to use so-called bifurcated fee arrangements, where chapter 7 debtors can pay all costs and fees in installments *after* filing. *In re Hazlett*, 16-30360, 2019 BL 130458 (Bankr. D. Utah April 10, 2019). To read ABI's report on *Hazlett*, [click here](#).

The appeal in the Fifth Circuit dealt with so-called no-money-down chapter 13s, where debtor's counsel pays the filing fee, the fee for credit counseling and the cost of a credit report. Counsel would intend to recoup the fees through an allowance of compensation and reimbursement of expenses. We will refer to the fees and costs collectively as the "expenses."

Debtors, of course, do not pay prepetition retainers to lawyers whose business plan is no money down. In the test case on appeal, the debtor's counsel intended to take advantage of a local rule in the Western District of Louisiana permitting a so-called no-look fee. So long as the requested fee does not exceed the amount specified in the local rule, the debtor's counsel fees will be allowed





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and paid under the plan without filing a detailed fee application, assuming there is no objection. The Fifth Circuit had previously permitted no-look fees.

The local rule in the district had changed. Previously, the local rule explicitly required the expenses to be included in the no-look fee. However, the local rule was modified in early 2017. The amended rule did not mention expenses, raising the question of whether debtors' counsel could recover expenses in addition to no-look fees.

And that's what debtor's counsel did, by filing a chapter 13 plan where the expenses would be reimbursed to the lawyer from the debtors' post-petition income. The chapter 13 trustee objected to the plan.

The bankruptcy court ruled that the expenses were not separately reimbursable under the local rule and were not administrative expenses reimbursable under Section 503(b)(1). Causing consternation in the debtor's bar, the bankruptcy court also held that the expenses could never be reimbursable as part of compensation in a fee application under Section 330(a).

Debtor's counsel appealed and lost in district court. *McBride v. Riley (In re Riley)*, 17-1302, 2018 BL 129776 (W.D. La. April 12, 2018). To read ABI's reports on the bankruptcy and district court opinions, click [here](#) and [here](#).

On the second appeal, Judge Elrod affirmed in part and reversed in part, employing *de novo* review.

## The Circuit's Analysis

Judge Elrod began by upholding the bankruptcy court's interpretation of the new local rule: Under the no-look rule, counsel was not entitled to reimbursement of expenses "separately from (and in addition to) the applicable no-look fee amount."

Likewise, Judge Elrod had little difficulty upholding the bankruptcy court's ruling that the expenses were not necessary costs of preserving the estate under Section 503(b). Had they fallen under Section 503(b), they would have been reimbursed in full as expenses of administration.

Judge Elrod said the expenses did not come under Section 503(b) because they were either the debtor's personal expenses or did not preserve the estate. She therefore upheld the lower courts by ruling that the expenses were not reimbursable as costs of administration under Section 503(b).

Of perhaps greatest significance to debtors' counsel, Judge Elrod concluded the opinion by holding that the fees "could" be allowed as part of attorneys' compensation under Section 330(a)(4)(B).



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In an individual's chapter 12 or 13 case, the subsection provides that "the court *may allow* reasonable compensation to the debtor's attorney for representing the interests of the debtor in connection with the bankruptcy case based on a consideration of the benefit and necessity of such services to the debtor and the other factors set forth in this section." [Emphasis added.]

As "a matter of statutory interpretation," Judge Elrod rejected the lower courts' conclusions that the expenses never could be reimbursed. She said that Section 330(a)(4)(B) "vests the bankruptcy courts with discretion to determine what constitutes 'reasonable compensation.'"

Given the discretionary language in Section 330(a)(4)(B), Judge Elrod rejected the notion that the bankruptcy court must always reimburse counsel for advancing expenses. However, she held that the subsection "permits bankruptcy courts to reimburse debtor's counsel for the [expenses] as reasonable compensation."

Of significance beyond chapter 13, Judge Elrod held that "the plain meaning of 'compensation' is broad enough that it would generally be understood to include reimbursement." Still, she said, there is a separate question: Does the subsection permit reimbursement of the filing fee, the credit counseling fees, and the cost of a credit report?

To answer the question, Judge Elrod noted the "textual distinction" between Section 503(b)(1) and Section 330(a)(4)(B).

Section 503(b)(1) is limited to the expenses of preserving the estate, while Section 330(a)(4)(B) encompasses compensation for representing the debtor's interests. "[B]y any ordinary understanding of the words," the expenses are "interests" of the debtor, Judge Elrod said.

Therefore, Judge Elrod held that Section 330(a)(4)(B) "grants bankruptcy courts the discretion to authorize compensation to a Chapter 13 debtor's counsel even when the underlying activity fulfills a personal obligation of the debtor — such as advancing the cost of a filing fee — so long as that obligation is an interest of the debtor connected with the bankruptcy case."

Judge Elrod added, however, that the statute does not compel reimbursement. "That call remains within the discretion of each bankruptcy court."

The appeals court upheld the lower courts' rulings that counsel was not entitled to reimbursement of the expenses under the local rule, but the circuit vacated the rulings that the bankruptcy court could never award compensation including reimbursement of expenses.

## The Takeaway



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The Fifth Circuit is saying that courts can reimburse counsel for advancing prepetition costs. But will bankruptcy courts refuse reimbursement on the theory that passing debtors' expenses to the estate will diminish creditors' recoveries?

Maybe there should be no hard-and-fast rule. If a debtor is flush with cash, perhaps the debtor should pay the prepetition costs and not pass the expenses along to creditors. If the debtor is flat broke, and paying costs means defaulting on a mortgage or car payment, perhaps reimbursement is proper, if not almost compulsory.

Counsel nonetheless need a bright-line rule. This is another mess that Congress needs to clean up so those most in need can file bankruptcy.

[The opinion is](#) *McBride v. Riley (In re Riley)*, 923 F.3d 433 (5th Cir. May 13, 2019).



*A debtor's assertion of estate claims implicates 'real party in interest,' not Article III standing, circuit court says.*

## **Fourth Circuit Widens the Split on Judicial Estoppel's Bad Faith Presumption**

The Fourth Circuit widened an existing split of circuits by holding that the doctrine of judicial estoppel does not include a presumption of bad faith. In the same opinion, the appeals court said that a debtor's assertion of a claim that might belong to the estate implicates "real party in interest," not Article III standing.

The August 12 opinion by Circuit Judge Pamela Harris is debtor-friendly in both respects. Nominated by President Obama, she was confirmed by a vote of 50-43 after the Senate in substance revoked the filibuster rule for judicial nominations.

### The Facts

The facts were typical for a case involving judicial estoppel, although perhaps more favorable to the debtor than most. In substance, the debtor had settled a claim against third parties before bankruptcy. In advance of her chapter 7 petition, the debtor discovered facts that might have led her to believe that she could rescind the settlement and seek additional damages from the third parties. Initially, however, she did not list the potential claims in her schedules.

After receiving her discharge, the debtor filed suit in district court against three defendants who had allegedly been released by the pre-bankruptcy settlement. After the defendants moved to dismiss, the debtor reopened her case and amended the schedules to include her claims. The trustee abandoned the claims and closed the chapter 7 case a second time.

Although the trustee had abandoned the claims, the district court dismissed the suit for two reasons. First, the district court said the debtor lacked Article III standing when she filed the suit. Second, the presumption of bad faith required dismissal under the doctrine of judicial estoppel.

In the Fourth Circuit, Judge Harris reversed on both grounds and remanded for the district court to reconsider judicial estoppel.

### Standing



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Judge Harris said that the district court had “conflated” Article III standing with “real party in interest.” The district judge had worked from the proposition that standing is determined on the day when the suit is filed and cannot be cured later.

Right off the bat, Judge Harris said that the debtor satisfied the requisites of Article III standing because she alleged a “distinct injury” at the hands of the defendants. The real question, she said, was “real party in interest,” governed by Federal Rule 17.

Rule 17 is “clear,” Judge Harris said, that the facts on the date of filing do not control. Rather, Rule 17(a)(3) allows the proper party to join or be substituted. Consequently, the trustee’s abandonment of the claims made the debtor “the real party in interest, with the right to bring the claims on her own.”

## Judicial Estoppel

Moving on to judicial estoppel, Judge Harris described the split of circuits. The Fifth and Tenth Circuits, she said, hold that judicial estoppel in the bankruptcy context includes a presumption of bad faith by the debtor. As a result, she said, the only question is “knowledge” of the unscheduled claims, because “debtors always have a motive to conceal.” In the case at hand, the debtor undoubtedly had knowledge of facts before filing that might have allowed her to rescind the settlement and release.

Employing no presumption, the Eleventh and Ninth Circuits sit on the opposite sides of the fence. See *Slater v. U.S. Steel Corp.*, 871 F.3d 1174 (11th Cir. 2017) (*en banc*); and *Ah Quin v. City of Kauai Dep’t of Transp.*, 733 F.3d 267 (9th Cir. 2013). For ABI’s discussion of the Eleventh Circuit’s *en banc* opinion, [click here](#).

Judge Harris said that the two circuits rejected the presumption “in thoroughly reasoned opinions.” She said that the presumption of bad faith “runs the risk of producing a decidedly non-equitable result, counter to the very underpinnings of judicial estoppel.”

Judge Harris remanded the case for the district judge to “consider all relevant factors and take account of all facts and circumstances in determining whether it is appropriate to invoke judicial estoppel against [the debtor] without reliance on a presumption of bad faith.”

[The opinion is](#) *Martineau v. Wier*, 18-2294, 2019 BL 298416, 2019 US App Lexis 23969 (4th Cir. Aug. 12, 2019).





*Judge Olson refers a lawyer for civil and criminal investigations after uncovering dozens of unauthorized filings.*

## **For Petitions the Clients Had Not Seen or Signed, Lawyer Recommended for Disbarment**

A solo bankruptcy practitioner in Florida was suspended from practice for two years and referred to the state and federal grievance committees with a recommendation that she be disbarred, for filing schedules and statements in dozens of cases where the debtors had neither seen, signed nor verified the papers under oath.

In his 37-page opinion on June 25, Bankruptcy Judge John K. Olson of Fort Lauderdale, Fla. called the lawyer “grossly incompetent” to practice in the bankruptcy court or anywhere else. Given that her actions had “serious criminal implications,” Judge Olson declined to invoke the “empty head but pure heart” defense.

After reading Judge Olson’s opinion, Prof. Nancy Rapoport told ABI, “In addition to being educated about a phrase I’ve misused all of my life (“Pandora’s Jar,” not “Pandora’s Box”) and loving the way Judge Olson writes, I think the main take-away is that those of us responsible for keeping the system of justice honest (in other words, *all* lawyers) must be vigilant in terms of reporting abuse, once we discover it, and I’m especially grateful to the lawyer who took the case *pro bono*.”

Prof. Rapoport is the Garman Turner Gordon Professor of Law at the Univ. of Nevada at Las Vegas William S. Boyd School of Law, where she is an expert on legal ethics and fee allowances in bankruptcy cases.

### The Slow Motion Train Wreck

The scandal unfolded by happenstance. A chapter 7 trustee filed a complaint to revoke a debtor’s discharge because the trustee obtained information suggesting that the schedules and statement of affairs were not accurate. The revocation action, according to Judge Olson, opened “Pandora’s Jar,” later making him “aware of a multitude of extremely serious violations.”

The lawyer who filed the petition and schedules — and soon found herself in hot water — was granted authority to withdraw as the debtor’s counsel.

In discussions with the debtor who was then represented by *pro bono* counsel, the chapter 7 trustee learned that the debtor had neither seen nor signed the filed version of the debtor’s



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schedules and statement of affairs. So, the trustee filed a motion for sanctions against the debtor's former counsel.

At the conclusion of the ensuing hearing, Judge Olson entered an order directing the lawyer to produce all of her files for every bankruptcy the lawyer had filed in the previous two years. To his "shock and dismay," he said the lawyer did not produce a "single document." Instead, counsel for the lawyer filed a response saying that the documents filed with the court "in many instances" may have had "slight variations" from versions that the debtors had signed.

Counsel for the lawyer said his client had "made significant changes to her practice in order to avoid this problem in the future."

Judge Olson was not satisfied. He said the response was "in fact a last-ditch effort to keep the lid on Pandora's Jar, a farcical attempt to avoid accountability." So, he ordered the lawyer again to produce every document from her files for the 123 cases she had filed in the prior two years. He also directed her to show cause why she should not be suspended from practice.

By the required date, the lawyer produced a banker's box of documents which, it turned out, did not include 17 cases filed during the relevant time period. Judge Olson surmised that the records in those 17 cases may have reflected "especially poorly upon her, above and beyond the horrors produced in the banker's box."

What he found in the produced documents sent Judge Olson into earth orbit.

The lawyer had not produced all documents in 70% of the cases. On average, the lawyer filed the petitions 53 days after the debtors had signed drafts of the petitions and schedules. The filed petitions and schedules were not the ones the debtors had signed.

Judge Olson examined 10 cases in depth. In one, the schedules signed by the debtor omitted more than \$1 million in debt appearing in the filed schedules. In another, the signed schedules omitted some \$160,000 in income appearing in the filed schedules.

Like "the oncologist conducting exploratory surgery who finds metastatic cancer," Judge Olson said he "peaked and shrieked." From the documents and the attorney's testimony in court, he found, as a fact, that the debtors "have never seen, sworn to, or verified the accuracy of the documents" that the attorney filed.

On top of identifying violations of Bankruptcy Rule 9011(b), Judge Olson found that that the "method of production manifests a bad faith attempt to avoid detection of [the attorney's] shockingly inadequate and possible criminal standard operating procedure."

## The Sanctions



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“Accordingly and extremely regrettably,” Judge Olson said he had “no other choice but to suspend [the lawyer] for a considerable period of time and to recommend that other entities act to disbar [her] from the practice of law entirely.” He was convinced that “[n]o amount of continuing legal education could possibly fill the gaps of incompetence demonstrated here.”

Judge Olson therefore suspended the lawyer from practice in the bankruptcy court for the Southern District of Florida for two years. He referred her to the state and federal grievance committees with a recommendation of disbarment. Finally, he referred the matter to the U.S. trustee and the U.S. Attorney for such investigations as they “see fit.”

Observation: Having lost her livelihood, the lawyer will presumably appeal. Will an appellate court grant a stay pending appeal? Will a softhearted appellate court give the lawyer a second chance and lift the suspension? How many hours of CLE would be enough? Should reinstatement depend on the lawyer’s serving as an intern in a law office that abides by the rules?

A Possible Remedy: How should the courts respond if it appears that the Florida lawyer is not alone in filing petitions that debtors have not verified and signed? The Bankruptcy Rules could be amended or judges could adopt local rules requiring counsel to file optically scanned petitions and schedules showing the debtors’ “wet” signatures with the debtors’ “wet” initials on every page.

[The opinion is](#) *In re Pina*, 18-15928. 2019 BL 237273 (Bankr. S.D. Fla. June 25, 2019).



## *Discharge/Dischargeability*



*Fifth Circuit now says that student loans must 'impose intolerable difficulties' to be dischargeable.*

## **Fifth Circuit Makes Student Loans Even More Difficult to Discharge**

In the Fifth Circuit, student loans are arguably more difficult to discharge than elsewhere. The New Orleans-based appeals raised the already-high bar by holding that student loans may not be discharged unless “repayment would impose intolerable difficulties on the debtor.”

To meet the *Brunner/Gerhardt* test in the Fifth Circuit, a debtor evidently must be both disabled and unemployable.

### The Disabled Debtor

The debtor was a woman who contracted diabetic neuropathy after taking down \$7,000 in student loans. The affliction is a degenerative condition that causes pain in the legs and feet. The debtor could not hold down jobs requiring her to stand and was unable to land a sedentary job.

The debtor filed a complaint to discharge the student loans, alleging she had shown “undue hardship” as required by Section 523(a)(8).

Bankruptcy Judge Harlan D. Hale of Dallas opened his opinion by saying that some debtors seeking to discharge student loans in his court “appeared to satisfy the plain language of the statute, which merely requires that the debt, if excepted from discharge, would impose an ‘undue hardship’ on the debtor and the debtor’s dependents.”

In his 15 years on the bench, Judge Hale said he had never discharged a single student loan over an objection by the lender, because “none have satisfied the demanding standard adopted as controlling law in this Circuit.” He was referring to *In re Gerhardt*, 348 F.3d 89 (5th Cir. 2003), authored by Circuit Judge Edith H. Jones.

Although Judge Hale said he had “sympathy” for the debtor’s “situation,” he was constrained to rule that *Gerhardt* barred discharging the debt. He said the debtor conceded that she was “unable to show she is completely incapable of any employment now or in the future.”

Although the district judge was similarly sympathetic to the debtor’s plight, he upheld the judgment for the reasons given by Judge Hale. On appeal to the Fifth Circuit, the debtor and *amici* implored the appeals court to revisit *Brunner* and *Gerhardt*.





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The Fifth Circuit rebuffed the debtor's appeal in an 11-page opinion on July 30, written by Judge Jones, who had been *Gerhardt's* author.

## The *Brunner/Gerhardt* Standards

Judge Jones explained that eight circuits, in addition to the Fifth Circuit, have adopted the so-called *Brunner* test laid down by the Second Circuit in 1987, years before the adoption of Section 523(a)(8) as it now reads. *Brunner v. New York State Higher Education Service Corp.*, 831 F.2d 395 (2d Cir. 1987).

To discharge student loans under *Brunner*, the debtor must prove that (1) she cannot maintain a "minimal standard of living" if forced to repay the loan, (2) additional circumstances show that the state of affairs is likely to persist for a significant portion of the repayment period, and (3) the debtor has made a good faith effort to repay the loans.

As the bankruptcy court had concluded, Judge Jones said that the debtor failed the second part of the test regarding the persistence of her inability to work.

Applying the gloss on *Brunner* added by *Gerhardt*, Judge Jones said that the second part of the test is "exceptionally demanding." She said it requires the debtor to "show that circumstances out of her control have resulted in a 'total incapacity' to repay the debt now and in the future." *Gerhardt*, 348 F.3d at 92.

Judge Jones rejected the debtor's contention that *Brunner/Gerhardt* is inconsistent with the plain meaning of "undue hardship." She also rebuffed the debtor's argument that the Fifth Circuit should adopt the Eighth Circuit's more lenient "totality of the circumstances" test. *Long v. Educ. Credit Mgmt. Corp. (In re Long)*, 322 F.3d 549, 554 (8th Cir. 2003).

Judge Jones said the debtor failed the second part of the *Brunner* test because she admitted that she was "capable of employment in sedentary work environments." The circuit judge also said there was no evidence that the debtor's "present circumstances, difficult though they are, are likely to persist throughout a significant portion of the loans' repayment period."

The debtor's critiques of *Brunner/Gerhardt* were "unconvincing," Judge Jones said, in view of the history of the repeated legislative tightenings of the student loan dischargeability statute. She said that "the series of amendments clearly evinces an intent to limit bankruptcy's use as a means of offloading student loan debt except in the most compelling circumstances."

Judge Jones consulted the dictionary definitions of "undue" and "hardship" to conclude that Congress means for student loans to be dischargeable only when the debt "would impose



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intolerable difficulties for the debtor.” She went on to say that Section 523(a)(8) “proscribe[s] student loan discharges in all but the most severe circumstances.”

Upholding the nondischargeability of the student loans, Judge Jones said that adopting the Eighth Circuit’s “totality of the circumstances” test would risk “creating intolerable inconsistency of results.”

## The ABI Commission Recommendation

Reacting to the Fifth Circuit’s refusal to revisit *Brunner/Gerhardt*, Rudy J. Cerone told ABI, “It will take either an *en banc* reversal or a statutory revision by Congress to effect a change.” Cerone, from McGlinchey Stafford PLLC in New Orleans, was a member of ABI’s Commission on Consumer Bankruptcy.

The ABI commission’s Final Report said that *Brunner*, “[i]f reasonably applied, . . . can allow appropriate bankruptcy relief during a period when discharge of student loans is not otherwise available.” The commission went on to recommend that Congress “return to the pre-1998 rule that allowed student loans to be discharged after seven years from the time they first became payable. Before seven years, student loans would be dischargeable only upon a finding of undue hardship.”

The commission also recommended that “only student loans made, insured, or guaranteed by a governmental unit receive any protection from discharge.”

To read the commission’s report, [click here](#).

The opinion is *Thomas v. Department of Education (In re Thomas)*, 18-11091, 2019 BL 282170, 2019 USApp Lexis 22584 (5th Cir. July 30, 2019).



*Conflicting standards among the circuits warrant a grant of certiorari to define 'undue hardship' required for discharging a student loan.*

## **Recent Decisions Deepen and Entrench Circuit Split on Discharging Student Loans**

There are two and perhaps three tests among the circuit courts for deciding when the repayment of a student loan amounts to an “undue hardship,” enabling the court to discharge the debt under Section 523(a)(8).

Discharging a student loan is conceivable under the Eighth Circuit’s somewhat lenient “totality of the circumstances” test. In the majority of circuits employing the so-called *Brunner* test, discharging a student loan is exceedingly difficult. Although professing to follow *Brunner*, the Fifth Circuit’s new test means that student loans are essentially impossible to discharge.

Decisions in late July by the Fifth Circuit and the First Circuit Bankruptcy Appellate Panel underscore the need for the Supreme Court to grant *certiorari* and resolve the circuit split.

### The Three Tests

The *Brunner* test emanated from the Second Circuit in 1987, 18 years before Congress adopted the current iteration of Section 523(a)(8). *Brunner v. New York State Higher Education Service Corp.*, 831 F.2d 395 (2d Cir. 1987).

To discharge a student loan under *Brunner*, the debtor must prove that (1) she cannot maintain a “minimal standard of living” if forced to repay the loan, (2) additional circumstances show that the state of affairs is likely to persist for a significant portion of the repayment period, and (3) the debtor has made a good faith effort to repay the loans. *Brunner* is followed in the Second, Third, Fourth, Fifth, Sixth, Seventh, Ninth and Eleventh Circuits.

Standing alone, the Eighth Circuit developed the so-called totality of the circumstances test, where the court must consider (1) the debtor’s future financial condition, (2) the debtor’s and dependents’ reasonable and necessary living expenses, and (3) “other relevant facts and circumstances surrounding each particular bankruptcy case.” *Long v. Educ. Credit Mgmt. Corp.* (*In re Long*), 322 F.3d 549, 554 (8th Cir. 2003). Rejecting *Brunner*, the Eighth Circuit said it preferred a “less restrictive approach.” *Id.*



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Although professing to follow *Brunner*, the Fifth Circuit seemed to tighten its already higher standard by ruling on July 30 that a debtor may not discharge a student loan unless “repayment would impose intolerable difficulties on the debtor.” *Thomas v. Department of Education (In re Thomas)*, 18-11091, 2019 BL 282170, 2019 US App Lexis 22584 (5th Cir. July 30, 2019). To read ABI’s discussion of *Thomas*, [click here](#).

If nothing more, the Supreme Court should grant *certiorari* to decide whether the Fifth Circuit’s requirement of showing “intolerable difficulties” is tougher than the “undue hardship” standard in the statute.

## The Facts in the First Circuit BAP

The First Circuit has not definitively decided whether to follow *Brunner* or the “totality of the circumstances” test. However, most of the bankruptcy judges in the First Circuit and the circuit’s BAP employ *Long* from the Eighth Circuit. Although invoking *Long*, a bankruptcy court in Massachusetts refused to discharge student loans owned by a debtor who was virtually destitute in terms of current income.

The debtor was in her mid-60s and lived alone in a home she purchased in 1998. She provided some support for her adopted child who was in his early 20s and attending college.

The debtor earned an undergraduate degree in 1997 and enrolled later in law school, emerging with a JD degree in 2009. In the process, she amassed \$110,000 in student loans. Although she passed the bar and sought a law job for two years, she received no offers of employment and only had one interview after filing 100 job applications.

Suffering from a long list of medical ailments, she worked only sporadically as a solo practitioner and for a not-for-profit legal clinic where she earned minimal income. In three years before attempting to discharge the student loans, her annual income was no greater than \$14,800.

More recently, her monthly income was less than \$1,500 and her monthly expenses resulted in a deficit of \$76 a month.

But here’s the kicker: The debtor estimated that she had an equity of \$125,000 in her home. The home was encumbered by a \$59,000 mortgage.

The debtor claimed an exemption in the home. No one objected. The maximum homestead exemption in Massachusetts is \$500,000, meaning that her exemption was one-quarter of what the state allows.

Although finding that the debtor lived “a spartan lifestyle not susceptible to further expense reduction,” the bankruptcy court refused to discharge the student loans. According to the BAP, the





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bankruptcy judge said that the equity in the home by itself was “dispositive” and “negates any claim that payment of the loan imposes an undue hardship.”

While the bankruptcy court did not require the debtor to sell the home, the bankruptcy judge said that the “substantial equity . . . can be used to pay these student loans in full.”

## The Remand by the BAP

The debtor appealed and won a remand in a July 26 opinion for the BAP written by Bankruptcy Judge Diane Finkle.

Judge Finkle emphasized two factor: Section 522(c) and *Law v. Siegel*, 571 U.S. 415 (2014). Section 522(c) says that exempt property “is not liable during or after the case for any debt of the debtor that arose . . . before the commencement of the case.” *Law v. Segal* teaches that the court may not employ equitable considerations to override a debtor’s statutory homestead exemption.

Judge Finkle therefore held that the debtor’s “home equity is protected from liability for her student loans.” She went on to say that Section 522(c)(3) does not permit invading an exempt asset to repay a student loan unless the loan was obtained through fraud.

Turning to *Long*, Judge Finkle said that the existence of exempt assets is not one of the factors in the “totality” test. By relying solely on the home equity, she said that the bankruptcy court “sidestepped the necessary evaluation of whether in the foreseeable future [the debtor] could increase her income and pay” part of all of the loans.

Judge Finkle ruled that the bankruptcy court committed error by overlooking the policy articulated in *Law v. Segal* and by “not fully evaluating other relevant factors” such as the debtor’s future earning capacity and the impact of her health “on her future financial prospects.”

Judge Finkle remanded the case for the bankruptcy judge to make the findings outlined in her opinion for the BAP. Unless facts come to light not evident from the BAP decision, the debtor would seem to be eligible in the First Circuit to discharge her student loans on remand.

However, the same debtor would not seem eligible to discharge the loans in the Fifth Circuit under the new *Thomas* standard.

## The Need for High Court Review

Except in the Eighth Circuit, discharging student loans is exceptionally difficult. In the Fifth Circuit after *Thomas*, it appears that a debtor must be both disabled and unemployable to discharge student loans.





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At a minimum, the Supreme Court should decide whether *Brunner* or the Eighth Circuit's "totality" test is proper. More fundamentally, the high court should decide whether all of the circuits have adopted standards that are higher than the statutory standard of "undue hardship." In other words, the Supreme Court needs to specify the degree of hardship a debtor is required to endure before discharging student loans.

[The First Circuit BAP opinion is \*Schatz v. Access Group Inc. \(In re Schatz\)\*, 18-016, 2019 BL 284018, 2019 WL3432801 \(B.A.P. 1st Cir. July 26, 2019\).](#)



*A debtor with a law degree but only \$37,500 in gross annual income was permitted to discharge more than \$220,000 in student loans.*

## **Courts Interpret *Brunner* Too Harshly, Bankruptcy Judge Cecelia Morris Says**

Observing that some courts have incorrectly interpreted the *Brunner* test to impose “punitive standards,” Chief Bankruptcy Judge Cecelia G. Morris of the Southern District of New York allowed a debtor to discharge more than \$220,000 in student loans, even though the debtor had a law degree and was neither disabled nor unemployable.

The debtor obtained loans to finance his undergraduate education and a law degree between the years 1993 and 2004. With interest, the original principal amount of \$116,500 had grown to more than \$220,000 when the debtor filed his chapter 7 petition and received a general discharge.

The debtor’s means test listed about \$37,500 in annual pre-tax income. His Schedules I and J showed monthly net income after taxes of about \$2,500 and expenses of some \$4,000, giving him negative current monthly income of about \$1,500.

Significantly, the lender did not object to the schedules. Judge Morris therefore said that the debtor’s “income and expenses are undisputed.”

The record on the summary judgment motion shows that the debtor passed the bar but worked as a lawyer less than three months before deciding that he couldn’t stomach being a lawyer. Recently, he ran a camping equipment retail store in Brooklyn that failed and is currently employed as a hiking and camping guide.

The debtor lodged a complaint to discharge his student loans as imposing an “undue hardship” under Section 523(a)(8). The lender and the debtor filed cross motions for summary judgment. In her 12-page opinion on January 7, Judge Morris granted the debtor’s motion and discharged the student loans.

Judge Morris was bound by the Second Circuit’s *Brunner* decision, handed down in 1987, 18 years before the adoption of the current iteration of the student loan-discharge statute. *Brunner v. New York State Higher Education Service Corp.*, 831 F.2d 395 (2d Cir. 1987).



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Judge Morris said that *Brunner* “has received a lot of criticism for creating too high of a burden for most bankruptcy petitioners to meet.” She said that “harsh results” are “often . . . the result of cases interpreting *Brunner*.”

For instance, Judge Morris insinuated that the requirement of “certainty of hopelessness” does not emanate from the language of *Brunner*. Similarly, she criticized courts for finding bad faith when a debtor files bankruptcy just to discharge student loans.

Judge Morris vowed that she would “not participate in the perpetuation of these myths.” Instead, she proceeded to “apply the *Brunner* test as it was originally intended.”

Applying *Brunner* to the undisputed facts on summary judgment, Judge Morris first dealt with the question of whether the debtor could “maintain a ‘minimal’ standard of living using only Petitioner’s ‘current income and expenses.’” *Id.* at 396.

Relevant to the first prong of *Brunner*, Judge Morris said that the lender had accelerated the entire \$220,000 debt and that the debtor was not eligible for a repayment plan. Since it was proven that the debtor currently had negative income, she ruled that the debtor met the first test because there was no money left over to repay the loans while maintaining a minimal standard of living.

The second prong of *Brunner* requires the debtor to show that “additional circumstances exist indicating that the state of affairs is likely to persist for a significant portion of the repayment period . . . .” *Id.*

In a departure from decisions by some other courts, Judge Morris said that the “*Brunner* test does not require the Court to make a determination that the [debtor’s] state of affairs are going to persist forever.” Rather, she said, the question is whether the circumstances will persist for “significant portion of the repayment period.” *Id.*

The repayment period for the debtor had ended, Judge Morris said, because the lender had accelerated. She concluded that the debtor satisfied the second test because the debtor’s “circumstances will certainly exist for the remainder of the repayment period,” given that the loan was accelerated and the repayment period had ended.

On the third prong of *Brunner* – has the debtor made a good faith effort to repay – Judge Morris said that the debtor sometimes had not paid installments in full but had missed only 16 payments since the consolidated loan was originated in 2005. She noted that the debtor had requested and obtained forbearances on five occasions.

It was not a case, Judge Morris said, where the debtor paid nothing for 20 years. She discharged the student loans because the debtor had satisfied by the third prong of *Brunner* by having made a good faith effort to repay.



## Observations

Prominently, Judge Morris focused on the debtor's current income, whereas some courts emphasize the debtor's ability to increase her or his income. In that regard, the acceleration of the loan was significant.

Following acceleration, the lender would be entitled to judgment and to garnish a portion of the debtor's income. Losing part of his income would be intolerable when the debtor already had negative income after meager expenses.

In that respect, the decision by Judge Morris is similar to an opinion in August by Bankruptcy Judge Peter C. McKittrick of Portland, Ore. *Nitcher v. Educational Credit Management Corp. (In re Nitcher)*, 606 B.R. 67 (Bankr. D. Ore. Aug. 23, 2019).

Judge McKittrick allowed a debtor to discharge all but \$16,500 of her \$51,800 in private student loans because the loans had been accelerated, and the debtor was facing garnishment when her income was already negative after debt service on the student loans. With regard to the portion that was not discharged, Judge McKittrick in effect compelled the lender to allow repayment at the rate of \$150 a month for 110 months without interest. To read ABI's report on *Nitcher*, [click here](#).

The opinions by Judges Morris and McKittrick mean that lenders are at greater peril of discharge if they have accelerated student loans. On the other hand, a lender would have little leverage over a debtor to work out a partial repayment plan without accelerating.

If there is an appeal from the decision by Judge Morris, the debtor might argue that *Brunner*, as interpreted by courts around the country, is more stringent than the "undue hardship" standard enacted by Congress in Section 523(a)(8). Indeed, the debtor might suggest that the court should craft an entirely new standard focusing on the meaning of "undue hardship," since Section 523(a)(8) came years after *Brunner* and did not allude to the three-part test in *Brunner*.

[The opinion is](#) *Rosenberg v. N.Y. State Higher Education Services Corp. (In re Rosenberg)*, 18-09023, 2020 BL 12333, 2020 Bankr Lexis 73 (Bankr. S.D.N.Y. Jan. 7, 2020).



*Fifth Circuit bars nationwide class actions to enforce the discharge injunction. However, the appeals court ruled that private student loans are dischargeable.*

## **Discharge Is Enforceable Only in the Issuing District, Fifth Circuit Says**

As a prudential matter and not for lack of jurisdiction, the Fifth Circuit held that the district where a bankruptcy case was pending is the only district that can enforce a discharge injunction. The appeals court all but declared that bankruptcy courts may not conduct countrywide class actions regarding the discharge of debts.

The appeals court even went so far as to raise a question about the ability of a bankruptcy court to enforce a discharge granted by another court *in the same district*.

Nonetheless, student loan debtors won a victory because the Fifth Circuit became the first appeals court to rule that private student loans can be discharged without proving “undue hardship,” which is virtually impossible in the Fifth Circuit. The appeals court rejected the notion that 2005 amendments to Section 523(a)(8)(A)(ii) made private student loans nondischargeable.

### **Debtors Win in Bankruptcy Court**

A debtor in Texas had received a chapter 7 discharge. His liabilities included a loan to fund preparation to take the bar examination, but the loan was not part of a governmental loan program.

A different debtor had obtained a chapter 7 discharge in Virginia. The Virginia debtor had received a loan from the same lender to finance courses at an unaccredited technical school.

After discharge, the lender made frequent calls to the two debtors demanding payment on the student loans. The Texas debtor responded by filing suit in the Texas bankruptcy court seeking a declaration that the debt was discharged and a judgment holding the lender in contempt of the discharge injunction.

After the Virginia debtor joined as a plaintiff in the same adversary proceeding, they filed an amended complaint to certify a nationwide class and declare that private loans, like theirs, were dischargeable. The lender replied with a motion for summary judgment, contending that the Texas bankruptcy court had no jurisdiction to interpret and enforce a discharge injunction from another district.





The bankruptcy court denied the lender's motion and declared that the debtors' private loans had been discharged under Section 523(a)(8). The bankruptcy court had not certified a class, however.

The bankruptcy court authorized an interlocutory appeal and a direct appeal to the Fifth Circuit. The Fifth Circuit accepted the direct appeal.

## Don't Enforce Another Court's Discharge

On the question of whether a bankruptcy judge may enforce a discharge granted in another district, Circuit Judge Leslie H. Southwick said the closest authority was a Fifth Circuit opinion saying that a bankruptcy court "may" have jurisdiction over claims in other cases *in the same district*.

In the case on appeal, the bankruptcy judge had reasoned that a bankruptcy court could enforce a discharge injunction from elsewhere, because the injunction is statutory and did not result from an order crafted by another judge. In other words, no purpose would be served by forcing a debtor to return to the issuing court.

In his October 21 opinion, Judge Southwick required more than the bankruptcy court's reasoning, unsupported by authority, to overcome the conclusions he would reach based on contempt jurisprudence and the relevant statutes, present and former.

Principally, Judge Southwick focused on 1970 legislation amending Section 14 of the former Bankruptcy Act. That statute permitted an order of discharge to be registered in another district. It then allowed a court in another district to enforce the discharge in the same manner as the court in the issuing district. In other words, the Texas court could have enforced the Virginia discharge under the 1970 law.

The 1970 law was repealed with the adoption of the Bankruptcy Code, but the Bankruptcy Rule that replaced the 1970 statute did not authorize enforcement in another district "in like manner." The omission, Judge Southwick said, "gives weight" to the notion that discharge enforcement in another district is "prohibited."

Next, Judge Southwick dealt with the current statute, 28 U.S.C. § 1963, which allows judgments issued by bankruptcy courts for "recovery of money or property" to be registered in other districts and enforced there. He said that Section 1963 does not allow another district to enforce an injunction, citing the Wright, Miller & Kane treatise.

In sum, Judge Southwick said that the "most direct support" for enforcing a foreign discharge came from the 1970 statute, which, he said, "is no more." Likewise, current Bankruptcy Rule



4004(f) contains no provision allowing “in like manner” enforcement in the district in which the discharge order was registered.

Next, Judge Southwick dealt with the idea that enforcing discharge is only the enforcement of a statute, not another judge’s injunction. In response, he said that the Second, Seventh, Ninth and Eleventh Circuits only allow the issuing court to enforce discharge injunctions through contempt.

Judge Southwick did not follow the Eleventh Circuit and find a jurisdictional bar to enforcement of discharge from another district. Instead, he rested the decision on prudential grounds. The debtors’ arguments, he said, were insufficient to “allow an exception from the usual rules” permitting only the issuing court to enforce an injunction.

Judge Southwick therefore reversed the bankruptcy judge’s enforcement of the Virginia debtor’s discharge.

Noting that the bankruptcy court had not yet certified a class, Judge Southwick went on to say that he was “highly dubious” about a nationwide class. On remand, he left it for the bankruptcy court to decide whether there was power to enforce a discharge issued by another court *in the same district*.

## Dischargeability of Private Student Loans

The lender argued that the private student loans were “an obligation to repay funds received as an educational benefit, scholarship, or stipend” under Section 523(a)(8)(A)(ii). Judge Southwick noted the conspicuous absence of the word “loan” in that subsection when it is included in other subsections defining nondischargeable student loans.

The words “benefit, scholarship, or stipend,” he said, imply money that was granted, not loaned, Judge Southwick said. If those words subsumed all student loans, then the other subsections in (a)(8) would be surplusage, he said.

The lender cited cases holding that any funds received for an educational purpose, including private loans, are nondischargeable. The lender conceded, however, that there has been increasing caselaw since 2015 holding that private student loans are dischargeable. No circuit has ruled on the subject in a precedential holding, Judge Southwick said.

Judge Southwick affirmed the ruling that private student loans are dischargeable. The notion that the 2005 amendments made all student loans nondischargeable, he said, “is not only unsupported by the text, it is unsupported by some of [the lender’s] authorities.”



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Judge Southwick went on to say that Section 523(a)(8)(A)(ii) results in the nondischargeability of “educational payments that are not initially loans but whose terms will create a reimbursement obligation upon the failure of conditions of the payments.”

## Observations

State courts have concurrent jurisdiction to decide whether a debt was discharged. If a state court in another state can enforce a discharge, why would a federal court in that state lack similar power?

What if a debtor moves to another state after discharge? To enforce the discharge, must the debtor sue, perhaps thousands of miles away, in his or her former hometown? Or will the precedential rule bend by allowing a debtor to enforce the discharge in his or her hometown, whether or not it was the venue of the bankruptcy case?

Assume that a state court had personal jurisdiction over a debtor in a state different from the one where the debtor filed bankruptcy. If the lender were to sue for collection of the debt, the debtor could raise the discharge as a defense and seek an injunction. But what if there were diversity, allowing the debtor to remove the suit to federal court? Would the debtor be barred from enforcing the discharge injunction if the district was not the one where he or she had filed bankruptcy, even though the debtor could have sought an injunction in state court?

And if the suit remained in state court, could the debtor raise a class counterclaim?

Could a debtor circumvent Judge Southwick’s holding by filing suit only for a declaration about discharge, while seeking neither an injunction against collection nor contempt?

Judge Southwick’s opinion gives reason for considering an amendment to Bankruptcy Rule 4004(f) by allowing a debtor to enforce discharge anywhere. If it was possible in 1970, why can’t it be now?

[The opinion is](#) *Navient Solutions LLC v. Crocker (In re Crocker)*, 18-20254 (5th Cir. Oct. 21, 2019).



*On an appeal involving contempt of the discharge injunction, would the circuit court have reached a different conclusion by employing the standard under Taggart?*

## **Seventh Circuit Opinion on Contempt Raises Questions under *Taggart***

Without citing the *Taggart* decision by the Supreme Court in June, the Seventh Circuit reversed the lower courts and held a creditor in contempt of the discharge injunction.

In *Taggart v. Lorenzen*, 139 S. Ct. 1795, 204 L. Ed. 2d 129 (June 3, 2019), the Supreme Court rejected a strict-liability standard for the imposition of contempt for violating the discharge injunction. Instead, the high court held unanimously that the bankruptcy court “may impose civil contempt sanctions when there is no objectively reasonable basis for concluding that the creditor’s conduct might be lawful under the discharge order.” *Id.* 139 S. Ct. at 1801.

Later, we will explore the question of whether the outcome would have been different had the parties relied on *Taggart*. To read ABI’s discussion of *Taggart*, [click here](#).

### The Arrest Warrant

In 2002, the creditor obtained a default judgment for about \$2,500. In 2009, the debtor filed bankruptcy and obtained a discharge in January 2010. The creditor received notice of both the bankruptcy and the discharge, but the creditor did not notify its counsel about the bankruptcy filing or the discharge.

Unaware of the bankruptcy, the creditor’s counsel brought supplemental proceedings. For the debtor’s repeated failure to appear at hearings, the state court in Indiana issued an arrest warrant in April 2010, several months after discharge. Having stopped to give the debtor assistance for a flat tire, a police officer discovered the warrant and arrested the debtor in March 2011, more than a year after discharge. She spent two days in jail.

In bankruptcy court, the debtor sued the creditor and its counsel for contempt, alleging a willful violation of the discharge injunction. After a two-day trial, the bankruptcy court absolved both the creditor and its counsel of contempt.

The bankruptcy judge cleared the lawyers of contempt, because the lawyers lacked knowledge of the bankruptcy and didn’t have an affirmative duty to run a bankruptcy search. The bankruptcy





judge also let the creditor off the hook, saying that the client was unaware of the lawyer's collection actions and therefore did not violate the discharge injunction willfully.

The district court affirmed.

In an opinion on August 13 by Circuit Judge Amy J. St. Eve, the Seventh Circuit upheld the conclusion regarding the lawyers but reversed and ruled that the creditor was in contempt for a willful violation of the discharge injunction. Of potential significance on remand, Judge St. Eve mentioned that the creditor "aggressively" pursued the collection of small debts and had "referred hundreds of collection cases" to the same law firm.

### The Circuit Reverses as to the Creditor

The appeal was argued in the circuit in April, two months before the Supreme Court handed down *Taggart*. Without mentioning *Taggart*, Judge St. Eve said that a creditor can be held in contempt only for a willful violation of discharge. Possibly equating contempt of discharge with contempt of the automatic stay, she said that willfulness does not require a specific intent to violate a court's order. Rather, she said, willfulness requires clear and convincing evidence that the creditor violated the court's order and that the creditor had "actual knowledge" that bankruptcy was in process or had ended in discharge.

Judge St. Eve upheld dismissal of the contempt citation against the lawyers, because the firm had not received notices from the client about the bankruptcy and the discharge and did not otherwise know the debtor was in bankruptcy. Since a client's knowledge is not imputed to the lawyer, she said that the firm could not have willfully violated the discharge injunction.

For the creditor, Judge St. Eve said the law requires "both actual knowledge of the discharge order and an action violating it."

Judge St. Eve saw no reason to overturn the bankruptcy court's finding that the creditor had knowledge of the discharge. The bankruptcy court had absolved the client of contempt because the client itself had taken no action to violate discharge. That finding, Judge St. Eve said, "might be factually correct, but it reflects an error in legal reasoning."

Citing the Restatement (Third) of Agency, Judge St. Eve said that the lawyer's conduct is imputed to the client, "even if that conduct did not, standing alone, constitute a tort." She therefore held that the lawyers' actions, imputed to the creditor, "were taken despite [the client's] knowledge of the discharge order, meeting the requirements for civil contempt."

Judge St. Eve was not persuaded by the creditor's argument that it was unaware of the lawyers' actions. She said it was "not a case where counsel committed a wrongful act outside the scope of its authority."





Judge St. Eve ended by justifying her conclusions on policy grounds, saying the result was “sensible.” “Holding otherwise,” she said, “would create a loophole through which creditors could avoid liability by simply remaining ignorant of their agent’s actions or by failing to notify their agents of debtors’ bankruptcy proceedings. We decline to incentivize such *careless behavior*.” [Emphasis added.]

By the way, there is no indication on the circuit court’s docket that counsel alerted the appeals court to the *Taggart* opinion, as required by F.R.A.P. 28(j). However, there may have been a so-called 28(j) letter, but it was not registered on the docket. Regardless, the circuit could have construed *Taggart* because most appellate courts believe they can affirm on any basis evident from the record, whether raised by the parties or not.

## Violation of the Local Rule

Northern District of Indiana Local Rule B-4002-1(a)(2) requires a debtor to give immediate notice of the order for relief to any court where an action is pending. According to Judge St. Eve, the debtor violated the order by not notifying the state court.

Judge St. Eve said that the debtor’s arrest, which she called a “regrettable event,” could have been avoided had she complied with the local rule. On remand, she said the bankruptcy court could exercise discretion by factoring the violation of the local rule “into the damages calculation.”

## What Result After *Taggart*?

More so, the law firm is off the hook after *Taggart*. To quote *Taggart*, the law firm had an “objectively reasonable basis for concluding that [its conduct] might be lawful under the discharge order” because three courts found no contempt.

Arguably, the creditor is also absolved by *Taggart*, because the bankruptcy and district courts both found no contempt. Is a conclusion by even one court always an “objectively reasonable basis” for believing that an action is not contemptuous? But is a court’s ruling an “objectively reasonable basis” if founded on an erroneous legal conclusion, as Judge St. Eve held in the case on appeal?

However, an “objectively reasonable basis” is not the entirety of *Taggart*’s holding.

Rather, *Taggart* permits a finding of contempt if there is “no objectively reasonable basis for concluding that the creditor’s conduct *might be lawful under the discharge order*.” [Emphasis added.]



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By not forwarding bankruptcy notices to the law firm, Judge St. Eve characterized the creditor's actions as "careless behavior." Arguably, careless behavior cannot qualify as an objectively reasonable belief that the conduct was permissible in light of discharge. In that regard, recall how Judge St. Eve said that the client "aggressively" pursued the collection of small debts and had "referred hundreds of collection cases" to the same law firm.

In this writer's view, *Taggart* should not immunize careless conduct, nor should *Taggart* relieve creditors of a duty to undo actions taken before bankruptcy that could result in violations of discharge later.

[The opinion is](#) *In re Sterling*, 18-2773, 2019 BL 300198 (7th Cir. Aug. 13, 2019).



*If the parties litigate but the defendant eventually defaults, the default judgment can result in nondischargeability via issue preclusion, Eleventh Circuit holds.*

## **Default Judgments Are (Sometimes) Nondischargeable Under Issue Preclusion**

Two decisions handed down on successive days under Illinois law explain when a default judgment will or will not result in a nondischargeable debt as a result of issue preclusion, or collateral estoppel.

Bankruptcy Judge Thomas M. Lynch of Rockford, Ill., confronted the more typical case. The debtor and the plaintiff were riding their motorcycles together after dark. The front wheel of the debtor's motorcycle hit the back of the plaintiff's, causing both to fall off their bikes and resulting in injuries to the plaintiff.

The plaintiff filed suit in Illinois state court, alleging negligence. The debtor did not respond to the complaint. The plaintiff's counsel submitted a \$1 million judgment by default, in which he inserted a handwritten section stating that the judgment was for willful and malicious conduct.

The debtor filed a chapter 7 petition after entry of the judgment. The plaintiff filed a complaint alleging that the \$1 million default judgment was nondischargeable under Section 523(a)(6) as a "willful and malicious injury."

In an opinion on August 6, Judge Lynch said that the debtor had not received notice that the plaintiff would base the default judgment on "willful and wanton" conduct. Calling for a trial on the merits, he denied the plaintiff's motion for summary judgment based on issue preclusion.

After trial, Judge Lynch explained why the facts would not invoke Illinois law on issue preclusion. He said that language about "willful and malicious conduct" was "unnecessary to the judgment on a complaint for negligence." Also, he said that the debtor "received no notice that the judgment may have included such a finding and the Plaintiff failed to show that the issues of maliciousness and willfulness were actually litigated."

In an August 7 opinion also under Illinois law, the Eleventh Circuit explained when issue preclusion *can* result in nondischargeability following a default judgment. However, the facts were different in critical respects.



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The plaintiffs sued in Illinois state court, alleging that the defendants violated state securities laws by making misrepresentations and selling unregistered securities. The complaint also claimed common law fraud.

The defendants answered the complaint, asserted affirmative defenses, submitted affidavits and exhibits, and filed a motion to dismiss and a motion for summary judgment. Later, the trial court entered a judgment by default when the defendants refused to respond to interrogatories and produce relevant documents.

After the entry of judgment, the defendants filed chapter 7 petitions in Florida. The plaintiffs responded with an adversary proceeding to render the judgment nondischargeable under Section 523(a)(19). That section makes debts nondischargeable if based on a “judgment” or “order” for violation of state or federal securities laws.

Invoking issue preclusion, Bankruptcy Judge Cynthia C. Jackson of Orlando, Fla., ruled that the debt was nondischargeable. The district court affirmed, and so did the Eleventh Circuit in an 11-page, unpublished opinion on August 7. The circuit court interpreted Illinois law on issue preclusion because it was the state in which the judgment was entered.

Illinois applies the usual rules on issue preclusion. The issues in the prior proceeding must have been (1) identical with those in the subsequent proceeding, (2) actually litigated, (3) necessarily decided in a final judgment on the merits, and (4) asserted against the same party or someone in privity.

The circuit court surveyed Illinois caselaw and reported that the common type of default judgment — where the defendant never appears — does not give rise to issue preclusion.

The Eleventh Circuit was obliged to make a so-called *Erie* guess because the Illinois Supreme Court has not ruled on whether issue preclusion can apply to default judgments. However, the Atlanta-based appeals court said there were no Illinois cases saying that “issue preclusion could never apply to a default judgment.”

The circuit court concluded that Illinois would not adopt a rule where a default judgment would never have preclusive effect. The appeals court found a distinction between cases where the defendant never appeared and those where the defendant litigated, asserted defenses, and filed motions.

The circuit court concluded that the issue was “actually litigated,” with the result that “the default judgment qualified for issue preclusion under Illinois law.”



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Were the rule otherwise, the appeals court said that a defendant could engage in “gamesmanship” by litigating until “the case was not going their way” and then drop out, hoping to “escape the preclusive effect of that judgment because it was entered by default.”

The Eleventh Circuit upheld the judgment of nondischargeability. Because the complaint specifically alleged violations of state securities law, the appeals court ruled that “the default judgment was necessarily for the violation of securities laws.”

In Judge Lynch’s case, by the way, he entered judgment after trial in favor of the debtor discharging the debt. He said that the plaintiff had failed to prove that the debtor was anything other than negligent or reckless. Of significance, he said that the debtor’s lack of a motorcycle license and insurance were not material to whether the debtor intended to injure the plaintiff.

Observation: Neither opinion is inconsistent with *Brown v. Felsen*, 442 U.S. 127 (1979), where the Supreme Court held that *res judicata*, or claim preclusion, does not bar the bankruptcy court from looking behind a stipulated judgment in state court to determine whether the debt was nondischargeable.

[The Eleventh Circuit opinion is \*Creech v. Viruet \(In re Creech\)\*, 18-12584, 2019 BL 292693 \(11th Cir. Aug. 7, 2019\)](#); the [Illinois bankruptcy court opinion is \*Draka v. Andrea \(In re Andrea\)\*, 18-96014, 2019 BL 291848 \(Bankr. N.D. Ill. Aug. 6, 2019\)](#).





*On an issue dividing the courts, the Seventh Circuit rules that an obligation to repay a domestic support obligation is a dischargeable debt, not a nondischargeable DSO.*

## **Overpaying a DSO Doesn't Result in a Nondischargeable Debt, Seventh Circuit Holds**

The Seventh Circuit narrowly interpreted “domestic support obligation” in direct appeals from rulings by two bankruptcy judges in Chicago. Some might say the appeals court ignored the plain meaning of Section 101(14A), defining a domestic support obligation, or DSO.

Others would say the Seventh Circuit employed good judgment to achieve a result that Congress likely intended and did not abandon common sense by relying only on the terse language of a statute.

### The Cases in Bankruptcy Court

The cases before Bankruptcy Judges Deborah Thorne and A. Benjamin Goldgar were similar but not identical. In one, the chapter 13 debtor had received an \$8,000 overpayment of child care tuition by the state. In the other, the chapter 7 debtor had received an overpayment of \$3,400 for food stamps for herself and her two children.

In both cases, the state filed claims and contended that the overpayments were nondischargeable DSOs. Section 101(14A) defines a DSO as a debt “owed to or recoverable by . . . a spouse, former spouse . . . or a governmental unit” that is “in the nature of alimony, maintenance, or support (including assistance provided by a governmental unit) . . . .”

The state contended that the overpayments fit neatly within the definition because the benefits given by the state were designed to help the women support their children. If the obligations to repay the overpayments were DSOs themselves, the debts would be nondischargeable under Section 523(a)(5).

Judges Thorne and Goldgar concluded that the debts arising from the overpayments were not DSOs and were therefore dischargeable. When the state appealed, both bankruptcy judges certified direct appeals to the circuit. The circuit accepted the direct appeals, since courts around the country disagree on the outcome. To read ABI's report on Judge Thorne's decision, [click here](#).



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In her June 27 opinion for the appeals court, Chief Circuit Judge Diane P. Wood upheld the bankruptcy courts, saying that the result sought by the state “would expand the definition of domestic support obligation far beyond what is intended by the bankruptcy code.”

Judge Wood favorably cited a 2010 decision by another Illinois bankruptcy judge involving a man who won a judgment for the repayment of child support because it turned out that he was not the father. The bankruptcy court held that the repayment obligation was not a DSO because erroneously charging the man for support obligations did not transform the refund obligation into a DSO.

Judge Wood said that the debtors did not owe “money for support obligations.” Rather, she said they owed a debt because “they received money they were not statutorily entitled to.”

Since the payment obligations by the debtors were “not in the nature of alimony, maintenance or support, we agree with the bankruptcy court decision that this is merely an overpayment of benefits and not a domestic support obligation,” she said.

[The opinion is](#) *In re Dennis*, 18-2899, 2019 BL 239286 (7th Cir. June 27, 2019).



*BAP joins the majority of courts by saying that defaulting on direct mortgage payments precludes a chapter 13 debtor from receiving a discharge.*

## **Direct Mortgage Payments Are 'Under the Plan,' Ninth Circuit BAP Says**

Circuitously, the Ninth Circuit Bankruptcy Appellate Panel joined what it called the “overwhelming majority of courts” by concluding that direct payments on a mortgage by a chapter 13 debtor are “payments under the plan.”

Assuming the BAP’s ruling is followed by lower courts, debtors in the Ninth Circuit who miss direct payments on their mortgages will not be entitled to discharges under Section 1328(a).

But that’s not how the case arose.

### Direct Mortgage Payments Under the Debtors’ Plan

The debtors confirmed a 60-month chapter 13 plan calling for them to make monthly mortgage payments directly to the lender, not through the chapter 13 trustee. To deal with \$65,000 in arrears, the plan had alternative provisions.

The plan provided that the arrears would be “cured” if the lender agreed to a mortgage modification. If the lender did not agree, the debtors were to modify the plan to pay the arrears. The plan paid nothing on unsecured claims.

After the last plan payment, the lender filed a motion for modification of the stay, alleging that the debtors failed to make more than \$120,000 in mortgage payments. In the 67th month after they began making plan payments, the debtors responded with a motion to modify the plan by surrendering the property.

The bankruptcy court approved the plan modification. The chapter 13 trustee appealed and won in a May 6 opinion for the BAP by Bankruptcy Judge Julia W. Brand.

### The Question on Appeal

Section 1329(a) allows modification of a plan “[a]t any time after confirmation of the plan but before the completion of payments under such plan.” Because they had not made direct mortgage



payments, the debtors contended that they had not completed plan payments and were thus entitled to modify the plan.

The BAP was thus charged with deciding whether the debtors had completed payments “under such plan.” The analogous question arises under Section 1328(a), where the debtor must receive a discharge “after completion . . . of all payments under the plan.”

Courts around the country are divided on whether a debtor who misses direct mortgage payments is nonetheless entitled to a discharge because the direct payments were not “under the plan.”

Judge Brand said that the “overwhelming majority of courts” have concluded that direct mortgage payments are under the plan and must be made for the debtor to receive a discharge. However, she cited and analyzed two cases holding to the contrary: *In re Gibson*, 582 B.R. 15 (Bankr. C.D. Ill. 2018), and *In re Rivera*, 13-20842, 2019 WL 1430273 (Bankr. D. Ariz. Mar. 28, 2019).

In both cases, Judge Brand said, the debtors’ sympathetic circumstances helped explain the outcomes. In *Gibson*, the debtor innocently misunderstood the plan’s requirements. In *Rivera*, the debtor did not default on the mortgage until the 41st month of the plan. To read ABI’s discussions of *Gibson* and *Rivera*, click [here](#) and [here](#).

Although Judge Brand said that *Gibson* and *Rivera* were “thoughtful and well-intended,” she “respectfully disagreed” and found “some flaws” in interpreting the statute.

First, Judge Brand did not understand how the debtor could obtain a discharge after missing mortgage payments when defaulting on the mortgage was grounds for dismissal.

Second, Judge Brand said that the computation of disposable income assumes the debtor will make mortgage payments. By skipping the mortgage, she said that the debtor would benefit from “living without mortgage payments at the expense of creditors.” Had the debtors surrendered the home, the distribution to unsecured creditors would have increased.

## Modification Shouldn’t Have Been Allowed

Judge Brand laid the foundation for ruling that the debtors were not entitled to discharges. However, her legal analysis also led to the conclusion that the debtors had not completed payments under the plan. Ironically, the debtors were theoretically entitled to propose a plan amendment.

The bankruptcy court nevertheless erred in allowing the amendment.



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Judge Brand identified three Code provisions prohibiting a plan running longer than five years, thus barring a payment in the 67th month.

The debtors argued that surrendering the home was not a payment and thus did not run afoul of the Code. Judge Brand disagreed. She held that “surrender is a form of payment for purposes of Section 1329(c).”

Finally, Judge Brand hinted that the proposed modification was not in good faith, thus rendering the amendment unconfirmable under Section 1325(a)(3). She said the debtors’ good faith was “in question” because they paid nothing to unsecured creditors while retaining over \$100,000.

The BAP therefore reversed the bankruptcy court for abuse of discretion because the court had no authority to allow an amendment after the 60th month.

N.B.: Since Arizona is in the Ninth Circuit, *Rivera* likely would have been reversed on appeal. However, there was no appeal, so the *Rivera* debtors received their discharges. The *Gibson* debtors likewise received their discharges because there was no appeal.

[The opinion is](#) *Derham-Burk v. Mrdutt (In re Mrdutt)*, 17-1256, 2019 BL 188185, 2019 Bankr Lexis 1587 (B.A.P. 9th Cir. May 6, 2019).





*Georgia judge focuses on 'good faith' to decide whether a chapter 13 debtor should lose a discharge after missing direct mortgage payments.*

## **Split Continues on Loss of Chapter 13 Discharge for Missing Direct Mortgage Payments**

The debate continues on the right of a chapter 13 debtor to a discharge after missing direct payments to a home mortgage lender.

Bankruptcy Judge Susan D. Barrett of Augusta, Georgia, joined the minority by holding that a post-petition default on direct mortgage payments “standing alone does not constitute a material default” justifying dismissal under Section 1307(c)(6).

Before granting a discharge, Judge Barrett is still requiring her debtors to survive a good faith hearing and explain how they spent the money not paid to the lenders. Implicit in her September 30 opinion is the suggestion that the debtors cannot prove good faith if the money not paid to lenders would have increased the distribution to unsecured creditors.

### Two Cases, Same Facts

Raising the same legal issue, the chapter 13 trustee filed motions to dismiss two chapter 13 cases.

The debtors had completed payments to the trustee under their confirmed chapter 13 plans. The plans had no dividends for unsecured creditors. One debtor was paying \$745 a month for three years, and the other paid \$310 a month for five years. Both plans cured prepetition defaults on the mortgages through payments from the trustee.

To avoid fees otherwise earned by the trustee, both plans called for the debtors to make post-petition mortgage payments directly to the mortgage lenders. After the debtors completed making all payments to the trustee, it turned out that the debtors were both some \$47,000 in arrears in post-petition mortgage payments that should have been made directly to the lenders.

The chapter 13 trustee filed motions to dismiss under Section 1307(c)(6), contending that defaults on the mortgages were material defaults under the plan. Had Judge Barrett granted the motions, the debtors would have lost their discharges on top of the likely loss of their homes.



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Section 1307(c)(6) provides that the court “may dismiss . . . for cause, including . . . [a] material default by the debtor with respect to a term of a confirmed plan.”

## The Courts Are Split

Judge Barrett collected authorities supporting both the majority and minority points of view.

The pivotal statute is Section 1328(a), which provides that the court “shall grant the debtor a discharge of all debts provided for by the plan” after completing “all payments under the plan.”

She explained why the majority hold that “all payments under the plan” includes payments made directly to a mortgage lender.

Judge Barrett sided with the minority in ruling that “all payments under the plan” does not include direct mortgage payments. She said that a default on the mortgage, “standing alone[,] does not merit the dismissal of a debtor’s bankruptcy case, the denial of their discharges, and most likely the loss of their home.”

Judge Barrett laid out arguments on both sides. In support of the minority’s point of view, she relied upon the statutory language in Sections 1329(a) and 1325(b)(1)(B), along with Bankruptcy Rule 3002.1.

One of Judge Barrett’s more persuasive arguments was based on the 2005 amendment to Section 1328(a), requiring a debtor to certify that he or she is current on all domestic support obligations. But, the judge said, “Congress did not require a certification regarding direct loan payments.”

The statutory consequence for failing to make domestic support payments is loss of discharge. For failure to make mortgage payments, Judge Barrett said that the “proper statutory consequence . . . is potentially the loss of your home, not the denial of discharge.”

Another cogent argument by Judge Barrett derives from Bankruptcy Rule 3002.1, adopted in 2011 as additional protection for debtors. However, the rule has had the effect of bringing direct mortgage defaults to light for the first time. She cited a judge who surmised that he had previously granted discharges in “countless” cases where there had been mortgage defaults unknown to the trustee.

Judge Barrett recited the rule of statutory construction “that a statute is not to be read as eroding past practices absent a clear indication from Congress.”

Judge Barrett found support for her conclusion in *Dukes v. Suncoast Credit Union (In re Dukes)*, 909 F.3d 1306 (11th Cir. Dec. 6, 2018), where a majority of the Eleventh Circuit panel



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held that direct payments by a chapter 13 debtor to a mortgagee are not “provided for by the plan” under Section 1328(a). Judge Barrett admitted that the circuit court was “not addressing the exact issue” in the cases before her. To read ABI’s discussion of *Dukes*, [click here](#).

## Good Faith Remains an Issue

In line with the holding of a minority of courts, Judge Barrett ruled that the failure to make direct mortgage payments “is not *per se* grounds for denial of discharge.” The debtors were not home free, though.

The trustee noted that debt service on the debtors’ mortgages was included in calculating payments to creditors. The trustee argued that the money withheld from the lenders “should have gone to the Debtors’ creditors.”

Although the debtors had not explained how they spent the money withheld from the lenders, they requested that Judge Barrett hold hearings “on their respective expenditures of these funds.”

Judge Barrett directed the clerk “to set a hearing on” the trustee’s motion to dismiss for lack of good faith where the debtors’ uses of the funds would evidently be the primary issue.

## Observations

Courts on both sides of the issue make cogent arguments based on the language in several sections of the Bankruptcy Code. This writer submits that the answer therefore cannot be found in the plain language of the statute.

Assuming there is no answer in the statutory language alone, courts must face up to the task of deciding what the law ought to be, because Congress has not clearly said what it is. But perhaps Congress did suggest the answer in policies evident in the Bankruptcy Code. The question is, however, which of several policies in the Code is controlling when it comes to direct mortgage payments?

Judge Barrett may be barking up the right tree by focusing on good faith. What did the debtors do with the \$47,000 they didn’t pay their lenders? Did they put the money in their pockets and live better, or did they use the money for unexpected expenses? Did the inability to pay the mortgages result from the loss of a job or illness?

Theoretically, debtors should return to court for an amended plan if circumstances change. But how much legal acuity should we demand from debtors? And can they afford to pay a lawyer for the legal footwork?



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Perhaps evaluating a debtor's decisions with the benefit of hindsight is a better answer than laying down a bright-line rule.

The opinion is *In re Simmons*, 14-10757 (Bankr. S.D. Ga. Sept. 30, 2019).



*Finding 'undue hardship' held not to require discharging all student loan debt.*

## **District Court Upholds Discharge of a Portion of Student Loan Debt**

A district judge in Kansas upheld a decision handed down last year by Bankruptcy Judge Robert E. Nugent of Wichita, Kan., who ruled that a bankruptcy court has authority to discharge interest on a student loan while leaving the principal intact.

In his May 2 opinion, District Judge John W. Broomes also held that a discharge under Section 523 (a)(8) is not an “all or nothing” proposition. If the court decides that payment of part of a student loan results in undue hardship, the judge is not required to discharge the entire loan.

The debtor was a 59-year-old single woman with no dependents. Her gross annual income had ranged between \$40,000 and \$43,000, with little chance of substantial increase. Judge Nugent found that her standard of living was “spartan.”

The debtor presented an attractive case for discharging student loans. She had borrowed about \$16,000 between 1989 and 1991 to attend college for two years. She had paid about \$14,000 toward the loans, almost all in a succession of three chapter 13 cases. Because her payments did not cover interest, the outstanding balance had grown to more than \$67,000.

Having completed payments in her most third and most recent chapter 13 plan, the debtor sought to discharge the student loans under Section 523(a)(8).

Under three payment plans offered by the government, the only one she could afford was the smallest at \$203 a month. If she made all the payments over the succeeding 25 years, Judge Nugent calculated that she would have ended up at age 84 owing more than \$152,000, because \$203 a month would be \$301 a month short of paying current interest. If the remainder were forgiven at the end of the repayment program, she faced the possibility of incurring a nondischargeable tax liability for forgiveness of indebtedness income.

On the other hand, Judge Nugent calculated that she could pay off the \$16,000 principal balance in about 10 years if she were to pay \$203 a month.

Judge Nugent therefore ruled that everything in excess of the \$16,000 principal balance would be discharged.





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Both sides appealed. The lender argued that the debtor failed the so-called *Brunner* test and was not entitled to discharge anything. The debtor contended that the bankruptcy court should have discharged the entire debt, arguing that the statute does not permit a partial discharge if the court finds an undue hardship.

The issues were well presented on appeal. The National Association of Bankruptcy Attorneys, the National Consumer Bankruptcy Rights Center, and the National Consumer Law Center submitted an *amicus* brief authored by Jill A. Michaux, William R. Fossey, and Tara Twomey. District Judge Broomes overruled the lender's opposition to the filing of the *amicus* brief.

Judge Broomes affirmed Judge Nugent right down the line. He began by explaining how the Tenth Circuit had adopted *Brunner* and its three-prong test. *Brunner v. New York State Higher Education Services Corp.*, 831 F.2d 395, 396 (2d Cir. 1987). Nonetheless, he said the Tenth Circuit had "cautioned" that the test "must not be applied such that debtors who truly cannot afford to pay their loans may have their loans discharged," quoting *Education Credit Management Corp. v. Polleys*, 356 F.3d 1302, 1309 (10th Cir. 2004).

On the first test — whether the debtor can maintain a minimal standard of living while repaying the debt — Judge Broomes cited Judge Nugent's finding that the debtor could only afford about \$200 a month.

Because the debtor could pay something, the lender contended that the debtor failed the first test, making the entire loan nondischargeable. Judge Broomes disagreed. He cited the Tenth Circuit for holding that a debtor is not required to participate in one of the repayment programs to qualify for discharge. That, he said, is considered to be part of the good faith test.

Judge Broomes said that the lender had failed to make a "colorable argument that [the debtor] could ever truly repay her loan." He ruled that the debtor had therefore satisfied the first test, because participating in one of the repayment programs "would thwart the fresh start policy."

The second test asks whether the debtor's circumstances are likely to persist. Judge Broomes upheld Judge Nugent's finding that her financial condition was "likely to persist."

The third test deals with the debtor's good faith. On that topic, Judge Broomes upheld Judge Nugent's finding that the debtor had made a good faith effort to repay her loans.

Finally, Judge Broomes turned to the debtor's cross appeal, where she contended the court must discharge the entire loan once the debtor proves that paying the entire debt is impossible. The debtor cited *Skaggs v. Great Lakes Higher Education Corp. (In re Skaggs)*, 196 B.R. 865, 866-67 (Bankr. W.D. Okla. 1996), for the notion that discharging student loans is an all-or-nothing proposition under Section 523(a)(8).



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According to Judge Broomes, the Tenth Circuit rejected the all-or-nothing approach in *dicta*, as do the “majority of courts.” Requiring courts to discharge student loans entirely, he said, would run counter to the bankruptcy court’s equitable authority to enforce bankruptcy laws.

Judge Broomes therefore ruled that the bankruptcy court has “equitable powers . . . to grant a partial discharge of student loan debt upon a finding of undue hardship.”

Question: Where is the power in the statute allowing the bankruptcy court to impose a payment program on a lender long after the plan expires?

Answer: The bankruptcy court could tell the lender, “Agree to accept \$203 a month without interest, or I will discharge the entire debt.”

Observation: Creative uses of equitable powers, such as this, strike this writer as similar to the development of asbestos channeling injunctions before the adoption of Section 524(g).

The opinion is *Educational Credit Management Corp. v. Metz*, 18-1281, 2019 BL 158864, 2019 WL 1953119 (D. Kan. May 2, 2019).



*Congress may have intended to preclude 'stay and pay,' but it didn't succeed.*

## **BAPCPA Limits Remedies Against Debtors Who Don't Reaffirm or Surrender**

In the BAPCPA amendments in 2005, Congress may have intended to bar debtors from allowing mortgages to “ride through” bankruptcy, but the statute won't help a lender in all circumstances, according to Bankruptcy Judge Mark X. Mullin of Fort Worth, Texas.

In his March 8 opinion, Judge Mullin said there was no statutory authority enabling the court to compel a debtor to turn over mortgaged property to the lender or to withhold entry of discharge until the debtor fulfills his or her stated intention of surrendering the property.

### The Facts

Debtors in chapter 7, the husband and wife owned a mobile home that is personal property in Texas. The lender held a purchase money security interest in the mobile home. There were no defaults either before or after bankruptcy. The note did not contain a so-called *ipso facto* clause that would have made bankruptcy a default.

Originally, the debtors filed a statement of intention in which they elected to retain the mobile home and enter into a reaffirmation agreement with the lender. After the first meeting of creditors and after conferring with attorneys, Judge Mullin said, the couple decided not enter into a reaffirmation agreement.

Instead, the debtors amended their statement of intention by electing to “surrender” the mobile home.

When the debtors continued to pay the debt and had not vacated the mobile home, the lender filed motions asking Judge Mullins to (1) delay the entry of the debtors' discharges until they had surrendered the property and the lender had “secured” the property, and (2) allow the lender to “secure” the mobile home. The lender argued that simply modifying the automatic stay did not benefit nor provide adequate protection to the lender.

### The Desired Remedy Isn't in the Statute

On issues raised by the lender, Judge Mullin said that courts around the country disagree.



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Judge Mullin explained why the debtors' actions already had resulted in modifications of the automatic stay, on several grounds. Because the debtors had not timely performed their intention to surrender, the automatic stay terminated under Section 362(h)(1)(B). The automatic stay also terminated under Section 521(a)(6) because the debtors had not entered into reaffirmation agreements before the prescribed deadline. And, of course, the stay would terminate on discharge under Section 362(c). Discharge would absolve the debtors of personal liability were they to default later.

Because there was no default entitling the lender to foreclosure, the lender argued that the debtors were attempting to have the security interest “ride through” bankruptcy, allegedly in violation of Section 521(a)(2). That Section prescribes deadlines for debtors to state their intentions and perform their intentions regarding surrender of property. Indeed, Section 521(a)(6) provides that the debtor “shall . . . not retain possession of personal property” absent a reaffirmation agreement or redemption.

The lender argued that the word “surrender” in Section 521(a)(2) was sufficient to justify the requested relief. Noting that “surrender” is not defined in the Code, Judge Mullin cited the First Circuit for saying that “surrender” is not synonymous with “deliver.” It means, he said, that the debtors will take “no action to resist any effort by the creditor to gain its collateral.”

Therefore, Judge Mullin said, “the Debtors are not required to affirmatively deliver the Mobile Home to [the lender].” Aside from modifying the stay to permit foreclosure if there were a default, Judge Mullin said the “Bankruptcy Code does not provide any other remedy . . . resulting from the Debtors’ failure to comply with Section 521(a)(2).”

Likewise, Section 521(a)(6) did not give the lender a remedy. That section says that “a debtor shall . . . not retain possession of personal property . . . unless the debtor . . . either” signs a reaffirmation agreement or redeems the property.

For violation of Section 521(a)(6), Judge Mullin said the remedy is in the hanging paragraph following Section 521(a)(7). In addition to modifying the automatic stay, the hanging paragraph allows the trustee to require “the debtor to deliver any collateral in the debtor’s possession to the trustee.”

The trustee is entitled to seek delivery of the property, Judge Mullin said, but the Code does not give a similar remedy to creditors.

Also in the 2005 amendments, Section 521(d) gave creditors an additional remedy: If a debtor has violated Section 521(a)(6), *ipso facto* clauses become enforceable. Unfortunately, the lender had no *ipso facto* clause, so even Section 521(d) provided no effective remedy.



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With regard to delaying discharge, Judge Mullin said that Section 727(a) contains 12 grounds for delaying discharge, but none applied to the case. Absent grounds for delay, Rule 4004(c) requires the court to enter discharge “forthwith.” The statute and rules therefore did not permit delaying discharge as a remedy for violating Section 521(a)(2).

In sum, the Code does not contain a remedy of the sort the lender requested. The court, Judge Mullin said, does not have the prerogative to provide a remedy not authorized by Congress.

In November 2017, Bankruptcy Judge Phillip J. Shefferly of Detroit reached a similar result in a similar case. *See In re McCray*, 578 B.R. 403 (Bankr. E.D. Mich. Nov. 30, 2017). Judge Mullin cited *McCray* among the authorities supporting his conclusions. For ABI’s discussion of *McCray*, [click here](#).

The opinion is *In re Seiffert*, 8-43114, 2019 BL 96637, 2019 Bankr Lexis 869 (Bankr. N.D. Tex. March 8, 2019).





## *Fraudulent Transfers/Children's Tuition*



*The case in the appeals court apparently did not involve a student account structured to prevent the college from being the initial recipient of a fraudulent transfer.*

## **First Circuit Starkly Holds that Tuition for an Adult Child Is a Fraudulent Transfer**

The First Circuit starkly held – without any ifs, ands, or buts – that college tuition paid by an insolvent parent for an adult child is a constructive fraudulent transfer.

The lower courts are divided on the issue, but the First Circuit is the first court of appeals to decide the question.

The debtor was a fraudster sentenced to 10 years in prison for perpetrating a Ponzi scheme and was slapped with a \$9.7 million judgment by the Securities and Exchange Commission for securities law violations. As usual, the college was an innocent bystander.

Insolvent at the time, the fraudster-parent had paid almost \$65,000 in college tuition for an adult child over two years. The last payment was some two months before the father copped a guilty plea. Two months after the plea, he filed a chapter 7 petition.

The chapter 7 trustee sued the college on theories of actual and constructive fraudulent transfer. On cross motions for summary judgment, the college contended that the debtor-father received equivalent value because an educated child will not be an economic burden on the parents.

The bankruptcy court ruled in favor of the college, finding that the debtor received reasonably equivalent value. The bankruptcy court certified a direct appeal to the circuit.

In an eight-page opinion on November 12, Chief Circuit Judge Jeffrey R. Howard reversed, ruling *de novo* on a question of law that the payments were constructively fraudulent transfers under Section 548(a)(1)(B).

Judge Howard explained that courts “evaluate transfers from the creditors’ perspective . . . , measuring value at the time of transfer.” He conceded that lower courts are divided on the issue, “although the recent cases have mostly ruled for trustees.”



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Judge Howard said the answer is “straightforward,” because the tuition payments “depleted the estate and furnished nothing of direct value to the creditors who are the central concern of the code provisions at issue.”

Judge Howard said that none of the exceptions in Section 548(d)(2)(A) were applicable, nor did the debtor have any legal obligation in Massachusetts to pay “college” tuition for an adult child. He was not swayed even if payments were for “worthy causes,” such as caring for “elderly parents or needful siblings.”

Judge Howard reversed and remanded the case to the bankruptcy court, saying that the Bankruptcy Code “is the end of the matter” when there is “a clear statutory command.”

## What the Opinion Does Not Consider

Evidently, the parties conceded that the college was the initial recipient of the fraudulent transfer, thus preventing the college from claiming to be a subsequent transferee who could raise a good faith defense under Section 550(b).

Aware of the threat of being sued, colleges and universities are getting smart. We have reported cases where colleges set up accounts for each student. The parents make payments to the students’ accounts, not to the colleges. If the child is the initial recipient, the college is in a better position to claim the good faith defense. Click [here](#) and [here](#) for ABI reports on district court and bankruptcy court decisions where colleges crafted partial protection for themselves.

Until Congress or state legislatures confer immunity, colleges and universities may be able to adopt concepts of structured finance to provide near total protection from fraudulent transfer suits. In the process, however, schools and colleges will be making adult children liable to bankruptcy trustees.

Curiously, we have not come across any reported cases where a trustee has sued a child for being the recipient of a fraudulent transfer resulting from a tuition payment. Perhaps trustees see no reason for suing penurious college-age children. Anyway, a student or recent graduate would likely be eligible to discharge a fraudulent transfer debt in chapter 7.

[The opinion is](#) *DeGiacomo v. Sacred Heart Univ. Inc. (In re Palladino)*, 942 F.3d 55 (1st Cir. Nov. 12, 2019).



*Texas Supreme Court rules that an inability to discover fraud won't absolve a transferee from the duty to investigate suspicions of fraud.*

## **The Texas UFTA Has No 'Futility Defense' When a Transferee Is on Inquiry Notice**

Answering a certified question from the Fifth Circuit, the Texas Supreme Court held that a defendant in a fraudulent transfer suit who is on inquiry notice, but does not investigate, is not entitled to the good faith defense even if inquiry would have been futile.

In his December 20 opinion for the Texas high court, Justice J. Brett Busby said that holding “otherwise rewards willful ignorance and undermines the purpose of” the Texas Uniform Fraudulent Transfer Act, or TUFTA.

“The ruling will have a significant effect on fraudulent transfer litigation not only in Texas, but in other jurisdictions around the country,” Eric D. Madden, a partner with Reid Collins & Tsai LLP of Dallas, told ABI. Madden submitted an *amicus* brief in the Texas Supreme Court on behalf of the National Association of Bankruptcy Trustees.

### The Stanford Ponzi Scheme

The question arose in the \$7 billion Ponzi scheme perpetrated by R. Allen Stanford, now serving a 110-year prison sentence. The Securities and Exchange Commission obtained the appointment of a receiver, who brought lawsuits to aid defrauded investors.

Under TUFTA, the receiver sued an investor who took out \$79 million in principal shortly before the fraud was exposed, but after news of the SEC investigation had become public. The district court ruled that the investor was the recipient of a transfer made with actual intent to hinder, delay or defraud. The only issue was the investor's good faith defense under TUFTA.

Under TUFTA, the defendant would have no liability if it could prove that it received the transfer “in good faith and for reasonably equivalent value.” Good faith was the only issue, because repayment of the investor's principal established reasonably equivalent value.

The parties agreed that the defendant conducted no investigation. The jury was therefore left to decide two questions. First, the jury concluded that the defendant was on inquiry notice regarding the question of good faith. On the second question, however, the jury decided that an investigation would have been futile. A futile investigation was defined in the jury charge as “a



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diligent inquiry that would not have revealed to a reasonable person that Stanford was running a Ponzi scheme.”

The district court ruled that the defendant was entitled to the good faith defense under TUFTA by having proven that an investigation would have been futile. The receiver appealed.

## The First Fifth Circuit Opinion

In January, a three-judge panel of the Fifth Circuit reversed the district court and found the defendant liable. *Janvey v. GMAG LLC*, 913 F.3d 452 (5th Cir. Jan. 9, 2019).

The opinion by Chief Circuit Judge Carl E. Stewart made a so-called *Erie* guess by presuming that the Texas Supreme Court would not recognize the futility defense. Ironically, Judge Stewart said that the same facts would have given the transferee a complete defense were the defendant able to raise the seemingly identical good faith defense under Section 548(c) of the Bankruptcy Code.

The defendant who received the fraudulent transfer filed a motion for panel rehearing and rehearing *en banc*.

## The Fifth Circuit's Certified Question

In a *per curiam* opinion in May, the panel granted the motion for panel rehearing and vacated the opinion from January.

In a certified question, the panel asked the Texas Supreme Court to rule on whether a defendant on inquiry notice who did not conduct an inquiry is nonetheless entitled to the good faith defense if inquiry would have been futile. *Janvey v. GMAG LLC*, 925 F.3d 229 (5th Cir. May 24, 2019).

To read ABI's reports on the first and second Fifth Circuit opinions, click [here](#) and [here](#).

## The Texas Court Is Tough on Recipients of Fraudulent Transfers

The Texas Supreme Court summarized the question and the answer like this: “May a transferee on inquiry notice of a fraudulent transfer satisfy TUFTA’s good-faith defense without conducting a diligent investigation? We conclude that the answer is no . . . regardless of whether the transferee reasonably could have discovered the fraudulent activity through diligent inquiry.”

The opinion seems based in significant part on policy perceived to underlie TUFTA. For example, Justice Busby said that the uniform act “was created to ensure defrauded creditors attain similar remedies.” He also said that “choosing to remain willfully ignorant of any information an investigation might reveal is incompatible with good faith.”





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In general, Texas law doesn't seem to cut much slack for recipients of fraudulent transfers who have reason to suspect fraud was afoot.

Although TUFTA does not define good faith, Texas courts have ruled that a “transferee must show that its conduct was honest in fact, reasonable in light of known facts, and free from willful ignorance of fraud,” Justice Busby said.

Because the jury decided that the defendant was on inquiry notice, Justice Busby said that his court was tasked with deciding “how a transferee with inquiry notice of fraud can prove good faith.” Citing *Black's Law Dictionary*, he defined inquiry notice as “[n]otice attributed to a person when the information would lead an ordinarily prudent person to investigate the matter further.”

If a diligent inquiry would have uncovered facts showing fraudulent intent, Justice Busby said that “Texas common law imputes knowledge of those additional facts to the transferee as well.” Furthermore, a transferee is infected with knowledge “so long as it reasonably could have been discovered at the time of the transfer.”

Focusing on the certified question, Justice Busby said that “a transferee seeking to prove good faith must show that it investigated the suspicious facts diligently. A transferee who simply accepts a transfer despite knowledge of facts leading it to suspect fraud does not take in good faith.”

But what if a diligent inquiry would not have disclosed fraud? Justice Busby found the answer embedded in the notion of good faith.

Justice Busby said that “choosing to remain willfully ignorant of any information an investigation might reveal is incompatible with good faith . . . . If the transferee fails to demonstrate its good faith and avoid willful ignorance by conducting a diligent investigation, it cannot be characterized as acting with honesty in fact.”

Concluding the opinion, Justice Busby held that a “transferee on inquiry notice of fraud cannot shield itself from TUFTA's clawback provision without diligently investigating its initial suspicions — irrespective of whether a hypothetical investigation would reveal fraudulent conduct.”

[The opinion is](#) *Janvey v. GMAG LLC*, 19-0452, 2019 BL 487782 (Tex. Sup. Ct. Dec. 20, 2019).



*There is no prohibited double recovery from multiple defendants, the appeals courts says, until the trustee has recovered cash equaling the value of the fraudulently transferred property.*

## **Second Circuit Defines a Prohibited Double Recovery on Fraudulent Transfers**

Affirming Bankruptcy Judge Alan S. Trust , the Second Circuit explained when a trustee is prohibited from making a double recovery following an avoided transfer. Basically, a trustee can recover from multiple transferees until the cash taken in by the trustee equals the value of the avoided transfer.

Creditors filed an involuntary petition against the debtor, who owned a home with her husband as tenants by the entireties. The home was worth \$260,000 above the first mortgage.

The debtor hired a lawyer to represent her in bankruptcy. Six months after the order for relief, the debtor was indicted for defrauding her creditors. The debtor then retained the same lawyer and two others to represent her in the criminal proceedings.

To fund her legal defense, the debtor and her husband borrowed \$250,000 from a friend, secured by a second mortgage on their home. The original lawyer drafted the note and mortgage loan documents. The friend transferred \$250,000 cash to the debtor's original lawyer, who in turn gave slightly more than half to the other two criminal lawyers.

The chapter 7 trustee sued the friend for avoidance of the second mortgage as an unauthorized post-petition transfer under Section 549. The friend settled by allowing the second mortgage to be avoided and preserved for the benefit of the estate.

The trustee then sought to sell the home under Section 363(h). Bankruptcy Judge , of Central Islip, N. Y., refused to permit a sale of the property, concluding that the interest of the husband and the couple's child in the home outweighed the economic benefit to the estate.

Meanwhile, the trustee had also sued the first lawyer for the \$119,000 that he had retained from the \$250,000. The lawyer argued that a money judgment against him would be a double recovery barred by Section 550(d), because the trustee had already avoided the second mortgage.

Bankruptcy Judge overruled the objection and entered judgment against the lawyer for about \$59,500. Judge reasoned that \$125,000 from the loan was the amount the trustee was authorized



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to recover, given the wife's half interest in the home. The \$59,500 represented half of the \$119,000 that the lawyer had retained for himself.

After the lawyer appealed, the district court upheld Judge , resulting in a second appeal to the Second Circuit. Circuit Judge Gerard E. Lynch affirmed in an opinion on July 25.

Judge Lynch began by citing circuit authority for the proposition that a bankruptcy court has "broad discretion" in applying post-petition avoidance powers under Section 549 and in ordering the return of transferred property or its value pursuant to Section 550(a).

On appeal in the circuit, the lawyer did not challenge the idea that granting the mortgage was avoidable under Section 549(a), which permits a trustee to recover a transfer that "occurs after the commencement of the case" and that was "not authorized under [the Bankruptcy Code] or by the court."

Instead, the lawyer focused on the fact that the trustee had already avoided and preserved the second mortgage "for the benefit of the estate" under Section 550(a). The lawyer argued that a money judgment against him contravened Section 550(d), which says that a "debtor is entitled to only a single satisfaction under subsection (a) of this section."

Judge Lynch explained that Section 550(d) "commonly applies" when a trustee seeks to recover transferred property from more than one transferee, possibly allowing the trustee to recover more than the value of the transferred property.

The case on appeal was different, Judge Lynch said, because the "debtor had not realized any part, let alone all, of the value of the debtor's equity interest" in the home. The preserved second mortgage, he said, "carries only a right to foreclose." He noted that the bankruptcy judge had already prohibited the trustee from selling the home.

Furthermore, Judge Lynch said, the settlement with the friend, which preserved the second mortgage for the estate, "did not provide for any payment to the Estate." He went on to say that the estate "realized none of the equity value of the Second Mortgage for the benefit of creditors and, notably, did not obtain title to real property."

The "debtor's only route to realize any recovery for the Estate . . . was by seeking the proceeds" of the loan received by the lawyer, Judge Lynch said. Under the "plain language" of the statute, he therefore held that the trustee's "recovery of a portion of the [loan] does not violate the single satisfaction rule of Section 550(d)."

Having upheld Judge 's judgment against the lawyer, Judge Lynch ended the opinion by saying what happens next. If the trustee eventually manages to recover from the preserved second mortgage, Judge Lynch said the trustee is entitled to retain the debtor's equity in the home less the



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\$59,500 that he recovered from the lawyer. Judge Lynch said nothing about the right to contribution, if any, among the recipients of fraudulent transfer.

[The opinion is](#) *Jones v. Brand Law Firm PA (In re Belmonte)*, 18-2098, 2019 BL 274629, 2019 Us App Lexis 22173 (2d Cir. July 25, 2019).



*Assisting a debtor in effecting a fraudulent transfer with 'actual intent' isn't enough to hold the transferee liable.*

## **Returning a Fraudulent Transfer Absolves the Recipient of Liability, Fifth Circuit Rules**

Circuit Judge Andrew S. Oldham, the most recent appointment to the Fifth Circuit, was tasked with writing another bankruptcy opinion. He ruled that the recipient of a fraudulent transfer cannot be tagged with a judgment if the transferee has retransferred the property to the debtor, even if the debtor “frittered the money away” before bankruptcy.

The debtor was a man later sentenced to two years in prison for bankruptcy fraud. Before bankruptcy, the debtor's wife took \$275,000 from the joint account with her husband and used the money to open a new bank account with her sister-in-law.

A month later, the debtor's wife took herself off the account with her sister-in-law. At the direction of the debtor's wife, the sister-in-law subsequently transferred \$33,500 for the benefit of the debtor's daughter. After being sued, the daughter returned the \$33,500, so that transfer was no longer at issue.

From the remaining \$241,500, the sister-in-law transferred \$200,000 to a company owned by the debtor and \$32,000 to the debtor's wife's personal account. Both transfers were before bankruptcy.

The trustee sued the sister-in-law for the \$241,500. Affirmed in district court, the bankruptcy court held the sister-in-law liable for \$241,500 as the initial recipient of a constructive fraudulent transfer and a transfer with “actual intent” to hinder, delay or defraud.

On appeal in the circuit, the sister-in-law conceded that the transfer was avoidable. However, she argued that she was a mere conduit and not liable for the transfer. Reversing on other grounds in an opinion on December 23, Judge Oldham did not reach the mere conduit defense.

The sister-in-law successfully contended that she could not be liable for \$232,000 because she returned that much money to the debtor before bankruptcy.

Judge Oldham said that “Section 550(a) permits the trustee to ‘recover’ the property.” Citing dictionary definitions, he said that “recover” means to “get back or regain in full or in equivalence.”





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Judge Oldham said that property already returned “cannot be ‘recovered’ in any meaningful sense.” “Obtaining a duplicate of something is not getting it back; it’s getting a windfall,” he said.

In similar cases, Judge Oldham said that other courts bar recovery by relying on the single-satisfaction rule in Section 550(d). Other courts, he said, exercise “equitable discretion to adjust the trustee’s recovery to prevent a windfall.”

Whatever the theory, Judge Oldham said that a “bankruptcy trustee cannot ‘recover’ property that the transferee returned to the debtor before the bankruptcy filing.”

The debtor or his wife had spent the \$232,000 before bankruptcy. “If the [debtor and his wife] frittered the money away – and perhaps they did – it has nothing to do with the fraudulent transfer or [the sister-in-law],” Judge Oldham said.

Judge Oldham reversed and remanded for further proceedings. Evidently, the sister-in-law is not out of the woods.

According to a footnote, the bankruptcy court did not decide whether \$232,000 made its way back to the debtor himself, because \$200,000 went to a company owned by the debtor and \$32,000 was transferred to the wife’s personal account. The appeals court instructed the bankruptcy court to decide whether the \$232,000 was in fact “returned” to the debtor.

Will it be enough on remand for the sister-in-law to show that the debtor directed how the \$232,000 was spent, even if it was frittered away? And if the \$232,000 did not return to an account for the debtor or a joint account with his wife, will it be sufficient if there is evidence that the money was spent for the benefit of the debtor and his wife?

Will the trustee prevail if there is proof on remand that the debtor directed the disposition of the \$232,000 in a manner showing intent to hinder and delay creditors? Or does Judge Oldman’s language about the debtor’s right to “fritter away” the money preclude a claim for actual or constructive fraudulent transfer? Perhaps the “fritter away” language was *dicta* that will not bind the bankruptcy court or a subsequent panel of the Fifth Circuit.

And who will bear the burden of proof?

Last January, Judge Oldham was the author of *Ultra Petroleum Corp. v. Ad Hoc Committee of Unsecured Creditors (In re Ultra Petroleum Corp.)*, 913 F.3d 533 (5th Cir. Jan. 17, 2019), where he wrote at length about the allowance of claims for a so-called makewhole premium. Granting a motion in November for panel rehearing, Judge Oldman withdrew the January opinion and issued a shorter opinion eliminating pages of *dicta* about makewhole premiums and limiting the ruling to a declaration that disallowance of portions of a claim by the operation of provisions of the Bankruptcy Code does not amount to “impairment” of the claim entitling the creditor to vote for



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or against confirmation of a chapter 11 plan. *Ultra Petroleum Corp. v. Ad Hoc Committee of Unsecured Creditors (In re Ultra Petroleum Corp.)*, 943 F.3d 758 (5th Cir. Nov. 26, 2019). To read ABI's reports on the opinions, click [here](#) and [here](#).

[The opinion is](#) *Whitlock v. Lowe (In re DeBerry)*, 18-50335, 2019 BL 491080, 2019 Us App Lexis 38290 (5th Cir. Dec. 23, 2019).



*Third Circuit lauds Bankruptcy Judge Agresti for 'prescient thinking.'*

## **Third Circuit Pronounces a Damages Formula for Fraudulent Entireties Transfers**

Bankruptcy Judge Thomas P. Agresti of Erie, Pa., was given the supreme compliment by the Third Circuit: The appeals court saluted his “prescient thinking” in devising a formula for calculating damages in a complex fraudulent transfer suit.

A man had been a partner in a law firm that went out of business. He was saddled with millions of dollars of liability for his guarantee of his “old” firm’s lease. While working at a “new” firm, he was hit with a multimillion-dollar judgment in favor of the landlord.

To avoid having income from his “new” firm garnished, he directed the firm to deposit his income directly into an entireties account in his name and his wife’s. Because the wife was not liable on the judgment, the landlord could not attach the joint bank account.

The man was forced into bankruptcy by the judgment. The trustee sued the debtor and his wife to recover fraudulent transfers under the Pennsylvania Uniform Fraudulent Transfer Act.

Eventually, the bankruptcy judge entered judgment against the debtor and his wife, calculating damages of about \$275,000 under a formula suggested by the Third Circuit. The district court affirmed. Both the couple and the trustee appealed.

In an opinion on February 20, Circuit Judge Thomas L. Ambro upheld the judgment. In the process, he lauded Judge Agresti for recommending a formula for calculating damages resulting from fraudulent transfers into entireties accounts.

### Liability

Judge Ambro had no difficulty finding fraudulent transfer liability. “When the wages of an insolvent spouse are deposited into a couple’s entireties account, both spouses are fraudulent transferees,” he said.

The direct deposit of the debtor’s wages into the joint account was a “transfer” of an “asset” because: (1) Wages were the debtor’s asset; (2) the wages were no longer his asset after deposit into the entireties account; and (3) the change in status was a “transfer.”



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The Third Circuit, Judge Ambro said, presumes that transfers into an entireties account are not made for reasonably equivalent value. Because the debtor was insolvent, the transfers of the debtor's income were therefore fraudulent transfers.

Next, Judge Ambro said that the wife was liable as a transferee. He cited the Third Circuit and numerous courts that have held a spouse liable for a fraudulent transfer into entireties property.

Judge Ambro went on to hold that the debtor was liable as both the transferor and a transferee.

## Damages

The tricky question was damages, because some of the funds in the account came from the wife or sources that were not fraudulent transfers. Moreover, courts have held there is no liability when money is spent for reasonable and necessary household expenses. In that regard, the trustee must "prove by a preponderance of the evidence that [the debtor's] wage deposits were not spent on necessities," Judge Ambro said.

At that juncture, Judge Ambro said that the trustee faces "what appears to be an impossible task in a commingled account." Because money is fungible, he said it may be impossible to determine what deposit was used for a particular expenditure.

For his "prescient thinking," Judge Ambro praised Judge Agresti for advocating a damages formula that the Third Circuit went on to adopt in the February 20 opinion.

For "future courts facing commingled funds," Judge Ambro laid down what he called the "*pro rata*" formula for damage calculation. He said it "accounts for the fungibility of wage and nonwage funds that are commingled."

It goes like this: First calculate the deposits that were fraudulent transfers and those that were not. In the case at bar, the debtor's wages represented fraudulent transfers equaling about 60% of the deposits into the joint account.

Payments from the account totaled about \$2.1 million, of which about \$1 million were for non-necessities.

Applying the percentage of fraudulent deposits to the expenses for non-necessities, Judge Ambro said that the judgment should have been about \$600,000.

Applying a prior formula that the Third Circuit seemingly had endorsed, the bankruptcy judge found the couple liable for only \$275,000.



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In substance, Judge Ambro said that the damages formula from the prior Third Circuit opinion was not holding and thus was not binding on a subsequent panel. In that respect too, he praised Judge Agresti for “sounding the alarm” about shortcomings in the prior damages formula.

The debtor got off lucky, however. Judge Ambro upheld that \$275,000 judgment because the trustee had waived the issue regarding the formula.

N.B.: Circuit Judge Patty Shwartz did not join in the discussion of the *pro rata* formula, believing it was unnecessary given the trustee’s waiver of the issue. She also believes that the amount of liability should be left to the discretion of the trial court.

[The opinion is](#) *Shearer v. Titus (In re Titus)*, 916 F.3d 293 (3d Cir. Feb. 20, 2019).





## *Arbitration*



*Fifth Circuit panel does not interpret recent Supreme Court authority as overruling circuit opinions allowing bankruptcy courts to disregard arbitration agreements.*

## **Fifth Circuit Still Precludes Arbitration of 'Core' Bankruptcy Issues**

Recent decisions by the Supreme Court did not change the law and do not require bankruptcy courts to compel arbitration of core issues, the Fifth Circuit.

More particularly, the appeals court ruled on October 17 that the bankruptcy court had discretion not to enforce an arbitration agreement when a debtor initiated a class action contending that a creditor had violated the discharge injunction. The Fifth Circuit thus lines up with *One Bank NA v. Anderson (In re Anderson)*, 884 F.3d 382 (2d Cir. March 7, 2018), *cert. denied*, *One Bank NA v. Anderson* 139 S. Ct. 144, 202 L. Ed. 2d 35 (Oct. 1, 2018), where the Second Circuit decided that arbitration was not required when the debtor mounted a class suit in bankruptcy court alleging a violation of the discharge injunction. For ABI's discussion of *Anderson*, [click here](#).

### Simple Facts

The debtor confirmed a chapter 13 plan in 2013 and received a discharge in 2018. The student loan lender had filed a proof of claim and had received payments under the plan.

After discharge, the debtor received letters from the student loan lender. The debtor filed a class action in bankruptcy court contending that the communications were an attempt at collecting a debt in violation of the discharge injunction.

The lender responded with a motion to compel arbitration, relying on a provision in the loan agreement requiring arbitration of any dispute "arising out of or related to" the debt. Bankruptcy Judge David R. Jones of Houston denied the motion, relying in large part on *In re National Gypsum Co.*, 118 F.3d 1059 (5th Cir. 1997).

The lender appealed, arguing that the Fifth Circuit's *National Gypsum* opinion is no longer good law in view of more recent authority from the Supreme Court. The Fifth Circuit accepted a direct appeal.

### The Supreme Court on Arbitration



# ROCHELLE'S DAILY WIRE

In recent years, the Supreme Court has become more strident in requiring enforcement of arbitration agreements. Historically, however, the Supreme Court seemed to have been more lenient.

In 1987, the Supreme Court ruled that a court could decline to enforce an arbitration agreement if there was an inherent conflict between arbitration and a statute's underlying purpose. *Shearson/American Express Inc. v. McMahon*, 482 U.S. 220, 227 (1987).

Latching onto *McMahon*, the Second, Fourth, Fifth and Ninth Circuits have held in bankruptcy cases that the court may decline to compel arbitration if the issue is "core" and arbitration would represent a "severe conflict" with the Bankruptcy Code.

Interpreting *McMahon*, the Fifth Circuit in *National Gypsum* and the Second Circuit in *Anderson* both decided that the bankruptcy court may decline to enforce arbitration when the debtor alleges a violation of the discharge injunction.

*National Gypsum*, *Anderson* and the other circuit decisions overriding arbitration agreements in bankruptcy cases were all decided before *Epic Systems Corp. v. Lewis*, 138 S. Ct. 1612, 1624 (May 21, 2018), where the Supreme Court held that the language of a statute must be "clear and manifest" before a court can disregard an arbitration agreement. In *Epic*, the Supreme Court nixed a class action and required individual arbitration of a former employee's claim that the employer's failure to pay overtime violated the Fair Labor Standards Act.

*Epic* was a 5/4 decision, with the justices divided on ideological grounds.

The term after *Epic*, the Supreme Court was even more emphatic in deciding *Henry Schein Inc. v. Archer & White Sales Inc.*, 139 S. Ct. 524, 202 L. Ed. 2d 480 (Sup. Ct. Jan. 8, 2019). There, the high court reiterated and expanded the notion that arbitrators have the exclusive right to determine whether a dispute is within the scope of the arbitration agreement.

Even if the argument for arbitration is "wholly groundless," *Henry Schein* says that federal courts must allow the arbitrators to decide whether the dispute is within the scope of the arbitration agreement. In other words, the federal court may only decide whether there is an enforceable arbitration agreement. If there is, arbitrators will decide whether the particular issue is within the scope of arbitration.

## The Fifth Circuit's Analysis

In the Fifth Circuit, the lender conceded that the case was properly decided under *National Gypsum*. The lender nonetheless contended that *National Gypsum* is no longer good law in view of *Epic*.



# ROCHELLE'S DAILY WIRE

The Fifth Circuit panel consisted of Circuit Judges Carolyn Dineen King, Stephen A. Higginson, and Stuart K. Duncan. To depart from the mandate of *National Gypsum*, the panel said in its *per curiam* opinion that authority from the Supreme Court must be “unequivocally direct and controlling.” Possibly contrary high court authority does not allow a three-judge panel to overrule prior circuit precedent if the Supreme Court opinion is “merely illuminating.”

To disregard an arbitration agreement, *National Gypsum* said that the proceeding must adjudicate a statutory right conferred by the Bankruptcy Code. Second, the court may override an arbitration agreement only if arbitration would conflict with a purpose of the Bankruptcy Code, such as the centrality of administration.

The panel said that *McMahon*, *National Gypsum*'s “doctrinal foundation, “remains sound.” *Epic* and *McMahon*, the panel said, employ “substantially” the “same test,” even though *Epic* evidences a “different tone.” The panel concluded that the difference between a “deducible” congressional intent and a “clear and manifest” intent “is not an unequivocal direction to overrule our precedent.”

Holding that *National Gypsum* remains good law following *Epic*, the panel affirmed the bankruptcy court's exercise of discretion not to compel arbitration of an alleged violation of the discharge injunction.

## Is ‘Cert’ in the Making?

Although *per curiam*, the Fifth Circuit's panel opinion is precedential. However, there is no clear-cut circuit split because the Fifth and Second Circuits are on the same page.

The lender, however, may file a motion asking the Fifth Circuit to sit *en banc*. If the appeals court hears the case *en banc* and overrules *National Gypsum*, there then will be a split with the Second Circuit's *Anderson* decision, providing the foundation for an attractive *certiorari* petition.

In other words, we are several steps away from a case for the Supreme Court to decide whether a creditor may compel arbitration over “core” bankruptcy issues.

[The opinion is](#) *Henry v. Educational Finance Service (In re Henry)*, 18-20809 (5th Cir. Oct. 17, 2019).



*State attorney general was allowed to intervene in a class suit alleging that a lender violated usury laws.*

## **Another Appellate Court Bars Arbitration of 'Core' Claims**

A district court has held that a creditor may not compel arbitration to determine the allowance of a claim, even if the objection has been coupled with a class action seeking damages for violation of state law.

The October 22 opinion by District Judge David J. Novak of Richmond, Va., also held that the state may intervene on the side of the debtor and seek monetary relief for the citizens of the state.

### The Usurious Loan

The debtor had taken down a \$1,500 loan from a so-called payday lender. The loan bore interest of 0.75% per day, with a \$100 origination fee. The annual percentage rate worked out to 274%.

The loan agreement contained a broadly worded clause requiring individual arbitration of any disputes “arising from or related to” the debt. The clause also purported to bar the debtor from bringing or joining in a class action.

After the debtor filed a chapter 13 petition, the lender filed an unsecured proof of claim for almost \$2,800. The debtor filed an objection to the claim a few days before the bankruptcy court confirmed her plan.

Several months after confirmation, the debtor filed an adversary proceeding in bankruptcy court against the lender objecting to allowance of the claim. On behalf of herself and a class consisting of debtors in the court who had similar loans from the lender, the debtor’s complaint contained additional counts alleging that the loan was usurious under Virginia law and violated the federal Fair Debt Collection Practices Act.

Among other relief, the complaint sought disallowance of the claim, damages for violation of state law and the FDCPA, and disgorgement of principal and interest paid to the lender.

Contending that similar loans violated state consumer finance and usury statutes, the Virginia attorney general filed a motion to intervene, together with a proposed complaint seeking to bar the lender from collecting from bankrupts on similar loans. The attorney general also sought restitution for any principal and interest paid by borrowers.





The lender opposed the motion to intervene and filed a motion to compel arbitration. Bankruptcy Judge Kevin R. Huennekens granted intervention and denied the arbitration motion. The district court granted leave to appeal.

## No Arbitration of 'Core' Claims

Appealing the order denying the motion to compel arbitration, the lender argued that the claims were not core because the debtor was seeking monetary damages including restitution, disgorgement and attorneys' fees.

Regarding arbitration, District Judge Novak followed Fourth Circuit authority in *Moses v. CashCall*, 781 F.3d 63 (4th Cir. 2015), where the appeals court held that a bankruptcy court has discretion to refuse arbitration of "core" claims. The judge therefore proceeded to decide whether the debtor's claims were core or noncore.

Judge Novak concluded that the debtor's claims were core even though the complaint sought monetary relief for herself and the class, because the claims for monetary relief will be necessarily decided in determining the allowability of claims against similarly situated debtors.

Given that the claims were core, Judge Novak found no abuse of discretion because compelling arbitration would undermine an "animating purpose" of bankruptcy, the centrality of administration.

## Intervention

Next, Judge Novak tackled the order allowing the attorney general to intervene under F.R.C.P. 24, made applicable by Bankruptcy Rule 7024. The standard of review on appeal, he said, is "clear abuse of discretion" because decisions to allow or prevent intervention are "particularly deferential."

The lender only challenged the bankruptcy court's subject matter jurisdiction over the attorney general's claims.

Because disallowance of the claims would prevent the lender from collecting unlawful loans from bankrupts, Judge Novak reasoned that the claims arose in title 11 or were related to the case under title 11. He therefore ruled that the bankruptcy court had subject matter jurisdiction under 28 U.S.C. §§ 157 and 1334(d).

Jurisdiction having been established, Judge Novak found no clear abuse of discretion and therefore upheld the order allowing intervention.



# ROCHELLE'S DAILY WIRE

## Observations

The enforceability of arbitration agreements in bankruptcy is a hot topic that may end up in the Supreme Court if there is a split of circuits.

Last week, we reported *Henry v. Educational Finance Service (In re Henry)*, 18-20809, 2019 BL 399760 (5th Cir. Oct. 17, 2019), where the Fifth Circuit held that the bankruptcy court has discretion not to enforce an arbitration agreement when a debtor initiated a class action contending that a creditor had violated the discharge injunction.

The Fifth Circuit's opinion is in accord with *One Bank NA v. Anderson (In re Anderson)*, 884 F.3d 382 (2d Cir. March 7, 2018), *cert. denied*, *One Bank NA v. Anderson* 139 S. Ct. 144, 202 L. Ed. 2d 35 (Oct. 1, 2018), where the Second Circuit decided that arbitration was not required when the debtor mounted a class suit in bankruptcy court alleging a violation of the discharge injunction.

The lender who lost in *Henry* may be filing a motion for rehearing *en banc*. If the Fifth Circuit sits *en banc* and reverses the three-judge panel, there will be a circuit split giving rise to an attractive petition for *certiorari* to the Supreme Court.

In recent terms, the Supreme Court has been nearly rabid (although sometimes not unanimous) in enforcing arbitration agreements. Eventually, the high court will lay down rules describing the circumstances, if any, when a bankruptcy court may decline to enforce an agreement to arbitrate.

To read ABI's discussion of *Henry*, [click here](#).

We will not be surprised if the lender takes Judge Novak's opinion to the Fourth Circuit, because the panel on *CashCall* was divided, and the applicability of the majorities' opinions is not free from doubt.

[The opinion is](#) *Allied Title Lending LLC v. Taylor*, 18-845 (E.D. Va. Oct. 22, 2019).



*Someday, the Supreme Court will decide whether bankruptcy has an exemption from arbitration not available in ordinary commercial litigation.*

## **District Court Overrides Arbitration on Disputes Regarding Defective Proofs of Claim**

A debtor cannot be forced into individual arbitration after filing a class action suit in bankruptcy court alleging that a buyer of defaulted debt violated Bankruptcy Rule 3001, according to District Judge Elizabeth K. Dillon of Roanoke, Va. Judge Dillon upheld Bankruptcy Judge Rebecca B. Connelly of Harrisonburg, Va.

One of these days, the Supreme Court will set down what the limits are on a bankruptcy judge's ability to override an arbitration agreement. If it turns out that bankruptcy cases are subject to the ordinary rules for commercial litigation, all manner of disputes over claims will end up in arbitration.

### The Defective Proofs of Claim

Two chapter 13 debtors filed adversary proceedings against a buyer of defaulted credit card debt. In their class action complaints, they alleged that the creditor violated Bankruptcy Rule 3001 and the federal Fair Debt Collection Practices Act, or FDCPA, 15 U.S.C. § 1692-1692p. Specifically, the debtors contended that the debt collector violated Rule 3001(c)(2)(A) by incorrectly stating in the proofs of claim that the claims did not include interest, fees or other charges. The complaint also alleged that the debt collector did not file itemized statements of the interest, fees and other charges within 30 days of a request by a debtor, in violation of Rule 3001(c)(3)(B).

The bankruptcy court consolidated the two suits. The agreements with the credit card lender contained arbitration clauses.

The debt collector filed a motion to dismiss and a motion to compel the debtors to pursue individual arbitration. Bankruptcy Judge Connelly denied the motion to compel arbitration. She also retained jurisdiction over the FDCPA claims until deciding whether the debt collector had violated the Bankruptcy Rules.

The debt collector appealed both rulings, but Judge Dillon affirmed in an 11-page opinion on August 13.



## Judge Dillon's Ruling

The standard on appeal was somewhat complex. Judge Dillon conducted *de novo* review on the question of whether the bankruptcy court had discretion to deny arbitration. Were she to conclude that the bankruptcy court had discretion to deny arbitration, then she would review that decision for abuse of discretion.

Judge Dillon recited Fourth Circuit rules on compelling arbitration. To override an arbitration clause, the court must find that Congress demonstrated “an intention to preclude a waiver of judicial remedies for the statutory rights at issue.” *Moses v. CashCall Inc.*, 781 F.3d 63, 71 (4th Cir. 2015). The requisite intent may be found in the statutory text, legislative history or “an inherent conflict between arbitration and the statute’s underlying purpose.” *Id.*

Judge Dillon said that the status of claims as core or non-core is “[i]mportant but not dispositive.” Again citing *Moses*, she said that the fundamental question is “whether compelling arbitration for a claim would inherently undermine the Bankruptcy Code’s animating purpose of facilitating efficient reorganization . . . through” centrality of administration.

Adopting Judge Connelly’s analysis, Judge Dillon said that a violation of Rule 3001 “is not a private right of action.” The bankruptcy court, she said, has discretion to enforce the rules “by imposing sanctions if the standards are not met.” In turn, Rule 3001(c) gives the bankruptcy court discretion to bar the admission of evidence if the rule has been violated. The court also has discretion to enforce the rules by the imposition of other sanctions, such as allowance of attorneys’ fees and expenses.

Applying the law to the facts, Judge Dillon concluded that two “animating purposes” of the Bankruptcy Code “would be severely undermined if a distant arbitrator was tasked with the discretion to determine if a creditor should be sanctioned for a Rule 3001 violation.” She was alluding to the “prompt administration of the bankruptcy estate and the centralization of disputes regarding a debtor’s legal obligations.”

Judge Dillon went on to say that Bankruptcy Judge Connelly did not abuse her discretion because “giving an arbitrator supervisory authority over the claims-filing process would substantially interfere with plaintiffs’ efforts to reorganize their financial affairs in bankruptcy.”

Judge Dillon also ruled that Bankruptcy Judge Connelly had not abused her discretion in retaining jurisdiction over the FDCPA claims. In the eyes of Judge Connelly, those claims amounted to deciding whether the debt collector complied with the Bankruptcy Rules.

Because the bankruptcy court had not “definitively ruled” on whether the FDCPA claims should go to arbitration, Judge Dillon said there was no abuse of discretion in retaining jurisdiction pending a ruling on the Rule 3001 issue. She authorized the debt collector to “renew its argument





in favor of arbitration [on the FDCPA claims] after the bankruptcy court resolves the Rule 3001 issues.”

## The Supreme Court on Arbitration

How the Supreme Court will come down ultimately on arbitration in the bankruptcy context is far from clear. In nonbankruptcy disputes, the high court has been enforcing arbitration clauses to the hilt.

In the Court's last term, the justices ruled unanimously that a federal court cannot disregard an arbitration clause even if the demand for arbitration is “wholly groundless.” Rather, the judge must submit the arbitrability question to the arbitrator even if the demand for arbitration appears frivolous to the district court. *Henry Schein Inc. v. Archer & White Sales Inc.*, 139 S. Ct. 524, 202 L. Ed. 2d 480 (Sup. Ct. Jan. 8, 2019).

If there were no special rules for bankruptcy, *Henry Schein* would give arbitrators responsibility for deciding whether they would rule on core bankruptcy issues such as allowances of claims or dischargeability of debts.

Indeed, a bankruptcy court has allowed an arbitrator to rule on the discharge of student loans. See *Williams v. Navient Solutions LLC (In re Williams)*, 564 B.R. 770 (Bankr. S.D. Fla. 2017). On the other hand, the Second Circuit overrode an arbitration agreement by finding a severe conflict with the Bankruptcy Code and allowing a debtor to mount a class action contending that the creditor had violated the discharge injunction. *One Bank NA v. Anderson (In re Anderson)*, 884 F.3d 382 (2d Cir. March 7, 2018), *cert. denied* Oct. 1, 2018.

However, *Anderson* and the other circuit decisions overriding arbitration agreements in bankruptcy cases were decided before *Epic Systems Corp. v. Lewis*, 138 S. Ct. 1612, 1624 (May 21, 2018), where the Supreme Court held that the language of a statute must be “clear and manifest” before a court can disregard an arbitration agreement. *Epic* was a 5/4 decision, with the justices divided on ideological grounds.

The question comes down to this: Will the Supreme Court find “clear and manifest” language in the Bankruptcy Code allowing bankruptcy courts to disregard arbitration agreements? And if arbitration must proceed regarding some but not all disputes in the bankruptcy court, what is the line of demarcation? Is it core versus noncore? Will it matter if the creditor has filed a claim? What if a creditor files a claim but demands arbitration?

Conceivably, the Supreme Court could hand down a rule where a bankruptcy case will be running in tandem with one or more arbitrations, causing delay and expense for the debtor. Consumer debtors, in particular, may be unable to afford arbitration, and simultaneous arbitrations might kill a chapter 11 reorganization.





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The centrality of administration may lead the Supreme Court to exempt bankruptcy from general rules governing arbitrability. On the other hand, the Bankruptcy Code has no explicit exceptions regarding arbitration.

To read ABI's discussion of *Henry Schein*, [click here](#).

The opinion is *Midland Funding LLC v. Thomas*, 18-00128, 2019 BL 300579, 2019 US Dist Lexis 136758 (W.D. Va. Aug. 13, 2019).



*Florida case raises the question of whether the Supreme Court will eventually give bankruptcy a general exemption from arbitration, or an exemption only for core proceedings.*

## **Proceedings for Contempt Discharge Held Not Subject to Arbitration**

Proceedings for contempt of the discharge injunction were not within the scope of an arbitration agreement, according to bankruptcy and district judges in Tampa, Florida.

A chapter 7 debtor scheduled a cell phone provider's \$500 claim and later received a general discharge. The creditor never appeared in the bankruptcy case and did not challenge the debtor's discharge.

Five months after discharge, the creditor sent the debtor a letter demanding payment of the debt. The debtor responded with proceedings to hold the creditor in contempt of the discharge injunction.

Citing a broadly worded arbitration clause in the customer agreement with the debtor, the creditor moved to compel arbitration of the contempt allegations.

Bankruptcy Judge Roberta C. Colton of Tampa denied the arbitration motion.

The creditor appealed, but District Judge Steven C. Merryday of Tampa upheld Judge Colton for two independent reasons.

In his three-page opinion on September 24, Judge Merryday first ruled that the contempt proceedings were not within the scope of the arbitration agreement.

Judge Merryday said that the creditor "must establish that the parties agreed to arbitrate the dispute." There was no dispute, he said, that the debt was discharged.

The debtor, Judge Merryday said, was claiming that the creditor violated the discharge injunction and was not alleging a violation of the customer agreement. Thus, he ruled that the contempt proceedings were not within the scope of the arbitration agreement because the allegations did not relate to or arise from the customer agreement.



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The powers of the bankruptcy court provided the second reason for deciding that the contempt proceedings were not arbitrable.

Judge Merryday said that the bankruptcy court “retains the inherent power to enforce an order.” He cited Eleventh Circuit authority for the principle that contempt proceedings are an action of the court, although begun by a party.

Judge Merryday held that the customer agreement could not “deprive the bankruptcy court of the inherent power to enforce compliance with an injunction, the issuance of which was lawful, uncontested, and binding.”

## Observations

The customer agreement in the case on appeal evidently did not call for arbitrators to determine whether a particular dispute was within the scope of the arbitration agreement. If the agreement had called for arbitrators to rule on whether a dispute was arbitrable, Judge Merryday would have confronted an issue decided last term by the Supreme Court in *Henry Schein Inc. v. Archer & White Sales Inc.*, 139 S. Ct. 524, 202 L. Ed. 2d 480 (Sup. Ct. Jan. 8, 2019).

In *Henry Schein*, the high court reiterated and expanded the notion that arbitrators have the exclusive right to determine whether a dispute is within the scope of the arbitration agreement if the agreement submits the issue to the arbitrators.

Is *Henry Schein* applicable to bankruptcy cases and to contempt proceedings in particular? If the customer agreement called for arbitrators to decide whether a dispute was subject to arbitration, would Judge Merryday have been required to submit the arbitrability issue to arbitration?

Or, are disputes that arise in bankruptcy cases generally exempt from arbitration? And if there is an exemption from arbitration, does it apply only to “core” proceedings?

We raise these issues because the Supreme Court in recent terms has become increasingly emphatic about compelling arbitration while finding fewer loopholes to avoid arbitration.

## *Shearson, Epic and Schein*

In 1987, the Supreme Court ruled that a court could decline to enforce an arbitration agreement if there was an inherent conflict between arbitration and the statute’s underlying purpose. *Shearson/American Express Inc. v. McMahon*, 482 U.S. 220, 227 (1987).

Building on *McMahon*, the Second, Fourth, Fifth and Ninth Circuits have held in bankruptcy cases that the court may decline to compel arbitration if the issue is “core” and arbitration would represent a “severe conflict” with the Bankruptcy Code.



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Last year, the Second Circuit utilized that concept to override an arbitration agreement when a debtor mounted a class action contending that the creditor had violated the discharge injunction. *One Bank NA v. Anderson (In re Anderson)*, 884 F.3d 382 (2d Cir. March 7, 2018), *cert. denied* Oct. 1, 2018.

*Anderson* and the other circuit decisions overriding arbitration agreements in bankruptcy cases were all decided before *Epic Systems Corp. v. Lewis*, 138 S. Ct. 1612, 1624 (May 21, 2018), where the Supreme Court held that the language of a statute must be “clear and manifest” before a court can disregard an arbitration agreement. In *Epic*, the Supreme Court nixed a class action and required individual arbitration of a former employee’s claim that the employer’s failure to pay overtime violated the Fair Labor Standards Act.

*Epic* was a 5/4 decision, with the justices divided on ideological grounds.

## Applying *Epic* and *Schein* to Bankruptcy Cases

Assume that a debtor and a creditor had a prebankruptcy agreement to arbitrate all disputes, including any arising in bankruptcy, such as the allowance of claims, counterclaims, preferences, adequate protection, dischargeability and contempt. Further assume that the agreement calls for the arbitrator to decide whether the dispute is arbitrable, even following bankruptcy.

If *Epic* and *Schein* were applied rigorously and without exception, a bankruptcy judge arguably would have no right to bar the creditor from initiating arbitration, even if the dispute raised a core issue such as the allowance of a claim, dischargeability, adequate protection or contempt of the discharge injunction.

Will the Supreme Court eventually rule that the Bankruptcy Code evidences a “clear and manifest” exception to the rule that federal courts must enforce arbitration agreements? Or will the justices lay down a separate rule for deciding when a bankruptcy court must compel arbitration?

If *Epic* and *Schein* apply in bankruptcy, consumer debtors will be arbitrating the allowance of claims and dischargeability, and chapter 11 debtors will be defending or prosecuting defending dozens of arbitrations. Bankruptcy will have less efficacy for debtors if arbitration agreements are generally enforceable.

The opinion is *Verizon Wireless Personal Communications LP v. Bateman (In re Bateman)*, 18-1394 (M.D. Fla. Sept 24, 2019).



## *Wages & Dismissal*





*If the involuntary corporate debtor was deadlocked and unable to act, the dissenter would have permitted a 50% shareholder to seek damage for dismissal of the petition.*

## **Ninth Circuit Bars Third Parties from Seeking Damages for Dismissal of an 'Involuntary'**

Over a dissent, the Ninth Circuit held on April 29 that a 50% shareholder of an involuntary debtor cannot seek damages for dismissal of the involuntary petition, even if the debtor itself was deadlocked and unable to act in response to the petition.

The involuntary corporate debtor had two 50% shareholders. A vote of two-thirds of the board or of the shareholders was required for the company to act.

According to the dissent by Circuit Judge Mark J. Bennett, one 50% shareholder wanted to liquidate the debtor over the objection of the other. A creditor, who was a contingent shareholder, filed an involuntary petition.

The debtor corporation was deadlocked and unable to respond to the involuntary petition. The 50% shareholder who opposed liquidation filed a motion to dismiss the petition. According to the dissenter, the opposing shareholder also sought attorneys' fees and damages on behalf of the involuntary debtor.

According to the majority opinion by Fourth Circuit Judge Stephanie Dawn Thacker, sitting by designation, the petitioning creditor conceded at the hearing on the motion to dismiss that dismissal was proper. However, the bankruptcy court ruled that the opposing shareholder who won dismissal lacked standing to seek damages and attorneys' fees.

To read ABI's report on the affirmance in district court ruling that the shareholder could not seek damages, [click here](#).

If the court dismisses a petition, Section 303(i) provides that "the court may grant judgment—

- (1) against the petitioners and in favor of the debtor for—
  - (A) costs; or
  - (B) a reasonable attorney's fee; or
- (2) against any petitioner that filed the petition in bad faith, for—
  - (A) any damages proximately caused by such filing; or
  - (B) punitive damages."



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Note that the phrase “in favor of the debtor” appears in subsection (1) but not in (2).

Upholding the lower courts, Judge Thacker in substance ruled for the majority that the case was controlled by *Miles v. Okun (In re Miles)*, 430 F.3d 1083 (9th Cir. 2005). She appeared to read Section 303(i) as meaning that a non-debtor cannot seek damages for dismissal of an involuntary petition.

Judge Thacker based her conclusion on *Miles*, legislative history, an opinion by the Ninth Circuit Bankruptcy Appellate Panel, and the purpose of the statute to “alleviate the consequences that involuntary proceedings impose on the debtor.” She said that a third party “does not face those consequences.”

Dissenting, Judge Bennett said that the majority read *Miles* to mean that a third party who defeats an involuntary petition “can never request that the debtor be awarded costs, a reasonable attorney’s fee, or damages.” “*Miles* never went so far,” he said. The majority’s opinion, in his view, was “inconsistent with both the relevant statutory authority and the policies underlying the Bankruptcy Act.” [*sic.*]

Judge Bennett emphasized how the shareholder was seeking damages and attorneys’ fees “on behalf of the debtor.” He cited a bankruptcy court in Illinois, where someone who was in “a close relationship with the debtor” was permitted to collect damages and fees. *In re Fox Island Square Partnership*, 106 B.R. 962, 968 (Bankr. N.D. Ill. 1989).

The shareholder should have been allowed to seek fees and damages because it “was truly the only party willing and able to act” for the deadlocked corporate debtor. He distinguished *Miles*, because it involved “true third parties.” On the other hand, the opposing shareholder, he said, was “not such an independent third party — it was acting as a 50% shareholder during a corporate governance breakdown.”

Judge Bennett would have remanded the case for the bankruptcy court to determine whether anyone else could have opposed on behalf of the debtor and whether the petition was filed in bad faith. If the answers came in the right way, he would have allowed the bankruptcy court to fix appropriate fees and damages “in light of the totality of the circumstances.”

[The opinion is](#) *Vibe Micro Inc. v. SIG Capital LLC (In re 8Speed8 Inc.)*, 921 F.3d 1193 (9th Cir. April 29, 2019).



*Copious disclosure required for post-petition payment of fees to be permissible in chapter 7.*

## **Bifurcated Fees for Destitute Chapter 7 Debtors Approved in Utah**

To make chapter 7 accessible for those who can't pay fees before filing, Bankruptcy Judge Kevin R. Anderson of Salt Lake City laid down extensive guidelines and disclosure requirements enabling lawyers to use so-called bifurcated fee arrangements, where the debtor pays all costs and fees in installments *after* filing.

### Blame the Supreme Court for the Problem

In *Lamie v. U.S. Trustee*, 540 U.S. 526 (2004), the Supreme Court held that a chapter 7 debtor's counsel fees cannot be paid from estate property, and any prepetition obligation for unpaid attorneys' fees is dischargeable. In his April 10 opinion, Judge Anderson said that the "predicament" created by the high court "precipitated the concept of bifurcated fee agreements in consumer cases."

Often, Judge Anderson said, individuals needing immediate chapter 7 relief lack the cash to pay an attorney up front. Those consumers have "three ineffectual options," he said. They can file *pro se*, but 30% never receive a discharge. Second, "and more problematic," they can use a petition preparer.

Third, destitute debtors can file chapter 13 petitions to pay counsel fees through the plan, but they are bound to the bankruptcy process for three to five years when they would be eligible for an immediate chapter 7 discharge had they the resources to pay a prepetition retainer.

For a fourth and effective option, an enterprising attorney in Salt Lake City developed elaborate disclosures and procedures allowing a chapter 7 debtor to pay all costs and attorneys' fees after filing.

### The Solution

The lawyer gave the client three options. The client could pay a \$2,400 prepetition retainer to cover services throughout the subsequent chapter 7 case. Second, the lawyer could take \$500 to prepare and file a bare-bones petition, allowing the client proceed *pro se* or hire another lawyer after filing.



# ROCHELLE'S DAILY WIRE

Third, the lawyer offered a bifurcated fee arrangement, also known as a “zero-down option.” The client would pay nothing up front, but the lawyer would file a bare-bones petition. After filing, the debtor would sign a retainer agreement calling for 10 monthly payments of \$240, to be deducted automatically from a bank account.

Judge Anderson explained how the lawyer gave the client “a multitude of disclosures, explanations and warnings regarding the fee arrangement, the bankruptcy process and the “possible use of . . . a third party [factor] to collect the payments.” In addition, the judge said the lawyer gave the client written information and instructions, including 50 paragraphs of disclosures and explanations that the client was required to read and initial.

The client agreed to the bifurcated arrangement and paid nothing before filing. The lawyer filed the petition, and the client received a discharge 115 days later in the course of an uneventful chapter 7 case.

More than one year after the entry of discharge, the U.S. trustee filed a motion asking the court to cancel the fee arrangement, require the attorney to disgorge all fees, and impose sanctions. At oral argument, Judge Anderson said the U.S. trustee was more interested in “obtaining guidance from the court” than in sanctioning the lawyer.

## Copious Disclosure Is the Key

In a 27-page opinion worthy of reading in full text, Judge Anderson exonerated the debtor’s lawyer.

Judge Anderson ruled that bifurcated fee arrangements “to effectuate affordable legal services” in consumer chapter 7 cases are not prohibited *per se* by the Bankruptcy Code, nor do they “*per se* implicate ethical issues and they are not *per se* unfair.”

“With appropriate disclosures,” Judge Anderson held, “debtors can make informed decisions as to the risks and benefits of incurring a post-petition obligation in order to retain an attorney’s services.” He said the lawyer “had a reasonable basis to employ bifurcated fee arrangements when clients were unable to pay a full retainer prior to the bankruptcy filing.”

Judge Anderson found that “this process did not harm the Debtor. Indeed, it facilitated the Debtor’s ability to afford legal counsel to expeditiously receive a discharge.”

According to Judge Anderson, the “propriety of using bifurcated fee arrangements” is “directly proportional to the level of disclosure and information” provided to the client. In the case at bar, he said the documents given to the client “satisfy the requirements of full disclosure and informed consent.”



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Judge Anderson laid down what he called “essential practices” when using a bifurcated fee arrangement.

Naturally, the fee must be reasonable but not necessarily the same that a client would pay up front. Still, the “pricing differential must be based on reasonable and quantifiable factors, and it must not include the cost of pre-petition services,” Judge Anderson said.

Judge Anderson found that the fee was reasonable, because the client was paying about \$2,000 after deducting the filing fee. The lawyer kept time records, showing that the lodestar fee would have been \$2,240.

Finally, Judge Anderson dealt with the factoring arrangement where the collection agency paid the law firm \$1,800 for the right to collect \$2,400. The lawyer disclosed the discount to the client, but the factoring arrangement was not revealed in the lawyer’s disclosure of compensation filed with the court.

Judge Anderson quoted from a state bar association ethics opinion saying, among other things, that the client must consent to the sale of the receivable and be offered the same discount. The judge said he would “discourage” the use of a factoring arrangement “unless it strictly complies with the guidance from” the bar association’s ethics opinion.

Judge Anderson granted summary judgment in favor of the lawyer dismissing the U.S. Trustee’s motion for sanctions and disgorgement.

[The opinion is](#) *In re Hazlett*, 16-30360, 2019 BL 130455 (Bankr. D. Utah April 10, 2019).





## *Plans & Confirmation*



*Joining two other circuits, the Fourth Circuit now permits a chapter 13 debtor to strip down a short term home mortgage to the value of the property.*

## **Fourth Circuit Eliminates a Split on Modifying Short Term Mortgages in Chapter 13**

Sitting *en banc*, the Fourth Circuit voted 11-3 to overrule its own precedent and held that Section 1322(c)(2) permits a debtor to strip down a claim on a home mortgage that matures before the last payment is due under a chapter 13 plan. In other words, a debtor with an underwater, short term mortgage is only required to pay the value of the home and may discharge the remainder as an unsecured claim.

The 11-3 decision eliminated a split of circuits by aligning the Fourth Circuit with the Eleventh Circuit's opinion in *American General Finance Inc. v. Paschen (In re Paschen)*, 296 F.3d 1203, 1209 (11th Cir. 2002). However, the dissenters in the Fourth Circuit believe that Section 1322(c)(2) only permits modifying the payment schedule in a short term mortgage, not the amount of the claim.

Oddly, the Fourth Circuit had validated the so-called chapter 20 strategy six years ago in *Branigan v. Davis (In re Davis)*, 716 F.3d 331 (4th Cir. 2013), a seemingly more exaggerated employment of the same provisions of the Bankruptcy Code.

In a chapter 20 case, the consumer first files under chapter 7 to extinguish personal liability on an underwater mortgage. Later, the consumer initiates a separate chapter 13 case to strip off the mortgage lien that survived chapter 7 as an *in rem* liability solely against the real property. Although the Supreme Court's 1992 *Dewsnup* decision holds that a mortgage cannot be stripped off in chapter 7, the high court so far has thrown up no explicit roadblock to prevent chapter 20 from stripping off an underwater mortgage.

### The Facts

The debtor purchased a home for \$136,000, paying \$5,000 down and giving the seller a purchase money, 10-year, interest-only mortgage for \$131,000. Before bankruptcy, the mortgage matured, but the debtor did not refinance the mortgage or pay off the balance.

The holder of the mortgage initiated foreclosure proceedings that were halted when the debtor filed a chapter 13 petition. The debtor submitted a chapter 13 plan pegging the value of the home



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at \$47,000, the amount shown in a recent appraisal. There was a tax lien of approximately \$6,000 on the home.

The plan bifurcated the lender's claim into a secured claim of about \$41,000, representing the \$47,000 value of the home less the tax lien. The plan called for paying off the \$41,000 over the five-year life of the plan with interest at 4.5%.

The plan classified the remainder of the lender's claim as an unsecured claim to receive no payment under the plan.

Bound by the Fourth Circuit's precedent in *Witt v. United Companies Lending Corp. (In re Witt)*, 113 F.3d 508 (4th Cir. 1997), the bankruptcy court sustained the lender's objection to the plan. *Witt* held that Section 1322(c)(2) only permits modifying the payment schedule of a short term mortgage, not the amount of the secured claim.

The district court affirmed and so did a three judge panel of the Fourth Circuit. The appeals court granted rehearing *en banc* and heard oral argument in January.

## *Nobelman, Rash* and the Statutory Provisions

Section 506(a) provides for bifurcating a claim of a secured creditor, that is, allowing a secured claim to the extent of the value of the collateral together with an unsecured claim to the extent that the claim exceeds the value of the collateral. Section 1325(a)(5) provides that cramdown is one of the methods for dealing with a secured claim in a chapter 13 plan.

Section 1322(b)(2) allows a chapter 13 plan to modify secured claims, but not "a claim secured only by a security interest in real property that is the debtor's principal residence." In *Nobelman v. American Savings Bank*, 508 U.S. 324 (1993), the Supreme Court interpreted Section 1322(b)(2) to mean that a chapter 13 debtor may not employ Section 506(a) to strip down an undersecured home mortgage, that is, reduce the amount of the mortgage to the fair market value of the residence.

On the heels of *Nobelman* and as part of the Bankruptcy Reform Act of 1994, Congress added 1322(c)(2). "Notwithstanding subsection (b)(2) and applicable nonbankruptcy law," subsection (c)(2) becomes applicable when the last payment on a debtor's home mortgage falls before the last payment under the chapter 13 plan. In those circumstances, subsection (c)(2) permits the chapter 13 plan to "provide for the payment of the claim as modified pursuant to section 1325(a)(5)."

In *Associates Commercial Corp. v. Rash*, 520 U.S. 953, 957 (1997), the Supreme Court ruled that a chapter 13 debtor may cram a plan down on a secured creditor under Section 1325(a)(5) as long as the debtor pays the "total the present value of the allowed secured claim" under Section 506(a).



## The Majority's Opinion on Rehearing *En Banc*

*Witt* was not popular among courts and commentators. In *Paschen*, the Eleventh Circuit declined to follow *Witt*, and the *Collier* treatise disagreed with the result in *Witt*. In his May 24 opinion, Circuit Judge James A. Wynn, Jr., explained why the Fourth Circuit was overruling *Witt* and aligning with “every other court that has considered the issue.”

According to Judge Wynn, the “plain text” of Section 1322(c)(2) permits modifying a mortgage when the last payment is due before the last payment under the plan. *Witt*, he said, incorrectly concluded that the subsection was ambiguous.

Judge Wynn defined the question as follows: Does the phrase “payment of the claim as modified pursuant to section 1325(a)(5)” allow the debtor to modify the amount of the secured claim or only the payment schedule? In other words, does the subsection permit reducing the amount of the secured claim to the value of the property or does it only allow the debtor to stretch out payment of the entire claim (secured and unsecured) over the life of the plan?

Judge Wynn said that other courts “universally criticized *Witt*'s finding of ambiguity and attendant reliance on the statute's legislative history.” For instance, *Collier* said that *Witt* was contrary to canons of statutory construction.

Differing with the conclusion reached by a panel 22 years earlier, Judge Wynn said that the “most natural reading of statutory language” in subsection (c)(2) “allows bifurcation of such claims into secured and unsecured components” when a home mortgage matures before the last payment under the plan. He therefore reversed and remanded, because the statute permits the debtor to strip down a short term mortgage to the value of the property, not merely to modify the payment schedule.

On behalf of the National Association of Bankruptcy Attorneys and the National Consumer Bankruptcy Rights Center, Tara Twomey submitted an *amicus* brief supporting the debtor's petition for rehearing *en banc*.

## The Dissenters

Circuit Judge J. Harvie Wilkinson, III, dissented, joined by Circuit Judges Barbara Milano Keenan and Stephanie D. Thacker. They continue to believe that subsection (c)(2) only permits altering the payment schedule on a home mortgage.

Beyond the significance of the case for chapter 13 debtors, the opinions by the majority and the dissent are important for their differing approaches to statutory interpretation when Congress has overruled or modified a decision from the Supreme Court. The dissenters do not believe the



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statute itself and its legislative history clearly showed that Congress intended to change the result of *Nobelman* in some situations.

The opinion is *Hurlburt v. Black*, 17-2449, 2019 BL 191177, 2019 Us App Lexis 15603 (4th Cir. May 24, 2019).





*BAP reversed the bankruptcy court's ruling that personal liability on a discharged debt was resurrected in 'chapter 20.'*

## **Ninth Circuit BAP Squarely Upholds 'Chapter 20': No Lien and No Claim Survive**

At least when the debtor is eligible for a discharge in chapter 13, the Ninth Circuit Bankruptcy Appellate Panel squarely holds that a debtor may employ so-called chapter 20 to strip off an underwater subordinate mortgage while simultaneously avoiding personal liability for the debt.

The typical chapter 20 case works like this: The consumer first files under chapter 7 to extinguish personal liability on an underwater home mortgage. Later, sometimes the day after receiving a chapter 7 discharge, the consumer files a separate chapter 13 case to strip off the mortgage lien that survived chapter 7 as an *in rem* liability solely against the real property.

Although the debtor may not be eligible for a discharge in chapter 13, the debtor can strip off the subordinate lien by full payment under the plan of whatever unsecured debts she or he has.

Two Supreme Court decisions potentially bear on the issue. The Supreme Court held in 1992 in *Dewsnup* that a mortgage cannot be stripped off in chapter 7. *Dewsnup v. Timm*, 502 U.S. 410 (1992). In *Bank of America N.A. v. Caulkett*, 135 S. Ct. 1995 (2015), the high court held that a debtor may not strip down a mortgage in chapter 7.

So far, the Supreme Court has erected no explicit roadblock to prevent chapter 20 from stripping off an underwater mortgage.

### The Facts in the BAP

The facts in the BAP were actually better for the debtor than in the typical chapter 20 case. The debtor was eligible for a chapter 13 discharge because she filed the new petition more than four years after the order for relief in her prior chapter 7 case. See Section 1328(f)(1).

The debtor owned a home worth \$410,000. It was subject to a \$580,000 first mortgage. The home was also subject to a second mortgage of some \$300,000, but the debtor's personal liability on the second mortgage had been eliminated by the prior chapter 7 discharge.

On motion by the debtor but without opposition from the holder of the second mortgage, the bankruptcy court valued the lien of the second mortgage at zero.



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Later, the holder of the second mortgage filed an unsecured claim for \$300,000.

The bankruptcy court overruled the debtor's objection to the unsecured claim, ruling that the valuation of the lien at zero required the debtor to provide for the claim in full in her chapter 13 plan.

The debtor appealed and won in a July 30 opinion for the BAP written by Bankruptcy Judge William Lafferty.

## The Circuit and BAP Authorities

Two precedents provided guidance for the BAP.

In *HSBC Bank USA N.A. v. Blendheim (In re Blendheim)*, 803 F.3d 477 (9th Cir. 2015), the Ninth Circuit held that a debtor could strip off a subordinate mortgage in chapter 20. Technically speaking, the appeals court did not rule on whether the holder of the subordinate mortgage enjoyed an unsecured claim that somehow arose from the dead in the subsequent chapter 13 case.

The second, analogous authority came from the BAP itself. *Free v. Malaier (In re Free)*, 542 B.R. 492 (9th Cir. BAP 2015). There, the BAP held that personal liability on an underwater mortgage that had been extinguished in a prior chapter 7 discharge is not counted toward eligibility in subsequent chapter 13 filing.

Reversing the bankruptcy court, Judge Lafferty interpreted the authorities to mean that the unsecured claim of the subordinate lienholder "should have been disallowed." He found "simply no statutory basis for resurrecting the debtor's personal liability or for treating the claim as a claim against the estate."

Furthermore, Judge Lafferty said that the lien claim "was conditionally avoided through the valuation motion." If the debtor were to complete payments under a chapter 13 plan, the lien would be stripped off, and she would continue having no personal liability on the subordinated mortgage debt.

To read ABI's report on the bankruptcy court's decision that was reversed, [click here](#).

The opinion is *Washington v. Real Time Resolution Inc. (In re Washington)*, 18-1206, 2019 BL 284935 (B.A.P. 9<sup>th</sup> Cir. July 30, 2019).



*BAP holds that an individual in chapter 11 isn't required to contribute new value to retain exempt property.*

## **Absolute Priority Doesn't Require an Individual Debtor to Pay for Exempt Property**

Taking sides on an issue where the lower courts are divided, the Ninth Circuit Bankruptcy Appellate Panel held that an individual in chapter 11 may confirm a plan and “retain *exempt* property without making a commensurate ‘new value’ contribution.” [Emphasis added.]

A real estate broker filed a chapter 11 petition to deal with priority tax claims and creditors claiming \$260,000 for fraud and breach of contract. The debtor claimed a \$150,000 Arizona homestead exemption in a home allegedly worth \$300,000. The home was subject to a \$156,000 mortgage.

The debtor filed a chapter 11 plan calling for a third party to contribute \$15,000 to increase the distribution to unsecured creditors to about 5%. The contribution was designed to represent “new value” enabling the debtor to retain nonexempt property.

Dominated by creditors claiming \$260,000, the unsecured creditor class rejected the plan, compelling the debtor to cram down the plan on unsecured creditors under Section 1129(b)(2)(b). Based on that section and virtually every requirement in Section 1129(a), the creditors objected to confirmation.

Bankruptcy Judge Brenda Moody Whinery of Tucson, Ariz., overruled the objections and confirmed the plan.

The creditors appealed, but Robert J. Faris wrote the August 21 opinion for the BAP upholding confirmation. He affirmed most of the issues on appeal by finding no flaws in Judge Whinery's findings of fact. For example, he said that the \$15,000 of contributed new value allowed the debtor to retain nonexempt property.

Most prominently, Judge Faris addressed a question of first impression in the Ninth Circuit where lower courts are divided: May an individual debtor in chapter 11 retain exempt property without making a commensurate new value contribution?

The question implicates the so-called absolute priority rule in Section 1129(b)(2)(B). Judge Faris paraphrased the statute to mean that the court may cram the plan down on a dissenting class only if the plan “either provides for full payment of the dissenting class or provides that no junior



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class will receive or retain anything under the plan.” In other words, the creditors argued that the debtor violated the absolute priority rule by retaining exempt property for which the debtor paid nothing.

The rule has two exceptions. Section 1129(b)(2)(B)(ii) allows an individual debtor to retain post-petition property and income from post-petition services. The second exception is the so-called “new value” theory.

Judge Faris explained that the exception applies if the value is new, substantial, is made in “money or money’s worth,” is necessary for a successful reorganization, and is “reasonably equivalent to the value or interest received,” citing *Bonner Mall Partnership v. U.S. Bancorp Mortgage Co.* (*In re Bonner Mall Partnership*), 2 F.3d 899, 909 (9th Cir. 1993).

The creditors contended that the debtor contributed no new value equal to the value of his exempt assets.

Rejecting the creditor’s statutory interpretation, Judge Faris reworded Section 1129(b)(2)(B)(ii) to say that the debtor may not receive or retain “any property . . . under the plan on account of [the debtor’s interest] . . . .” He held that “exempt property is not properly included within the phrase ‘any property’ under the absolute priority rule.”

Judge Faris reached his conclusion for two reasons.

First, Judge Faris said that a “debtor does not retain exempt property either ‘under a plan’ or ‘on account of the debtor’s interest . . . .’ Rather, the debtor retains exempt property due to the exemption statutes.” The debtor, he said, would not retain exempt assets “under a plan” because the “debtor would be entitled to the exempt property even if no plan were confirmed.”

Second, Judge Faris said that the creditor’s interpretation of Section 1129(b) would conflict with Sections 522(c) and (k), which provide that exempt property “is not liable for the payment of prepetition claims or administrative expenses.” He said that “[r]equiring a debtor to pay for exempt assets via a new value contribution would effectively make those assets available to creditors.”

Consequently, Judge Faris concluded that “the bankruptcy court did not err in allowing [the debtor] to retain his exempt property without making a corresponding ‘new value’ contribution.”

[The opinion is](#) *Todeschi v. Juarez (In re Juarez)*, 19-1028, 2019 BL 313425, 2019 BankrL exis 2639 (B.A.P. 9th Cir. Aug. 21, 2019).





*In calculating eligibility for chapter 13, Judge Nevins in Connecticut differs from some other bankruptcy judges in the Second Circuit.*

## **Debt Discharged in Prior Chapter 7 Isn't Counted in Later Chapter 13 Eligibility**

On an issue where the courts are divided, Bankruptcy Judge Ann M. Nevins of New Haven, Conn., ruled that personal liability on a secured debt that was eliminated in a prior chapter 7 discharge is not counted toward the debt limits in a subsequent chapter 13 case.

The decision by Judge Nevins was informed in part by a decision from the Ninth Circuit Bankruptcy Appellate Panel on July 30. *Washington v. Real Time Resolution Inc. (In re Washington)*, 18-1206, 2019 BL 284935, 2019 Bankr. Lexis 2389, 2019 WL 345052 (B.A.P. 9th Cir. July 30, 2019).

In a so-called chapter 20 case, the BAP held in *Washington* that personal liability extinguished in a prior chapter 7 discharge is not resurrected and is not a claim to be paid in the debtor's subsequent chapter 13 case. To read ABI's discussion of *Washington*, [click here](#).

### The Extinguished (?) Personal Liability

Judge Nevins was ruling on motions by the trustee to dismiss two chapter 13 cases. Together, the debtors in both cases had owned a business that went belly up. They had both personally guaranteed about \$3 million in business debts and secured those debts with subordinate mortgages on their homes.

They had both filed chapter 7 petitions and received discharges in April 2013. The chapter 7 discharges standing alone meant that the debtors' personal liabilities on the \$3 million subordinate mortgages were no longer personal liabilities, although the chapter 7 discharges did not strip the mortgages from the homes. In legal parlance, the mortgages remained *in rem* liabilities encumbering the homes but not personal liabilities of the debtors themselves.

To strip down or strip off the subordinate mortgages from their homes, the debtors employed the so-called chapter 20 strategy by filing chapter 13 petitions in August 2018. Because the new filings were entered more than four years after their chapter 7 discharges, they were both theoretically eligible for discharges in the new chapter 13 cases.





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One debtor owned a home worth \$460,000 that had a first mortgage of about \$500,000. Standing alone, Section 506(a)(1) would treat the \$3 million subordinate mortgage as a wholly unsecured claim.

The second debtor owned a home worth \$175,000 that was subject to a \$140,000 first mortgage. Consequently, all but about \$35,000 of the \$3 million on the subordinate business mortgage would be treated as unsecured under Section 506(a)(1).

The debtors had incurred new unsecured and priority debts after receiving their chapter 7 discharges. They both filed chapter 13 plans proposing to pay \$1,400 a month for 60 months, representing a 21% dividend for unsecured creditors.

If the chapter 20 strategy holds up, and if they were to complete all payments under their chapter 13 plans, the debtors planned on stripping off most or all of the subordinate mortgages from their homes while paying nothing on those business debts, because they were no longer personal liabilities as a consequence of the chapter 7 discharges.

Nonetheless, the chapter 13 trustee filed a motion to dismiss, contending that the debts exceeded the limits in Section 109(a). That section makes an individual eligible for chapter 13 if the debtor “owes . . . unsecured debts of less than [\$394,725] and noncontingent, liquidated, secured debts of less than [\$1,184,200].”

Differing with some bankruptcy judges in the Second Circuit, Judge Nevins denied the motions to dismiss in an opinion on August 16 and held that the debtors were eligible for chapter 13, assuming that a later valuation trial confirms the debtors’ valuations of their homes.

## The Courts Are Split on ‘Eligibility’

If the \$3 million in subordinate mortgages were counted as either secured or unsecured debts, the debtors would be ineligible for chapter 13 under Section 109(a). In that regard, Judge Nevins cited decisions from bankruptcy courts in the Second Circuit holding that unsecured portions of liens can make a debtor ineligible for chapter 13 relief even though personal liability had been extinguished in a prior chapter 7 case. However, Judge Nevins was headed in a different direction.

Judge Nevins pointed out a subtle but critical distinction in the statutory language. Section 109(a) makes a debtor ineligible for chapter 13 if the debtor “owes . . . unsecured debts” of more than \$1,184,200. The statutory language is “debts,” not “claims.”

Judge Nevins said that a “debt is not the precise equivalent of a claim.” Consequently, she said that a “claim must be evaluated for enforceability . . . since, ‘not all claims are debts of the debtor,’” quoting the *Collier* treatise.



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Therefore, Judge Nevins said the statute imposes a “debt limit, not a claim limit.” In her view, Congress could have used the word “claim” but chose “debt” instead. Because the previously discharged subordinate mortgage debts were no longer “claims” against the debtors, they should not count toward the chapter 13 debt limits.

There was another problem, however. In chapter 20 cases, some courts have required debtors to pay previously discharged personal liabilities on subordinate mortgages in their subsequent chapter 13 plans. However, Judge Nevins adopted the position of “[m]any courts” and the *Collier* treatise by holding that nonrecourse debts should not be counted toward chapter 13 eligibility.

Alluding to holdings by some courts, the trustee insinuated that the debtors must treat the previously discharged personal liabilities from the prior chapter 7 cases as unsecured claims in the subsequent chapter 13 plans.

“I disagree,” Judge Nevins said. “While many courts would resurrect *in personam* liability and require such treatment,” she found the rationale of the Ninth Circuit BAP in *Washington* “to be more persuasive.” Reviving the previously discharged debt, she said, “would be to impose liability on a chapter 13 estate when none exists for the chapter 13 debtor.”

Although Judge Nevins upheld the theory behind the debtors’ chapter 13 plans, she called for a valuation hearing to confirm that the subordinate mortgages would be allowed as secured claims in amounts not exceeding the chapter 13 limits.

[The opinion is](#) *Napolitano v. Rumbin (In re Rumbin)*, 18-31424, 2019 BL 306726 (Bankr. D. Conn. Aug. 16, 2019).



## *Compensation*



*Indiana bankruptcy and district judges rule that secured lenders are only entitled to 'adequate protection' until the debtor's counsel's allowed fees have been paid in full.*

## **Debtors' Attorneys Are Paid in Chapter 13 Before Secured Creditors**

On an issue where the courts are divided, bankruptcy and district judges in Indianapolis allow a chapter 13 debtor's attorney to be paid in full before secured creditors receive more than adequate protection payments.

The chapter 13 debtor owed \$12,000 on a car he intended to retain. His lawyer had a \$3,900 allowed administrative claim. The debtor was paying the auto lender adequate protection payments of 1% a month.

The plan called for the debtor to pay his attorney's fees in full before starting to pay full monthly debt service on the auto lender's secured claim. The full monthly debt service of \$285 would begin in the 21st month of the plan. The adequate protection payments would cease when the monthly debt service began.

The lender objected to confirmation of the plan, contending that the debtor must begin paying full monthly debt service alongside payments on the attorney's priority claim.

Bankruptcy Judge James M. Carr of Indianapolis overruled the objection and confirmed the plan. Chief District Judge Jane Magnus-Stinson affirmed in an October 2 opinion. She explained that courts are split on the outcome and that no circuit has ruled on the question so far.

The appeal chiefly turned on Section 1326(b)(1), which provides that any unpaid administrative claims "shall" be paid "[b]efore or at the time of each payment to creditors under the plan."

Judge Magnus-Stinson said that courts are split three ways. Two groups of courts employ different rationales, but end up holding that the trustee cannot make only partial payments to the debtor's attorney while giving full debt service to a secured lender.

The third group, with the opposite result, requires full debt service to secured lenders upon confirmation.



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Judge Magnus-Stinson sided with the decision by Bankruptcy Judge Marvin Isgur of Houston in *In re DeSardi*, 340 B.R. 790 (Bankr. S.D. Tex. 2006). Like Judge Isgur, she held that the attorney's administrative claim must be paid in full before the lender receives anything other than adequate protection.

Judge Magnus-Stinson found the answer in the "plain language" of Section 1326(b)(1), which says that unpaid administrative claims "shall be paid" either "[b]efore or at the time of each payment to creditors under the plan." She reasoned that adequate protection is paid "independent of the plan" and therefore "can begin before any plan is approved and do[es] not necessarily have to be provided for in the plan."

Therefore, Judge Magnus-Stinson concluded that unpaid attorneys' fees "'shall be paid' either 'before or at the time of each' [regularly monthly] payment [of debt service] required by the plan."

Judge Magnus-Stinson agreed with a second reason given by Judge Isgur: "[T]he most natural reading of the phrases 'any unpaid claim' and 'shall be paid' is that any outstanding balance owed must be paid in full."

As a third reason for her conclusion, Judge Magnus-Stinson said that the plain language of Section 1326(b)(1) "would not be satisfied" if full monthly payments were made simultaneously to the attorney and the auto lender.

Judge Magnus-Stinson therefore held that Section 1326(b)(1) "requires that an administrative claim for the debtor's attorney's fees be paid in full before or at the same time as [full debt service] payments to secured creditors begin." In that regard, she noted that the Code does not say when full debt service begins or ends.

Judge Magnus-Stinson found a practical reason for her conclusion.

If full debt service and full monthly payments to secured creditors must begin on confirmation, the statute would effectively mean that debtors would be required to pay administrative claims in full in the first month after confirmation, but, Judge Magnus-Stinson said, "it is unlikely that a bankrupt debtor would be able to pay the entire attorney fee and all [full monthly debt service] to secured creditors at the same time."

The result would be "absurd and infeasible," Judge Magnus-Stinson said, if the statute required payments that many debtors could not make.

Finally, Judge Magnus-Stinson said that her holding "is consistent with the policy of incentivizing attorneys to participate in bankruptcy proceedings."

[The opinion is](#) *Credit Acceptance Corp. v. Thompson*, 19-1802 (S.D. Ind. Oct. 2, 2019).





## *Exemptions*



*Courts are split on whether creditors in chapter 13 are entitled to the postpetition appreciation in a debtor's property.*

## **Chapter 13 Debtor Keeps Postpetition Appreciation in Nonexempt Property, BAP Says**

Differing with the First Circuit, the Ninth Circuit Bankruptcy Appellate Panel allowed a chapter 13 debtor to retain the post-petition increase in value of a nonexempt asset.

Building on a prior Ninth Circuit BAP opinion, Bankruptcy Judge Robert J. Faris said in his December 31 decision that the “chapter 13 deal” allows a debtor to retain all prepetition property, such as money and real estate, in exchange for committing all postpetition disposable income to the payment of unsecured creditors’ claims.

The decision is important. Were it otherwise, the debtor’s property would be subject to revaluation throughout the life of a chapter 13 case. The debtor would not know until the end whether he might be forced to pay more for a discharge if some of his property had appreciated in value.

### The Facts

Reduced to essentials, the complicated facts and procedural history were these:

The debtor owned nonexempt rental real estate that he scheduled with a value of \$44,000. Given his modest income, the debtor’s commitment period was three years.

The debtor confirmed a chapter 13 plan calling for payments of \$250 a month for 59 months. Evidently, he stretched out the plan for five years rather than three to lower his monthly payments.

In addition, the plan called for the debtor to sell the real property and pay an additional \$45,000 to unsecured creditors.

Although the commitment period was three years, the plan allowed the debtor to make payments for a longer period, “but in no event” for more than 60 months. The plan revested estate property in the debtor on confirmation.

More than three years after confirmation, the bankruptcy court approved the sale of the property for \$107,000. The chapter 13 trustee proposed an amended plan where creditors would



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receive not only the promised \$45,000 but also an additional \$50,700, representing the remainder of the net proceeds of the sale after deduction for the costs of sale.

The bankruptcy court approved the amended plan over the debtor's objection. The debtor appealed to the BAP and won.

## The Competing Statutes

The appeal boiled down to the question of which provision of the Bankruptcy Code controlled. The debtor stood behind Sections 1327(b) and (c), which vest all estate property in the debtor on confirmation and provide that revested property is "free and clear of any claim or interest of any creditor provided for by the plan."

Based on Sections 1327(b) and (c), the debtor contended that the real estate revested in him on confirmation free of creditors' claims, allowing him to pay nothing more to creditors than the \$45,000 provided in the plan.

The trustee urged the BAP to follow Section 1306(a), which defines property of the estate to include all property specified in Section 541 plus all property described in Section 541 "that the debtor acquires after commencement of the case but before the case is closed, dismissed, or converted . . . ."

The trustee argued that appreciation in the value of the real estate was property that the debtor acquired after filing and thus must be earmarked for creditors.

## *Burgie*

In his 25-page opinion deciding which section to follow, Judge Faris was not writing on a blank slate. *See McDonald v. Burgie (In re Burgie)*, 239 B.R. 406 (B.A.P. 9th Cir. 1999). He said that "*Burgie* is on point."

In *Burgie*, the debtors sold their homestead soon after chapter 13 confirmation, generating net proceeds of \$63,000 after paying off the mortgages. The debtors purchased a new home using \$43,000 of the proceeds and stated that they intended to use the remaining \$20,000 to support themselves and cover plan payments.

The BAP in *Burgie* decided that the debtors could retain the \$20,000 rather than pay it in a lump sum to creditors.

In *Burgie*, the BAP said:



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The chapter 13 deal permits a debtor to retain all prepetition property, including earnings, assets, money in the bank and real estate. In exchange for keeping all of these assets, the debtor must commit all postpetition disposable income to the payment of creditors under a chapter 13 plan for a period of three to five years. If the debtor makes all of the payments required under the plan, all of the debtor's dischargeable debts are discharged, and the debtor keeps all of the prepetition assets.

*Id.* at 410.

Of significance in the case on appeal, *Burgie* continued:

Postpetition disposable income does not include prepetition property or its proceeds. This is the chapter 13 debtor's bargain. Creditors of a chapter 13 debtor have no claim to any of these assets.

*Id.*

*Burgie* went on to say that the result does not depend on whether the property at issue is exempt. The BAP held that "the debtor is entitled to keep all of the debtor's prepetition property, whether or not it qualifies under the applicable exemption laws." *Id.* at 411.

## Applying *Burgie* and the Split

In the case on appeal, the debtor had owned the real property on filing, and it reverted in him on confirmation. Because *Burgie* was on point, Judge Faris reversed the lower court and held that the debtor owned the property "outright, free of his creditors' claims."

The trustee urged the BAP to follow *Barbosa v. Soloman*, 235 F.3d 31 (1st Cir. 2000), where the First Circuit held that appreciation in the value of prepetition property is property that the estate acquires after confirmation and therefore belongs to creditors.

Judge Faris acknowledged the split of authority and cited decisions going both ways. However, he said the Ninth Circuit BAP already had "squarely rejected *Barbosas's* approach in" *California Franchise Tax Bd. v. Jones (In re Jones)*, 420 B.R. 506, 515 (B.A.P. 9th Cir. 2009), *aff'd California Franchise Tax Bd. v. Kendall (In re Jones)*, 657 F.3d 921, 928 (9th Cir. 2011).

Required to follow its own precedent and Ninth Circuit authority, Judge Faris held that "the vesting provision of the confirmed plan means that the debtor owns the property outright and that the debtor is entitled to any postpetition appreciation." He said the bankruptcy court erred by requiring the debtor to turn over excess sale proceeds to creditors.

## How to Avoid the Result



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Richard P. Carmody told ABI how a chapter 13 trustee or creditors could avoid the result reached by the BAP:

If creditors believe that there is a potential for future appreciation of the Debtor's property, especially property to be sold to fund the plan (a red flag), they should try to delay the reversion of the property at confirmation in order to capture the appreciation.

Carmody is of counsel to Adams & Reese LLP, which maintains offices in Atlanta and Birmingham, Ala., among other locations.

[The opinion is](#) *Black v. Leavitt (In re Black)*, 18-1351, 2019 BL 498389, 2019 Bankr Lexis 3944 (B.A.P. 9th Cir. Dec. 31, 2019).





*A judicial lien impairing a homestead exemption is avoidable in some states under Section 522(f), but not in others.*

## **A Judgment Lien on Entireties Property Isn't Avoidable in Illinois, Seventh Circuit Says**

Most of us would assume that a home owned by a married couple as tenants by the entireties would be exempt in all respects in all states. But no, that is not true in Illinois and states with similar laws, according to the Seventh Circuit.

In Illinois, a homestead owned as tenants by the entireties cannot be foreclosed and sold by a judgment lien creditor of one spouse, but the entireties interest is *not* entirely exempt, the Chicago-based appeals court says.

Consequently, a spouse cannot avoid a judgment lien on his or her contingent future interest in the home because that interest is not exempt in Illinois. In other words, a judgment lien that attached to one spouse's contingent future interest in a homestead survives bankruptcy in Illinois.

In his August 5 opinion for the appeals court, Circuit Judge William J. Bauer warns that state laws vary dramatically on entireties property, so the result will not be uniform throughout the U.S.

### The Death of the Wife

Years earlier, creditors filed a \$1 million judgment lien against an attorney in the Illinois county where he owned a home with his wife as tenants by the entireties. The lawyer later filed a chapter 7 petition.

The lawyer-debtor claimed that his interest in the home was exempt under Illinois law and Section 522(b)(3)(B). He therefore sought to avoid the judgment lien as an impairment on his exempt property under Section 522(f).

After filing, the debtor's wife died, terminating the tenancy by the entireties and vesting the debtor with fee simple interest in the home. Outside of bankruptcy, the creditors could have foreclosed the judgment lien after the wife's death. Thus, it became imperative for the debtor to avoid the judgment lien.

Bankruptcy Judge A. Benjamin Goldgar of Chicago held that the debtor's contingent future interest as a tenant by the entireties was not exempt under Illinois law. Therefore, Judge Goldgar ruled that the debtor could not avoid the judgment lien.



The district court reversed, but Circuit Judge Bauer reversed once again, focusing on the debtor's contingent interest under Illinois law.

## The Significance of State Law

The outcome turned on two sections of the Bankruptcy Code. Section 522(f) allows a debtor to avoid a judicial lien “on an interest of the debtor in property to the extent that such lien impairs an exemption to which the debtor would have been entitled . . . .”

Section 522(b)(3)(B) determines whether the relevant property interest is exempt. The section allows a debtor to exempt “any interest in property in which the debtor had, immediately before the commencement of the case, an interest as a tenant by the entirety . . . to the extent that such an interest as a tenant by the entirety . . . is exempt from process under applicable nonbankruptcy law.”

Judge Bauer, of course, said that Illinois exemption law was the “applicable nonbankruptcy law.” He said that Illinois courts have not decided whether a judgment lien attaches to “the individual interests (in particular contingent future interests) of a tenant by the entirety.” So, he made a so-called *Erie* guess.

Parsing the Illinois statutes, Judge Bauer concluded that “interests held in a tenancy by the entirety or contingent future interests held by tenants by the entirety” are not exempt from judgment. He said that the statutes “merely exempt the *tenancy interest* from the attachment of a judgment lien.” [Emphasis in original.]

Judge Bauer therefore held that the judgment lien attached to the debtor's “contingent future interest in the property.” Next, he said that the debtor's interest as a tenant by the entirety would be estate property under Section 541(a), at least initially.

Judge Bauer then examined whether Section 522(b)(3)(B) exempted the debtor's contingent future interest in the homestead. Although Illinois would exempt the tenancy interest, he said that “lesser interests” are not exempt in Illinois, such as the debtor's “contingent future interest in the entireties property.”

Focusing on “such interest” in Section 522(b)(3)(B), Judge Bauer deduced that a debtor's interest as a tenant by the entirety is “exempt to the extent that those interests the debtor holds as a tenant by the entirety are exempt under state law.”

Fitting the pieces together, Judge Bauer said that the creditor obtained a judgment lien on the debtor's contingent future interest that existed on the petition date. Next, he said that Illinois does not make “all interests” immune from process that are held by a tenant by the entirety. Because



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Illinois does not exempt “contingent future interests,” he concluded that the debtor could not exempt his contingent future interest in the homestead.

Since the debtor’s contingent future interest was not exempt, Judge Bauer ruled that the debtor therefore could not avoid the lien on that interest. Although bankruptcy terminated the debtor’s personal liability, the creditor presumably could enforce the judgment lien.

Although a contingent future interest is not exempt, Judge Bauer said that the “main protection” in Illinois “is that a creditor is unable to force the sale of the property to collect a debt against only one of the tenants.”

Judge Bauer cautioned that laws around the country “are not uniform.” For example, he cited Indiana, where the law exempts “any interest” in property held by as a tenant by the entirety.

Another example is found in a decision in February by the Eighth Circuit. There, the appeals court held under Missouri law that a judicial lien is avoidable in Missouri as an impairment of the debtor’s homestead exemption. *CRP Holdings A-1 LLC v. O’Sullivan (In re O’Sullivan)*, 914 F.3d 1162 (8th Cir. Feb. 1, 2019). To read ABI’s report on *CRP*, [click here](#).

[The opinion is](#) *William v. Jaffe (In re Jaffe)*, 18-2726, 2019 BL 289042, 2019 Us App Lexis 23287 (7th Cir. Aug. 5, 2019).



*The date of the closing of a case is not a 'specified period' invoking Rule 9006(b)(1) and requiring a debtor to show excusable neglect before amending schedules to claim an exemption.*

## **Without Excusable Neglect, Debtors May Claim Exemption in Reopened Cases**

Reversing bankruptcy courts, the Tenth Circuit Bankruptcy Appellate Panel held that a debtor can reopen a closed case to schedule assets and claim exemptions without showing excusable neglect.

Two cases on appeal presented the same fact pattern. The chapter 7 debtors sustained personal injuries before bankruptcy. They did not schedule the personal injury claims. The debtors received their discharges, and their cases were closed.

On motions by the debtors, the bankruptcy judges reopened the cases and allowed the debtors to schedule the claims. However, the bankruptcy courts denied the exemptions because the debtors did not show excusable neglect in failing to amend the schedules before the cases were originally closed.

The debtors appealed and won, in an opinion for the BAP on February 5 by Bankruptcy Judge Michael E. Romero, Colorado's chief bankruptcy judge.

Judge Romero began by laying out the rules. Bankruptcy Rule 1009(a), governing amendments to petitions and schedules, allows a debtor to amend a schedule "at any time before the case is closed." Bankruptcy Rule 9006(b)(1), dealing with enlargements of time, only requires a showing of "cause" to extend a deadline if the application for an extension is made before the "specified period" expires.

Beyond the "specified period," Rule 9006(b)(1) requires a showing of "excusable neglect."

Judge Romero said the BAP "cannot conclude that Rule 9006(b)(1) applies to Rule 1009(b)."

Judge Romero focused on the language in the two rules. He said that "at any time before a case is closed" in Rule 1009(a) is not a "specified time" in Rule 9006(b)(1). Using a "plain meaning" analysis, he said that Rule 1009(a) does not specify a time for amending because it is impossible to know the deadline until the case is actually closed.



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Reopening a case is “purely administrative,” Judge Romero said. He declined to “read Rule 1009(a)’s language to impose a substantive deadline on the debtor’s ability to amend” schedules. He noted that Rule 1009(a) makes no distinction between original and reopened cases.

The BAP remanded the cases for the bankruptcy courts to rule on the merits of the claimed exemptions.

[The opinion is](#) *Mendoza v. Montoya (In re Mendoza)*, 595 B.R. 849 (B.A.P. 10th Cir. Feb. 5, 2019).





*Former NFL players with neurological impairment can file bankruptcy and exempt payments under league's concussion settlement.*

## **Payments Under the NFL's Brain Injury Settlement Are Held Exempt on Appeal**

In the first-ever appeal from the first decision on the question, a district judge in Florida upheld Bankruptcy Judge John K. Olson of Fort Lauderdale by ruling that payments under the National Football League Players' Concussion Injury Litigation Settlement are exempt assets under Section 522(d)(10)(C).

The chapter 7 debtor was a retired 10-year veteran of the NFL. The former All American was a first-round pick in the 1992 NFL draft. On account of neurocognitive impairment, he claimed that whatever he receives under the concussion settlement will be exempt.

The trustee objected to the claimed exemption. Although Florida does not allow its citizens to take federal exemptions, state law allows Floridians to claim exemptions under Section 522(d)(10). Subsection (C) allows debtors to exempt the right to receive "a disability benefit, illness, or unemployment benefit."

Judge Olson upheld the exemption claim on June 27, 2018, ruling that the payments are exempt assets under Section 522(d)(10)(C). To read ABI's discussion of Judge Olson's decision, [click here](#).

The trustee argued that the concussion settlement was nothing more than a non-exempt litigation settlement of a tort claim. In her March 26 opinion, District Judge Kathleen M. Williams of Fort Lauderdale agreed with Judge Olson that the concussion settlement is an exempt asset, even though it resulted from litigation.

Regardless of whatever led to the concussion settlement, Judge Williams framed the question as whether the payments are a "disability benefit."

According to Judge Williams, there are only three remotely relevant decisions, all from bankruptcy courts. Two favored the debtor. A Florida decision relied upon by the trustee, she said, "is not determinative, or even persuasive." That case involved a \$1.2 million payment to settle claims arising from an auto accident that did not involve an employer/employee relationship.



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Judge Williams said that Judge Olson was correct in concluding that the “overall structure [of the concussion settlement] is undeniably indicative of a disability policy.” Again quoting Judge Olson, she said the settlement “proceeds are not simple, guaranteed payments, but rather carefully tailored compensation schemes, consistent with and indicative of disability policies.”

Judge Williams also agreed with the conclusion by Judge Olson that the concussion settlement “is vastly different from a traditional class action tort settlement.” The genesis of the settlement in class litigation “is not dispositive because . . . the real issue is whether ‘his recovery actually represents a disability payment.’”

As support from her conclusion that it “does not matter that the ‘disability benefits’ arose from litigation,” Judge Williams cited a Michigan bankruptcy court decision holding that a \$193,000 lump-sum worker’s compensation payment for the accidental amputation of a hand was exempt under Section 522(d)(10)(C).

[The opinion is](#) *Salkin v. Williams*, 18-61581, 2019 BL 120010 (S.D. Fla. March 26, 2019).



## *Claims*



*Appeals courts won't allow bankruptcy to shield debtors from paying parking tickets and fines incurred in the course of a chapter 13 case.*

## **Seventh Circuit Holds that Parking Tickets and Fines Are Chapter 13 'Admin' Expenses**

The Seventh Circuit slammed the door on another theory used by bankrupt citizens of Chicago to avoid paying traffic tickets and parking fines incurred while in chapter 13.

In March, the Chicago-based appeals court ruled that bankruptcy courts may not, as a general practice, approve chapter 13 plans providing for debtors' cars to remain estate property after confirmation. In that regard, the standard plan in Chicago deviated from Section 1327(b), which "vests all property of the estate in the debtor" upon confirmation.

The distinction is important. If a car after confirmation is property of the estate, it remains protected by the automatic stay. If it becomes the debtor's property, there is no protection from the automatic stay.

When a plan retained a car in a debtor's estate, the city could not collect a parking fine without obtaining a modification of the automatic stay. In his March opinion, Circuit Judge Frank Easterbrook said, "Immunity from traffic laws for the duration of a chapter 13 plan does not seem to us an outcome plausibly attributed to the Bankruptcy Code." To read ABI's report on the March opinion, [click here](#).

In the March appeal, the City of Chicago had also contended that traffic tickets and parking fines incurred in the course of a chapter 13 case should be afforded administrative priority. At the time, Judge Easterbrook believed it was unnecessary to rule on administrative priority. However, the parties pointed out in a petition for rehearing that the issue needed to be decided.

So, the appeals court granted panel rehearing and reversed the two lower courts on the additional question of administrative priority. In his new opinion on November 12, Judge Easterbrook held that tickets and fines incurred during a chapter 13 case must be accorded administrative priority under Section 503(b).

In the new opinion, Judge Easterbrook relied primarily on the rationale in his March opinion.



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To qualify for administrative status, tickets and fines must represent “actual, necessary costs and expenses of preserving the estate.” To interpret the statute, Judge Easterbrook found guidance in a receivership decision from the Supreme Court. *Reading Co. v. Brown*, 391 U.S.471 (1968).

Judge Easterbrook characterized *Reading* as holding that “torts committed during a bankruptcy must be treated the same as debts voluntarily incurred.” He went on to say, “What is true of involuntary debts for torts is equally true of involuntary debts amassed while operating a car.”

To fit within the confines of Section 503(b), Judge Easterbrook said that “maintaining an automobile is necessary for the success of a Chapter 13 bankruptcy.” If a driver must pay for gasoline and insurance, then a debtor must also necessarily pay involuntary debts like fines and tickets.

Judge Easterbrook cited several decisions from other circuit courts holding that fines for civil offenses committed during bankruptcy “must be treated as administrative expenses.”

Judge Easterbrook summed up the rationale near the end of his opinion. Given that operating a car is necessary for a debtor to commute to work to earn the money required to make plan payments, “then the costs of operating that necessary asset are themselves necessary.” He therefore held that “vehicular fines incurred during the course of a Chapter 13 bankruptcy are administrative expenses that must be paid promptly and in full.”

## Observations

Ironically, the debtor’s theory that persuaded the lower courts ended up being the engine of the debtor’s destruction in the Seventh Circuit.

The debtor argued that the car deserved protection from the bankruptcy court because the car was necessary for commuting to work and generating income to cover plan payments. Judge Easterbrook took the car’s necessity for income production as reason for holding that car expenses are chapter 13 “admin” costs.

As it now stands in the Seventh Circuit, the city can file a motion to dismiss the chapter 13 case if the debtor does not promptly pay a ticket or fine. On dismissal, the city can impound the car. In addition, the debtor will not receive a discharge for the debts the debtor was paying under the plan.

But what if a chapter 13 debtor cannot pay other post-confirmation expenses? Do all expenses after confirmation fall into the category of administrative expenses?





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If everything is an administrative expense, post-confirmation creditors can use the threat of dismissal to coerce payment. If everything is not an administrative expense, where is the line between personal expenses and administrative expenses?

If a debtor commutes to work on public transit, will the failure to pay parking fines result in dismissal? Will bankruptcy courts in Chicago come to the conclusion that post-confirmation administrative expenses are limited to those directly related to income production?

Conceivably, bankruptcy courts may apply the Seventh Circuit's holding only to situations where the debtor has declared that a car is necessary for income production.

The opinion is *In re Steenes*, 17-3630, 2019 BL 475108, 2019 US App Lexis 36740 (7th Cir. Nov. 12, 2019).



*Disagreeing with a decision by the First Circuit last December, the Fifth Circuit rules that the 'plain language' in Section 362(c)(3)(A) does not terminate the automatic stay as to estate property 30 days after the second filing within one year.*

## **Fifth Circuit Creates a Circuit Split on Stay Termination for Repeat Filers**

Creating a split of circuits, the Fifth Circuit held that Section 362(c)(3)(A) only terminates the automatic stay as to the debtor and property of the debtor, but not as to property of the estate.

Section 362(c)(3)(A) is one of the most curiously drafted provisions in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, or BAPCPA. It uses the phrase “with respect to” three times.

If an individual’s case under chapters 7, 11 or 13 has been dismissed within one year, the subsection provides that the automatic stay in Section 362(a) terminates 30 days after the most recent filing “with respect to any action taken with respect to a debt or property securing such debt . . . with respect to the debtor . . .” [Emphasis added.]

In December 2018, the First Circuit adopted the position taken by the minority of lower courts in ruling that Section 362(c)(3)(A) terminates the automatic stay entirely, including property of the estate. *Smith v. State of Maine Bureau of Revenue Services (In re Smith)*, 910 F.3d 576 (1st Cir. Dec. 12, 2018). To read ABI’s discussion of *Smith*, [click here](#).

Finding the statute ambiguous, the First Circuit vacated the stay altogether, believing that Congress adopted BAPCPA to prevent abuses of the Bankruptcy Code.

In its *per curiam* opinion on December 10, the Fifth Circuit looked at the same language but decided that the “plain language” of the statute does not terminate the stay as to estate property.

The issue arose indirectly in the Fifth Circuit. The debtor had filed bankruptcy four times to forestall foreclosure of her home.

While her last bankruptcy was still pending, the debtor sued the mortgage lender in district court, contending that the Texas four-year statute of limitations on foreclosure had lapsed. Whether the statute had lapsed depended on how many days the statute had been tolled on account of bankruptcy.

The debtor argued that the automatic stay was in place with regard to the home for only 135 days. If that were so, the statute would have lapsed before the lender began foreclosure.

The lender took the view that the stay as to the house was effective for the entire 269-day duration of the debtor’s four bankruptcies. In other words, the lender contended that the automatic



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stay had not terminated 30 days after filing as to estate property. Concededly, the home was estate property.

On cross motions for summary judgment, the district judge ruled in favor of the lender, holding that the statute was tolled for all 269 days the debtor was in bankruptcy. The district judge followed opinions by bankruptcy courts in Texas and Louisiana that had adopted the majority view and ruled that Section 362(c)(3)(A) does not terminate the stay 30 days after filing as to estate property.

Based on “the plain language of the provision,” the Fifth Circuit affirmed, adopting the majority view and disagreeing with the First Circuit.

The Fifth Circuit said the statute was “clear.” The appeals court found “no mention of the bankruptcy estate” in the statutory language, which reads, “the stay under [Section 362(c)(3)(A)] . . . shall terminate *with respect to the debtor*.” [Emphasis in original.]

Referring to the next subsection, Section 362(c)(4)(A)(i), the appeals court said that Congress knows how to terminate the stay entirely when that is the objective.

Unlike the First Circuit, which was persuaded by policy arguments, the Fifth Circuit was “not convinced” that a more narrow interpretation “substantially harms creditors.” The appeals court noted that a mortgage lender can file a motion to modify the stay when “a debtor is abusing the automatic stay.”

The Fifth Circuit also said it was “not unsympathetic to other courts’ conclusions that a contrary interpretation may better serve the BAPCPA’s policy goals.” But when the statute “is clear, that is where our inquiry ends.”

The First Circuit opinion was 34 pages in length. The Fifth Circuit knocked off the issue in a mere nine pages. Although the Fifth Circuit opinion was unsigned, Chief Judge Priscilla R. Owen was on the panel.

[The opinion is](#) *Rose v. Select Portfolio Servicing Inc.*, 19-50598 (5th Cir. Dec. 10, 2019).



*A creditor without knowledge of bankruptcy isn't always entitled to file a late claim in chapters 7, 12, and 13, Judge Harner says.*

## **In Chapters 7 and 13, 'Excusable Neglect' Won't Always Justify Filing a Late Claim**

On an issue where the courts are divided, Bankruptcy Judge Michelle M. Harner of Baltimore ruled that a creditor without notice of a chapter 13 case was not permitted to file a late claim, nor was the creditor entitled to a modification of the stay.

Tomorrow, we will report a decision where Bankruptcy Judge Elizabeth W. Brown of Denver reached the opposite result on essentially the same facts. She found discretion to allow the late filing of a claim in a chapter 13 case when the creditor was not listed on the creditor matrix.

### The Facts in Judge Harner's Case

The debtor filed the list of creditors on time but omitted one creditor. Not knowing that the debtor-defendant had filed a chapter 13 petition, the creditor proceeded with a lawsuit in state court. The creditor did not learn about the bankruptcy until attempting to garnish the debtor's wages.

The creditor sought authority to file a late claim and to modify the automatic stay. Judge Harner denied both motions in a pair of opinions on October 4. Judge Harner was a law professor at the University of Maryland before ascending to the bench in 2017.

### Permission to File a Late Claim

The case turned on the rule applicable to late claims in chapter 13.

Generally, Bankruptcy Rule 9006(b)(1) permits an extension after a deadline on the showing of excusable neglect. But when the question deals with filing claims, Rule 9006(b)(3) permits an extension of time only for the reasons given in Bankruptcy Rule 3002(c).

Rule 3002(c) applies only in chapters 7, 12 and 13. In chapter 11, Rule 9006(b) allows late claims on a showing of excusable neglect.



The rule for extensions of time for filing late claims in chapters 7, 12 and 13 is not so liberal. Rule 3002(c) lists seven exceptions to the claim-filing deadline. The rule does not use the word “including,” so the list is exclusive.

For the case before Judge Harner, the most nearly applicable rule was found in subsection (c)(6), which allows the filing of a late claim “if the court finds that: (A) the . . . debtor failed to timely file the list of creditors . . . required by Rule 1007(a); or (B) the notice was insufficient under the circumstances to give the creditor a reasonable time to file a proof of claim, and the notice was mailed to the creditor at a foreign address.”

With regard to Rule 3002(c)(6)(A), Judge Harner said that the rule was amended in 2017 to require “both insufficient notice *and* an untimely filing of the Creditor List . . . .” (Emphasis in original.)

More particularly, Judge Harner said that eligibility for an extension under subsection (c)(6)(A) requires the showing of two elements: “(i) insufficient notice *caused by* (ii) the debtor’s failure ‘to timely file the list of creditors . . . .’” (Emphasis in original.) “A creditor must prove both elements to receive an extension of the claims bar date,” she said.

If the creditor list is timely filed, Judge Harner held that “Bankruptcy Rule 3002(c)(6) does not permit enlarging the time for a moving creditor to file a proof of claim.” Although the drafters of the rule “could have intended broader coverage,” she said that she was “uncomfortable making such inferences when the language of the rule is unambiguous.”

Because the debtor had filed schedules on time, Judge Harner held that “the plain language of the Bankruptcy Rules precludes any enlargement of the claims bar date under the facts of this matter.” Nonetheless, Judge Harner said the creditor “is not without a remedy,” because the claim will not be discharged.

Judge Harner said the creditor could pursue its claim in state court on the completion of the debtor’s plan or on an earlier termination of the stay.

### The Motion to Modify the Stay

The creditor had also sought a modification of the stay, presumably to allow enforcement of the state court judgment. Judge Harner also denied the stay motion, but without prejudice.

Judge Harner said she could not “identify any immediate need for relief from stay or prejudice to the [creditor] from a continued stay of the [creditor’s] state court action.” She noted that Section 108 tolls “most statutes of limitations . . . with respect to commencing or continuing an action” based on the creditor’s prepetition claims.





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Although the creditor's rights are preserved, Judge Harner said that other creditors "could be significantly prejudiced in that the Debtor is required to commit time and resources to the [creditor's] state court litigation."

On balance, Judge Harner found "no cause to lift or modify the stay."

The [claim filing](#) and [stay](#) opinions are both *In re Somerville*, 18-20807 (Bankr. D. Md. Oct. 4, 2019).



*Bankruptcy Judge Elizabeth Brown of Denver differs with Bankruptcy Judge Michelle Harner of Baltimore on the interpretation of Bankruptcy Rule 3002(c)(6).*

## **Courts Split on Allowing a Late Claim if the Creditor Was Not Listed**

Yesterday we reported a decision where Bankruptcy Judge Michelle M. Harner of Baltimore ruled that newly modified Bankruptcy Rule 3002(c)(6) did not give her discretion to allow a creditor to file a late claim when the creditor did not know there was a bankruptcy and the creditor had been omitted from the creditor matrix.

Today, we have an opinion by Bankruptcy Judge Elizabeth W. Brown of Denver who reached the opposite result and found discretion to allow the filing of a late claim under the same rule.

### The Facts in Judge Brown's Case

The facts in the case before Judge Brown were functionally the same as those confronting Judge Harner. The chapter 13 debtor filed his creditor matrix on time but inadvertently omitted his credit card lender, who therefore did not have notice of the filing.

The creditor learned about the bankruptcy about one month after the bar date and filed a motion under Bankruptcy Rule 3002(c)(6) for authority to file a late claim. The debtor supported the motion to allow the late filing of the claim.

Noting that courts have come down both ways, Judge Brown found discretion to allow the late filing of the claim. Like Judge Harner, she observed that the rule was amended, effective December 1, 2017. The recent amendment has given courts little time to sort out the issues.

Rule 3002(c)(6) was the governing rule. It allows the filing of a late claim "if the court finds that: (A) the . . . debtor failed to timely file the list of creditors . . . required by Rule 1007(a); or (B) the notice was insufficient under the circumstances to give the creditor a reasonable time to file a proof of claim, and the notice was mailed to the creditor at a foreign address."

Like Judge Harner, Judge Brown said in her August 28 opinion that the "express terms" of the rule only permit the filing of a late claim "when the debtor fails to file the Creditor Matrix on a timely basis." Because the debtor filed the creditor list, the rule on its face would seem to deprive the court of discretion to allow a late claim.



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Also like Judge Harner, Judge Brown noted the difference in language between subsections (c)(6)(A) and (B). Where clause (A) requires insufficient notice and the late filing of the creditor list, clause (B) only requires insufficient notice.

The two judges agreed that the inclusion of the condition regarding the creditor list in clause (A) and its omission in clause (B) implies that the drafters intended to permit no discretion to allow a late claim if the debtor had filed the creditor list on time.

However, that's where Judge Brown parted company with Judge Harner.

Judge Brown said that a strict reading of (c)(6)(A) will rarely, if ever, come into play because a case will be automatically dismissed in 45 days after filing under Section 521(i)(1) if the debtor has not filed a list of creditors. If the case has been dismissed, there will be no need for creditors to file claims and thus no need for permission to file a late claim.

Judge Brown said she “interpreted [the rule] more broadly to apply whenever a *full and complete* Creditor Matrix is not timely filed, such as when a creditor is omitted from the list or is listed incorrectly in such a way that the creditor does not receive notice.” (Emphasis in original.) She went on to say that both the creditor and the debtor can benefit by a more flexible reading of the rule.

Where the benefit to the creditor is obvious, a debtor can benefit because, for example, estate assets can be paid on account of priority or nondischargeable debts.

Allowing the creditor to file a claim beyond the bar date, Judge Brown said she “believes that the intent of Congress is best effectuated by reading this rule to apply whenever the debtor fails to timely file a full and complete Creditor Matrix.”

N.B. Judge Harner could not have known about Judge Brown's opinion because it was not reported on Lexis until later in October after Judge Harner had filed her opinion.

[The opinion is](#) *In re Vanderpol*, 19-10072 (Bankr. D. Colo. Aug. 28, 2019).



## *Automatic Stay*



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In December 2018, the First Circuit adopted the position taken by the minority of lower courts in ruling that Section 362(c)(3)(A) terminates the automatic stay entirely, including property of the estate. *Smith v. State of Maine Bureau of Revenue Services (In re Smith)*, 910 F.3d 576 (1st Cir. Dec. 12, 2018). To read ABI’s discussion of *Smith*, [click here](#).

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On cross motions for summary judgment, the district judge ruled in favor of the lender, holding that the statute was tolled for all 269 days the debtor was in bankruptcy. The district judge followed opinions by bankruptcy courts in Texas and Louisiana that had adopted the majority view and ruled that Section 362(c)(3)(A) does not terminate the stay 30 days after filing as to estate property.

Based on "the plain language of the provision," the Fifth Circuit affirmed, adopting the majority view and disagreeing with the First Circuit.

The Fifth Circuit said the statute was "clear." The appeals court found "no mention of the bankruptcy estate" in the statutory language, which reads, "the stay under [Section 362(c)(3)(A)] . . . shall terminate *with respect to the debtor*." [Emphasis in original.]

Referring to the next subsection, Section 362(c)(4)(A)(i), the appeals court said that Congress knows how to terminate the stay entirely when that is the objective.

Unlike the First Circuit, which was persuaded by policy arguments, the Fifth Circuit was "not convinced" that a more narrow interpretation "substantially harms creditors." The appeals court noted that a mortgage lender can file a motion to modify the stay when "a debtor is abusing the automatic stay."

The Fifth Circuit also said it was "not unsympathetic to other courts' conclusions that a contrary interpretation may better serve the BAPCPA's policy goals." But when the statute "is clear, that is where our inquiry ends."

The First Circuit opinion was 34 pages in length. The Fifth Circuit knocked off the issue in a mere nine pages. Although the Fifth Circuit opinion was unsigned, Chief Judge Priscilla R. Owen was on the panel.

[The opinion is](#) *Rose v. Select Portfolio Servicing Inc.*, 19-50598, 2019 BL472507 (5th Cir. Dec. 10, 2019).



*Despite atrocious mortgage servicing, the circuit court cut a jury's \$3 million award of punitive damages to \$582,000.*

## **Seventh Circuit Limits Punitive Damages to Total Compensatory Damages of \$582,000**

As a matter of constitutional law, the Seventh Circuit reduced punitive damages from \$3 million to \$582,000 when the jury had awarded the debtor \$582,000 in compensatory damages as a consequence of the mortgage servicer's "reprehensible conduct" and its "obstinate refusal" to correct its mistakes.

The story told by Circuit Judge Amy J. St. Eve in her November 27 opinion would be amusing if it did not depict horrors inflicted on a debtor about to lose her home even though she was current on the mortgage.

The debtor had filed a chapter 13 petition and dutifully cured arrears on her \$135,000 home mortgage over the life of her 42-month plan. The servicer did not even object after receiving notice under Bankruptcy Rule 3002.1 stating that the debtor had cured the arrears.

The nightmare for the debtor began when the servicer received the discharge but erroneously marked the file to say that the case had been dismissed. The mistake was compounded because the servicer failed to credit two of her monthly payments.

You know what happens next. The servicer deluges the debtor with threatening letters, demands thousands of dollars not owing, and incurs expenses (which it charges to the debtor) incurred in initiating foreclosure. Along the way, the debtor and her lawyers on multiple occasions sent hundreds of pages of documents to the servicer showing that the mortgage was current.

The servicer's incompetence was shown by statements that varied from month to month by thousands of dollars. One inaccurate statement even showed that the debtor was \$2,800 ahead in mortgage payments.

The lender halted foreclosure proceedings when the debtor filed suit in federal district court. The debtor asserted claims for breach of contract and for violating the Fair Debt Collection Practices Act, the Real Estate Settlement Procedures Act, and the Illinois Consumer Fraud and Deceptive Business Practices Act. The Illinois statute was the only claim under which the debtor was entitled to punitive damages.



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After trial, the jury awarded the debtor \$500,000 in compensatory damages for her breach-of-contract claims and claims under the FDCPA and the RESPA. On the Illinois CFDBPA claims, the jury gave her \$82,000 in compensatory damages and \$3 million in punitive damages. The jury may have been persuaded to impose large punitive damages because the servicer was already operating under a consent decree for shoddy servicing.

The damage award totaled \$3,582,000. The district court affirmed, but the servicer appealed the punitive damages award to the Seventh Circuit.

Judge St. Eve said that “jury was well within its rights to punish” the servicer, but “the award is excessive.”

Anyone on either side of a case involving an egregious violation of the discharge injunction or the automatic stay should read the opinion in full text. Judge St. Eve meticulously analyzes constitutional principles governing the award of punitive damages. Most prominently, she parses leading cases that propound flexible formulas to divine the limits on punitive damages.

For the case at hand, Judge St. Eve decided that \$582,000 was the “maximum permissible punitive damages award.” She concluded that a 1:1 ratio between the total compensatory and punitive damages was “consistent with Supreme Court guidance.” Likewise, 7:1 was a similarly permissible ratio between \$582,000 and the \$82,000 award under the Illinois statute.

Judge St. Eve said that \$582,000 punished the servicer for its “atrocious recordkeeping” without “equating its indifference to intentional malice.”

The servicer sought a new trial, given the disallowance of the jury’s punitive damage award. Judge St. Eve said that the servicer was not entitled to a new trial, because the constitutional limit on punitive damages is a question of law not within the purview of a jury. Therefore, she said, the “court is empowered to decide the maximum permissible amount without offering a new trial.

[The opinion is](#) *U.S. Bank NA v. Saccameno*, 943 F.3d 1071 (7th Cir. Nov. 27, 2019).



*The Seventh Circuit's opinion interpreting the amendment to Rule 62 is nonprecedential and prompted a dissent, and it may apply only in some states.*

## **Seventh Circuit Makes Stays Pending Appeal Automatic in Mortgage Foreclosures**

Over a dissent, the Seventh Circuit ruled “provisionally” in a nonprecedential opinion that “stays pending appeal should be the norm in mortgage foreclosure appeals” in states where the foreclosure judgment is not final and appealable until the homeowner faces imminent eviction.

### The Seventh Circuit's *Townsend* Rule

The Seventh Circuit's opinion on February 6 was an outgrowth from *HSBC Bank U.S.A. N.A. v. Townsend*, 793 F.3d 771 (7th Cir. 2015), where the appeals court held that a foreclosure judgment under Illinois law is not final and appealable until the district court not only has foreclosed the mortgage but has also ordered a sale of the property, confirmed the sale and ordered eviction of the homeowner. Later, the Seventh Circuit extended the foreclosure-finality rule to Wisconsin.

The majority in the February 6 opinion — composed of Circuit Judges Ilana D. Rovner and David F. Hamilton — interpreted *Townsend* to mean that a homeowner's first opportunity to appeal and seek a stay of foreclosure in Illinois and Wisconsin comes 30 days before eviction.

Consequently, the majority said, *Townsend* would require the appeals court to undertake “a quick evaluation of the likely merits of the appeal, where the parties, lawyers, and the judges must act under time pressure of a 30-day eviction deadline.” In the application for a stay before the court, the majority framed the question as “whether we should allow normal appellate procedures to work as they would in most other cases.”

The majority admitted that most mortgage foreclosures “are likely to be affirmed.” But still, the majority said, “there is plenty of room for human and legal error in mortgage foreclosures.”

### The Facts in the Case on Appeal

The homeowner's appeal was hardly frivolous. The lender began foreclosure in 2007, but the case was dismissed on the parties' agreement. After a few months passed, the lender initiated another foreclosure action, which the state court dismissed two years later for want of prosecution.





After the mortgage was transferred, the new holder of the mortgage began foreclosure in 2013. Invoking *res judicata*, the district court dismissed the foreclosure action because the lender had not refiled the suit within one year. On motion for reconsideration, the district court reinstated the case and later entered a foreclosure order on summary judgment. The homeowner appealed, but the appeal was dismissed under *Townsend* because the summary judgment order was not final.

After the district court entered a foreclosure judgment, the appeals court again dismissed the appeal under *Townsend*. Finally, the district court order a sale and approved the sale to the lender. Facing imminent eviction, the homeowner appealed and sought a stay, which the district court denied.

The homeowner applied to the Seventh Circuit for a stay. The appeals court granted the stay in July 2018, saying that an explanation would follow.

The February 6 order “is the explanation,” the appeals court said. In the meantime, Rule 62 of the Federal Rules of Civil Procedure was amended as of December 1, 2018.

### The Majority’s Rationale

The majority said that the 2018 amendments to Rule 62 “have clarified the law for purposes of this case and made its application simpler and more flexible.”

Under the prior version of the rule, the majority said that the lender’s mortgage on the property “should ordinarily suffice to protect the lender’s rights pending appeal for the purposes of Rule 62,” thus entitling the homeowner to a stay pending appeal. A stay may not be proper, the majority said, if taxes or insurance were not being paid or the property was not being “cared for.”

The majority interpreted *Townsend* to “clearly” imply “that stays in pending appeals in foreclosure sales should be routine to prevent the irreparable harm of losing one’s home.”

The amendments to Rule 62, the majority said, “reinforce making a stay pending appeal the norm in mortgage foreclosure cases.” For a blackline showing the amendments to Rule 62, [click here](#).

The majority quoted the Committee Notes to the amendments, which say, “The new rule’s text makes explicit the opportunity to post security in a form other than a bond.”

“Given that flexibility,” the majority said, “continuing the security interest . . . should provide adequate security in most cases, at least so long as the property is cared for and protected by insurance and payment of property taxes.”





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The majority made the opinion nonprecedential for a reason: The “issues have not yet been the subject of a full adversarial presentation,” the majority said. The two judges expressed a “willingness to reconsider our thinking, particularly if and when we have the benefit of briefing by counsel on both sides.”

## The Dissent

Circuit Judge Amy J. St. Eve dissented. She said, “Whatever interest a lender has in a foreclosed piece of property, it seems a stretch to liken it to a bond.” She went on to say the amendments to Rule 62 do not “clearly dictate the majority’s result.”

Judge St. Eve said she also disagreed with the majority’s interpretation of the “old” Rule 62. She saw no reason to opine on the new rule when the stay had been granted in July under the old rule.

[The opinion is](#) *Deutsche Bank National Co. v. Cornish*, 18-2429 (7th Cir. Feb. 6, 2019).



*Filing a 'lift stay' motion doesn't violate RESPA's loss mitigation rules.*

## **Stay Modified Despite Possibly Valid RESPA Claim**

A mortgage servicer filed a motion for relief from the automatic stay, seeking to continue a foreclosure action relating to Chapter 13 debtor's principal residence, which had resulted in a judgment of foreclosure and sale. Debtor objected and also filed an adversary proceeding against the mortgage servicer for alleged violations of state and federal law arising from denials of her requests to modify her mortgage.

The court reviewed the federal Real Estate Settlement Procedures Act ("RESPA") 12 U.S.C. § 2601(a), and particularly the regulations promulgated thereunder, commonly referred to Reg X, 12 C.F.R. §§ 1024.1-1024.41. In particular, Debtor asserted that post-petition the lender violated RESPA's "dual tracking" prohibition, specifically 12 C.F.R. § 1024.41(g), because the stay relief motion was filed prior to the loss mitigation process, including any appeals, finally concluding. Debtor also claimed that the lender violated RESPA post-petition, specifically 12 C.F.R. § 1024.41(d), by failing to provide a specific basis for denying Debtor's loan modification request. Debtor had also claimed pre-petition violations, but those were the subject of the separate adversary proceeding.

The court reviewed the statute, implement rules and available case law. After noting RESPA is a broad remedial statute enacted by Congress to protect consumers from unnecessarily high settlement charges and other abusive practices in the real estate settlement process, the court discussed 12 C.F.R. § 1024.41(g), which expressly provides that if a borrower submits a loss mitigation application more than "37 days before a foreclosure sale," then "a servicer shall not move for foreclosure judgment or order of sale, or conduct a foreclosure sale" until the loss mitigation process is complete under the regulations.

A mortgage servicer that receives a complete loss mitigation application more than 37 days before a foreclosure sale must evaluate the borrower for all loss mitigation options, provide the borrower with written notice of its options, if any, and notify the borrower in writing if its application has been rejected.

However, Debtor had not cited a single case, nor had the court found one, holding that a mortgage servicer violates RESPA by merely seeking stay relief to continue a foreclosure action, and the court determined that merely filing a stay relief motion is not prohibited by § 1024.41(g), as seeking and obtaining an order lifting the stay is not the same as moving for a foreclosure judgment or an order of sale, or conducting a foreclosure sale.



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The court stated that “since Congress passed both the Bankruptcy Code and RESPA, if it had intended to prohibit stay relief from being pursued while the Reg X loss mitigation process proceeded, it could have said so either in the Bankruptcy Code or in RESPA; it did not.”

Finally, the court noted that all of Debtor’s state and non-bankruptcy federal law claims can be tried and determined in accordance with ordinary litigation processes in the adversary proceeding, as opposed to in the summary stay relief context.

Borrowers have a private right of action to enforce the procedural requirements set forth in § 1024.41, and the remedies available are set forth in section 6(f) of RESPA, which provides for the recovery of monetary damages in the amount of ‘(A) any actual damages to the borrower as a result of the failure; and (B) any additional damages, as the court may allow, in the case of a pattern or practice of noncompliance with the requirements of this section, in an amount not to exceed \$2,000.’

After applying a tradition lift stay analysis, the court granted the stay relief motion.

[The opinion is](#) *In re Kolnberger*, 2019 WL 2082152 (Bankruptcy Court, EDNY May 10, 2019).



## Municipal Debt Adjustment & Puerto Rico



*California judge sides with former  
Bankruptcy Judge Steven Rhodes by  
holding that the U.S. Trustee does not have  
statutory power to appoint an unsecured  
committee in a chapter 9 case.*

## **U.S. Trustee May Not Appoint an Unsecured Committee in a Municipal Bankruptcy**

Reaching the same result as former Bankruptcy Judge Steven W. Rhodes in Detroit's municipal debt restructuring, Bankruptcy Judge René Lastreto, II of Fresno, California, concluded that the U.S. Trustee does not have authority to appoint an unsecured creditors' committee in a chapter 9 case.

In the municipal debt adjustment of a hospital district in California, the U.S. Trustee had appointed an unsecured creditors' committee, asserting that the power of appointment derives from Section 1102(a)(1), allegedly made applicable in chapter 9 cases by Section 901(a).

The debtor filed a motion to disband the committee, which Judge Lastreto granted in an opinion on October 2.

In some sense, the result reached by Judges Rhodes and Lastreto is counterintuitive, given the language of the two statutes.

Section 901(a) makes Section 1102 applicable in chapter 9 cases. Notably, Section 901(a) on its face seems to make all of Section 1102 applicable. In contrast, Section 901(a) makes only parts of some other sections applicable in chapter 9. For instance, only subsections (c), (d), (e) and (f) of Section 364 are applicable in chapter 9 cases.

Section 1102(a) requires the U.S. Trustee to appoint an unsecured creditors' committee "as soon as practicable *after the order for relief in chapter 11 . . .*" [Emphasis added.]

The decisions by Judges Rhodes and Lastreto turned on the italicized language.

Judge Lastreto pointed to the decision by Judge Rhodes as "the only published decision . . . the court has found confronting the UST's authority to appoint committees in Chapter 9 cases." *In re City of Detroit*, 519 B.R. 673 (Bankr. E.D. Mich. 2014).

Judge Lastreto acknowledged, however, that creditors' committees have been appointed and served without objection in municipal bankruptcies in the Ninth Circuit and around the country. Despite the





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*Detroit* decision, he said it remains the policy of the U.S. Trustee Program to appoint unsecured creditors' committees in chapter 9 cases except in the Eastern District of Michigan, where Detroit is located.

Judge Lastreto began his analysis by referencing the duties and powers of the U.S. Trustee in chapter 9, or, more accurately, the lack of them. For instance, Section 307 gives the U.S. Trustee standing to appear and be heard. Notably, Section 307 is not applicable in chapter 9 under Section 901(a).

Like Judge Rhodes, Judge Lastreto concluded that the critical language in Section 1102(a) (“as soon as practicable after the order for relief under chapter 11”) “effectively limits Section 1102 to chapter 11 exclusively.” It is logical for Section 1102(a) to be inapplicable, Judge Lastreto said, because other subsections in Section 1102 “clearly do not apply in chapter 9 cases, such as Section 1102(a)(3) and Section 1102(b)(2).”

Because there is no order for relief in chapter 11 in a chapter 9 case, Judge Lastreto saw Section 1102(a) as “plainly” showing there is no predicate for appointing an unsecured committee in a municipal bankruptcy.

Judge Lastreto therefore held that the U.S. Trustee “does not have authority under Section 1102(a) to appoint an unsecured creditors’ committee in a chapter 9 case.”

Since the U.S. Trustee lacked authority to form a committee, Judge Lastreto ruled that the “Committee should be disbanded.”

[The opinion is](#) *In re Coalinga Regional Medical Center*, 18-13677 (Bankr. E.D. Cal. Oct. 2, 2019).



*Appeals court says that the bankruptcy court must always address the existence of a trust when ruling on a motion to modify the automatic stay.*

## **First Circuit PROMESA Opinion Addresses the Automatic Stay and Trust Funds**

In an opinion in Puerto Rico's debt-adjustment proceedings under PROMESA, the First Circuit pointed out how a creditor has a lighter burden in modifying the automatic stay if the creditor is going after funds that the debtor holds in trust.

In its September 25 opinion, the First Circuit decided it was error for the district court to deny a motion to modify the stay without making a preliminary determination about the existence of a trust.

### **The Reserve Account**

The dispute revolved around \$76 million held in a reserve account by the Puerto Rican government resulting from duplicate insurance premiums paid by owners of autos between 1998 and 2010. Litigation ensued for years and reached settlement in 2016.

The settlement established a notice and claim-filing process for those who paid duplicate premiums. From the reserve account, the settlement called for paying valid claims for overpayment.

Later in 2016, Congress enacted the Puerto Rico Oversight, Management, and Economic Stability Act, or PROMESA (48 U.S.C. §§ 2161 *et. seq.*). In May 2017, the Oversight Board under PROMESA initiated the Title III debt-adjustment proceedings, which invoked the automatic stay under Section 362 of the Bankruptcy Code.

In view of the stay, Puerto Rico halted payments from the reserve fund.

In early 2018, plaintiffs in the duplicate-payment litigation filed a motion to modify the automatic stay in the district court presiding over the PROMESA proceedings. The district judge denied the motion, although she did require the continued submission and review of claims.

In denying the lift-stay motion, the district court evaluated the 12 factors laid out in *Sonnax Industries v. Tri Components Products Corp.* (*In re Sonnax Industries*), 907 F.2d 1280 (2d Cir. 1990). The decision to deny a modification of the stay rested in significant part on the district



court's view that disputes over payment from the reserve fund should be resolved in the process of confirming a plan.

In his opinion for the First Circuit, Circuit Judge William J. Kayatta, Jr. said that the district court had declined to decide whether the funds in the reserve account were held in trust. If the funds were in trust, the island's government would have had no equity interest in the monies.

## 362(d)(1) vs. 362(d)(2)

On appeal, the plaintiffs argued that they were entitled to stay relief because the money they sought was being held by the commonwealth as trustee. Judge Kayatta pointed out that the plaintiffs made a mistake in litigation strategy.

The plaintiffs sought stay modification "for cause" under Section 362(d)(1), which invokes the *Sonnax* factors. Instead, Judge Kayatta said the plaintiffs should have sought stay relief under the "more obvious path for relief laid out in subsection 362(d)(2)."

The facts a creditor must prove are more limited under Section 362(d)(2). When the creditor seeks to proceed "against property," the subsection allows the court to modify the stay if the debtor has no equity in the property and the property is not necessary for an effective reorganization. In footnote 2, Judge Kayatta suggested that the plaintiffs were likely to rely on subsection (d)(2) on remand.

Even under Section 362(d)(1), Judge Kayatta said that the district judge "first needed to make at least a preliminary determination of the parties' respective property interest[s] in the disputed funds." He went on to say that several of the *Sonnax* factors would turn on the parties' respective interests in the disputed funds.

Judge Kayatta was therefore constrained to reverse the district judge because she "should not have declined to consider" the existence of trust funds. He said that "[m]any courts have decided to grant stay relief 'for cause' after first finding that the debtor only had a legal, rather than equitable, interest in the property at issue."

## The Partial Reversal

Addressing the \$76 million still held in a reserve fund, Judge Kayatta said that the "members of the plaintiff class who qualify for reimbursement from this subset of funds have made a *prima facie* showing of traceability and the existence of a trust relationship."

With regard to creditors with claims against the reserve fund, Judge Kayatta reversed and remanded for the district judge "to consider on remand in preliminarily deciding whether the Commonwealth possesses any equity in the segregated funds." After making a preliminary



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determination about Puerto Rico's interest in the reserve fund, he said the district court should reapply the *Sonnax* factors.

However, Judge Kayatta did sustain the district court's denial of a stay modification with regard to creditors who did not have claims against segregated funds. He said they could not show a *prima facie* case for the existence of trust funds.

## *Nota Bene*

Judge Kayatta's opinion explains why the automatic stay in a municipal bankruptcy sweeps more broadly than the stay in an ordinary individual or corporate bankruptcy.

[The opinion is](#) *Gracia-Gracia v. Financial Oversight and Management Board (In re Financial Oversight and Management Board for Puerto Rico)*, 18-1463 (1st Cir. Sept. 25, 2019).



*Supreme Court let a First Circuit opinion stand that barred bondholders from compelling payment during Puerto Rico's restructuring under PROMESA.*

## **Supreme Court Won't Hear a Case to Compel Paying Puerto Rico Bondholders Currently**

While we await a decision from the Supreme Court on the constitutionality of the Puerto Rico Oversight Board, the high court denied *certiorari* today from a decision by the First Circuit holding that bondholders cannot compel payment during the course of restructuring proceedings and before confirmation of a plan. *Assured Guaranty Corp. v. Financial Oversight and Management Board for Puerto Rico (In re Financial Oversight and Management Board for Puerto Rico, as Representative for the Puerto Rico Highways and Transportation Authority)*, 919 F.3d 121 (1st Cir. March 26, 2019). To read ABI's report on the First Circuit's opinion in March, [click here](#).

In April, bondholders filed a petition for rehearing and rehearing *en banc*. The First Circuit denied the rehearing motion on July 31. *Assured Guaranty Corp. v. Financial Oversight and Management Board for Puerto Rico (In re Financial Oversight and Management Board for Puerto Rico, as Representative for the Puerto Rico Highways and Transportation Authority)*, 931 F.3d 111 (1st Cir. July 31, 2019).

Circuit Judge Sandra L. Lynch wrote a 16-page dissent from denial of rehearing *en banc*. In substance, she was urging the Supreme Court to grant *certiorari* and reverse. Correctly interpreting the import of the decision, she said that Puerto Rico cannot be compelled to pay pledged special revenues to bondholders during a proceeding under the Puerto Rico Oversight, Management, and Economic Stability Act, or PROMESA (48 U.S.C. §§ 2161 *et. seq.*).

In other words, Judge Lynch said, "bondholders cannot receive payment of special revenues promised to them . . . unless [Puerto Rico] *voluntarily* makes such payment." [Emphasis in original.] *Id.*, 931 F.3d at 120.

Joined by the two other judges from the original panel, Circuit Judge William J. Kayatta, Jr. issued a statement on July 31 explaining why the March 26 decision was correct. His statement read like a memorandum to the Supreme Court explaining why the justices should deny *certiorari*.

Judge Kayatta's four-page statement explained how Sections 922 and 928 of PROMESA work together. In his view, the statute allows, but does not require, a municipal debtor to continue paying special revenue bonds during the course of a proceeding and before adoption of a restructuring plan.





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Instead, Judge Kayatta said that the statute preserves a bondholder's pre-petition liens, allowing the creditor to "assert its right to those funds during the plan-of-adjustment phase." To read ABI's report on denial of rehearing, [click here](#).

Bondholders filed a petition for *certiorari* on September 20. The Puerto Rico Oversight Board filed papers in opposition on November 25. The justices considered the petition in a conference on January 10 and issued an order denying *certiorari* on January 13.

The denial of *certiorari* was not surprising because there was no split of circuits. The bondholders contended that the issue was extraordinarily important. Indeed, that's true. Had the Supreme Court taken the case and reversed, reorganization for Puerto Rico might have been impossible, and likewise municipal bankruptcies under chapter 9.

On October 15, the Supreme Court heard oral argument in *Financial Oversight and Management Board for Puerto Rico v. Aurelius Investment LLC*, 18-1334 (Sup. Ct.). The case will decide whether the appointment of the members of the Financial Oversight and Management Board of Puerto Rico violated the Appointments Clause of the Constitution because they were not nominated by the President and confirmed by the Senate. To read ABI's report on oral argument, [click here](#).

[The denial of certiorari was in](#) *Assured Guaranty Corp. v. Financial Oversight and Management Board for Puerto Rico*, 19-391 (Sup. Ct. *cert. den.* Jan. 13, 2020).



*The logical court to challenge the constitutionality of PROMESA isn't the PROMESA court itself.*

## **First Circuit Nixes Another Attempt at Unraveling Puerto Rico's Debt Arrangement**

On the last page of an 18-page opinion, the First Circuit told Puerto Rico bondholders how they can challenge the constitutionality of the Puerto Rico Oversight, Management, and Economic Stability Act, or PROMESA (48 U.S.C. §§ 2161 *et. seq.*). Under PROMESA, the island commonwealth is restructuring its unsupportable debt.

Curiously, bondholders cannot raise a challenge to the constitutionality of PROMESA in the proceedings in the Puerto Rico District under PROMESA.

### The Bondholders' Plight

After the Supreme Court ruled in June 2016 that Puerto Rico's instrumentalities are ineligible for municipal debt adjustment under chapter 9 of the Bankruptcy Code and that the island commonwealth cannot adopt local laws dealing with the insolvencies of its units, Congress adopted PROMESA, which is patterned in large part on the municipal debt arrangement provisions in chapter 9 of the Bankruptcy Code.

The dispute came to the First Circuit on appeal by holders of highway bonds. To secure the debt, Puerto Rico pledged oil and gas tax revenues and highway tolls, among other things. The pledge, however, was not absolute. Puerto Rico had the right to divert the pledged revenues to the payment of general obligation bonds if other revenue sources were insufficient.

Even before commencement of the formal debt arrangement proceedings under PROMESA, Puerto Rico adopted a moratorium that halted the flow of the pledged revenues to the bondholders. The moratorium also barred the bondholders from enforcing remedies.

Next, the Financial Oversight and Management Board of Puerto Rico, established under PROMESA, adopted a fiscal plan calling for the continued diversion of the pledged revenues. The initiation of the debt arrangement proceedings under Title III of PROMESA invoked an automatic stay akin to Section 362 of the Bankruptcy Code.

The Puerto Rico fiscal agency then directed the bondholders' trustee to withhold payments to bondholders from funds already held in . A default on the bonds ensued.



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The guarantor for the highway bonds filed an adversary proceeding in the PROMESA proceedings district court in Puerto Rico. The suit alleged that the diversion of pledged revenues was in violation of the Contracts, Takings and Due Process Clauses of the U.S. Constitution, among other things. The suit sought a declaration and injunction to restore the flow of revenue to the bondholders.

On a variety of grounds, the district court dismissed the suit last year. *See Ambac Assurance Corp. v. Puerto Rico (In re Financial Oversight & Management Board for Puerto Rico)*, 297 F. Supp. 3d 269 (D.P.R. 2018).

## The Circuit's Opinion

In an opinion for the First Circuit on June 24, Circuit Judge William J. Kayatta, Jr. upheld dismissal. Simply stated, two provisions in PROMESA stripped the PROMESA court of jurisdiction or power to grant the relief sought by the bondholders' guarantor.

The first bar appears in Section 106 of PROMESA, 48 U.S.C. § 2126(e), declaring there "shall be no jurisdiction in any United States district court to review challenges to the Oversight Board's certification determinations under this chapter." According to Judge Kayatta, the injunctive relief sought by the bondholders, invalidating the Oversight Board's fiscal plan, "is plainly precluded as a result of section 106."

The second bar to relief for the bondholders flows from Section 305 of PROMESA, 48 U.S.C. § 2165, which provides that "the court may not, by any stay, order or decree . . . interfere with (1) any of the political or governmental powers of the debtor . . ." Judge Kayatta explained that Section 305 "mimics" Section 904 of the Bankruptcy Code.

"On its face," Judge Kayatta said that "the text of section 305 bars the [PROMESA] court from granting [the bondholders] such relief absent consent from the Oversight Board or unless the Fiscal Plan so provides."

Judge Kayatta reported how the bondholders contended at oral argument that the appeals court's interpretation of Section 305 "would raise due process concerns because [the bondholders] would be left without a venue in which to bring its constitutional claims." Not so, the judge said.

"[N]othing in our holding today," he said, "suggests that [the bondholders] cannot seek traditional stay relief pursuant to 11 U.S.C. § 362 and raise its constitutional and statutory arguments in a separate action." Quoting from *Financial Oversight and Management Board for Puerto Rico v. Ad Hoc Group of Puerto Rico Electric Power Authority Bondholders*, 899 F.3d 13, 21 (1st Cir. 2018), he said that Section 305 does not "impose any such restraint on *another court*." [Emphasis added.]



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## Observations

Do the bondholders have a ghost of a chance under either route offered by Judge Kayatta? In terms of winning a modification of the automatic stay, it ain't gonna happen, at least not in district court. When is the last time you saw a reorganization court modify the stay in a huge case and wreck the restructuring?

And what about a separate suit in district court, but not in the PROMESA court, attacking PROMESA as unconstitutional on its face or as applied?

At the conclusion of the PROMESA proceedings, the bondholders are assured of the recognition of whatever rights they have under PROMESA and the U.S. Constitution. The bondholders are not being deprived of their right to payment permanently, only temporarily during the course of the PROMESA proceedings. So, it seems unlikely a court will find a deprivation of constitutional rights.

In a number of decisions already, the district court and the First Circuit have rebuffed attempts by other bondholders to short circuit the PROMESA proceedings and take home their marbles immediately. *See, e.g., Assured Guaranty Corp. v. Financial Oversight and Management Board for Puerto Rico (In re Financial Oversight and Management Board for Puerto Rico, as Representative for the Puerto Rico Highways and Transportation Authority)*, 919 F.3d 121 (1st Cir. March 26, 2019). For ABI's discussion of *Assured Guaranty*, [click here](#).

[The opinion is](#) *Ambac Assurance Corp. v. Commonwealth of Puerto Rico (In re Financial Oversight and Management Board of Puerto Rico)*, 18-1214, 2019 BL 232204, 2019 Us App Lexis 18763 (1st Cir. June 24, 2019).



*First Circuit reverses, upholding the validity of bondholders' security interests in \$2.9 billion of collateral.*

## **Puerto Rico Retirement System Bondholders Win Their Security Interest Back**

Reversing the district court in part, the First Circuit did not decide whether the Puerto Rico Oversight, Management, and Economic Stability Act, or PROMESA (48 U.S.C. §§ 2161 *et. seq.*), could be used to avoid security interests granted before the enactment of PROMESA.

Perhaps motivated by the venerable legal principle known as *rachmones*, the First Circuit reversed District Judge Laura Taylor Swain, who had ruled in August that bondholders did not have a perfected a security interest in collateral securing \$2.9 billion in bonds issued by the island commonwealth's employee retirement system, commonly known as ERS. (*Rachmones* is a Yiddish term meaning pity or sympathy. It is sometimes spelled *rachmunis* or *rachmanis*.)

Significantly, however, the First Circuit did uphold Judge Swain's ruling under the Uniform Commercial Code that a UCC-1 financing statement cannot describe collateral by reference to a document not found in the filing office.

### The Avoidance Litigation

After the Supreme Court ruled that Puerto Rico was ineligible for chapter 9 municipal bankruptcy, Congress quickly adopted PROMESA. Months later, the Financial Oversight and Management Board of Puerto Rico initiated court-supervised debt-restructuring proceedings for Puerto Rico and its instrumentalities in the District of Puerto Rico. The Chief Justice tapped District Judge Swain of New York to oversee the PROMESA proceedings in Puerto Rico.

ERS, Puerto Rico's retirement system, was authorized by statute to issue secured debt. The retirement system issued bonds in 2008 to be secured by ERS's revenue, among other things. The UCC-1 financing statement described the collateral as the property shown on the security agreement that was attached.

However, the security agreement described the collateral as having the meaning defined in the statute that authorized issuance of secured bonds. The statute or its definition of collateral was not attached to the financing statement.

In 2015, UCC-3 continuation statements were filed. Unlike the original UCC-1 in 2008, the 2015 UCC-3s contained complete descriptions of the collateral. However, the continuation





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statements identified the debtor as ERS but did not use a new name, commonly abbreviated as RSE. Allegedly, RSE was the new name officially given to ERS in the English translation of an amendment to the statute governing the retirement system. The amendment was enacted after the bonds were issued but before the UCC-3s were filed.

Acting on behalf of the retirement system in Puerto Rico's debt-adjustment proceedings, the Oversight Board sought a declaratory judgment that the bondholders' security interest was unperfected and could be avoided under Section 544(a), incorporated by Section 301 of PROMESA.

In August, Judge Swain granted the Board's motion for summary judgment and declared the security interest to be unperfected and therefore unenforceable.

Judge Swain said that a financing statement need only "reasonably" identify the collateral under UCC § 9-110. The collateral description by reference, she said, may only refer to a document attached to the UCC filing or to another document on file in the UCC clerk's office. She therefore held that the original UCC-1s in 2008 failed to perfect the security interest.

The question remained: Was the security interest perfected by the filing of the UCC-3s in 2015, which did include a description of the collateral?

For Judge Swain, the UCC-3s raised a different question: Was the debtor properly identified because the UCC referred to ERS, not RES?

UCC § 9-503(a)(1) requires that the debtor's name on a financing statement must be the name "on the public organic record most recently filed with or issued or enacted by the registered organization's jurisdiction." A trade name is insufficient under UCC § 9-503(c).

Judge Swain ruled that the UCC-3s failed to perfect the security interest because she concluded that ERS was a trade name, which "Article 9 expressly provides is insufficient." She therefore held that the security interest was also unperfected by the filing of the UCC-3s.

To avoid the loss of secured status, the bondholders contended that the Board could not use Section 544(a) to invalidate a security interest granted before the enactment of PROMESA. However, Judge Swain held that Section 544(a) could be employed retroactively to avoid an unperfected security interest granted before the adoption of PROMESA.

The bondholders appealed.

## The First Circuit's Reversal



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The First Circuit reversed in part in an opinion on January 30 by Circuit Judge Sandra L. Lynch, who wrote two notable bankruptcy opinions in 2018 regarding the repeat-filing stay modification and the good faith defense to a discharge violation.

Agreeing with Judge Swain, Judge Lynch ruled that the bondholders were not perfected in 2008 because the collateral description was inadequate. Parting company with Judge Swain, Judge Lynch held that the bondholders did become perfected by the UCC-3s in 2015.

With regard to the 2008 financing statements, Judge Lynch said they were “insufficient to perfect the security interest” because: (1) The collateral was “not described, even by type(s),” (2) the 2008 financing statements “do not tell interested parties where to find the referenced documents,” and (3) the bond resolution laying out the collateral was “not at the UCC filing office.”

Judge Lynch said bondholders were not secured at the outset because the original filings did not give “fair notice to other creditors and the public of a security interest.”

On the other hand, Judge Lynch concluded that the bonds became secured on the filing of the UCC-3s in 2015. The opinion will have little precedential value beyond Puerto Rico, because she said the result turned on “a unique confluence of circumstances involving two languages and a translation.”

Puerto Rico has two official statutory languages, Spanish and English. The 2013 Spanish language statute allegedly changing the retirement system’s official name from ERS to RSE was not officially translated into English until a year later.

Judge Lynch explained that the English language version uses the two terms “seemingly interchangeably.” Indeed, RSE is used only three times in the statute, while ERS appears more than 35 times.

Despite the prevalence in the usage of ERS, the Oversight Board contended that the one subsection in the statute using RES was the only provision that governed the retirement system’s official name. On that basis, Judge Swain believed that ERS was not the proper name for UCC filings.

Interpreting the language of UCC § 9-503(a)(1), Judge Lynch said that the court was not obliged to follow only one clause in a statute to pinpoint the debtor’s name in the “public organic record.” Rather, she said, the “UCC provision directs focus to the entire ‘public organic record.’”

In addition to the prevalence of the use of ERS in the English version of the statute, Judge Lynch pointed out that ERS was the name “consistently used by the [retirement system] itself, including in court filings, before and after the translation of the amended Act in 2014.”



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Having concluded that the bondholders were secured after all, Judge Lynch did not reach the question of whether the Bankruptcy Code's avoiding powers can be employed to set aside a transaction that occurred before the adoption of PROMESA.

The appeals court remanded the case to Judge Swain for further consideration in light of the opinion.

[The opinion is](#) *Altair Global Credit Opportunities Fund (A) LLC v. Financial Oversight and Management Board for Puerto Rico (In re Financial Oversight and Management Board for Puerto Rico)*, 914 F.3d 694 (1st Cir. Jan. 30, 2019).



*First Circuit finds no exceptions to the automatic stay under PROMESA subjecting Puerto Rico to 'ordinary course' litigation.*

## **Automatic Stay Applies to 'Ordinary Course' Litigation in Puerto Rico, Circuit Holds**

Reversing the district court, the First Circuit held that the automatic stay applies broadly to “ordinary course” litigation under the Puerto Rico Oversight, Management, and Economic Stability Act, or PROMESA (48 U.S.C. §§ 2161 *et. seq.*). The March 21 opinion also contains significant First Circuit jurisprudence on the “finality” of orders regarding the automatic stay.

### The Medicaid Reimbursement Litigation

Puerto Rico has been in litigation with health care providers since 2003 regarding Medicaid reimbursement. Years ago, the district court in Puerto Rico appointed a special master and entered an injunction requiring reimbursement under a formula developed by the master. Periodically, the master and the district court revisit the formula.

In April 2017, about one month before Puerto Rico initiated debt-adjustment proceedings under PROMESA, the special master issued a report proposing changes in the reimbursement formula. One month into PROMESA, a district judge in Puerto Rico (but not the district judge presiding over the PROMESA proceedings) adopted the master’s report. The providers appealed.

The circuit court in substance remanded the appeal to the district court to determine whether the automatic stay under PROMESA applied to the proceedings regarding the Medicaid reimbursement formula. In July 2018, Chief District Judge Gustavo A. Gelpí concluded that the automatic stay did not apply. In several opinions reported in this column, Judge Gelpí has been more prone to rule that the automatic stay does not apply to ordinary course litigation.

Puerto Rico appealed the district court’s order finding that the stay did not apply. In a 36-page opinion, Circuit Judge David J. Barron reversed. Judge Barron was a clerk for Justice John Paul Stevens and a professor at Harvard Law School.

### The First Circuit’s Stay Analysis

Naturally, Judge Barron began with the automatic stay in Section 362 of the Bankruptcy Code, incorporated by Section 301(c) of PROMESA. With little ado, he saw no “indication that the



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automatic stay is not fully applicable here.” If the court were to confine its analysis to Sections 362 and 301(c), he said “it would be clear that the automatic stay does apply.”

The providers, however, contended that several provisions in PROMESA made the automatic stay inapplicable. Judge Barron analyzed those provisions one by one.

Judge Barron began with Section 304(h) of PROMESA, entitled “Public Safety,” which provides that PROMESA “may not be construed to permit the discharge of obligations arising under Federal policy or regulatory laws, including laws relating to . . . public health or safety . . . . This includes compliance with obligations, requirements under consent decrees or judicial orders . . . .”

Seemingly a show-stopper, Judge Barron quickly concluded that Section 304(h) did not apply. Section 304(h), he said, “only bars the ‘discharge’ — not the ‘stay’ — of ‘compliance obligations.’” Discharge “is not at issue here,” he said, “only a stay is.”

Judge Barron added an important caveat. If the federal government were enforcing Medicaid laws, the “enforcement action would be excepted from the automatic stay. *See* 11 U.S.C. § 362(b)(4).”

Judge Barron turned to Section 204(d)(1) of PROMESA, entitled, “Implementation of Federal Programs.” The section says, “In taking actions under [PROMESA], the Oversight Board shall not exercise applicable authorities to impede territorial actions to — (1) comply with a court-issued consent decree or injunction . . . with respect to Federal programs.”

Again, Section 204(d)(1) seemed like a show-stopper — until Judge Barron focused on the statutory language and observed that imposing the automatic stay was not an “action” by the Oversight Board, because “the stay follows automatically, without the Board taking any action.”

Ultimately, Judge Barron dealt with Section 7 of PROMESA, which reads, “Except as otherwise provided in [PROMESA], nothing in this chapter shall be construed as . . . relieving a territorial government . . . from compliance with Federal laws or requirements . . . protecting the health . . . of persons in such territory.”

Giving “effect to all of the words in the statute,” Judge Barron held that the automatic stay in PROMESA falls under the “Except as otherwise” phrase, thus making Section 7 inapplicable to the case at bar.

## Appellate Jurisdiction





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Was an order finding the automatic stay to be inapplicable a final order bestowing appellate jurisdiction under 28 U.S.C. § 1291? Judge Barron said the First Circuit has not ruled on the question.

All circuits have held that granting relief from the automatic stay is a final order. The circuits to address the issue, Judge Barron said, have held that orders regarding the applicability of the stay are likewise final.

Judge Barron cited a PROMESA decision where the First Circuit held that denial of a motion to modify the stay “is not necessarily a final, appealable order . . . under every circumstance.” If there were “rapidly changing circumstances,” he said that an order denying a modification of the stay might not be final.

Ultimately, Judge Barron decided that the order on appeal was final under the “more flexible” rules in bankruptcy.

[The opinion is](#) *Commonwealth of Puerto Rico v. Migrant Health Center Inc.*, 919 F.3d 565 (1st Cir. March 21, 2019).



## Cross-Border Insolvency



*Madoff feeder fund allowed to conduct primary liquidation in the Cayman Islands.*

## **Location of Assets in the U.S. Doesn't Defeat COMI in the Cayman Islands**

Even though the primary asset of an offshore feeder fund is located in the U.S., the Cayman Islands are still the fund's center of main interests, according to Bankruptcy Judge Stuart M. Bernstein of New York.

Judge Bernstein therefore recognized the fund's liquidation in the Cayman Islands as the chapter 15 foreign main proceeding under Section 1517(b)(1).

The controversy involved the Ascot feeder fund, which was incorporated in the Caymans. The feeder fund transferred money taken in from its investors around the world to an affiliate that was a Delaware limited partnership. The Delaware entity, in turn, invested everything in the Bernard Madoff Ponzi scheme.

After Madoff went into liquidation in New York under the Securities Investor Protection Act, a receiver in New York took over the Delaware limited partnership. In the New York bankruptcy court, the Madoff trustee sued the feeder fund, the Delaware limited partnership, and Ezra Merkin, who controlled both. The Madoff trustee alleged that Merkin was in cahoots with Madoff and knew about the fraud all along.

The suit ended in a complex settlement where the Madoff trustee received \$280 million and will distribute about \$40 million to the Delaware limited partnership, now in the hands of the receiver. Eventually, some of the \$40 million will flow downstream to the feeder fund for ultimate distribution to the fund's investors.

Fearing that Cayman law and a court in the Cayman Islands would determine the methodology for the distribution to the feeder fund's investors, one of the investors filed a lawsuit in a New York state court against the feeder fund, seeking appointment of a receiver to oversee the distribution.

The feeder fund was already in the hands of voluntary liquidators in the Caymans. The liquidators in turn commenced liquidation proceedings in the Grand Court of the Cayman Islands, where they became the joint official liquidators, or JOLs. Having been authorized by the court in the Caymans, the JOLs filed a chapter 15 petition in New York, where they sought recognition of the Caymans liquidation as the foreign main proceeding.



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Under Section 1517, the New York bankruptcy court would recognize the proceedings in the Caymans as the foreign main proceeding if it were to find that the feeder fund's center of main interests, or COMI, was in the Cayman Islands.

The investor who was seeking a receiver in New York objected to foreign main recognition. The investor reasoned, among other things, that the feeder fund's COMI was not in the Cayman Islands because the \$40 million is currently located either with the limited partnership's receiver in New York or in Delaware, where the limited partnership was organized.

In his 27-page opinion on August 12, Judge Bernstein overruled the objection, determined that the Caymans are the feeder fund's COMI, and recognized the proceedings in the Caymans as the foreign main proceeding.

Section 1516(c) provides that the debtor's registered office (in this case, the Cayman Islands) is presumed to be the COMI absent "evidence to the contrary." In *Morning Mist Holdings Ltd. v. Krys (In re Fairfield Sentry Ltd.)*, 714 F.3d 127 (2d Cir. 2013), the Second Circuit laid down other guiding principles to determine a company's COMI.

As Judge Bernstein said, *Fairfield Sentry* requires assessment of COMI on the chapter 15 filing date, with an ability to look back in time if it appears that the debtor attempted to manipulate COMI.

Unlike other cases where the COMI was not offshore even though the debtor was incorporated abroad, Judge Bernstein found that the JOLs were both residents of the Caymans. Before the JOLs took over, the feeder fund's two board members both resided in the Caymans. He said that the JOLs and their staff of accountants "have directed and conducted [the feeder fund's] liquidation in the Cayman Islands."

Admittedly, the feeder fund had been in a largely inactive wind-down since 2008. The most intense activity had been litigation in New York in connection with the Madoff liquidation and the limited partnership's receivership.

"This does not mean that the New York litigations define [the feeder fund's] COMI," Judge Bernstein said. He went on to find that the objector had not overcome the presumption of COMI in the Cayman Islands. Even if the presumption were surmounted, Judge Bernstein said that the JOLs had "shown by a preponderance of the evidence that the location of the [feeder fund's] headquarters and those who managed it were situated in the Cayman Islands on the Petition Date."

Although the location of the assets in the U.S. "weighs against recognition," Judge Bernstein said "it does not follow" that the situs of the assets is the "key piece of evidence."



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As icing on the cake, Judge Bernstein said that investors always knew that their rights would be governed by Cayman law and had submitted to jurisdiction in the islands in the event of disputes.

Finally, Judge Bernstein said that “COMI has not been manipulated as . . . [the] principal place of business has always been in the Cayman Islands.”

[The opinion is](#) *In re Ascot Fund Ltd.*, 19-10594, 2019 BL 298615, 2019 Bankr Lexis 2528 (Bankr. S.D.N.Y. Aug. 12, 2019).