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Rochelle's Daily Wire

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Supreme Court

Decided Last Term

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

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

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

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

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

The Facts

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

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

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

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

Justice Breyer's Opinion

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

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

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

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

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

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

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

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

The Standing Question

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

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

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

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

'Gift' Plans

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

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

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

The Dissent

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

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

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

ROCHELLE'S DAILY WIRE

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

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

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

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

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

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

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

The Facts

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

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

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

The Majority Opinion

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

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

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

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

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

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

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

Justice Sotomayor's Dissent

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Bankruptcy Venue Standards

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

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

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

Bristol-Myers and Class Actions

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Implications of *Bristol-Myers* in Bankruptcy

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

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

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

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

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

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

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

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

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

This Term

Intermediate transfers to financial institutions do not trigger the safe harbor.

Supreme Court Narrowly Interprets the Safe Harbor, Overrules the Majority of Circuits

Resolving a split of circuits, the Supreme Court ruled unanimously today in *Merit Management Group LP v. FTI Consulting Inc.* that the so-called safe harbor under Section 546(e) only applies to "the transfer that the trustee seeks to avoid." In other words, using a bank as an escrow agent does not preclude a trustee from recovering a constructively fraudulent transfer under Section 548(a)(1)(B), when the trustee is seeking to recover from the ultimate recipient of the transfer but not from an intermediary bank.

The Supreme Court had been asked to resolve a split of circuits and decide whether the safe harbor applies when a financial institution is only a "mere conduit." Instead, the unanimous opinion by Justice Sonia Sotomayor decided the case on a different and broader ground. The opinion may lead to a rethinking of safe harbor cases and might open the door to suits that previously were believed to rest comfortably within the safe harbor.

The Seventh Circuit Opinion

The case came to the Supreme Court from the Seventh Circuit, where a bankruptcy trustee had sued a selling shareholder in the leveraged buyout of a non-public company. The transaction was structured so that the purchase price for the stock initially came from an investment bank and was transferred to a commercial bank acting as escrow agent. As escrow agent, the bank paid a total of $16.5 million to the selling shareholder. The trustee sued the selling shareholder for receipt of a constructively fraudulent transfer.

The district court granted a motion to dismiss, reasoning that the safe harbor applied because the transfer included both a transfer from an investment bank and a transfer to a commercial bank, before the funds ended up in the hands of the selling shareholder.

On appeal, the Seventh Circuit reversed, in an opinion by Chief Circuit Judge Diane P. Wood. *FTI Consulting Inc. v. Merit Management Group LP*, 830 F.3d 690 (7th Cir. July 28, 2016).

The Seventh Circuit opinion stands for the proposition that routing consideration for an LBO of a non-public company through a financial institution cannot preclude a fraudulent transfer attack if it turns out that the seller was rendered insolvent.

Since the purchaser was buying stock, it was clear to the Seventh Circuit that the transfers were either a settlement payment or a payment in connection with a securities contract. The appeals court said it was therefore only necessary to decide whether the safe harbor protects transactions "simply [because they were] conducted through financial institutions."

The Seventh Circuit refused to "interpret the safe harbor so expansively that it covers any transaction involving securities that uses a financial institution or other named entity as a conduit for funds." Instead, the appeals court said "it is the economic substance of the transaction that matters."

The Chicago-based appeals court therefore reversed the district court, which had utilized the safe harbor to dismiss the trustee's suit.

The Seventh Circuit opinion deepened an existing circuit split because the Second, Third, Sixth, Eighth and Tenth Circuits have invoked the safe harbor when a financial institution is nothing more than a conduit. The Eleventh Circuit was aligned with the Seventh, requiring the financial institution to be more than a conduit.

The defendant-selling shareholder filed a petition for *certiorari*, which the Supreme Court granted in May 2017. Oral argument was held on Nov. 6.

The Unanimous Opinion

The seeds for Justice Sotomayor's opinion were sown in an exchange at oral argument between Justice Anthony M. Kennedy and former Solicitor General Paul D. Clement, counsel for the trustee. Justice Kennedy asked whether the opinion should be qualified to require that the financial institution have an "equity participation" before the safe harbor applies.

Clement said he had a "simpler way to write the opinion[: by just looking] to the transfer that the trustee seeks to avoid." And that's what Justice Sotomayor did.

Laying out the statute in full text in her opinion, Justice Sotomayor traced the many amendments to the safe harbor, saying Congress "each time expand[ed] the categories of covered transfers or entities."

In pertinent part, Section 546(e) provides that a trustee "may not avoid a transfer" that is a "settlement payment . . . made by or to (or for the benefit of) a . . . financial institution" or that "is a transfer made by or to (or for the benefit of) a . . . financial institution . . . in connection with a securities contract . . . ."

Justice Sotomayor framed the question as whether the safe harbor applied because the transfer was "'made by or to (or for the benefit of) a . . . financial institution.'" She said that asking whether the bank had a beneficial interest in the transferred property "put the proverbial cart before the horse."

Before deciding whether the transfer was made to a covered entity, "the court must first identify the relevant transfer," she said.

Justice Sotomayor devoted the bulk of her opinion to explaining why the "language of Section 546(e)," the "specific context in which that language is used, and the broader statutory structure all support the conclusion that the relevant transfer for purposes of the Section 546(e) safe-harbor inquiry is the overarching transfer that the trustee seeks to avoid." She said the trustee properly identified the transfer as the sale of stock by the seller to the buyer, not intermediate transfers involving investment or commercial banks.

Uttering a phrase that will be cited countless times in the future, Justice Sotomayor cautioned that a trustee "is not free to define the transfer it seeks to avoid in any way it chooses."

Justice Sotomayor devoted the final third of her 19-page opinion to refuting the selling shareholder's arguments. The last part of her opinion arguably broadens the scope of the holding and makes the safe harbor more narrow than it is now generally understood to be.

She said that the addition of "(or for the benefit of)" in 2006 was only intended for the scope of the safe harbor to match the scope of the avoiding powers, where similar language is used. She rejected the selling shareholder's contention that the language was intended to bar avoidance if the financial institution was an intermediary without a financial interest in the transfer.

Next, the selling shareholder mounted an argument based on the inclusion of a securities clearing agency as one of the entities covered by the safe harbor.

If the relevant transfer is from the buyer to the seller, Justice Sotomayor said, "the question then becomes whether the transfer was 'made by or to (or for the benefit of)' a covered entity," such as a clearing agency.

Answering her own question, Justice Sotomayor said, "If the transfer that the trustee seeks to avoid was made 'by' or 'to' a securities clearing agency . . . , then Section 546(e) will bar avoidance, and it will do so without regard to whether the entity acted only as an intermediary."

On the next page, Justice Sotomayor acknowledged there was "good reason to believe that Congress was concerned about transfers '*by* an industry hub.'" [Emphasis in original.]

She went on to say that the safe harbor protects securities transactions "'made by or to (or for the benefit of)' covered entities. See Section 546(e). Transfers 'through' a covered entity, conversely, appear nowhere in the statute."

What exactly did the justice mean by her statements?

It was generally understood, at least before today's opinion, that a trustee could not recover a fraudulent transfer resulting from the sale of stock in a publicly held company, because the payoff to the selling shareholder would have been made through a "covered entity," like a clearing agent. Does today's opinion mean that a trustee for a public company can recover from selling shareholders but, of course, not from a clearing agent?

It had also been held that the LBO of a privately held company was protected by the safe harbor, if the sale of the stock utilized a bank somewhere in the stream of payments. It seems reasonably clear that an LBO of a privately held is no longer protected, unless the transferee is a financial institution.

However, what results if the transfer ends up in the coffers of a bank that held a lien on the stock being sold? May the trustee recover only from the beneficial owner of the stock but not from the bank where the money ended up?

The meaning of *Merit Management* will be debated in other contexts. For instance, the Second Circuit held in *Note Holders v. Large Private Beneficial Owners (In re Tribune Co.)*, 818 F.3d 98 (2d Cir. 2016), that the safe harbor bars suits by creditors under state law to recover payments made in securities transactions.

In *Tribune*, the Second Circuit concluded that Congress intended broad protection for securities markets, even to the extent of barring creditors from prosecuting claims that belong to them and not to bankruptcy trustees. Does *Merit Management* undercut the Second Circuit's notion that the safe harbor broadly immunizes any transaction involving securities whenever there has been a bankruptcy?

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

Some justices are critical of the existing test for ruling on non-statutory insider status.

Supreme Court Says Insider Status Is Reviewed for Clear Error Under Existing Test

The Supreme Court used a bankruptcy case to elucidate the standard of review when an appellate court confronts a mixed question of law and fact. According to Justice Elena Kagan, who wrote the March 5 opinion for the unanimous Court, clear error was the proper standard of review because the arm's-length nature of the transaction was primarily factual in nature.

In concurring opinions, four justices questioned whether the Ninth Circuit employed the proper legal test for non-statutory insider status. Implying that the dissenter in the Ninth Circuit was on the right track, they laid out a test for non-statutory insider status that would be more consonant with the statute and produce a different outcome.

At oral argument in the Supreme Court on October 31, it seemed possible that the justices might rule that review is *de novo* when the facts in the trial court were undisputed. However, the Court's opinion hewed to the traditional notion that inferences taken from undisputed facts are reviewed for clear error.

The Ninth Circuit Decision

In this chapter 11 reorganization, there were only two creditors. One was a bank with a $10 million secured claim. The other was the debtor's general partner, who had a $2.8 million unsecured claim.

The bank opposed the plan and could have defeated confirmation for lack of an accepting class, because the insider's vote could not be counted under Section 1129(a)(10) in cramming down the plan on the bank.

To create an accepting class and open the door to confirmation via cramdown, the insider sold her claim for $5,000 to a very close friend. The plan provided a $30,000 distribution on the unsecured claim.

The bankruptcy judge ruled that the buyer automatically became an insider by purchasing the insider's claim. The Bankruptcy Appellate Panel reversed and was upheld by the Ninth Circuit in a 2-1 opinion.

All three circuit judges agreed that the purchaser did not automatically become an insider by purchasing the insider's claim. The majority then said that status as an insider entails a "factual inquiry that must be conducted on a case-by-case basis." To be a non-statutory insider, the appeals court laid out a two-part test. A claim buyer "must have a close relationship with the debtor and negotiate the relevant transaction at less than arm's length."

The Ninth Circuit did not remand the case to the bankruptcy court because the bankruptcy judge had ruled that the buyer purchased the insider's claim in an arm's-length transaction. Since the purchaser bought the claim at arm's length, the second prong of the test had not been met, leading the majority on the Ninth Circuit to rule that the purchaser was not a non-statutory insider.

The majority on the circuit court therefore upheld the appellate panel because the bankruptcy judge's findings of fact on insider status were not clearly erroneous.

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

The Petition for *Certiorari*

The bank filed a petition for *certiorari*, which was granted in March 2017. The Court limited its review to the appellate standard of review. The U.S. Solicitor General, who had opposed granting *certiorari*, submitted a merits brief on the side of the debtor and argued that the Ninth Circuit properly applied the clear-error standard of appellate review. The Solicitor General did not take a position on whether the bankruptcy judge committed clear error.

The Unanimous Opinion

In her 11-page opinion for the unanimous court, Justice Kagan said that courts have developed standards for non-statutory insiders that "are not entirely uniform." Many, she said, focus on whether the transaction was conducted at arm's length.

The buyer and seller were in a romantic relationship but lived apart and kept their finances separate. Despite the close relationship, the bankruptcy judge had found that the sale of the claim was negotiated at arm's length.

Justice Kagan said that the bankruptcy court had correctly applied the Ninth Circuit's two-part test. The Supreme Court, however, did not include a review of the test within the grant of *certiorari*. Instead, the Court only agreed to review the proper appellate standard for a ruling on non-statutory insider status.

Parsing the standards of appellate review, Justice Kagan said that findings of historical fact — such as "what, when or where, how or why" — are reviewable for clear error.

On the other hand, whether historical facts satisfy the test for non-statutory insider status is a mixed question of law and fact, Justice Kagan said. She then said that mixed questions "are not all alike."

Pinpointing the standard of review for mixed questions "all depends," she said, on whether the work of the appellate court is "primarily legal or factual."

Deciding whether the sale of the claim was "conducted as if the [buyer and seller] were strangers to each other" was "about as factual sounding as any mixed question gets," Justice Kagan said. Indeed, she said, applying the Ninth Circuit's two-part test amounts to what the Court "previously described as 'factual inferences[] from undisputed facts."

Justice Kagan said that the bankruptcy court had the "closest and the deepest understanding of the record" from hearing the witnesses and presiding over the presentation of evidence.

The appellate standard of review was therefore for clear error because the appellate court was called on to perform "[p]recious little" legal work in applying the Ninth Circuit's two-part test.

Approaching the issue from a different direction, Justice Kagan said that even a *de novo* review "will not much clarify legal principles or provide guidance to other courts resolving other disputes."

The Concurring Opinions

Justice Sonia Sotomayor wrote a seven-page concurring opinion joined by Justices Anthony M. Kennedy, Clarence Thomas, and Neil M. Gorsuch.

Justice Sotomayor said it "is not clear to me" that the two-prong test in the Ninth Circuit "is consistent with the plain meaning of the term 'insider' as it appears in [Section 101(31) of] the Code."

The enumerated statutory insiders in Section 101(31) do not lose that status, Justice Sotomayor said, by negotiating at arm's length. Therefore, she said, "it is not clear why the same should not be true of non-statutory insiders."

Finding shortcomings in the Ninth Circuit's test, Justice Sotomayor proceeded to offer two other tests.

First, the court could focus on "commonalities" between enumerated insiders and "characteristics of the alleged non-statutory insider." Second, the court might consider "other aspects of the parties' relationship" if the transaction was negotiated at arm's length.

Had the trial court applied one of her proposed tests, Justice Sotomayor said it "is conceivable" that the standard for review might have been different.

In the penultimate paragraph of her concurrence, Justice Sotomayor said that the facts of the case as applied to one of her two alternative tests may have resulted in a finding that the purchaser was an insider, even if the clear-error test were applied.

In a signal that she and her three colleagues were dissatisfied with the Ninth Circuit's existing test, Justice Sotomayor ended her opinion by imploring courts "to grapple with the role that an arm's-length inquiry should play in a determination of insider status."

Justice Kennedy wrote a separate two-page concurrence to emphasize that the Court's opinion should not be taken as an endorsement for the Ninth Circuit's existing two-part test. He also questioned whether the bankruptcy judge was correct in finding that the purchaser was not an insider, but said "*certiorari* was not granted on this question."

The opinion is *U.S. Bank NA v. The Village at Lakeridge LLC,* 15-1509 (Sup. Ct. March 5, 2018).

The high court seemed primed to rule that a debt will be discharged despite an oral misrepresentation about one asset.

Supreme Court Holds Argument in *Lamar, Archer & Cofrin* on Dischargeability

The Supreme Court heard oral argument yesterday in *Lamar, Archer & Cofrin, LLP v. Appling*, 16-1215 (Sup. Ct.). The justices seem primed to rule that a false statement about one asset must be in writing to provide grounds for ruling that a debt is nondischargeable under Section 523(a)(2).

The high court granted *certiorari* on Jan. 12 to resolve a split of circuits. The courts of appeals are evenly split, with the Eleventh and Fourth Circuits holding that a false oral statement about one asset is a "statement respecting the debtor's . . . financial condition" that must be in writing to result in denial of discharge of a debt under Section 523(a)(2). The Fifth and Tenth Circuits ruled to the contrary and held that misrepresenting one asset can result in nondischargeability of the debt owing to the creditor to whom the misrepresentation was made.

Among the lower courts, a majority follow the Eleventh and Fourth Circuits.

In a telling indication of how the Court may come out, the justices spent perhaps one-third of oral argument discussing the best rule they could devise to reach the same result as the Eleventh Circuit and hold that an oral misrepresentation about one asset cannot lead to the nondischargeability of a debt.

The Case Below

A client told his lawyers that he expected a large tax refund that would enable him to pay his legal bills. Based on that representation, the lawyers continued working.

Although the refund was smaller than represented, the client spent it on his business, falsely telling his lawyers that he had not received the refund. The lawyers continued working. Later, they obtained a judgment they could not collect when the client filed bankruptcy.

The bankruptcy judge held that the claim for legal fees was not discharged. The ruling in bankruptcy court was upheld in district court, but the Eleventh Circuit reversed in a Feb. 15, 2017, opinion authored by Circuit Judge William Pryor, *Appling v. Lamar, Archer & Cofrin LLP (In re Appling)*, 848 F.3d 953 (11th Cir. Feb. 15, 2017). To read ABI's discussion of the Eleventh Circuit opinion, click here.

The creditor filed a petition for *certiorari*. The U.S. Solicitor General recommended that the Court grant the petition, submitted an *amicus* brief, and participated in oral argument, contending that the Eleventh Circuit was correct and that an oral misstatement about one asset is a statement about "financial condition" that must be in writing before the debt can be declared nondischargeable.

The Issue and the Statute

The case centers around Sections 523(a)(2)(A) and 523(a)(2)(B). Under (a)(2)(B), a debt will not be discharged if it resulted from a materially false *written* statement "respecting the debtor's . . . financial condition."

Under (a)(2)(A), a debt will not be discharged if it resulted from "a false representation or actual fraud, other than a statement respecting the debtor's . . . financial condition."

The circuits are split about the result when a debtor prevaricates about one asset, rather than lies about his or her net worth or overall financial condition. Curiously, the Fifth and Tenth Circuits would discharge a debt if a debtor makes a big lie orally about his or her net worth, but would declare the debt nondischargeable if the debtor makes a smaller, oral lie about only one asset.

Oral Argument

The justices were uncharacteristically quiet, interrupting counsel on both sides less often than they do in most arguments. Perhaps the justices have already decided how they will rule. Or perhaps they were simply exhausted after the morning's prior argument in a very consequential case, *South Dakota v. Wayfair, Inc.*, to decide whether the Court will overrule its prior precedent and allow states to impose sales taxes on goods purchased through the Internet.

As the petitioner in the bankruptcy case, counsel for the creditor argued first. He asked the justices to rule "that a statement about a single asset or a single liability is not a statement respecting financial condition." He focused on the statutory word "respecting" to mean that a misrepresentation about "overall financial condition" is the only type of statement that must be in writing to result in nondischargeability. In "commercial practice," he said, "financial condition" refers "to one's overall financial status."

The creditor's counsel argued that the result might be different if the statute had used "about" rather than "respecting." But Justice Elena Kagan countered, "I honestly couldn't find one [example] where [the two words] meant something different."

Justice Stephen G. Breyer took a different approach. He focused on the word "statement" rather than "respecting" to broaden the meaning of "financial condition" to encompass one asset.

In the same vein, Justice Ruth Bader Ginsburg asked why a statement about a forthcoming tax refund "isn't . . . a statement respecting the financial condition."

Similarly, Justice Neil M. Gorsuch asked why a misrepresentation about a major asset "can't . . . be about your overall financial condition."

Justice Breyer used the example of a debtor who claimed to own an original painting by Vermeer. He asked, "What's that if it's not about overall financial [condition]?"

Later, counsel for the creditor addressed these questions by saying that a misstatement about one asset "goes to the ability to pay, not overall financial condition."

Counsel for the debtor and the Solicitor General drew even fewer questions.

Counsel for the debtor rested his case on the plain language of the statute, as did the creditor. Fleshing out his interpretation of the statute, he said "that any statement that has a direct impact on one's overall financial condition . . . is a statement respecting financial condition."

The debtor's counsel proposed the following test: "Does the statement describe what would be a line item on one's balance sheet or income statement?"

He described the government's proposed test as saying that a statement pertains to financial condition if it is "an affirmative representation about a single asset if that representation is offered as evidence of the debtor's ability to pay."

In response to questions from the bench, he could not think of a circumstance where the result would differ depending on which test was employed.

When the time came for the Solicitor General to speak, he agreed that "there is no practical difference in how it turns out" if the debtor's formulation were used rather than the government's. He grounded the government's position in history.

According to the Solicitor General, the phrase "financial condition" was not "plucked out of the ether in 1978" with the adoption of the Bankruptcy Code. He said it had existed in bankruptcy law "dating back to 1926 [and] had been interpreted by courts over the years to extend beyond statements about overall financial condition to include statements about particular assets."

The justices asked no questions of the creditor's counsel during rebuttal argument.

The creditor was represented in the Supreme Court by Gregory George Garre from Latham & Watkins LLP in Washington, D.C. The debtor's counsel was Paul Whitfield Hughes from Mayer

Brown LLP in Washington, D.C. Arguing for the government was Jeffrey E. Sandberg, Assistant to the Solicitor General.

To read the transcript of oral argument, click here.

The case is *Lamar, Archer & Cofrin, LLP v. Appling*, 16-1215 (Sup. Ct.).

Reorganization

Dismissal

The Fifth Circuit is being asked to decide whether loan structuring can prevent a borrower from filing bankruptcy.

The Validity of a 'Golden Share' to Bar a Filing Goes to the Fifth Circuit

The Fifth Circuit is being asked to accept a direct appeal and decide whether a creditor can structure a loan agreement to prevent a borrower from filing bankruptcy, sidestepping the principle that public policy prohibits waiving the right to file bankruptcy.

Bankruptcy Judge Edward Ellington of Jackson, Miss., ruled in December that a creditor with a comparatively small claim who is also a minority equity holder can be given the right, wearing its shareholder hat, to preclude the borrower from filing bankruptcy. Consequently, Judge Ellington dismissed the debtor's chapter 11 petition for lack of proper corporate authorization.

The case raises the question of whether a creditor can utilize a so-called golden share to prevent a borrower from filing bankruptcy. On Jan. 17, Judge Ellington certified the case for direct appeal to the Fifth Circuit.

Judge Ellington said that a "blocking provision or golden share is a relatively new provision created by the credit community in an attempt to work around the prohibition against an entity contracting away the right to file bankruptcy."

The Golden Share Structure

The debtor owned a car rental company. To finance an acquisition, the debtor received a $15 million investment from a diversified financial group. In return, the investor was given 49% of the debtor's preferred equity.

An affiliate of the investor was a creditor with a $3 million claim. Judge Ellington said that the investor controlled the affiliate-creditor.

The debtor's Delaware certificate of incorporation included a golden share provision prohibiting the company from filing bankruptcy without consent from the investor wearing its hat as a preferred stockholder.

After the debtor filed a chapter 11 petition, the investor, in its status as the holder of the golden share, filed a motion to dismiss, contending the filing was accomplished without proper corporate authorization. Judge Ellington granted the motion and dismissed the petition in December when the debtor was in the midst of selling the assets.

Caselaw on Golden Shares

Judge Ellington said there are six opinions from bankruptcy courts and one from a district court shedding light on the ability of a golden shareholder to block the filing of bankruptcy. All of the cases are new. The first was handed down in 2007. The six others date from 2014 or later. None reached a circuit court.

All of the seven cases, according to Judge Ellington, begin with the "general premise that the waiving or contracting away the right to file for relief under the Bankruptcy Code is contrary to public policy." All of the cases, he said, hold that a blocking power held by a creditor is "void as a matter of public policy."

On the other hand, Judge Ellington said it is "clear" from the cases dealing with "golden shares or blocking provisions" that "either provision will be upheld as valid if it is held by an equity holder."

Applying the caselaw to the facts at hand, Judge Ellington concluded that the blocking position held by the "substantial equity holder" was "valid and enforceable and . . . not contrary to public policy under federal law."

Judge Ellington conceded that the investor-creditor wears two hats, as a creditor owed $3 million and an equity holder with a $15 million investment. Quoting one of the seven cases, the judge said the equity investor had the "unquestioned right" to block a voluntary bankruptcy.

Judge Ellington also concluded that a golden share or blocking provision in articles of incorporation is not invalid under Delaware law.

Should the Fifth Circuit accept the direct appeal, Judge Ellington tasked the appeals court with deciding three issues: (1) Is a blocking provision or golden share, held by either a creditor or equity holder, invalid as a violation of public policy if it prevents a corporation from filing bankruptcy; (2) if the holder is both a creditor and shareholder, is barring bankruptcy invalid as a violation of public policy, and (3) under Delaware law, may a certificate of incorporation contain a blocking provision or golden share, and if permissible, does Delaware law impose fiduciary duties on the holder in exercising its power?

Enforcing the blocking provision may seem reasonable in a case like this where the equity investment was five times larger than the claim as a creditor. But what if the facts were reversed and the claim was five times larger than the equity investment? Where should the Fifth Circuit draw the line on the ratio between debt and equity? Does the creditor's control invalidate the exercise of shareholder rights? Should the bankruptcy court make a finding of fact and decide whether the shareholder was using its blocking power to collect the debt or eliminate the bankruptcy court as a platform where other creditors might sue the shareholder-creditor?

The validity of a golden share in the hands of someone who is both a shareholder and creditor cries out for a bright-line rule, otherwise the outcome of every case will be uncertain and law could develop in different directions around the country, leading to inconsistent results and forum-shopping.

The December opinion and the certification of a direct appeal are both in *In re Franchise Services of North America Inc.*, 17-2361, 2018 BL 16789 (Bankr. S.D. Miss. Dec. 18, 2017 and Jan. 17, 2018).

Rochelle's Daily Wire

Executory Contracts & Leases

***First Circuit follows the Fourth Circuit's* Lubrizol *and rejects the Seventh Circuit's* Sunbeam.**

Circuit Split Deepens on Rejection of Trademark Licenses

Pointedly disagreeing with the Seventh Circuit, the First Circuit deepened an existing split by adopting the Fourth Circuit's conclusion in *Lubrizol* and holding that rejection of a trademark license agreement precludes the licensee from continuing to use the license.

The 2/1 opinion from the First Circuit on Jan. 12 reversed the Bankruptcy Appellate Panel, which, to the contrary, had followed Circuit Judge Frank Easterbrook's decision in *Sunbeam Products Inc. v. Chicago American Manufacturing LLC*, 686 F.3d 372 (7th Cir. 2012). In *Sunbeam,* the Seventh Circuit rejected the Fourth Circuit's rationale in *Lubrizol Enterprises Inc. v. Richmond Metal Finishers Inc.*, 756 F.2d 1043 (4th Cir. 1985).

In simple terms, the First Circuit's decision means that the licensee of patents can continue using the technology after rejection as a consequence of Section 363(n), but the same licensee cannot continue using trademark licenses that went along with the technology.

The Genesis of Section 365(n)

In *Lubrizol*, the Fourth Circuit ruled in 1985 that rejection of an executory contract licensing intellectual property halted the non-bankrupt's right to use patents, trademarks and copyrights. Three years later, Congress responded by adding Section 365(n), which, in conjunction with the definition of "intellectual property" in Section 101(35A), provides that the non-debtor can elect to continue using patents, copyrights and trade secrets despite rejection of a license.

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

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

In *Sunbeam*, the Seventh Circuit split with the Fourth in 2012. Judge Easterbrook acknowledged that Section 365(n) does not preserve the right to use trademarks, but at the same time does not prescribe the consequences of rejection. Judge Easterbrook instead relied on Section 365(g), which teaches that rejection "constitutes a breach" of contract.

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

The First Circuit Case

Before bankruptcy, the debtor in the case before the First Circuit had granted the licensee a non-exclusive, irrevocable, fully paid, transferrable license to its intellectual property including patents. However, the irrevocable license excluded the debtor's trademarks.

Separately, the license agreement granted a non-exclusive, non-transferable, limited license to use the debtor's trademarks.

The day after filing a chapter 11 petition, the debtor filed a motion to reject the trademark and patent licenses as executory contracts under Section 365(a). During the ensuing litigation, the debtor conceded that Section 365(n) allowed the licensee to retain its rights in the intellectual property and patents, but not the trademarks.

Ultimately, the bankruptcy court ruled that Section 365(n) did not preserve the licensee's rights in the trademarks. The bankruptcy judge believed that the omission of trademarks from the definition of intellectual property in Section 101(35A) meant that Section 365(n) does not protect rights in trademarks.

On the first appeal, the BAP followed *Sunbeam* and reversed the bankruptcy court, calling *Lubrizol* "draconian" and saying that rejection does not "vaporize" trademark rights. To read ABI's report on the BAP opinion, click here.

With regard to trademarks, Circuit Judge William J. Kayatta, Jr. reversed the BAP in a 2/1 opinion, holding that the right to use trademarks did not survive rejection.

Judge Kayatta said that *Sunbeam* "largely rests 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." That premise, he said, is wrong because "effective licensing of a trademark" requires the licensor to continue monitoring and exercising control over the quality of the goods sold under the mark.

Sunbeam is wrong, in Judge Kayatta's view, because it "entirely ignores the residual enforcement burden it would impose on the debtor just as the Code otherwise allows the debtor to free itself from executory burdens" and "invites further degradation of the debtor's fresh start options."

Judge Kayatta therefore favored "the categorical approach of leaving trademark licenses unprotected from court-approved rejection, unless and until Congress should decide otherwise."

The Dissent

Circuit Judge Juan R. Torruella dissented with regard to trademarks. Like *Sunbeam*, he would have held that rights in a trademark "did not vaporize" as a result of rejection.

Judge Torruella based his dissent in large part on the legislative history surrounding the adoption of Sections 363(n) and 101(35A). He saw Congress as allowing courts to use their equitable powers to protect trademark licensees.

Rather than eviscerating the licensee's trademark rights, Judge Torruella said he instead would "be guided by the terms of the [license agreement], and non-bankruptcy law, to determine the appropriate equitable remedy of the functional breach of contract."

Distribution Rights

The litigation in bankruptcy court also involved the debtor's license of distribution rights. Affirmed by the BAP, the bankruptcy court had ruled that rejection cut off distribution rights too.

On appeal in the circuit, the licensee mounted several creative arguments aimed at showing that distribution rights were an adjunct to the patents and technology and therefore should survive.

Judges Kayatta and Torruella agreed that rejection cut off distribution rights.

The Next Steps

If the licensee does not throw in the towel, the next step will be a petition for rehearing *en banc* or a petition for *certiorari*. The circuit split pits not only the First Circuit against the Seventh. In his concurrence in *In re Exide Technologies*, 607 F.3d 957, 964 (3d Cir. 2010), Third Circuit Judge Thomas L. Ambro reached the same result as the Seventh Circuit on much the same reasoning.

The opinion is *Mission Product Holdings Inc. v. Old Cold LLC (In re Old Cold LLC)*, 879 F.3d 376 (1st Cir. Jan. 12, 2018).

ROCHELLE'S DAILY WIRE

*For swaps, the Section 560 safe harbor overrides the anti-***ipso facto** *provisions in the Bankruptcy Code.*

Flip Clauses in Swaps Held Enforceable by District Judge in New York

In a broadly worded opinion, District Judge Lorna G. Schonfield of Manhattan ruled that a so-called flip clause in a swap agreement is enforceable under the exception to the automatic stay in Section 560 of the Bankruptcy Code.

Judge Schonfield affirmed a June 2016 opinion by Bankruptcy Judge Shelley C. Chapman and in the process disagreed with former Bankruptcy Judge James M. Peck, who had held in a pair of opinions in 2010 and 2011 that a flip clause is an *ipso facto* clause that is not enforceable under Sections 365(e)(1), 541(c)(1)(B) and 363(l) of the Bankruptcy Code.

The Lehman Flip Clauses

Lehman Brothers Holdings Inc. and its subsidiaries had thousands of swaps in their portfolios when they began filing for chapter 11 protection in September 2008. Some included so-called flip clauses that came into play when Lehman was "in the money" at the outset of bankruptcy and stood to recover from termination of the swaps.

Briefly stated, the flip clauses provided that collateral securing the swaps ordinarily would go first to Lehman subsidiary Lehman Brothers Special Financing Inc. (known as LBSF) as the swap counterparty in an ordinary maturity or termination.

If the Lehman parent or LBSF were to file bankruptcy and thus cause an event of default, the swap counterparty could terminate the swap prematurely. If the Lehman parent or LBSF were the defaulting party, the flip clause would kick in and direct the collateral proceeds first to noteholders, not to LBSF. Since the noteholders were never paid in full, LBSF got nothing when the flip clauses were invoked, even though LBSF would have been in the money were there are an ordinary maturity.

In 2010, Lehman sued 250 defendants in bankruptcy court, contending that the flip clauses violated the anti-*ipso facto* provisions in Sections 365(e)(1), 541(c)(1)(B) and 363(l) of the Bankruptcy Code. Lehman contended that flip clauses were invalid because those subsections provide that contractual provisions are unenforceable if they become effective on insolvency or bankruptcy.

In different adversary proceedings involving different counterparties, Judge Peck wrote decisions in 2010 and 2011 where he agreed with Lehman and concluded that flip clauses violated the anti-*ipso facto* statutes. He also decided that Section 560 did not apply. Neither of those decisions went up on appeal.

When Judge Peck left the bench, Judge Chapman took over the Lehman bankruptcy, including litigation over the flip clauses. The defendants filed motions to dismiss. Judge Chapman granted the motions in her opinion in June 2016, prompting Lehman to appeal. To read ABI's discussion of Judge Chapman's opinion, click here.

Judge Schonfield's Opinion

In her 16-page opinion on March 14, Judge Schonfield did not keep the reader in suspense. After laying out the facts and Judge Chapman's decision, she went to the heart of the case and said that flip clauses "do not violate the Bankruptcy Code" because they are protected by the safe harbor in Section 560.

Section 560 provides that "any contractual right of a swap participant . . . to cause the liquidation, termination or acceleration [of a swap agreement] shall not be stayed, avoided, or otherwise limited by operation of any provision" in the Bankruptcy Code. Citing legislative history, Judge Schonfield said that the "purpose of Section 560 is to protect securities markets."

The purpose of Section 560 in mind, Judge Schonfield said that "the most sensible literal reading of Section 560 applies to the distributions in this case." Enforcing a flip clause, she said, is the "'exercise of [a] contractual right . . . to cause the liquidation [or] termination'" of a swap.

Judge Schonfield rejected Lehman's argument that "liquidation" as used in Section 560 only refers to the calculation of amounts owed, not to the actual distribution of funds.

Because the safe harbors in the Bankruptcy Code must be "interpreted based on their plain meaning," Judge Schonfield said that Lehman's argument was "nonsensical because it would nullify any protection Section 560 provides to swap agreements." The "mere calculation" of a swap, she said, would provide "no security to swap participants."

Next, Lehman contended that the trustees who held the collateral were the only parties entitled to enforce the flip clauses. Since the trustees were not swap participants, according to Lehman, their actions were not protected by the Section 560 safe harbor.

Although she found no authority on the topic, Judge Schonfield said that Lehman's "argument is incorrect and contrary to the plain language of the statute." Section 560, she said, "only requires the exercise 'of' a swap participant's contractual right, but that right need not be exercised 'by' the swap participant." Therefore, when the trustees terminated the swaps, she said "they exercised the rights 'of'" the swap participants.

Lehman also made claims under state law for unjust enrichment, constructive trust, money had and received, replevin and breach of contract. Those claims were properly dismissed, Judge Schonfield said, because the distributions were not improper given that the flip clauses "were not unenforceable *ipso facto* clauses."

Judge Schonfield also upheld dismissal of Lehman's fraudulent transfer claims based on the notion that the swap participants did not give fair consideration. Since the payments "indisputably" were repayments of a debt owning to the swap participants, they gave fair consideration, thus barring any fraudulent transfer claims.

Judge Schonfield specifically declined to follow Judge Peck's decisions from 2010 and 2011, saying that they were not binding authority.

The opinion is *Lehman Brothers Special Financing Inc. v. Bank of America NA (In re Lehman Brothers Holdings Inc.)*, 17-1224 (S.D.N.Y. March 14, 2018).

Sales

Section 363(m) allows an appeal if the remedy won't upset the sale itself, Third Circuit says.

Third Circuit Explains When Sale Orders Are Not Automatically Moot

On an issue under Section 363(m) where the circuits are split, the Third Circuit is in the minority, aligned with the Sixth and Tenth Circuits by holding that an appeal from an order approving a sale to a good faith purchaser is not automatically moot.

In an opinion on Oct. 24, the Third Circuit fleshed out the circumstance in which an appeal will not be moot, even though the bankruptcy court approved the lease or sale of property and there was no stay pending appeal.

The sale was contentious and factually complex, but for the purpose of analysis, the circumstances were not unusual. A chapter 7 trustee was selling the estate's claims against insiders. The first bid of $125,000 came from a group of creditors. In addition to paying the purchase price, they agreed to contribute proceeds from lawsuits to the estate for distribution to all creditors.

After the insiders submitted a competing bid, the bankruptcy court authorized the trustee to hold an auction. The creditors submitted a bid of $180,000 and won the auction. In conjunction with their opposition to approval of the sale to the insiders, the insiders offered as much as $220,000.

The bankruptcy court approved the sale to the creditors for $180,000, theorizing that the creditors' offer was higher because they would contribute recoveries to the estate and because the insiders had not complied with auction rules.

On appeal, the district court dismissed the insiders' appeal as moot under Section 363(m). That section provides that reversal or modification of an order approving a sale or lease "does not affect the validity" of the sale or lease "to an entity that purchased or leased such property in good faith, whether or not such entity knew of the pendency of the appeal, unless such authorization and such sale or lease were stayed pending appeal."

Circuit Judge Kent A. Jordan synthesized the Third Circuit's precedent on Section 363(m) in a 37-page opinion upholding the lower courts and declaring that the appeal was moot. He explained that the section is designed to promote finality of sales and thereby attract investors and "effectuate debtor rehabilitation." If the section "is to have teeth," Judge Jordan said, "any reasonably close question" should be resolved in favor of finding the appeal to be moot.

Previously, the Third Circuit had held that an appeal will be moot if three conditions are met: (1) There was no stay pending appeal, (2) reversal would affect the validity of the sale, and (3) the sale was to a good faith purchaser.

Judge Jordan found "no clear error" in the bankruptcy court's findings that the parties were in good faith because there was no collusion; the creditors followed the auction rules; and there was no evidence to "suggest that the bidding took place at less than arm's length."

Having found that the sale was conducted in good faith, Judge Jordan then addressed the other two issues, first confirming there was no stay pending appeal. Before dismissing the appeal as moot, the pivotal issue became the ability of the appellate court to modify or reverse without affecting the validity of the sale.

Judge Jordan said that appellate rights are preserved "only in those rare circumstances where collateral issues not implicating a central or integral element of a sale are challenged."

The insiders argued that they were not challenging the validity of the sale, only the ability of the creditors to pursue claims of the estate. Agreeing with the trustee's contention, Judge Jordan said it would have made no sense for the creditors to purchase the estate's claims if they could not pursue them.

Judge Jordan therefore dismissed the appeal as moot, because the circuit court could not give the creditors a remedy "without affecting the validity of the sale."

Of significance, the ability of the creditors to prosecute the estate's claims was not resolved either in the sale order or by dismissal of the appeal, because the sale did not obviate any of the insiders' defenses. Back in bankruptcy court, the insiders were moving to dismiss the creditors' suit against them on the theory that the creditors were not entitled to prosecute estate claims. The bankruptcy court held the dismissal motion in abeyance pending the outcome of the appeal.

For ABI's discussion of a recent Sixth Circuit opinion widening the split on Section 363(m), click here.

The opinion is *Schepis v. Burtch (In re Pursuit Capital Management LLC)*, 874 F.3d 124 (3d Cir. Oct. 24, 2017).

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

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

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

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

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

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

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

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

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

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

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

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

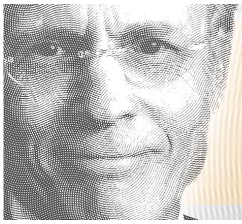
Upholding the sale free of the leases because they had not been rejected, Judge Block said that Section 365(h)(1)(A)(ii) shows an intent "to protect lessees' rights outside of bankruptcy, not an intent to enhance them."

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

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

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

Estate Property



Rochelle's Daily Wire

***Jewel* has now been formally rejected in New York and California. Washington, D.C., is next.**

California Supreme Court Kills the *Jewel* Doctrine on a Certified Question

The handwriting was on the wall, but now it's official in California, and probably everywhere else: Profits earned on unfinished hourly business after a law firm dissolves are *not* property of the "old" firm and can be retained by the new firm that completes the work.

Answering a certified question from the Ninth Circuit, the California Supreme Court held on March 5 that "a dissolved law firm's property interest in hourly fee matters is limited to the right to be paid for the work it performs before dissolution." A "narrow" exception allows the old firm to collect for work performed before dissolution and to be paid for preserving and transferring hourly fee matters to new counsel of the client's choice.

The state's high court did not rest its conclusion on a tortured analysis of the Revised Uniform Partnership Law or impressive-sounding legal mumbo jumbo. Instead, the state Supreme Court relied on logical conclusions based on common experience and longstanding principles. For instance, the court said that the dissolved firm cannot claim "a legitimate interest in the hourly matters on which it is *not* working — and on which it cannot work." [Emphasis in original.]

The result emanated principally from two value judgments: The law should not intrude "without justification on clients' choice of counsel" nor limit "lawyers' mobility postdissolution."

The Heller Ehrman Liquidation

A firm that once had 700 lawyers, Heller Ehrman LLP was liquidated in chapter 11. The confirmed plan created a trust that sued 16 firms for income that lawyers from the liquidated firm earned at their new firms in completing hourly matters originated at Heller Ehrman. All but four firms settled. The bankruptcy court granted summary judgment in favor of the trustee and against the four firms.

The bankruptcy court based its decision on *Jewel v. Boxer*, a 1984 decision by an intermediate California appellate court, which said that profits earned on unfinished business belong to the "old" firm. The *Jewel* court allowed the new firm to recover only its overhead and rejected arguments based on clients' rights to select attorneys of their choice. *Jewel* had been followed in one other California appellate decision, but the issue had not previously reached the state's highest court.

Jewel was attractive for trustees in law firm bankruptcies because asserting the principle brought in settlements generating assets that otherwise would be few and far between.

After the Heller Ehrman bankruptcy court ruled in favor of the trustee, District Judge Charles R. Breyer of San Francisco withdrew the reference. Reviewing the bankruptcy court's rulings *de novo*, he granted summary judgment for the law firms. The trustee appealed.

After hearing oral argument in June 2016, the Ninth Circuit issued an order the next month certifying the question to the California Supreme Court. The Ninth Circuit pointed out that California's highest court has never directly addressed the *Jewel* issue. The appeals court also alluded to *Jewel* litigation in New York.

On a certified question from the Second Circuit, the New York Court of Appeals held in July 2014 that *Jewel* is not the law in New York. The New York court ruled that there is no property interest in hourly unfinished business because it is "too contingent in nature and speculative to create a present or future property interest." The New York decision stemmed from the bankruptcies of Coudert Brothers LP and Thelen LLP.

In addition to citing the New York decision, the Ninth Circuit pointed out that California revised its partnership law in 1996, 12 years after *Jewel*.

Judge Breyer was not the only district judge to undermine *Jewel*. Granting an interlocutory appeal, District Judge James J. Donato of San Francisco reversed the bankruptcy court and held in favor of lawyers who went to new firms. He ruled that they could retain what they bill at their new firms.

Judge Donato issued his decision in the liquidation of Howrey LLP. On appeal, the Ninth Circuit certified the question to the District of Columbia Court of Appeals in February because the case turns on D.C. law, not California law.

The California Court's Analysis

The certified question was argued in the state's high court in December 2017. The March 5 opinion by Justice Mariano-Florentino Cuéllar went to the heart of the issue immediately. He said that a dissolved law firm has "no property interest in legal matters handled on an hourly basis, and therefore, no property interest in the profits generated by its former partners' work on hourly fee matters pending at the time of the firm's dissolution."

There is no property interest, he said, because the old firm "has no more than an expectation" that "may be dashed at any time by a client's choice to remove its business." He explained that the "mere possibility of unearned, prospective fees . . . cannot constitute a property interest."

Rather than tease the result from the Revised Uniform Partnership Act, or RUPA, Justice Cuéllar based the decision on a "sensible interpretation" of state law and "practical implications" to conclude that "the dissolved firm's property interest here is quite narrow."

Policy implications were paramount. The outcome should "protect the client's choice of counsel" and comport "with our policy of encouraging labor mobility while minimizing firm instability." He said that neither previous cases nor "specific statutory provisions . . . resolve the question before us."

In the law firm context, a property interest is grounded on a "sufficiently strong expectation." That expectation "requires a legitimate, objectively reasonable assurance rather than a mere unilaterally-held presumption."

The old firm, Justice Cuéllar said, claims an "interest in the hourly matters on which it is *not* working — and on which it cannot work" and "seeks remuneration for work that someone else must undertake." [Emphasis in original.] Given that neither clients nor lawyers would share that view, he said that the old firm's "expectation is best understood as essentially unilateral." He went on to add that the old firm's "hopes were speculative, given the client's right to terminate counsel at any time, with or without cause. As such, they do not amount to a property interest."

Again focusing on policy considerations, Judge Cuéllar recognized that former partners in a dissolved firm "may face limited mobility in bringing unfinished business to replacement firms." Similarly, recognizing a property interest in unfinished business "would also risk impinging on the client's right to discharge an attorney at will." He therefore affirmed the principle "that client matters belong to the clients, not the law firms."

Judge Cuéllar said that the principle in *Jewel* was unnecessary to prevent lawyers from jumping ship prematurely because the California Supreme Court had upheld the enforceability of a law partnership's noncompetition agreement.

Rather than basing the conclusion on RUPA, Judge Cuéllar said that "[n]othing else in RUPA cuts against our holding."

Judge Cuéllar pointedly declined to say whether overruling *Jewel* with regard to hourly matters would also apply to contingencies.

The opinion is *Heller Ehrman LLP v. Davis Wright Tremaine LLP*, S236208 (Cal. Sup. Ct. March 5, 2018).

Jurisdiction & Power

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

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

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

The Case Before the Magistrate

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

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

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

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

Disagreements Among Seventh Circuit Judges

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

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

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

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

The Three Opinions

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

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

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

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

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

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

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

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

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

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

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

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

Implications for Bankruptcy

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

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

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

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

Filing bankruptcy won't divest a district court of maritime jurisdiction, and a bankruptcy court can't adjudicate maritime lien rights.

Automatic Stay Doesn't Apply to Enforcement of Maritime Liens, Ninth Circuit Says

A bankruptcy filing cannot divest a district court of preexisting maritime jurisdiction over a vessel; the automatic bankruptcy stay does not apply to maritime lien rights, and the bankruptcy court does not have jurisdiction to adjudicate maritime liens, the Ninth Circuit said in a lengthy opinion by Circuit Judge Jacqueline H. Nguyen.

A vessel exploded, injuring a seaman who was unable to work as a result of his injuries. The seaman filed a verified complaint in admiralty in district court against the vessel, the corporation that owned the vessel and the individual who owned the corporation.

In her March 28 opinion for the three-judge panel, Judge Nguyen said the defendants never objected to admiralty jurisdiction, giving the district court *in rem* jurisdiction over the vessel. The seaman was seeking "maintenance and cure," maritime terms for an injured seaman's food, lodging and medical care while unable to work. None of the defendants had insurance to cover the seaman's maintenance and cure.

Fifteen months into the maritime suit, on the eve of trial to determine the amount of maintenance and cure, the individual defendant and the corporate owner of the vessel filed chapter 13 and 7 petitions, respectively. The district court stayed the maritime suit altogether, citing the Section 362 automatic stay.

Later, the bankruptcy court partially modified the automatic stay to allow the district court to determine the extent and validity of the seaman's maritime lien against the vessel but specifically barred enforcement of the lien.

Sua sponte, the district judge then dismissed the maritime suit, believing the court lost maritime jurisdiction because the seaman had not verified an amended complaint. Next, the bankruptcy court approved a sale of the vessel "free and clear." The seaman appealed dismissal of the maritime suit and the loss of his maritime lien rights.

Judge Nguyen reversed in 44-page opinion, making significant pronouncements about the intersection of bankruptcy and maritime jurisdiction.

Important for maritime law but not so much with regard to bankruptcy law, Judge Nguyen held that the failure to verify the amended complaint did not divest the district court of maritime jurisdiction because the defendants never objected to maritime jurisdiction in 15 months of litigation. She therefore reversed the dismissal of the maritime claim for lack of *in rem* jurisdiction over the vessel.

The defendants argued that the appeal nonetheless was moot because the bankruptcy court in the meantime had sold the vessel free of liens. The argument, Judge Nguyen said, assumes that the bankruptcy court had jurisdiction to dispose of the seaman's maritime lien. She held, "It did not."

The district court had ruled that the Section 362 stay enjoined the seaman from enforcing his maritime liens. Again, Judge Nguyen reversed.

Judge Nguyen relied on *U.S. v. ZP Chandon*, 889 F.2d 233, 238 (9th Cir. 1989), for the proposition that the automatic stay in bankruptcy court does not apply to a maritime lien for a seaman's wages. She reasoned that the principle in *Chandon* applies equally to a maritime lien for maintenance and cure, because maritime liens are "sacred liens" when owed to seamen as a consequence of their service. She cited 1893 Supreme Court authority as saying that a seaman's sacred liens are entitled to protection "as long as a plank of the ship remains."

Judge Nguyen held that "Congress would not have overruled this 'sacred' principle of admiralty law in the Bankruptcy Act *sub silentio*." Therefore, she said, the "bankruptcy stay did not apply to [the seaman's] efforts to enforce his maritime lien for maintenance and cure."

Next, Judge Nguyen held that the "bankruptcy court lacked jurisdiction to adjudicate [the seaman's] maritime lien because the admiralty court had already obtained jurisdiction over the [vessel]." To that point, she cited authority saying that "the court which first obtains jurisdiction is entitled to retain it without interference."

Consequently, the chapter 7 petition by the corporate owner of the vessel "could not have vested the bankruptcy court with the same jurisdiction," Judge Nguyen said.

Judge Nguyen said commentators are not sure whether a bankruptcy court has power to sell a vessel free of maritime liens. Regardless of the answer to that question, she held that "a maritime lien cannot be extinguished except through application of maritime law." Even if a bankruptcy court has jurisdiction to release a maritime lien, it "should be required to do so pursuant to maritime law" because priorities are different under the Bankruptcy Code and maritime law. For example, she said, seamen are in a "preferred position."

Judge Nguyen's opinion concluded with another extraordinary holding with regard to the seaman's motions for summary judgment, which had been denied below. Ordinarily, denial of a motion for summary judgment cannot be appealed.

Because she saw the decision below as manifestly incorrect, Judge Nguyen issued a writ of *mandamus* directing the district court to grant maintenance at a rate of $34 a day, subject to upward modification after trial. In that respect, the opinion is a useful survey of the law regarding *mandamus*.

The opinion is *Barnes v. Sea Hawaii Rafting LLC*, 16-15023 (9th Cir. March 28, 2018).

ROCHELLE'S DAILY WIRE

Delaware bankruptcy judge disagrees with district court on final adjudicatory power to include third-party releases in confirmation orders.

Bankruptcy Court Finds Constitutional Power to Grant Releases in Confirmation Orders

On remand from the district court in *Millennium Lab Holdings*, Bankruptcy Judge Laurie Selber Silverstein of Delaware decided that a bankruptcy court has constitutional power to enter a final order granting non-consensual, third-party releases of non-bankruptcy claims as part of a chapter 11 confirmation order.

Written with a passion suggesting it may be the most important decision of her career, Judge Silverstein's 69-page opinion on Oct. 3 concludes that the limitations on the constitutional power of a bankruptcy court under *Stern v. Marshall* are altogether 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.

Ordering remand in March, District Judge Leonard P. Stark of Delaware implied, without explicitly holding, that a bankruptcy court should only make proposed findings and conclusions when granting third-party releases as part of a chapter 11 confirmation order. Sending the case back to Judge Silverstein, he told her to consider the question of constitutional power and also decide whether the appellant had waived *Stern* objections.

In her Oct. 3 opinion, Judge Silverstein persuasively ruled that the appellant had waived *Stern* objections by never raising the issue during the confirmation process. If there is another appeal, Judge Stark and even the Third Circuit could uphold confirmation just on the issue of waiver and never reach the broader *Stern* questions given the principle that courts should not make constitutional rulings when a case can be decided on another ground.

Consequently, *Millennium Lab Holdings* may leave the constitutional issue undecided at the appellate level. Until the question is starkly raised and decided, parties will proceed at their peril if they consummate plans with releases based only on the bankruptcy court's confirmation order.

The Facts

The chapter 11 debtor, Millennium Lab Holdings II LLC, 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, Millennium 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. The plan did not allow the lenders to opt out of the releases.

Before confirmation, a lender 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, Judge Silverstein confirmed the plan and approved the third-party releases. The dissenting lender appealed.

Having consummated the plan, Millennium 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

Arguably for the first time, the objecting lender contended on appeal that the bankruptcy court lacked constitutional power to enter a final order granting third-party releases. Although the bankruptcy court had clearly found "related to" jurisdiction to impose the releases, District Judge Stark concluded that the bankruptcy court had not been called on to decide whether it had power under *Stern* to enter a final order including the releases.

To most readers, Judge Stark's decision in March implied, without holding, that granting the releases was beyond the bankruptcy court's constitutional power. Among other things, Judge Stark said that the objecting lender was entitled to an Article III adjudication because the releases were "tantamount to resolution of those claims on the merits against" the lender.

Rather than rule on a constitutional issue that had not been developed in the lower court, 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. If there were no power to make a final order, Judge Stark said that Judge Silverstein could submit proposed findings and conclusions or strike the releases from the confirmation order.

To read ABI's discussion of Judge Stark's opinion, click here.

Granting Releases Is a 'Core' Bankruptcy Power

Ruling after remand, Judge Silverstein didn't keep the reader in suspense. On the second page of her opinion, she said there is constitutional power to grant releases in a confirmation order. To rule otherwise, she said, would go "far beyond the holding of any court" and "dramatically change the division of labor between the bankruptcy and district courts."

Judge Silverstein found circuit court support for her conclusion. She cited post-*Marathon Pipeline* but pre-*Stern* decisions from the Seventh and District of Columbia Circuits finding constitutional power to grant third-party releases in a confirmation order.

Post-*Stern*, Judge Silverstein found support from two Third Circuit opinions for the proposition that a bankruptcy court can issue a final order on a core issue that has preclusive effect on a third party's lawsuit: *In re Lazy Days' RV Center Inc.*, 724 F.3d 418 (3d Cir. 2013), and *In re Linear Electric Co.*, 852 F.3d 313 (3d Cir. March 20, 2017). She emphasized a statement in *Lazy Days'* that *Stern* is "plainly inapposite" where the debtor sought relief "based on a federal bankruptcy law provision with no common law analogue."

More recently, Judge Silverstein cited bankruptcy court decisions from Boston and White Plains, N.Y., finding constitutional power to grant third-party releases in confirmation orders.

Adopting even the broadest interpretation of *Stern*, Judge Silverstein said that confirming a plan with releases "does not rule on the merits of the state law claims being released." Therefore, she said, "*Stern* is inapplicable as confirmation of a plan is not a state law claim of any type."

To the contrary, Judge Silverstein said, a bankruptcy court has final adjudicatory power because the court "is applying a federal standard" to ensure that the releases "comply with applicable provisions of the Bankruptcy Code."

In short, there is no contravention of *Stern* because the bankruptcy court is making a determination on confirmation based entirely on federal bankruptcy law, where there is statutory core power under 28 U.S.C. § 157(b)(2)(L). The fact that confirmation bars a creditor's state law claims against a third party is merely incidental.

Indeed, the incidental effect on third-party claims is the gist of the issue. Judge Silverstein pointed out the consequences of making *Stern* applicable to plans with third-party releases.

If there were no final adjudicatory power in the confirmation context, Judge Silverstein said that bankruptcy courts could no longer make Section 363 sale orders insulating buyers from successor liability. Similarly, bankruptcy courts would lack power, she said, to order substantive consolidation, bar annual shareholders' meetings, recharacterize debt as equity, or subordinate claims.

On the question of the waiver of *Stern* objections under *Wellness International*, Judge Silverstein thoroughly analyzed the record to conclude that the objecting lender never raised the constitutional question during or even after the confirmation process.

Her original ruling on confirmation did not deal with final adjudicatory power because any reference to *Stern* was so oblique that neither the court nor the parties understood that a constitutional issue was afoot. Citing the *Wellness International* prohibition of sandbagging, 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.

The opinion is *In re Millennium Lab Holdings II LLC,* 15-12284, 575 B.R. 252 (Bankr. D. Del. Oct. 3, 2017).

Makewhole Premiums

ROCHELLE'S DAILY WIRE

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

Third Circuit Splits with New York by Allowing Makewhole Premiums in Chapter 11

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

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

Litigation in the Lower Courts

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

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

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

Reversal in the Third Circuit

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

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

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

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

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

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

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

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

Judge Ambro Rejects *MPM Silicones*

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

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

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

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

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

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

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

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

***Till* doesn't apply in fixing cramdown interest rates in major corporate reorganizations, circuit says.**

Second Circuit Splits with Third on Makewholes Occasioned by Bankruptcy

Handing down an opinion almost a year in making, the Second Circuit made four significant pronouncements pertinent to major corporate reorganizations. In an opinion on Oct. 20 by Circuit Judge Barrington D. Parker, the appeals court abandoned the so-called *Till* formula for calculating the rate of interest paid to secured creditors in a chapter 11 cramdown.

Instead, the circuit court said that the interest rate on a crammed-down debt obligation must reflect the higher market rate, if one exists.

Although the cramdown ruling was favorable to lenders, Judge Parker's second holding was favorable to debtors because he held that a so-called makewhole premium is not earned on debt that was automatically accelerated by bankruptcy. The Second Circuit's opinion on that issue is starkly in conflict with the Third Circuit's *Energy Future* opinion from November 2016 holding precisely the opposite.

In a third ruling, again favorable to creditors, Judge Parker refused to dismiss the appeal under the doctrine of equitable mootness because the lenders had made every conceivable effort at obtaining a stay pending appeal.

Finally, the appeals court arguably engaged in appellate fact-finding in upholding the lower court's conclusion regarding contractual subordination.

The MPM Silicones Chapter 11 Plan

Bond indentures often contain provisions calling for yield maintenance, or makewhole premiums, to compensate bondholders for having to reinvest at lower interest rates if the loan is repaid before maturity. The provisions are designed as disincentives to refinance when interest rates drop.

Indentures are not crystal clear on whether the makewhole is due if prepayment occurs in chapter 11 cases when the debt is accelerated automatically on bankruptcy. And so it was with MPM Silicones LLC, also known as Momentive Performance, when the company was confirming its chapter 11 plan in 2014.

In confirming the plan over the objection of secured lenders claiming entitlement to a makewhole, the bankruptcy court issued four major rulings: (1) The secured lenders were not entitled to a makewhole; (2) In being given a new debt obligation in cramdown, the secured lenders were not entitled to a market rate of interest under the Supreme Court's *Till* decision from 2004; (3) The appeal was not equitably moot, and (4) Subordinated notes were indeed subordinated to second-lien debt and were therefore not entitled to any distribution under the plan.

The secured lenders deprived of the makewhole and the subordinated lenders took appeals, but the district court upheld the bankruptcy court in May 2015. The bankruptcy and district courts denied stays pending appeal, and the Second Circuit denied a stay for lack of appellate jurisdiction.

The ensuing appeal in the Second Circuit was argued on Nov. 9, 2016. A week later, the Third Circuit handed down *Delaware Trust Co. v. Energy Future Intermediate Holding Co. LLC (In re Energy Future Holdings Corp.)*, 842 F.3d 247 (3d Cir.). Written by Circuit Judge Thomas Ambro, *Energy Future* reversed the two lower courts in Delaware, ruled that the makewhole was owing, distinguished a leading Second Circuit case denying a makewhole, eviscerated the bankruptcy court's *MPM Silicones* opinion, and said that makewholes are owing under typically written indentures.

As a consequence of *Energy Future*, filing a major chapter 11 case in Delaware is a nonstarter if there is potential liability for a makewhole. On the other hand, New York is an attractive venue after *MPM Silicones*.

Although there is a split of circuits, the makewhole issue is not a likely case for the Supreme Court to grant *certiorari*, because the outcome turns on interpretation of an ambiguous contract governed by state law. Consequently, the split will endure unless New York State's highest court opines on that state's law and functionally decides whether makewholes are earned after bankruptcy, an outcome as to which Judge Ambro made an educated guess on state law.

Makewholes

In ruling that no prepayment premium was owing, Judge Parker described the bankruptcy and district courts as construing the indenture to mean that makewholes are "due only in the case of an 'optional redemption' and not in the case of an acceleration brought about by a bankruptcy filing." Judge Parker said, "We agree too."

His ruling in that respect was cabined by the Second Circuit's decision in *In re AMR Corp.*, 730 F.3d 88 (2d Cir. 2013), where, Judge Parker said, the appeals court upheld denial of a makewhole and "rejected nearly identical arguments."

To overcome the effect of automatic acceleration that was the key to denial of a makewhole, the creditors contended that they should have been permitted to deaccelerate the debt. Judge Parker rejected that argument too, saying that "the automatic stay barred rescission of the acceleration of the notes."

Judge Parker gave the Third Circuit's *Energy Future* opinion nothing more than a "but see" citation, without discussion of where Judge Ambro went wrong. Where the Third Circuit based its conclusion in large part on New York law, Judge Parker had no similarly detailed discussion.

Till Inapplicable in Major Chapter 11s

In *Till v. SCS Credit Corp.*, 541 U.S. 465 (2004), a plurality of the justices on the Supreme Court said that the interest rate to be paid to a secured lender being crammed down in chapter 13 on a subprime auto loan is the prime rate plus an upward adjust of 1% to 3% to cover the time-value of money, inflation and risk. The plurality rejected the notion of pegging the interest rate to market rates, because there usually is none for that type of consumer loan.

Employing *Till*, the bankruptcy court gave two issues of secured debt interest rates of 4.1% and 4.85%, based on a prime rate of 2.1%, to which the judge added 2.0% and 2.75%, respectively, for risk.

In footnote 14 in *Till*, the plurality said that the chapter 13 formula may not be suited to chapter 11, where there may be a market for similar loans to large bankrupt companies. Judge Parker adopted the approach of the Sixth Circuit in *In re American HomePatient Inc.*, 420 F.3d 559 (6th Cir. 2005), by departing from the *Till* formula if there is an "efficient market" for similar loans to companies in chapter 11. He said that *American HomePatient* "best aligns with the Code and relevant precedent."

Preparing for the confirmation of its plan, MPM Silicones scoured the market because the company would have been required to cash out the secured lenders had they accepted a plan that offered them no makewhole. The lenders argued that they should be entitled to interest on crammed-down debt of between 5% and 6%, reflecting offers the company had received for loans to finance confirmation.

Without intimating what the result should be, Judge Parker remanded the case for the bankruptcy court to "ascertain if an efficient market rate exists and, if so, apply that rate, instead of the formula rate." He said the lower courts erred "in categorically dismissing the probative value of market rates of interest."

Equitable Mootness

The debtor argued that the appeals court should dismiss the appeal on the ground of equitable mootness, because the plan had long since been implemented. Citing *In re Chateaugay Corp.*, 988 F.2d 322 (2d Cir. 1993), Judge Parker said that the "chief consideration" is whether the "appellant sought a stay of confirmation." If a stay was sought, the circuit will allow relief on appeal if it is "at all feasible" without knocking the props out from under the plan.

Because raising the interest rate to the level sought by the creditor would only increase the reorganized company's costs by $32 million spread over seven years, Judge Parker said that the appeal was not equitably moot.

In that regard, like the issue we discuss next, the appeals court may have engaged in appellate fact-finding by concluding that a higher interest rate would not cripple the reorganized company financially. Some might contend that Judge Parker should have remanded the case for the bankruptcy court to decide whether the interest rate could be raised without disrupting the reorganized company's finances.

Contractual Subordination

Plan confirmation precipitated an intercreditor dispute regarding the contractual subordination of one debt issue that turned on the definition of "senior debt." The erstwhile subordinated lenders constructed a sophistic but not frivolous argument to relieve themselves of the burden of subordination. Had they prevailed, they would have been entitled to a distribution under a plan that otherwise offered them nothing.

Finding the indenture to be unambiguous, the two lower courts agreed that the debt indeed was subordinated. Judge Parker reached the same conclusion, but he said the indenture was ambiguous.

In contract or statutory interpretation, courts search for a meaning that renders nothing superfluous. Any interpretation of the indenture, Judge Parker said, would result in making some words superfluous. "Where, as here, varying interpretations render contractual language superfluous, we are not obligated to arbitrarily select one as opposed to another," the judge said.

The differing reasonable interpretations made the indenture "ambiguous as a matter of law," Judge Parker said.

When a contract is ambiguous, courts look to extrinsic evidence. Judge Parker then cited the numerous instances of SEC filings and other public statements before bankruptcy where the debtor said that the debt was subordinated. In what arguably amounts to appellate fact-finding, he said it "was widely understood in the investment community that the Second-Lien Notes had priority."

Judge Parker rejected another argument that, he said, would result in an "irrational outcome." That argument was based on the notion that the granting of a security interest to the senior debt resulted in taking away senior status.

Upholding the lower courts on a different theory, Judge Parker had "little trouble concluding that extrinsic evidence establishes that the most reasonable interpretation of the indenture is that" the notes qualify as senior debt.

Evidently, Judge Parker believed that the record supported only one conclusion and that any other finding by the bankruptcy court would have been clearly erroneous. Perhaps it would have been better had he said so, to avoid the accusation of appellate fact-finding.

Regardless of whether the record led to any other plausible conclusion, relying on public filings is akin to making a decision on an ambiguous statute based on legislative history. Led by the Supreme Court, the use of legislative history is out of fashion, because statements by legislators are not necessarily in tune with the statute.

Similarly, public filings can represent the debtor's unilateral view about a complex transaction. Conceivably, a company could attempt to achieve a result by making SEC filings that it was unable to achieve in negotiating the transaction originally. Nonetheless, purchasers of securities in the secondary market are presumably aware of the issuer's subsequent description of the transaction.

This feature of the opinion will add a significant new wrinkle to the business of buying distressed debt based a novel interpretation of an ambiguous provision in the deal documents. With the Second Circuit telling lower courts they can or perhaps should interpret creditors' rights based on the debtor's public statements, courts may be unlikely adopt interpretations that run afoul of the issuer's pronouncements.

The Circuit Split

The Second and Third Circuits are now split on entitlement to a makewhole given language commonly used in some indentures. Unless the Second Circuit reverses course on a motion for rehearing or rehearing *en banc*, the split will persist.

The losing side in the Third Circuit had filed a motion for rehearing *en banc*, which was being held in abeyance by the appeals court pending the Second Circuit's opinion in *MPM Silicones*. In the meantime, however, the parties settled; the rehearing motion was withdrawn; and the *Energy Future* decision became final.

Although the Second Circuit is loath to grant rehearing *en banc*, a motion for reconsideration by the entire circuit bench would not be a surprise. As occurred in the Fifth Circuit in *Janvey v. Golf Channel Inc.*, 834 F.3d 570 (5th Cir. Aug. 22, 2016), the lenders pursuing a makewhole might ask on rehearing that the appeals court certify the underlying state law issue to the New York Court of Appeals, that state's highest court.

However, state law was not so much a focus of Judge Parker's decision as it was the Third Circuit's *Energy Future* opinion, where the losing side was seeking certification to the state tribunal before the parties settled.

The opinion is *BOKF NA v. Momentive Performance Materials Inc. (In re MPM Silicones LLC)*, 874 F.3d 787 (2d Cir. Oct. 20, 2017).

Plans & Confirmation

A secured creditor making the 1111(b) election is not automatically entitled to a due-on-sale clause paying the claim in full if the property is sold after confirmation.

Ninth Circuit Holds that One Accepting Class in Joint Plan Is Sufficient

In a case of first impression among the courts of appeals, the Ninth Circuit held that Section 1129(a)(10) does not require every debtor in a joint plan to have an accepting impaired class. On the question of whether there must be an accepting class on a “per plan” or a “per debtor” basis, the appeals court agreed with a bankruptcy court in New York but disagreed with a bankruptcy court in Delaware.

The Ninth Circuit also held in its Jan. 25 opinion that confirmation of a “cramdown” plan does not require the plan to include a due-on-sale clause when a secured lender has taken the Section 1111(b)(2) election.

Even though Section 1129(a)(10) by itself does not require each debtor in a multi-debtor plan to have an accepting class, one circuit judge insinuated in a concurring opinion that a secured creditor could defeat confirmation by claiming that a consolidated plan must comply with the standards for substantive consolidation.

The Tortured History of Transwest Resort Properties

Five debtors owned a hotel in a vertical ownership structure. The chapter 11 cases were not substantively consolidated. One lender held both the mortgage debt on the operating entity that owned the real estate and the mezzanine debt secured by the mezzanine borrower’s ownership interest in the operating company.

For the mortgage in the original principal amount of $209 million, the plan gave the lender a new $247 million note due in 21 years, paying interest only with a balloon payment on maturity. Although the mortgage originally had no due-on-sale clause, the new mortgage contained a due-on-sale clause.

If the buyer sold the project between the fifth and fifteenth years, the plan provided that the due-on-sale clause would not apply. Instead, a buyer in the 10-year gap would take ownership subject to the mortgage created at confirmation.

The joint plan for all five debtors had 10 classes of creditors. Five accepted the plan. The secured lender voted both claims against the plan and elected under Section 1111(b)(2) to have the entire mortgage claim treated as secured.

Because the mezzanine lender had the only claim against two mezzanine borrowers, the lender contended that cramdown requirements were not met because those two debtors had no accepting class. Contending that the 10-year gap in the due-on-sale clause depressed the value of the Section 1111(b)(2) election, the lender also argued that Section 1111(b)(2) requires a plan to have a due-on-sale clause.

The plan was sponsored by a purchaser who invested $30 million to acquire the equity.

The bankruptcy judge confirmed the plan in December 2011. Chief District Judge Raner C. Collins of Tucson, Ariz., dismissed the lender's original appeal on the ground of equitable mootness, because the plan had been consummated in the absence of a stay and the buyer had made its investment. Over a vigorous dissent, the Ninth Circuit held in September 2015 that a buyer who actively participates in reorganization is not protected by equitable mootness should a creditor appeal but not obtain a stay preventing consummation of the plan. *JPMCC 2007-C1 Grasslawn Lodging LLC v. Transwest Resort Properties Inc.* (*In re Transwest Resort Properties Inc.*), 801 F.3d 1161 (9th Cir. Sept. 15, 2015).

Denying a motion for rehearing *en banc*, the circuit remanded the case to Judge Collins, who upheld confirmation on the merits in June 2016. He ruled that one accepting class per plan is sufficient and that Section 1111(b) does not require a due-on-sale clause. To read ABI's discussion of Judge Collins' opinion, click here.

The lender appealed a second time, resulting in the Ninth Circuit's new opinion on Jan. 25 upholding confirmation and rejecting both of the lender's arguments.

Due-on-Sale Not Required on an 1111(b) Election

When a secured lender is undersecured, Section 1111(b) allows the lender to "elect to have its entire claim treated as a secured claim," Circuit Judge Milan D. Smith said in his opinion for the Ninth Circuit. The lender urged the appeals court to rule that a mortgage modified under a plan must include a due-on-sale clause to protect the value of the Section 1111(b) election.

Judge Smith said that the argument "finds no support in the text of the statute, nor does the language of the statute implicitly require the inclusion of such a clause." He added that the "broader statutory context of chapter 11 further undermines the lender's position."

Judge Smith said that Section 1123(b)(5) allows modification of a secured lender's claim, while Section 1129(b)(2)(A)(i)(I) "expressly allows a debtor to sell the collateral to another entity so long as the creditor retains the lien securing its claims, yet the statute does not mention any due-on-sale requirement . . . ."

Judge Smith found support from the Seventh Circuit, which had held that a due-on-sale clause is not a lien that must be retained for the court to confirm a plan. *In re Airadigm Communications Inc.*, 519 F.3d 640 (7th Cir. 2008).

He therefore held "that Section 1111(b)(2) does not require that a plan involving an electing creditor contain a due-on-sale clause."

One Accepting Class Per Plan Is Enough

Judge Smith said that the "plain language" of Section 1129(a)(10) "supports the 'per plan' approach." He said the section "requires that one impaired class 'under the plan' approve 'the plan.'"

The statute, the judge said, does not distinguish between single-debtor and multi-debtor plans: "[O]nce a single impaired class accepts a plan, Section 1129(a)(10) is satisfied as to the entire plan."

Judge Smith found fault with the rationale in *In re Tribune Co.*, 464 B.R. 126, 182–83 (Bankr. D. Del. 2011), where a bankruptcy judge in Delaware held that each debtor must have an accepting class in a multi-debtor plan. Although he did not cite the case, a bankruptcy court in New York had held that one accepting class is sufficient in a joint plan for several debtors. *JPMorgan Chase Bank N.A. v. Charter Communications Operating, LLC (In re Charter Communications)*, 419 B.R. 221, 264–66 (Bankr. S.D.N.Y. 2009).

In his opinion for the court, Judge Smith alluded to a shortcoming in the lender's litigation strategy that the concurring opinion developed. Judge Smith said that the lender did not object to confirmation by arguing that the joint plan amounted to substantive consolidation.

The Concurring Opinion

Circuit Judge Michelle T. Friedland wrote a concurring opinion where she agreed that Section 1111(b)(2) does not require a due-on-sale clause.

Finding the statute "somewhat ambiguous," Judge Friedland also agreed that the "better reading" of Section 1129(a)(10) leads to the conclusion that one acceptance per plan, not one per debtor, is sufficient.

Judge Friedland wrote a concurring opinion to say that objecting to the plan as *de facto* substantive consolidation may have enabled the lender to block confirmation. She said that the "problem" was "that the plan effectively merged the debtors without an assessment of whether consolidation was appropriate" under Ninth Circuit standards.

Judge Friedland said the lender did not object to confirmation by raising the issue of substantive consolidation and thus was barred from raising the theory on appeal.

Judge Friedland's opinion does not cite any authority for the proposition that substantive consolidation standards must be applied to multi-debtor plans. If joint plans could be confirmed only when substantive consolidation was proper, few multi-debtor plans would ever be approved.

Judge Friedland did not mention that Section 1129(a) contains several protections for dissenting creditors in a joint plan, such as the requirement that the plan must give the dissenter at least what it would receive in a liquidation. There was apparently no issue that the plan satisfied the best interests test for the dissenting mezzanine lender.

The opinion is *JPMCC 2007-C1 Grasslawn Lodging LLC v. Transwest Resort Properties Inc.* (*In re Transwest Resort Properties Inc.*), 16-16221 (9th Cir. Jan. 25, 2018).

Eighth Circuit insulates parishes and church schools from substantive consolidation.

Non-Bankrupt Nonprofit Entities Are Not Subject to Substantive Consolidation

Because substantive consolidation is the equivalent of involuntary bankruptcy, Section 303(a) precludes a bankruptcy court from ordering substantive consolidation with non-bankrupt nonprofit schools, churches and charitable organizations, the Eighth Circuit ruled on April 26, affirming two lower courts.

The appeal arose in the chapter 11 reorganization of the Archdiocese of St. Paul and Minneapolis, where the church is dealing with claims of clergy sexual abuse.

To expand the pool of assets available for abuse claimants, the official creditors' committee filed a motion seeking substantive consolidation of the archdiocese with about 200 non-bankrupt schools, parishes, and other nonprofit organizations controlled by the church. The committee said that the non-bankrupt church entities owned the majority of the assets in the archdiocese.

As described in the decision for the appeals court authored by Circuit Judge Michael J. Melloy, the committee's complaint alleged in detail how the archdiocese exercised direct and virtually total control of even minute activities by the parishes and schools, including the forced consolidation of parishes over opposition from the parishes themselves, the parishioners, and the parish priests.

Bankruptcy Judge Robert J. Kressel of Minneapolis granted the archdiocese's motion to dismiss without reaching the First Amendment or the Religious Freedom Restoration Act. He dismissed because substantive consolidation would be the equivalent of an involuntary petition against the nonprofit schools and parishes. The district court affirmed, as did Judge Melloy.

Judge Melloy explained that substantive consolidation "is an equitable remedy grounded in the broad powers" of Section 105(a), which gives the bankruptcy court authority to issue "any order" that is "necessary or appropriate to carry out the provisions of" the Bankruptcy Code. He described substantive consolidation as combining "the consolidated entities' assets and liabilities to satisfy creditors from a combined pool of assets."

Although the circuits allow substantive consolidation among debtors, Judge Melloy said that only the Ninth Circuit has permitted consolidation with non-bankrupt entities. However, no circuit has authorized consolidation with a nonprofit non-bankrupt entity.

Analyzing the propriety of the rulings below, Judge Melloy began with *Law v. Siegel*, 134 S. Ct. 1188, 1194 (2014), where the Supreme Court taught that the equitable powers in Section 105(a) cannot "override explicit mandates of other sections of the Bankruptcy Code."

Judge Melloy then turned to Section 303(a), which effectively prohibits the filing of an involuntary petition against "a corporation that is not a moneyed, business, or commercial corporation." Surveying state law governing the incorporation of religious entities, he said that the parishes, schools, and other non-bankrupt entities in the archdiocese were nonprofit corporations falling within the ambit of Section 303(a).

Judge Melloy agreed with Judge Kressel's conclusion that substantive consolidation "would necessarily pull non-profit entities into bankruptcy involuntarily in contravention of Section 303(a)." Again agreeing with Judge Kressel, Judge Melloy held there was no legal authority to order substantive consolidation because doing so "would override an explicit statutory protection in the Bankruptcy Code."

Judge Melloy went on to say that "Section 303(a) prevents the use of Section 105(a) to force truly independent non-profit entities into involuntary bankruptcy."

By using the words "truly independent," Judge Melloy left the door open to allegations that consolidation may be proper if the nonprofit entity is an *alter ego* under state law or was part of a fraudulent scheme, such as a Ponzi scheme.

However, Judge Melloy was careful to say that "isolated incidents of lack of corporate formality or commingling," as alleged in the committee's complaint, "fall far short of the requirement of *alter ego* status under Minnesota law." Moreover, Judge Melloy said that the committee's theory "would effectively nullify" Minnesota law, which gives the archbishop "effective control" over the affiliated entities.

In sum, Judge Melloy said that "global consolidation of all entities in the archdiocese is not authorized by the Bankruptcy Code."

To read ABI's report on the district court opinion, click here. To read the report on Judge Kressel's opinion, click here.

The opinion is *Official Committee of Unsecured Creditors v. Archdiocese of St. Paul and Minneapolis* (*In re Archdiocese of St. Paul and Minneapolis),* 17-1079 (8th Cir. April 26, 2018).

New York and Delaware judges disagree on third party releases by non-voting creditors.

Non-Voting Creditors' Consent to Third Party Releases Can't Be Inferred

Disagreeing with some of his colleagues in New York and Delaware, Bankruptcy Judge Stuart M. Bernstein ruled that he had neither jurisdiction nor statutory power to issue a release of claims against non-debtor third parties held by creditors who did not vote on the confirmed chapter 11 plan of SunEdison, Inc., a renewable energy developer.

Although he gave the debtors an opportunity to submit a modified release that he would approve, SunEdison might be unable to comply with the rigorous standards that Judge Bernstein imposed.

The SunEdison Plan

Although no one objected, Judge Bernstein said at the confirmation hearing in late July that he had questions about the propriety of the broadly worded third party releases contained in the plan. Judge Bernstein called for further briefing on the releases but went ahead and confirmed the plan, because the debtors and affected parties were willing to accept the risk that the judge would knock out the releases later.

In his Nov. 8 opinion, Judge Bernstein said that the claims to be released and the parties benefitting from the releases were equally broad. The releases bound not only creditors who voted for the plan but also creditors who did not vote at all. He said that non-voting creditors "would release a largely unidentified group of non-debtors from liability based on pre-petition, post-petition and post-confirmation (*i.e.*, future) conduct occurring through the plan's future effective date that related in any way to their clams or those bankruptcy cases."

Deemed Consent

First, Judge Bernstein analyzed whether non-voting creditors impliedly consented to the releases, much like the Supreme Court in *Wellness International Network, Ltd. v. Sharif*, 135 S. Ct. 1932, 191 L. Ed. 2d 911, 4337 (2015), said that creditors' inaction can result in implied consent to the bankruptcy court's authority to issue a final order.

Rather than focus on constitutional principles, Judge Bernstein analyzed contract law to decide whether non-voting creditors were deemed to consent to the releases, because they were warned in the disclosure statement that inaction might be taken as consent.

Judge Bernstein began from the proposition that silence does not constitute consent, absent a duty to speak. He cited the New York Court of Appeals for saying that silence operates as an estoppel "only when it has the effect to mislead."

Judge Bernstein disagreed with several New York and Delaware bankruptcy court decisions holding that non-voting creditors were deemed to consent to third party releases. He agreed, however, with other Delaware cases holding that third party releases only bound creditors who voted for the plan.

Explaining why he reached that conclusion, Judge Bernstein said that the debtors did not "identify" the source of the creditors' "duty to speak." Despite the warning in the disclosure statement that silence may equal consent, he said the debtors failed to show how the non-voting creditors' "silence was misleading or that it signified their consent."

Observing that the plan only provided a recovery of less than 3% for unsecured creditors, Judge Bernstein left the door open to the possibility of inferring consent if the dividend were meaningful.

Jurisdiction

Having decided that consent could not be implied, Judge Bernstein turned to the question of whether the court had jurisdiction and statutory authority to enjoin creditors' unasserted claims against third parties. Assuming there were jurisdiction, he said that third party releases "are proper only in rare and unique circumstances," citing *Deutsche Bank AG v. Metromedia Fiber Network, Inc. (In re Metromedia Fiber Network, Inc.)*, 416 F.3d 136 (2d Cir. 2005).

The debtors argued that the court had jurisdiction because claims against the third parties would give rise to indemnification obligations running in favor of officers, directors, employees and agents. Judge Bernstein conceded that potential indemnification claims would give rise to a "conceivable effect" on the estate, thus giving the court jurisdiction to enjoin.

However, he said, the proposed releases were "much broader than the indemnification obligations." He also said that the releases were not "limited to the potential indemnified parties listed by the debtors."

Consequently, Judge Bernstein said that the debtors "failed to sustain their burden of proving that the court has subject matter jurisdiction to approve the Release in its current form." He also said that the releases were not "appropriate" under *Metromedia*.

A Second Bite at the Apple

Judge Bernstein refused to approve the releases contained in the plan, but he gave the debtors 30 days to submit a new form.

Nonetheless, the new releases, Judge Bernstein said, "must specify the releasee by name or readily identifiable group and the claims to be released, demonstrate how the outcome of the claims to be released might have a conceivable effect on the debtors' estates, and show that this is one of the rare cases involving unique circumstances in which the release of the claims is appropriate under *Metromedia*."

The opinion is *In re SunEdison Inc.*, 576 B.R. 453 (Bankr. S.D.N.Y. Nov. 8, 2017).

ROCHELLE'S DAILY WIRE

Established practice governing distributions is upheld in Delaware district court.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

***Augie/Restivo* problems are avoided by including opt-out provisions in a substantive consolidation chapter 11 plan.**

District Court Endorses Opt-Out to Confirm Substantive Consolidation Plans

District Judge J. Paul Oetken of Manhattan endorsed a structure for chapter 11 plans to allow substantive consolidation without running afoul of *In re Augie/Restivo Baking Co.*, 860 F.2d 515 (2d Cir. 1988), where the Second Circuit ruled that substantive consolidation is only proper when (1) creditors dealt with affiliates as a single economic unit and did not rely on their separate corporate entities, and (2) the debtors' affairs are so entwined that consolidation will benefit all creditors.

In his March 28 opinion, Judge Oetken cited the Second Circuit for saying that substantive consolidation must be used "sparingly" and cannot harm creditors, although there is no requirement that it benefit creditors.

The appeal involved a holding company and an airline subsidiary that confirmed a plan based on substantive consolidation. The appealing creditor was an aircraft lessor who had a lease claim against the airline and a guarantee claim against the holding company parent arising from rejection of an aircraft lease. As a result of peculiarities in state law, the lessor contended that the claim against the parent was more valuable.

Effectuating substantive consolidation, the plan eliminated all guarantee claims. To obviate objection, the plan allowed creditors to opt out of consolidation. By opting out, a creditor would retain both its lease and guarantee claims and would receive payments as though substantive consolidation had not occurred. The plan gave the debtors the burden of proving the distributions that the creditor would have received were there no consolidation.

Despite the opt-out offer, the creditor still objected and appealed the confirmation order. The debtor put money aside in case the creditor were to prevail on appeal.

The decision by Judge Oetken in substance endorses substantive consolidation plans with opt-out provisions designed to avoid *Augie/Restivo* infirmities. The judge said that the plan did not unfairly discriminate against the lessor under Section 1123(a)(4). He also held that the bankruptcy court properly analyzed the *Augie/Restivo* factors.

The opinion has an interesting wrinkle, however. Because the opt-out option "negated any prejudice," Judge Oetken said that the lessor lacked standing to challenge substantive consolidation "because it suffered no harm from substantive consolidation."

The opinion is *In re Republic Airways Holdings Inc.*, 17-3442 (S.D.N.Y. March 28, 2018).

Committees

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

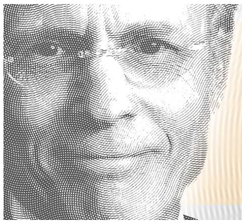
If there is a flaw in *Short Bark's* logic in relation to *Jevic*, perhaps it's because the proposed financing assured the ability to continue the business and the committee's objection to financing wouldn't necessarily be fatal were there no settlement.

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

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

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

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



Allowing intervention as of right, First Circuit repudiates its own prior authority as 'pure dicta.'

First Circuit Widens a Circuit Split on a Committee's Intervention Rights

Ruling on an expedited appeal involving Puerto Rico's debt restructuring, the First Circuit took sides in a circuit split and held that an official creditors' committee has an unqualified right to intervene in an adversary proceeding under F.R.C.P. 24(a)(1).

Immediately after Puerto Rico began the courtroom phase of its debt restructuring under the Puerto Rico Oversight, Management, and Economic Stability Act, or PROMESA (48 U.S.C. §§ 2161 *et. seq.*), several bond insurers initiated an adversary proceeding contending that Puerto Rico's fiscal plan violates PROMESA and the federal Constitution.

The official creditors' committee filed a motion to intervene, which the district court denied on Aug. 10.

Reversing on Sept. 22, Chief Circuit Judge Jeffrey R. Howard said that the "able district court" understandably rested her decision "exclusively" on a footnote in *Kowal v. Malkemus (In re Thompson)*, 965 F.2d 1136, 1142 n.8 (1st Cir. 1992), which says that Section 1109(b) of the Bankruptcy Code "does not afford a right to intervene under Rule 24(a)(1)."

Section 1109(b) provides that a creditors' committee "may raise and may appear and be heard on any issue in a case under this chapter." That section is among many provisions of the Bankruptcy Code incorporated into PROMESA.

Judge Howard said the footnote did not even involve a chapter 11 case and was "pure *dicta*" not binding on the circuit court.

Judge Howard said that *Thompson* relied primarily on a 1985 Fifth Circuit opinion holding that Section 1109(b) did not give a committee a right of intervention in an adversary proceeding. Two other circuits, he said, agreed with the Fifth Circuit in *dicta*.

Later, Judge Howard said, the Second and Third Circuits rejected the Fifth Circuit's approach by holding that Section 1109(b) bestows a committee with a statutory right of intervention under Rule 24(a)(1).

Not bound by *Thompson*, Judge Howard looked afresh at Section 1109(b) and observed that the language was "quite broad" by giving a committee intervention rights "on any issue in a case." Following the *Collier* treatise, he said that "any issue" subsumes adversary proceedings.

Although holding that Section 1109(b) grants a committee unconditional intervention rights, the section does not "dictate the scope of that participation," he said.

Because the district court had not reached the scope question, Judge Howard remanded the case with instructions to consider the extent of the committee's participation in the adversary proceeding. However, he said that the committee's own recommendations about limited participation "fit comfortably" within rules laid down by other courts.

The opinion is *Official Committee of Unsecured Creditors v. Assured Guaranty Corp. (In re Financial Oversight and Management Board for Puerto Rico)*, 872 F.3d 57 (1st Cir. Sept. 22, 2017).

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

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

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

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

The Liquidation Trust and the Policy

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

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

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

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

The Majority Opinion

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

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

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

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

The Noisy Dissent

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

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

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

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

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

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

If the "majority's decision becomes settled precedent," she said the "cost in terms of professional fees and judicial resources cannot be overstated" because creditors with valuable claims against management will be compelled to seek appointment of a trustee or propose their own plan.

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

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

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

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

Existence of a Committee Precludes Tolling the Statute for Adverse Domination

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

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

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

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

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

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

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

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

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

The opinion is *Gecker v. Estate of Flynn (In re Emerald Casino Inc.)*, 867 F.3d 743 (7th Cir. Aug. 11, 2017); rehearing and rehearing *en banc* denied Oct. 2, 2017.

Stays & Injunctions

Circuits are split on whether inaction is an 'act' that violates the automatic stay.

Tenth Circuit Direct Appeal to Decide Whether the Automatic Stay Is Really Automatic

The Tenth Circuit has just granted a direct appeal involving a deepening split where a minority of two circuits held that the automatic stay is not automatic.

In *WD Equipment v. Cowen (In re Cowen)*, 849 F.3d 943 (10th Cir. Feb. 27, 2017), the Tenth Circuit held that passively holding an asset of the estate, in the face of a demand for turnover, does not violate the automatic stay in Section 362(a)(3) as an act to "exercise control over property of the estate." *Cowen* was important, because it means that debtors in chapters 7, 11, 12 and 13 cannot recover their repossessed vehicles in six states without mounting a turnover action. It also means that businesses in chapter 11 cannot immediately resume operations if property was repossessed before filing.

In substance, the Tenth Circuit held that the automatic stay is not really automatic. Latching onto the words "any act" in Section 362(a)(3), the appeals court held that inaction is not an act and thus cannot violate the automatic stay.

The Tenth Circuit in *Cowen* sided with the D.C. Circuit. The Second, Seventh, Eighth, Ninth and Eleventh Circuits hold the opposite, having ruled that a lender or owner must turn over repossessed property immediately or face a contempt citation.

The case being directly appealed to the Tenth Circuit is *Davis v. Tyson Prepared Foods Inc. (In re Garcia)*, 17-5006, 2017 BL 235622 (Bankr. D. Kan. July 7, 2017), decided in July by Bankruptcy Judge Robert E. Nugent of Wichita, Kan. Forced to rule contrary to two prior decisions of his own, Judge Nugent reluctantly held that the automatic stay did not prevent a statutory worker's compensation lien from attaching automatically after bankruptcy to a recovery in a lawsuit. In other words, the lien attached to after-acquired property despite the policy evident in Section 552(a).

The chapter 13 trustee in *Garcia* appealed and obtained a certification of direct appeal from the district court without opposition. On Nov. 20, the Tenth Circuit granted a direct appeal.

The trustee's petition for direct appeal said that *Cowen* "deepened an existing split in the Circuit Courts" and "has been criticized by a bankruptcy court and commentators." The trustee cited the American Bankruptcy Institute among those who criticized *Cowen*.

The trustee in *Garcia* may mount a frontal assault on *Cowen*, but the upcoming three-judge panel in the Tenth Circuit might attempt to narrow *Cowen*. To the extent that the three judges rely on *Cowen*, they nonetheless will have laid the groundwork for an *en banc* rehearing to set aside *Cowen* entirely.

Preferably, the Tenth Circuit should address *Cowen en banc*, because attempting to narrow *Cowen* will result in increased complexity and a lack of predictability in how the Tenth Circuit might rule under slightly different circumstances.

To read ABI's discussion of *Cowen* and *Garcia*, click here and here.

The direct appeal is *Davis v. Tyson Prepared Foods Inc. (In re Garcia)*, 17-611 (10th Cir.).

Compensation

Rochelle's Daily Wire

Baker Botts v. ASARCO ***doesn't***
prohibit retention agreements allowing fees
for defense of fees, judge holds.

Retention Agreements Allowing Defense Fees Ok in New Mexico, but Not in Delaware

A company planning a contentious reorganization should consider filing chapter 11 in Albuquerque, N.M., because a judge there will permit retention agreements allowing compensation for successful defense of professionals' fee applications.

An oil field contractor with about $5.5 million in assets and liabilities filed a chapter 11 petition and sought authority to retain counsel under an engagement agreement that included compensation for successful defense of the attorneys' fee applications. The U.S. Trustee and the creditors' committee objected to the fee-defense provision, citing *Baker Botts LLP v. Asarco LLC*, 135 S. Ct. 2158, 192 L. Ed. 2d 208, 83 U.S.L.W. 4428 (2015), and *In re Boomerang Tube Inc.*, 548 B.R. 69 (Bankr. D. Del. 2016).

In his Sept. 20 opinion, Bankruptcy Judge David T. Thuma analyzed whether *ASARCO*, which disallowed defense fees under Section 330(a)(1), also precludes the inclusion of a fee-defense provision in a retention agreement under Section 328(a). He concluded, "*ASARCO* does not hold that a fee defense provision can never be a 'reasonable term' under Section 328(a)."

ASARCO involved a case where the bankruptcy court awarded debtor's counsel $5.2 million for successfully defending its fees. The lawyers' retention was under Section 327, and the allowance of fees was governed entirely by Section 330, because the attorneys had no agreement with the debtor for payment of defense fees that might bring the case under the umbrella of Section 328.

Judge Thuma parsed *ASARCO*, a 6/3 decision, and found that Justice Clarence Thomas disallowed defense fees because the "services" benefitted only the lawyers, not the estate.

Next, Judge Thuma analyzed *Boomerang*, where Delaware Bankruptcy Judge Mary F. Walrath refused to approve a retention application requiring the debtor to compensate committee professionals for successfully defending their fees. She barred the use of Section 328 as a vehicle for paying defense costs because it, like Section 330(a), was not a "specific and explicit statute" overriding the American Rule against fee-shifting. Section 328 permits the court to approve retentions "on any reasonable terms and conditions of employment."

The *Boomerang* committee contended that the engagement agreement fell under the so-called contract exception to the American Rule, allowing parties by contract to agree that the losing side pays everyone's lawyers. The argument was flawed, Judge Walrath said, because the debtor was not a party to the retention agreement. Even if the contract exception applied, Judge Walrath said she could not approve it because fee-defense costs would not entail any services for the committee, only benefit the lawyers themselves.

Judge Thuma disagreed with *Boomerang*. If the terms of employment have been approved by the court under Section 328(a), he said that the "professional's compensation is governed by those terms and conditions, rather than the general [reasonable compensation] language of Section 330(a)(1)(A)."

Judge Thuma noted that *ASARCO* did not involve a fee-defense provision in a retention agreement approved under Section 328(a). He then analyzed whether defense costs can be a "reasonable" term of employment.

Reasonable employment terms are not only those that benefit the client. Retention agreements, he said, will contain many provisions that benefit the lawyers as well. Even provisions that benefit lawyers also provide indirect benefit for the client because "the client obtains the services of needed, able professionals," Judge Thuma said.

Pre-*ASARCO*, Judge Thuma said that the experience in his district in paying successful defense costs had "been good for the most part," because "objections to fee applications have been limited to *bona fide* disputes, and the fee defense costs have been reasonable."

Unless *ASARCO* requires it, Judge Thuma said there "is no need to change the system," which "has worked pretty well." He did not read *ASARCO* "as mandating a change, if a properly drafted employment term is timely presented to the court and approved under Section 328(a)."

Judge Thuma ended his opinion by laying down criteria under which he would approve defense costs. Among other things, the debtor must approve them, committee counsel must be similarly protected, and fees will not be allowed for an unsuccessful defense.

The opinion is *In re Hungry Horse LLC*, 574 B.R. 740 (Bankr. D.N.M. Sept. 20, 2017).

Texas court shows antipathy to all theories seeking allowance of fees incurred in collecting fees.

ASARCO Read to Bar Fee-Defense Costs Even with a Fee-Shifting Agreement

In the wake of the Supreme Court's *ASARCO* opinion, a retained professional has virtually no chance of enforcing even a court-approved fee-shifting agreement, assuming that a decision from a district judge in Austin, Texas, was correct in upholding the denial of fees incurred in collecting fees.

The bankruptcy court approved a chapter 11 debtor's retention of an investment banker. The engagement agreement included a success fee and provided that if the success fee "is not fully paid when due," the debtor agreed "to pay all costs of collection . . . including but not limited to attorney's fees and expenses . . . ."

The debtor argued that the debt-for-equity conversion in the plan did not entitle the banker to a success fee. After the plan's effective date, the bankruptcy court disagreed and allowed the banker a $595,000 success fee. The debtor appealed but lost in both the district court and the Fifth Circuit.

After the bankruptcy court allowed the success fee, the banker moved in bankruptcy court under the fee-shifting agreement for payment of almost $200,000 in counsel fees incurred in establishing the right to collect the success fee. Bankruptcy Judge Craig A. Gargotta denied reimbursement of counsel fees.

Even though the fee-shifting agreement seemed on its face to entitle the banker to the recovery of counsel fees incurred in establishing a right to the success fee, District Judge Lee Yeakel wrote an opinion on Oct. 10 upholding Judge Gargotta on several independent grounds.

Although the bankruptcy court approved retention of the banker, Judge Yeakel ruled that the bankruptcy court must also approve attorneys hired by a court-approved professional. Since the banker's attorneys were not themselves retained with court approval, Judge Yeakel said that the banker's "claims for reimbursement of its attorney's fees and costs were properly denied."

Judge Yeakel also broadly interpreted *Baker Botts LLP v. Asarco LLC*, 135 S. Ct. 2158, 192 L. Ed. 2d 208, 83 U.S.L.W. 4428 (2015), which he construed as holding that a bankrupt estate is not responsible for a professional's time "spent litigating a fee application against the debtor in possession."

The banker argued that *ASARCO* did not apply because there was a "prevailing-party fee-shifting provision."

Judge Yeakel disagreed. The bankruptcy court properly denied reimbursement because the banker's attorney's fees and costs, "like those in *ASARCO*, were not incurred for labor performed for, or in service to," the debtor.

The result is not far removed from *In re Boomerang Tube Inc.*, 548 B.R. 69 (Bankr. D. Del. 2016), where Delaware Bankruptcy Judge Mary F. Walrath refused to approve a retention application requiring the debtor to compensate committee professionals for successfully defending their fees. In that respect, keep in mind that the bankruptcy court in the case at bar had approved fee-defense costs two years before the Supreme Court decided *ASARCO*. It is therefore questionable whether the bankruptcy court would have approved a fee-shifting agreement if *ASARCO* had already been on the books.

Judge Yeakel's decision may presage an attitude in the courts that fee-defense costs in bankruptcy will rarely if ever be reimbursed, even with a fee-shifting agreement.

The confirmed chapter 11 plan also preluded payment of the attorney's fees, according to Judge Yeakel. He focused on language in the fee-shifting agreement calling for reimbursement of the success fee were it "not fully paid when due."

The plan provided that claims would be paid on entry of a "final order," which was defined as an order no longer subject to appeal. Since the debtor promptly paid the success fee after it was upheld in the Fifth Circuit, there was no delay in payment and thus no right to recovery of attorney's fees.

The plan also included a bar date, four months after the effective date of the plan, for the filing of claims for administrative expenses. Since the bankruptcy court did not allow the claim for the success fee until after the bar date, the banker's claim for attorney's fees was untimely, Judge Yeakel said, because there were "no provisions in the plan requiring [the debtor] to pay administrative expenses that occur after the bar date."

The opinion is *Roth Capital Partners LLC v. Valence Technology Inc. (In re Valence Technology Inc.)*, 14-0949, 2017 BL 363805 (W.D. Tex. Oct. 10, 2017).

Fraudulent Transfers

ROCHELLE'S DAILY WIRE

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

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

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

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

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

The Facts

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

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

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

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

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

The Ninth and Seventh Circuits Split

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

In *EAR*, the Chicago-based court held that the waiver of immunity does not extend to Section 544(b)(1) suits because any actual creditor would have been barred from suing by the government's sovereign immunity. Judge Paez said he could find no other circuit decisions on the question.

Plain Language, Logic and Equity

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

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

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

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

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

The Second Issue

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

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

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

The opinions are *Zazzali v. U.S. (In re DBSI Inc.)*, 869 F.3d 1004 (9th Cir. Aug. 31, 2017).

Split decision refuses to invoke 'equity' to override a policy choice made by Congress.

In a Circuit Split, Ninth Circuit Tags Innocent Sellers with Fraudulent Transfer Liability

Should an innocent seller who gave full value be caught in the trap of a fraudulent transfer laid by someone who is defrauding the company he owns?

Siding with the Seventh Circuit and disagreeing with other courts of appeals, a split panel on the Ninth Circuit decided that Congress already made the policy decision and barred a seller from raising the good faith defense available to a subsequent transferee because the fraudster had kept the misappropriated money in a company account.

The owner of a business maintained a secret bank account in the company's name but under his control. Over the years, he diverted $8 million of his company's income into the account, which he used to pay personal and non-company expenses.

After the business went bankrupt, the trustee filed fraudulent transfer suits against 130 people or entities that received money from the secret account. In a test case, the bankruptcy judge dismissed a suit against a couple who sold real property to the owner in return for $220,000 from the secret account. The trustee alleged that the sellers received a constructively fraudulent transfer of $220,000 under Section 548(a)(1)(B) because the company, whose money paid the purchase price, received none of the consideration.

The bankruptcy court believed that the fraudster was the initial recipient of the fraudulent transfer, allowing the sellers to be subsequent transferees entitled to raise the defense of good faith under Section 550(b)(1) because they did not know there was fraud afoot.

The district court reversed in July 2015, ruling that the sellers were the initial transferees, making them ineligible for the good faith defense.

The majority on the court of appeals reached the same conclusion on Aug. 2 in an opinion authored by District Judge Algenon L. Marbley, sitting by designation from the Southern District of Ohio. Circuit Judge Jacqueline H. Nguyen dissented.

The majority opinion allocates the risk of fraud to the seemingly innocent sellers because they, as parties to the transfer, "generally stand in a better position to guard against corporate fraud than do unsuspecting creditors" not in a position to know that the money paying a personal expense came from a corporate account.

Section 550(b) is structured to give the good faith defense to subsequent transferees, but not to the initial transferee. On appeal, the sellers contended that they were subsequent transferees eligible for the defense because the fraudster should be viewed as the initial transferee. The decision in the circuit court therefore turned on the attributes of an initial transferee.

Judge Marbley said that the Ninth Circuit decided in 2006 to follow the Seventh Circuit by adopting the stricter "dominion test," rather than the more lenient "control test" employed, for instance, in the Eleventh Circuit. The question is a matter of federal common law because the Bankruptcy Code does not define "initial transferee" as used in Section 550(a)(1).

According to Judge Marbley, the dominion test focuses on who has legal title. He said that the control test "involves a more gestalt analysis" focusing on "'who truly had control of the money.'"

In the context of an insider, Judge Marbley said that the majority of courts hold that a principal who misappropriates company funds to pay a personal obligation is not an initial transferee. To become the initial transferee, the fraudster must first transfer the money to a personal account, which did not occur in the case at bar because the funds were always held in an account bearing the company's name and tax identification number.

Making the fraudster the initial transferee "both misallocates the monitoring costs that Section 550 sought to impose and deprives the trustee" of potential recoveries, Judge Marbley said. In his view, the minority draw "largely on equitable principles and a concern that seemingly 'innocent' third parties will be held liable for fraudulent transfers."

Judge Marbley declined to make a policy decision based on equitable principles "because Congress already performed that task." He ended by saying that the majority's decision would not let the fraudster off "scot-free" because he remains strictly liable under Section 550(a)(1) as the person "for whose benefit" the initial transfer was made.

Judge Nguyen began her dissent by saying, "There is nothing equitable about today's decision." She called on her circuit to sit *en banc*, repudiate the dominion test, and adopt the "control test used successfully in other circuits."

Even employing the dominion test, Judge Nguyen disagreed. Characterizing the facts, she would have found that "the sham account never belonged" to the company because the fraudster "was acting adversely to [the company] in opening the sham account, [and] he did so in his personal capacity, not as an officer of the company."

Don't be surprised if there is a petition for rehearing *en banc*, and don't be surprised if the petition is granted. But don't hold your breath. It could be two years before there is an opinion *en banc*.

The opinion is *Henry v. Official Committee of Unsecured Creditors (In re Walldesign Inc.)*, 872 F.3d 954 (9th Cir. Oct. 2, 2017).

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

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

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

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

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

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

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

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

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

The Eleventh Circuit said the outcome was governed by *In re Financial Federated Title & Trust, Inc.*, 309 F.3d 1325, 1331–33 (11th Cir. 2002), where, according to the panel, "we explicitly answered the question" by holding that "value under Section 548 is measured by the objective value of the property received by the debtor."

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

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

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

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

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

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

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

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

Venezuela let off the hook for expropriating assets.

Third Circuit Narrowly Interprets Delaware Fraudulent Transfer Law

A transfer by a non-debtor cannot be a fraudulent transfer, according to the majority on a Third Circuit panel interpreting Delaware's version of the Uniform Fraudulent Transfer Act.

The case arose from Venezuela's expropriation of mining assets worth billions. The dissenter said he was "hard-pressed to conceive of a scenario more worthy of a trial court's invocation of equitable powers under the Fraudulent Transfer Act."

The Venezuelan Expropriation

The government of former Venezuelan President Hugo Chavez expropriated a gold mine belonging to the plaintiff, a Canadian gold producer. Venezuelan government-owned Petroleos de Venezuela SA, or PDVSA, became the owner of the gold mine after expropriation. PDVSA later sold a 40% interest in the mine to the Venezuelan central bank for $9.5 billion.

In the World Bank, the plaintiff won a $1.2 billion arbitration award against Venezuela. The Venezuelan government was the only defendant in the arbitration. A federal district court in Washington confirmed the award.

President Chavez vowed publicly that his government would never pay that award nor others resulting from numerous expropriations. To ensure that the arbitration awards could not be enforced, Venezuela took steps to protect its assets in the U.S.

One of the assets was the Citgo oil refining and marketing business in the U.S. PDVSA was Citgo's indirect, ultimate owner. The plaintiff could not sue or collect from PDVSA, a foreign sovereign protected by the Foreign Sovereign Immunities Act.

To frustrate the collection of judgments in the U.S., the Citgo holding company sold $2.8 billion in debt. The holding company then made a $2.8 billion dividend to PDVSA to remove the proceeds from the U.S. and put them beyond the reach of judgment creditors. The transaction allegedly left the Citgo operating company insolvent and with a negative shareholders' equity.

Although unable to sue PDVSA, the plaintiff could sue Citgo's direct parent, a Delaware holding company. Therefore, the plaintiff sued the Citgo holding company in Delaware district court, alleging that the dividend and the subsequent transfers were fraudulent transfers under state law.

The holding company moved to dismiss the Delaware suit, contending there was no fraudulent transfer claim because it was not a debtor liable to the plaintiff on the arbitration award. Although conceding that the Venezuelan government and its alter ego PDVSA were the only debtors, the district court nonetheless denied the motion, believing that a non-debtor could be liable under the Delaware UFTA.

The district court certified the decision for interlocutory appeal to the Third Circuit.

The Majority Opinion

Reversing in an opinion on Jan. 3, Circuit Judge Marjorie O. Rendell wrote for herself and Circuit Judge Thomas I. Vanaskie, saying that her task was to guess how the Delaware Supreme Court would rule.

Judge Rendell said there are three elements to a fraudulent transfer claim: (1) a transfer, (2) by a debtor, (3) with actual intent to hinder, delay or defraud. She said there was no authority from Delaware's highest court saying whether a transfer by a non-debtor could sustain an UFTA claim.

Judge Rendell therefore relied on a Delaware Chancery Court decision for the proposition that "transfers by non-debtors are not fraudulent transfers under" the Delaware UFTA. She placed significance on the plaintiff's failure to allege that the Delaware holding company was liable for the arbitration award. The transfer, she said, was a transfer to a debtor (Venezuela), not a transfer by a debtor.

Making the Delaware company liable, Judge Rendell said, would "undermine a fundamental precept of Delaware corporate law: parent and subsidiary corporations are separate legal entities." She recounted how the plaintiff alleged that PDVSA was Venezuela's alter ego but did not contend that the Delaware holding company was an alter ego or provide "any other basis" to pierce the corporate veil.

Judge Rendell also said that Delaware courts have rejected the idea that there can be liability for aiding and abetting a fraudulent transfer. Similarly, she said, Delaware courts permit suits only against debtors, "thereby shielding advisors from liability."

The Dissent

Circuit Judge Julio M. Fuentes dissented. "[I]t cannot be," he said, that the UFTA, "which is firmly grounded in principles of equity," can leave "the victim of a purposeful and complicated fraud . . . without a remedy" for the holding company's "role in transferring $2.8 billion out of the U.S. to avoid Venezuela's creditors."

Beyond notions of equity, Judge Fuentes said that the transactions were indirect transfers that are voidable under UFTA. He also argued that the Chancery Court decision, relied on by the majority, did not hold that only debtors can be liable. That case, he said, dealt with aiding and abetting claims. "[I]t does not appear that the Delaware courts have ever held that non-debtor transferors are immune from liability under the Act."

Furthermore, Judge Fuentes did not interpret the complaint as alleging aiding and abetting liability. The plaintiff, he said, contended that the Delaware holding company "directly participated in the fraudulent scheme."

Because the majority and the dissent disagree about Delaware law, perhaps the Third Circuit should certify a question to the Delaware Supreme Court if there is a motion for rehearing. Even so, the case is a good example of how hard cases can make bad law.

Rather than attempting to stretch Delaware law, the plaintiff might have crafted a more creative complaint or, as the majority said, try to show that the holding company is Venezuela's alter ego.

The opinion is *Crystallex International Corp. v. Petroleos de Venezuela SA*, 879 F.3d 79 (3d Cir. Jan. 3, 2018).

Delaware district and bankruptcy judges now disagree with the Second Circuit's holding that the federal safe harbor preempts state fraudulent transfer law.

Delaware District Judge Seemingly Splits with Second Circuit on the Safe Harbor

For all practical purposes, District Judge Leonard P. Stark of Delaware has ratified an opinion from June 2016 where Bankruptcy Judge Kevin Gross disagreed with the Second Circuit and held that the safe harbor in Section 546(e) does not bar fraudulent transfer claims brought on behalf of creditors under state law.

In *Note Holders v. Large Private Beneficial Owners (In re Tribune Co.)*, 818 F.3d 98 (2d Cir. 2016), the Second Circuit found no loopholes in Section 546(e) and went so far as to say that the safe harbor bars suits by creditors under state law to recover payments made in securities transactions.

Saying that Second Circuit authority in *Tribune* was not binding on him, Judge Gross adopted the rationale taken by former Bankruptcy Judge Robert E. Gerber of Manhattan in *Lyondell Chemical Co.*, 503 B.R. 348 (S.D.N.Y. 2014), where he held that the safe harbor only bars trustees from suing, not creditors from asserting claims of their own.

Judge Gross's opinion was *PAH Litigation Trust v. Water Street Healthcare Partners LP (In re Physiotherapy Holdings Inc.)*, 2016 WL 3611831, 15-ap-51238 (Bankr. D. Del. June 20, 2016). The defendants filed a motion to allow an interlocutory appeal and for a direct appeal to the Third Circuit, contending that the case raised a dispositive issue of law as to which there is evident disagreement.

In an opinion on Dec. 21, Judge Stark denied both a direct appeal and the motion to allow an interlocutory appeal, saying in the process that Judge Gross had founded his opinion on "well-established Third Circuit and Supreme Court law." While pointing out important factual distinctions between *PAH* and *Tribune*, Judge Stark went almost as far as saying that the Second Circuit was wrong about federal preemption of state fraudulent transfer law, at least in cases involving the leveraged buyout of a nonpublic company.

The PAH Facts

Physiotherapy Holdings Inc. filed under chapter 11 not long after being acquired in a leveraged buyout. After confirmation of a plan, the litigation trust filed suit against the controlling shareholders to recover almost $250 million they received by selling their stock in the LBO.

To form the backbone of the suit, pre-LBO senior noteholders assigned their claims to the litigation trust. Asserting claims under both Section 548 and parallel provisions in Pennsylvania's Fraudulent Transfer Act, the complaint alleged that the LBO was both a constructive fraudulent transfer and a fraudulent transfer with "actual intent."

Significantly, the complaint alleged that the defendants were not innocent selling shareholders. The trust alleged that the controlling shareholders knew the company was issuing false financial statements grossly overstating net income, thus enticing the purchaser to acquire and pay more for the company.

The selling shareholders filed a motion to dismiss. Holding that the Section 546(e) safe harbor was not applicable, Judge Gross denied the motion with respect to the actual fraud claim under Section 548(a)(1)(A) and the senior noteholders' constructive fraud claim under state law. However, he held that the safe harbor was applicable and did dismiss the claims for constructive fraudulent transfers under Section 548(a)(1)(B) and the trustee's claims for actual and constructive fraudulent transfers under state law.

To read ABI's discussion of Judge Gross's decision, explaining why he followed *Lyondell* while rejecting *Tribune*, click here.

Judge Stark Agrees with Judge Gross

Judge Stark laid out the standards for allowing interlocutory and direct appeals to the circuit, under 28 U.S.C. §§ 158(d)(2)(A) and 1292(b). He said that the standards for certifying a direct appeal and granting leave to appeal are "essentially the same." In either instance, there must be "genuine doubt as to the correct legal standard."

Tribune, the authority that Judge Gross rejected, "determined that Section 546(e) preempts state fraudulent transfer law," Judge Stark said.

He said that the defendants' reliance on *Tribune* "ignores the fact that the Bankruptcy Court's [ruling that Section 546(e) did not preempt state law] turned on facts specific to this case," such as the absence of any ripple effect on the markets because the selling shareholders were transferring stock in a non-pubic company. The bankruptcy court also placed reliance on allegations that the selling shareholders "acted in bad faith."

Judge Stark came close to an outright affirmance when he said that Judge Gross's "preemption analysis followed well-established Third Circuit and Supreme Court law."

Summarizing why he was denying an interlocutory and direct appeal and sounding as though he would affirm on the merits, Judge Stark said that the "bankruptcy court's reading of the safe harbor is supported by the plain language of the statute, and its careful analysis followed controlling Third Circuit and Supreme Court precedent."

In the *PAH* suit, discovery will end and dispositive motions will be due in June 2018. Judge Stark's opinion increases the likelihood that the parties will settle. If that occurs, Judge Stark's opinion may be cited as tantamount to an affirmance.

The opinion is *PAH Litigation Trust v. Water Street Healthcare Partners LP (In re Physiotherapy Holdings Inc.)*, 16-misc-201, 2017 BL 457367 (D. Del. Dec. 21, 2017).

***Delaware's Judge Gross pens another controversial opinion in* PAH Litigation Trust.**

Fraudulent Transfer Claims Aren't Capped by Creditors' Losses

Bankruptcy Judge Kevin Gross of Delaware is back in the news with another important opinion in post-confirmation fraudulent transfer litigation involving Physiotherapy Holdings Inc. His new decision stands for the proposition that creditors who take stock in a reorganized company are entitled to recover more than the principal amount of their claims through successful post-confirmation prosecution of a fraudulent transfer action.

In June 2016, Judge Gross denied the defendants' motion to dismiss and disagreed with *Note Holders v. Large Private Beneficial Owners (In re Tribune Co*.), 818 F.3d 98 (2d Cir. 2016), where the Second Circuit expansively read the safe harbor in Section 546(e) to impliedly preempt state law and bar creditors from pursuing their own fraudulent transfer claims.

In a follow-up decision on Nov. 1 in the same lawsuit, Judge Gross handed the defendants another defeat by holding that recovery on fraudulent transfer claims is not capped by the amount of creditors' claims under a chapter 11 plan.

The Busted LBO

The *Physiotherapy* reorganization involved a typical leveraged buyout gone sour. Barely a year after the LBO closed, the company defaulted on $210 million in senior unsecured notes that had been sold to finance the acquisition. Although the noteholders were owed $237 million with accrued interest at the time of confirmation, the prepackaged plan gave them an allowed unsecured claim of $210 million, for which they received new common stock plus half of recoveries by a litigation trust.

The disclosure statement said that the new stock was worth about $85 million, or 40% of the noteholders' claims.

Somewhat more than two years after confirmation, the noteholders sold their stock in the reorganized company to a third party. In return, they received $282 million. Although more than the principal amount of their claims, the sale proceeds were less than $380 million, what the claims would be worth now, or $470 million, the amount noteholders would have received by maturity.

The Fraudulent Transfer Suit

After confirmation, the trust initiated suit against the sellers in the LBO, seeking to recover about $250 million they received in selling the company and alleging that the transaction was a fraudulent transfer “with actual intent” or was constructively fraudulent. After Judge Gross rejected *Tribune* and denied the defendants’ motion to dismiss the complaint last year, the parties entered into mediation.

The mediation came to a roadblock over the question of whether the noteholders’ recovery was capped by the amount of their claims. If there were a cap, the noteholders might be entitled to no further recovery, and the sellers could keep what they received in the LBO even though it may have been a fraudulent transfer.

To remove the logjam and foster settlement, Judge Gross agreed at the parties’ behest to decide whether the fraudulent transfer claims are capped. Undertaking what might seem like an advisory opinion, Judge Gross assumed without deciding that the LBO did entail a fraudulent transfer.

Judge Gross said that arriving at a decision about a cap “is not as apparent as it may seem.” He cited cases from the bankruptcy court in New York and the Ninth Circuit for the proposition that there is no cap. On the other hand, the defendants argued that “fraudulent transfer laws are remedial, not punitive.” Furthermore, he said, “Windfalls and punitive damages are not bankruptcy concepts,” and creditors “are not entitled to recover more than their unpaid claims.”

Arguing for a cap, the defendants contended that a recovery should be awarded only to recover harm to the creditors and that the $250 million sought in the lawsuit exceeded the noteholders’ actual losses.

Finding no authority in the Third Circuit, where the Delaware bankruptcy court sits, Judge Gross held that there is no cap. He relied in part on *Moore v. Bay*, 284 U.S. 4 (1931), where Justice Oliver Wendell Holmes, Jr. held that a trustee could avoid an entire fraudulent transfer, not simply the amount to cover claims of creditors in existence at the time of the transfer.

If there were a cap, Judge Gross said, the defendants “would keep most if not all of the transferred money. The Court cannot countenance such an inequitable result if liability exists.”

The defendants relied on Section 550, governing the liability of transferees of avoided transfers. They emphasized language in Section 550(a) allowing the trustee to recover “for the benefit of the estate.”

Judge Gross said that “‘for the benefit of the estate’ does not mean for the benefit of creditors,” because “estate” means all legal and equitable interests of the debtor.

By accepting stock for their claims, Judge Gross said that the noteholders "took a risk and are entitled to the benefits of their risk-taking." Although they ended up recovering more than the principal amount of their claims, the value of the reorganized company could have declined, and their losses could have increased.

Moreover, Judge Gross pointed out at the end of his opinion that the noteholders sustained a loss despite selling their stock for more than the principal amount of their claims. At present, the noteholders would be owed $380 million and would have taken in $470 million by maturity, in both cases less than they received for their stock in the reorganized company.

To read ABI's discussion of Judge Gross' decision last year, click here. To read about the Second Circuit's *Tribune* opinion, click here.

The opinion is *PAH Litigation Trust v. Water Street Healthcare Partners LP (In re Physiotherapy Holdings Inc.)*, 15-ap-51238 (Bankr. D. Del. Nov. 1, 2017).

Preferences & Claims

Eighth Circuit sides with the Third: 'Reasonably ascertainable,' not 'reasonably foreseeable,' determines which creditors are entitled to actual notice.

Eighth Circuit Broadly Draws the Line to Identify 'Unknown' Claims that Are Discharged

Taking sides with the Third Circuit, the Eighth Circuit established a "reasonably ascertainable" test for deciding whether a creditor received constitutionally adequate notice by publication of a potential toxic tort claim.

Even though the debtor had been sued numerous times by similar creditors and the debtor's property was a Superfund site, the appeals court concluded that the debtor had no obligation to give mailed (or actual) notice to all former workers at the plant.

Employed by a trucking company, a driver transported a chemical between 1990 and 1995 to a plant operated by predecessor corporations of the debtor. After several changes of name and ownership, the company confirmed a plan and received a chapter 11 discharge in 2010.

In 2012, the driver was diagnosed with a form of leukemia. After his death, his wife sued the reorganized debtor. The district court denied a motion for summary judgment by the debtor, who contended that the claim was barred by the discharge. After trial, a jury awarded $1.7 million to the driver's widow.

The company appealed. In an opinion on January 26, the Eighth Circuit set aside the judgment, ruling that the wife's claim was discharged because there was constitutionally adequate notice of the debtor's bankruptcy and the bar date.

The wife and her deceased husband were not listed as creditors and did not receive actual notice by mail. The debtor, however, published notice several times in two national newspapers and in a local newspaper where the plant was located.

The district court ruled that the driver's claim had arisen before bankruptcy, meaning that the claim ordinarily would have been discharged because the driver did not file a claim. The district court concluded that the claim was not discharged because the driver should have been given actual notice.

Writing for the Court of Appeals, Circuit Judge Duane Benton concluded that the district court had employed the incorrect standard for deciding the form of notice to which the creditor was entitled.

Judge Benton recited the general rule that a known creditor is entitled to actual notice by mail. For unknown creditors, notice by publication is constitutionally sufficient.

The district court believed that notice by publication was inadequate and that the claim was not discharged because the claim was "reasonably foreseeable." The district court based its conclusion on several factors: (1) The debtor had been fined $2.5 million by the EPA for discharges of the chemical that caused the driver's leukemia; (2) similar claims were 10% of the debtor's yearly toxic tort litigation, and (3) the plant had been declared a Superfund site requiring remediation.

Following the Third Circuit's decision in *Chemetron Corp. v. Jones*, 72 F.3d 341 (3d Cir. 1995), Judge Benton ruled that "reasonably ascertainable" was the standard, not "reasonably foreseeable."

Judge Benton identified several factors calling for reversal of the judgment. First, the Bankruptcy Rules only require giving notice of the names used by the debtor within eight years of bankruptcy. The years 1990-95 were well beyond the eight-year window, and none of the names under which the company operated at that time were among the 90 companies listed on the notices. However, Judge Benton conceded that following the Bankruptcy Rules may not always result in constitutionally adequate notice.

Of more significance, the debtor employed an experienced bankruptcy consultant to identify potential creditors. The consultant identified one million potential creditors to receive actual notice. The driver was not among them, thus labeling him an unknown creditor.

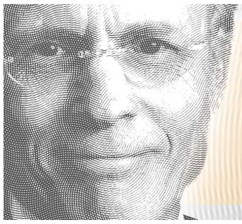
Citing *Tulsa Professional Collection Services Inc. v. Pope*, 485 U.S. 478, 490 (1988), Judge Benton said that publication notice to unknown creditors "generally suffices" after a "reasonably diligent search."

Next, Judge Benton concurred with the Third Circuit's *Chemetron* decision holding that debtors "cannot be required to provide actual notice to anyone who potentially could have been affected by their actions; such a requirement would completely vitiate the important goal of prompt and effectual administration of debtors' estates."

Like the Third Circuit, Judge Benton therefore held that the line to cordon off unknown creditors depends on whether the claim is "reasonably ascertainable," not "reasonably foreseeable." Because the claim was not "reasonably ascertainable" given the extensive search undertaken by the debtor's consultant, notice by publication was constitutionally adequate, and the claim was therefore discharged.

The opinion is *Dahlin v. Lyondell Chemical Co.*, 16-3419, 2018 BL 26501 (8th Cir. Jan. 26, 2018).

Perishable Commodities Act



Rochelle's Daily Wire

Ninth Circuit reverses its own precedent and eliminates a circuit split by favoring farmers.

En Banc, Ninth Circuit Holds: Only 'True Sales' of Receivables Comply with PACA

The Ninth Circuit sat *en banc*, reversed the three-judge panel by a vote of 8/3, overruled its own precedent, eliminated a split of circuits and closed a gaping loophole that the San Francisco-based appeals court had previously created in the federal Perishable Agricultural Commodities Act, or PACA (7 U.S.C. § 499a *et seq*.).

In *Boulder Fruit Express & Heger Organic Farm Sales v. Transportation Factoring, Inc.*, 251 F.3d 1268 (9th Cir. 2001), the Ninth Circuit had held that a lender to a fresh produce wholesaler can circumvent the strictures of PACA by denominating a secured loan as a sale of accounts receivable.

By virtue of its *en banc* opinion on Feb. 22, the Ninth Circuit has now aligned itself with the Second, Fourth and Fifth Circuits by holding that a transaction must be a "true sale" before a purchaser of accounts receivable can acquire an interest in a wholesaler's accounts ahead of the interests of produce suppliers who are beneficiaries of a PACA trust.

The PACA Loophole and the Split

Congress adopted PACA to protect farmers who were usually unpaid when a fresh produce wholesaler declared bankruptcy. The statute creates a statutory trust protecting growers by putting them ahead of accounts receivable *lenders*. Farmers, however, do not have recourse under PACA against *purchasers* of receivables. In deciding whether a financial institution is immune from PACA, the Second, Fourth and Fifth Circuits have first required the court to decide whether a true sale actually occurred and, second, to examine whether the sale was commercially reasonable.

In *Boulder Fruit* in 2001, the Ninth Circuit made a loophole in PACA by holding that the court need only decide whether a transaction was commercially reasonable before cutting off PACA protection. There was no threshold test in the Ninth Circuit to determine whether the transaction was a true sale so long as the transaction denominated itself as a sale of receivables.

Finding itself bound by *Boulder*, a three-judge panel of the Ninth Circuit ruled against farmers in a *per curiam* decision, *S&H Packing & Sales Co. v. Tanimura Distributing Inc.*, 850 F.3d 446 (9th Cir. Feb. 27, 2017). In a concurring opinion, two judges on the panel argued that *Boulder Fruit* was "wrongly decided" and urged the circuit to sit *en banc* to bring "the Ninth Circuit into line with the other circuits that have considered the issue."

The Ninth Circuit granted rehearing *en banc* in June, heard oral argument in September and overruled *Boulder Fruit* in an opinion for the majority written by Circuit Judge Ronald M. Gould.

The Majority's Opinion

Judge Gould held that the court must first "conduct a threshold true sale inquiry" before deciding whether a hypothecation of accounts receivable was "commercially reasonable." He based his decision on "the logical outcome of reading PACA, PACA's legislative history, and consideration of PACA's purpose."

In particular, legislative history told Judge Gould that "our focus should be on the true nature of the transactions at issue." The court, he said, "must focus on the true substance of PACA-related transactions and not on artificial indicators or labels." Later, he added, "labels . . . should be of little or no significance."

The lender argued that the result would be absurd if it had paid full value for receivables and was later required by PACA to pay farmers a second time for the same receivables.

Judge Gould said the lender was "wrong to describe the scenario as absurd. It is instead the result of a Congressional choice."

Judge Gould analogized PACA to state laws pertaining to general contractors, subcontractors and owners of real estate, because state law can force an owner to pay twice, just like a PACA lender. If an owner has not obtained releases of liens by subcontractors, the owner must pay the subcontractors a second time even if the owner has paid the general contractor. The PACA lender can pay twice if it has not policed the borrower to ensure that suppliers have been paid with the proceeds of its loans.

On remand, Judge Gould instructed the court to "use all the tools at its disposal . . . to determine whether the agreement was in substance a true sale or in substance a lending agreement."

The facts of the case suggest that the transaction was a secured loan rather than a true sale of accounts receivable, because the lender could force the wholesaler to buy back receivables proven uncollectable.

Judge Gould lauded the concurring opinion in the panel decision. He said, "This opinion is in substantial agreement with arguments made in [Circuit] Judge [Michael J.] Melloy's concurrence and draws heavily therefrom." Judge Melloy, from the Eighth Circuit, was sitting by designation on the three-judge panel.

The Dissent

In an opinion written by Circuit Judge Sandra S. Ikuta, the dissenters contended as a matter of policy that the majority's rule "allows the trust to accept the benefit of a loan agreement but disregard the obligation to repay it."

With regard to the law, Judge Ikuta relied on "basic trust principles" for the proposition that a trustee does not violate his/her fiduciary duty to trust beneficiaries by obtaining a secured loan.

Judge Gould answered the argument by saying that PACA imposes duties beyond those in trust law. He said that the dissenters gave "too little weight to the protective purposes of PACA" and disregarded "the purpose of PACA to protect agricultural growers."

Judge Gould clerked on the Sixth Circuit and the Supreme Court before being appointed to the Ninth Circuit in 1999. Judge Ikuta clerked for the Ninth Circuit and Supreme Court before her appointment to the circuit bench in 2006.

To read ABI's report on the decision by the three-judge panel and the concurrence, click here.

The opinion is *S&H Packing & Sales Co. v. Tanimura Distributing Inc.*, 14-56059 (9th Cir. Feb. 22, 2018).

Consumer Bankruptcy

Fair Debt Collection Practices Act

The Eighth Circuit bars clever litigation tactics designed to evade the FDCPA on suits to collect time-barred claims.

Eighth Circuit Broadly Interprets the FDCPA to Protect Consumers

The Eighth Circuit set up a test case where the Supreme Court could decide, in the wake of *Spokeo Inc. v. Robins*, 136 S. Ct. 1540, 194 L. Ed. 2d 635, 84 U.S.L.W. 4263 (Sup. Ct. 2016), whether damages under the federal Fair Debt Collection Practices Act, or FDCPA, are sufficiently "concrete" to pass constitutional muster.

The Eighth Circuit's opinion also pushes back against the tendency of some courts to read the FDCPA so narrowly that it fails its mission as a consumer protection statute.

The case centered around the practice of suing on debts where collection is barred by the statute of limitations. Intending to avoid liability under state laws or the FDCPA, the creditor will dismiss suits when consumers appear for trial. Otherwise, the creditor would obtain judgments against those not appearing or defending.

In the case that went to the Eighth Circuit, the debtor appeared, ready to try the case, but the creditor dismissed the suit. A month later, the creditor sued, alleging violations of the FDCPA. The district judge dismissed the suit, saying, among other things, that the creditor had only engaged in "permissible litigation tactics and not actionable false assertions."

In an opinion on Aug. 29, Circuit Judge Duane Benton reinstated the suit, reversing all the grounds for dismissal.

Relying on *Spokeo*, the creditor contended in the Eighth Circuit that the consumer-plaintiffs lacked constitutional standing because they were only alleging *de facto* damages created by statute, not the required "concrete" injury.

Broadly holding that violations of the FDCPA meet constitutional requirements when stale debts are involved, Judge Benton said that "Congress created a statutory right to be free from attempts to collect debts not owed, helping to guard against identified harms," such as the "risk of mental distress" and marital discord that can accompany the "harm of being subjected to baseless legal claims."

The creditor contended that serving discovery requests on the consumers' attorney was not an FDCPA violation because it was not served on the consumers themselves. Since papers served on an attorney "routinely" come to clients' attention, Judge Benton held that the service of discovery requests caused "concrete injury in fact."

For those engaged in practice under the FDCPA, we recommend reading the opinion in full, because Judge Benton handed down many holdings regarding consumers' rights.

For instance, the district court dismissed claims because the suit was not commenced within the one-year statute of limitations under the FDCPA. More particularly, the district judge said that the communications relied on in the complaint all related back to the filing of the creditor's original complaint, which was beyond the FDCPA's one-year window.

Judge Benton rejected the relation-back theory, holding that the limitations clock begins ticking with each alleged violation of the FDCPA.

Characterizing the creditor's pleadings and other actions as "permissible litigation tactics," the district court dismissed under 28 U.S.C. § 1692(e), which prohibits "any false, deceptive, or misleading representation or means in connection with the collection of any debt."

Judge Benton said that "the fact that it used an ordinarily 'permissible litigation tactic' does not insulate it from FDCPA liability" when the consumer plausibly alleges that the creditor threatened to go to trial.

Without mentioning all of Judge Benton's holdings, his analysis of Section 1692(f) is also significant. The creditor contended that the discovery requests did not violate that section, which prohibits debt collectors from using "unfair or unconscionable means to collect or attempt to collect any debt."

The district court dismissed, saying that the consumers were unlikely to be deceived by court papers served on the consumers' attorney.

Judge Benton countered by saying that Section 1692(f) contains no "misled, deceived, or duped" requirement. That section only proscribes "unfair or unconscionable" means to collect debts. He said that cases interpreting that section "do not impose a 'misled, deceived, or duped' requirement."

The FDCPA, the judge said, does not merely prohibit activities "that mislead consumers into paying debts not owed." The statute, "by its terms, guards against many other harms — the mental distress that can cause 'marital instability' and 'the loss of jobs,' as well as 'invasions of individual privacy.'"

Reversing the district court for having dismissed the consumer's suit, Judge Benton said, "The attempted collection of debts not owed harms consumers not just by inducing the payment of false claims. It also forces consumers to spend time and money addressing the false claims — even if they know they do not actually owe the claimed debt."

Judge Benton was appointed to the circuit bench in 2004 by President George W. Bush.

If the debt-collection bar is looking for a case worthy of the Supreme Court, the original *Spokeo* suit may be first in line. After remand from the Supreme Court, the Ninth Circuit ruled on Aug. 15 that the plaintiff had alleged constitutionally necessary "concrete" damages. To read ABI's discussion of *Spokeo* after remand, click here. For ABI's report on the Supreme Court's *Spokeo* decision, click here.

Whether the high court grants *certiorari* is uncertain because there still does not seem to be a circuit split. Nonetheless, the justices originally granted *certiorari* in *Spokeo* although there was no split at the time.

The opinion is *Demarais v. Gurstel Chargo PA*, 869 F.3d 685 (8th Cir. Aug. 29, 2017).

The Code or rules must change to bar debt collectors from filing stale claims, Judge Dow says.

Courts Can't Sanction Debt Collectors for Filing Stale Claims after *Midland Funding*

Now that the Supreme Court has allowed debt collectors to file stale claims, the statute or the Bankruptcy Rules must be amended before courts can halt the practice, according to Bankruptcy Judge Dennis R. Dow of Kansas City, Mo.

In *Midland Funding LLC v. Johnson*, 137 S. Ct. 1407, 197 L. Ed. 2d 790, 85 U.S.L.W. 4239 (Sup. Ct. May 15, 2017), the Supreme Court held that a debt collector who files a claim that is "obviously" barred by the statute of limitations has not engaged in false, deceptive, misleading, unconscionable, or unfair conduct and thus does not violate the federal Fair Debt Collection Practices Act.

The U.S. Trustee mounted a frontal attack on a debt collector engaged in the business of filing proofs of claim where collection would be barred by the statute of limitations. In an adversary proceeding begun eight months before the high court decided *Midland Funding*, the U.S. Trustee alleged that regularly filing claims based on stale debts was a "systemic abuse of the bankruptcy process."

The U.S. Trustee sought a nationwide injunction, a monitor, unspecified monetary damages, and sanctions for routinely filing stale claims. Despite finding the creditor's "behavior disturbing," Judge Dow dismissed the complaint while allowing the U.S. Trustee to proceed with objections to two stale claims.

Although critical of the creditor's practices and procedures, the bulk of Judge Dow's Sept. 1 opinion leads to the conclusion that the current state of the law and rules cannot be employed to outlaw so-called robo-signing or the filing of stale claims.

For example, Judge Dow found that the creditor's "alleged process for preparing and reviewing claims fell short of the requirement of Official Form 10 and Bankruptcy Rule 9011." Despite the fact that the creditor used "questionable practices," the judge concluded that the facts did not lend to the imposition of sanctions, in part because the form was not amended until 2016 "to require that the individual signing the proof of claim personally review it."

Judge Dow faulted the creditor's elaborate robo-signing procedures because there was "no indication" that the person who signed the claims "knew if, or to what extent, that process was followed." He also said it was "inconceivable that an individual could comply with the instructions for Official Form 10 without ever examining the claim." Evidently, the same person's signature appeared on about 54,000 claims.

Ultimately, the complaint failed to state a claim for sanctions, Judge Dow said, because the U.S. Trustee did not allege "bad faith in connection with its 'robo signing' practice," because the propriety of the practice was at least debatable.

The U.S. Trustee was barred from seeking sanctions under Bankruptcy Rule 9011 for filing stale claims because he had "failed to abide by the safe harbor provisions of that rule." Sanctions were similarly unavailable under Section 105 because the statutes of limitations in most states do not extinguish these types of claims. Also on the question of whether the filing of stale claims violates the Bankruptcy Code, Judge Dow said that the definition of "claim" is "extremely broad."

Therefore, "considering applicable state law and the provisions of the Code," Judge Dow decided that "creditors have the right to file such claims and that doing so is not sanctionable." There is no violation of Rule 9011, he said, unless the creditor continues asserting the claim "after the statute of limitations has been raised."

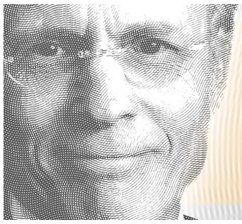
Locking the door after slamming it shut, Judge Dow said the U.S. Trustee would not be entitled to sanctions even if the creditor had been filing claims that did not comply with Rule 3001(c). The remedy for failure to file a claim in proper form, he said, is to strip the claim of its *prima facie* validity, "besides those enumerated in Rule 3001(c)."

The "other appropriate relief" allowed under the rule "does not include the disallowance of a claim." Likewise, there is no independent cause of action for a violation of Rule 3001.

Putting his finger on the nub of the issue, Judge Dow held that the creditor's behavior was "not sanctionable and may not be treated as such until changes are made either by Congress or the Rules Committee," even though the creditor's "conduct is unsettling and perhaps even distasteful or unseemly in some respects." In addition, Judge Dow said he had "no power to grant relief which would purport to be binding as to claims filed and conduct occurring in cases other than ones before this Court." Even if there were nationwide power, Judge Dow said he "would decline to exercise it."

The opinion is *Casamatta v. Resurgent Capital Services LP (In re Freeman-Clay)*, 578 B.R. 423 (Bankr. W.D. Mo. Sept. 1, 2017).

Discharge/Dischargeability



An unreasonable but good faith, subjective belief that there is no injunction bars a finding of contempt in the Ninth Circuit.

Violation of Discharge Is Now Difficult to Prove in the Ninth Circuit

A creditor's subjective, good faith belief that its action does not violate the discharge injunction precludes finding the creditor in contempt, even if the discharge injunction did apply and the creditor's belief was "unreasonable," the Ninth Circuit ruled in an April 23 opinion.

The opinion appears to mean that a creditor can act in good faith even if the creditor's belief is unreasonable. In other words, litigation in the Ninth Circuit over contempt of the discharge injunction will focus on the creditor's subjective good faith, without regard to whether the creditor's belief was right or wrong, reasonable or unreasonable.

The facts were horribly complex. With apologies for oversimplification, we summarize the facts as follows:

Before bankruptcy, the debtor transferred his interest in a closely held corporation. After the debtor received his chapter 7 discharge, two other shareholders sued the debtor 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 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 and found no contempt. In the process, he expanded the defenses available to someone charged with contempt of a discharge injunction.

To impose sanctions, existing Ninth Circuit precedent requires the debtor to show that the creditor knew the discharge injunction was applicable and prove that the creditor intended the actions that violated the injunction. In the case at hand, knowledge of the applicability of the injunction was the only issue.

Based on *In re Zilog Inc.*, 450 F.3d 996 (9th Cir. 2006), Judge Bea said that knowledge of the injunction cannot be proven by merely showing that the creditor was aware of the bankruptcy. Citing a footnote in *Zilog*, he went on to hold 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."

Judge Bea acknowledged that his interpretation of *Zilog* is "somewhat at tension" with two other Ninth Circuit precedents. Although Judge Bea said that *Zilog* was binding, it is arguable that the footnote in *Zilog* was *dicta* and therefore was not binding. Regardless of whether *Zilog* was binding or not, Judge Bea's opinion is now law in the Ninth Circuit, although it is unclear whether it was necessary for him to rule that an unreasonable belief is not actionable.

Based on his reading of *Zilog*, Judge Bea concluded, like the BAP, that the creditor had a good faith belief that the discharge injunction was inapplicable on the theory that the debtor had "returned to the fray." The creditor's belief in that regard was strengthened because the state trial court agreed.

Recall, however, that the state appellate court and the district court took the opposite view by concluding that the debtor had not "returned to the fray" but had been compelled to litigate. In other words, judges disagreed about the applicability of the injunction.

Although the creditors' belief in the inapplicability of the injunction ultimately was proven wrong, Judge Bea said that "their good faith belief, even if unreasonable, insulated them from a finding of contempt."

Judge Bea's opinion applies a subjective test with respect to belief in the inapplicability of the injunction. Moreover, there is no contempt even if the creditor's subjective belief is unreasonable.

Consequently, it seems that reliance on counsel's advice would always absolve a client from contempt liability in the Ninth Circuit.

Judge Bea's opinion also seems to stand for the proposition that there is no contempt if reasonable minds could differ on the applicability of the injunction. Since it's often debatable whether the discharge injunction applies, contempt henceforth may be difficult to prove in the Ninth Circuit.

Because an unreasonable belief is not grounds for a finding of contempt, an argument evidently must be at least frivolous before there is contempt.

We submit that the appeals court could have reached the same result on more narrow grounds by finding good faith since the trial judge in state court supported the creditors' belief by ruling that the injunction did not apply. By ruling more narrowly, the appeals court could have avoided pronouncing a rule that gives creditors license to disregard discharge injunctions by making pretextual arguments.

It is not clear from the opinion whether the same contempt standard applies to violation of the automatic stay. If it does, the automatic stay will have lost its teeth in the Ninth Circuit.

The opinion is *Lorenzen v. Taggart (In re Taggart)*, 16-35402 (9th Cir. April 23, 2018).

A 'no harm, no foul' stay violation is harmless error.

Co-Conspirator's Intent Is Enough for Nondischargeability, Fifth Circuit Holds

A co-conspirator's intent to commit larceny is enough render a debt nondischargeable even if the debtor did not show the requisite intent, the Fifth Circuit held in a case that also made important law about harmless violations of the automatic stay.

Appealing a judgment that a debt for larceny was nondischargeable under Section 523(a)(4), the debtor argued that the creditor failed to show that he possessed the requisite larcenous intent. However, the debtor admitted that his co-conspirators had shown the necessary intent.

Based on the language of the statute, Circuit Judge Stephen A. Higginson held in a July 18 opinion that a "debtor cannot discharge a debt that arises from larceny so long as the debtor is liable to the creditor for the larceny." He went on to say, "It is the character of the debt rather than the character of the debtor that determines whether the debt is nondischargeable under Section 523(a)(4)," which bars discharge of "any debt" for "fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny."

Judge Higginson rested his decision in large part on *Deodati v. M.M. Winkler & Assocs. (In re M.M. Winkler & Assocs.)*, 239 F.3d 746 (5th Cir. 2001), where the state court had held a partnership liable for the fraud of one partner. Reversing the bankruptcy court under Section 523(a)(2) in the ensuing bankruptcy of a partner, the Fifth Circuit held that the plain meaning of the statute barred the partners from discharging the debt "so long as they are liable to the creditor for fraud." *Id.* at 748. The court said that the "statute focuses on the character of the debt, not the culpability of the debtor." *Id.* at 751-52.

Importing the *Deodati* decision under subsection (a)(2) to (a)(4), Judge Higginson said that (a)(4) similarly bars discharge of "any debt . . . for . . . larceny." The text, he said, "adds no further criteria or qualifications."

Therefore, Judge Higginson said that "the intent and actions of [the debtor's] co-conspirators is sufficient to support nondischargeability under Section 523(a)(4)."

Judge Higginson stopped short of saying the result would be the same under Section 523(a)(6), because that subsection refers to "willful and malicious injury by the debtor . . . ." The additional words "by the debtor," he said, have led "several courts" to "require that the debtor have acted personally" to inflict the injury.

The appeal also presented an issue of first impression regarding the automatic stay.

The dischargeability litigation arose in the debtor's prior chapter 11 case. Although the bankruptcy court had dismissed the chapter 11 case, the parties agreed that the bankruptcy court could retain jurisdiction to complete the adversary proceeding.

After the bankruptcy court issued its opinion but before the entry of the judgment of nondischargeability, the debtor filed a chapter 7 petition in the same bankruptcy court. Although the debtor filed a suggestion of bankruptcy, the bankruptcy judge went ahead and entered the judgment of nondischargeability.

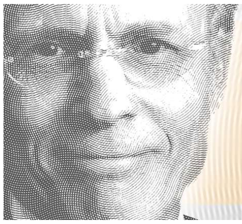
In the Fifth Circuit, the debtor argued that entry of judgment violated the automatic stay in his newly commenced chapter 7 case.

Without holding, Judge Higginson intimated there was no stay violation because the "automatic stay does not bar actions that are expressly allowed under the Bankruptcy Code." He also said, again without holding, that the stay does not bar actions in the same bankruptcy court.

Even if there were a stay violation, it was harmless error, Judge Higginson held. He examined "everything in the record" to conclude that the bankruptcy judge would have modified the automatic stay to allow the entry of judgment.

If the bankruptcy court had modified the stay, "the outcome would have been the same." Any error was harmless because the debtor would be "in the same position as he is in now."

The opinion is *Cowin v. Countrywide Home Loans Inc. (In re Cowin)*, 864 F.3d 344 (5th Cir. July 18, 2017).



ROCHELLE'S DAILY WIRE

Eighth Circuit says orders reducing nondischargeable claims may not be binding on the creditor.

No Contempt on Discharge Violation of Nondischargeable Debt, Circuit Says

The Eighth Circuit arguably narrowed a June 2016 opinion from its Bankruptcy Appellate Panel that could have been interpreted to mean that a decision in bankruptcy court reducing the amount of a nondischargeable debt is not enforceable outside of bankruptcy, the rules of *res judicata* or collateral estoppel to the contrary notwithstanding.

In chapter 13, a man listed his former wife as the holder of a priority unsecured domestic support obligation. The Missouri Division of Child Support Enforcement initially filed an unsecured priority claim for about $36,000. Believing it had incorrectly calculated the claim, the Division later filed an amended claim for over $88,000.

The debtor objected to the amended claim. The bankruptcy court disallowed the $88,000 claim and allowed the $36,000 claim, having concluded that the Department waived the excess under Missouri law by acquiescing to lower payments after the children were emancipated.

The debtor completed his five-year plan and got a discharge. The Department never appealed the disallowance order or the plan confirmation order.

After discharge, the Department began garnishing the debtor's salary to collect the disallowed $52,000. The bankruptcy court held the Department in contempt of the discharge injunction.

The BAP reversed, holding that the "discharge injunction does not apply to a nondischargeable domestic support obligation, even the disallowed portion." The debtor appealed and lost once more in an Aug. 22 opinion for the Eighth Circuit authored by Circuit Judge James B. Loken.

Judge Loken ducked the more significant issue regarding the preclusive effect of the bankruptcy court's ruling that the Department had waived the $52,000 claim under state law, because, he said, it was an appeal only from the contempt order, not the disallowance order.

With regard to contempt, Judge Loken said that the bankruptcy court could not use Section 105(a) to impose sanctions in contravention of specific statutory provisions, citing *Law v. Siegel*, 134 S. Ct. 188 (2014). He referred to Sections 523(a)(5) and 1328(c)(2) for the proposition that domestic support obligations "are not dischargeable under any circumstances," citing *United Student Aid Funds Inc. v. Espinosa*, 559 U.S. 260 (2010).

Together, those principles "eliminated the basis for the bankruptcy court's sanctions order," Judge Loken said.

In simple terms, the Eighth Circuit seems to say there is no contempt power available to enforce a bankruptcy court order reducing a nondischargeable claim.

Judge Lokens sidestepped the larger issue by refusing to "render an advisory opinion" on the preclusive effect of the bankruptcy court's order disallowing the additional claim for $52,000. Consequently, the circuit court expressed "no view on the merits of whether [the debtor] remains personally liable for the disallowed portion of [the Department's] bankruptcy claim." "These are not easy issues," he added.

With regard to whether the bankruptcy court even had jurisdiction to enforce its prior claim disallowance order, Judge Lokens said that *Local Loan v. Hunt*, 292 U.S. 234 (1934), "might give the bankruptcy court ancillary jurisdiction to enforce" that order. On the other hand, he said, the fact that domestic support claims are not dischargeable under any circumstances "puts a very different gloss on the issue," citing *Siegel*.

In substance, Judge Lokens might be saying that provisions of the Bankruptcy Code making some types of debt automatically nondischargeable may somehow divest the bankruptcy court of jurisdiction. Or, perhaps, the power of the bankruptcy court regarding nondischargeable claims does not extend beyond the bankruptcy case itself.

Although it is cold comfort for the debtor, Judge Lokens said that the state court was "fully competent" to rule on the preclusive effect of the bankruptcy court's disallowance order.

The opinion lends itself to a petition for rehearing *en banc*.

To read ABI's discussion of the BAP opinion and the dissent, click here.

The opinion is *Spencer v. State of Missouri Department of Social Services*, 868 F.3d 748 (8th Cir. Aug. 22, 2017).

Arbitration

New case seems inconsistent with Second Circuit's prior opinion compelling arbitration over an automatic stay violation.

Second Circuit Bars Arbitration in a Class Action for Violating the Discharge Injunction

Often solicitous of financial institutions caught up in bankruptcy litigation, the Second Circuit nonetheless held that the bankruptcy court properly exercised its discretion by refusing to allow arbitration in a class action alleging a violation of the Section 524 discharge injunction.

The unanimous opinion on March 7, written by Circuit Judge Rosemary S. Pooler, casts doubt on the continuing influence of *MBNA America Bank v. Hill*, 436 F.3d 104 (2d Cir. 2006). *Hill* stood for the proposition that a court in the Second Circuit must order arbitration in a class action alleging a willful violation of the Section 362 automatic stay.

The new decision from the Second Circuit came down two days after the Supreme Court issued its opinion in *U.S. Bank NA v. The Village at Lakeridge LLC*, 15-1509 (Sup. Ct. March 5, 2018), prescribing the standard of appellate review for mixed questions of law and fact. The Second Circuit did not cite *Lakeridge* and might have stated the standard of review differently had it analyzed the high court's new authority regarding bankruptcy appeals.

Judge Pooler's decision picked the winner between two district judges in New York who had reached diametrically opposite results on the same facts. Another winner is Bankruptcy Judge Robert D. Drain of White Plains, N.Y., who made the decision that was upheld by the Second Circuit on March 7.

The Class Action

An individual got a chapter 7 discharge covering credit card debt. Despite the discharge, the credit card lender continued reporting the debt as charged off rather than discharged in bankruptcy. After having received a discharge, the debtor reopened the chapter 7 case and filed a class action in bankruptcy court alleging that the failure to report the debt as discharged was an attempt at bringing pressure to repay the debt and thus violated the discharge injunction under Section 524 of the Bankruptcy Code.

The lender filed a motion to compel arbitration, relying on a provision in the credit card agreement calling for arbitration of "any controversy." Bankruptcy Judge Drain denied the motion to compel arbitration in May 2015, and the lender took an immediate appeal, permitted by the Federal Arbitration Act.

District Judge Nelson S. Román of White Plains upheld denial of the motion to compel arbitration. Interpreting *Hill*, he said that a bankruptcy judge has discretion to "override an arbitration agreement" if the lawsuit is a core proceeding based on provisions of the Bankruptcy Code that "inherently conflict" with the Federal Arbitration Act.

Judge Román found the lawsuit to be core, even though it was a class action, because "discharge is clearly a right created by federal bankruptcy law" and all class members were bankrupts. He next held that arbitrating claims under Section 524 "would necessarily jeopardize the objectives of the Bankruptcy Code."

In *Hill*, the Second Circuit had compelled arbitration in a class suit alleging a violation of the automatic stay when the debtor had received a discharge, the case had been closed, and the automatic stay was no longer in effect. Judge Román distinguished *Hill* because the case before him involved the discharge injunction, which is the "central purpose" of bankruptcy and remains in effect "even after the conclusion of the bankruptcy proceedings."

"[A]rbitration of a discharge violation would jeopardize this central objective," Judge Román said. To the *Hill* analysis, Judge Román added a fourth consideration: uniformity. He said that the need for uniformity was "compelling" because there could be "wildly inconsistent" results in arbitration.

In a case decided in October 2015 called *Belton v. GE Capital Consumer Lending Inc. (In re Belton)*, Vincent L. Briccetti reached the opposite result, also interpreting *Hill*. To read ABI's discussion of *Belton*, click here. Judge Briccetti and the Second Circuit both denied motions in *Belton* for leave to appeal.

As it turns out, the Second Circuit largely adopted Judge Román's logic, aided by an *amicus* brief submitted by Professors Ralph Brubaker, Robert M. Lawless and Bruce A. Markell and Tara Twomey of the National Consumer Bankruptcy Rights Center.

Mootness

The Second Circuit considered whether the appeal was moot because the lender was willing to update the credit reports for everyone in the class.

Judge Pooler ruled that the appeal was not moot because "the question presented and the relief sought both remain unsettled."

The ruling on mootness is significant because the result in *Hill* turned in part on the creditor's repayment of debt allegedly collected in violation of the automatic stay. Therefore, a defendant's ploy like the one in *Hill* may no longer suffice to kill off an appeal in the Second Circuit.

The Standard of Appellate Review

Next, Judge Pooler dealt with the standard of review, which she said "has been inconsistently or improperly applied by this Court."

Without citing *Lakeridge*, which had been decided two days earlier in the Supreme Court, and without analyzing whether the case presented mixed questions of law and fact, Judge Pooler said that the court would conduct *de novo* review of the core status of the suit. Similarly, she said, the review is *de novo* regarding the bankruptcy court's conclusion that arbitration would cause a "severe conflict" with the Bankruptcy Code.

After *Lakeridge*, appellate courts must decide that review is primarily legal in nature, rather than factual, before concluding that review is *de novo*. Judge Pooler did not undertake that analysis.

In deciding whether review is *de novo* or for clear error, *Lakeridge* tells appellate courts to examine whether review primarily entails a legal or factual analysis. Finding a "severe conflict" between arbitration and the Bankruptcy Code might entail either a legal or factual analysis.

Depending on the particular facts giving rise to the alleged violation of the discharge injunction, appellate review might invoke the plain error rule if the appellate court's task focuses more on the facts underlying the conclusion of "severe conflict."

The Merits

Hill taught that the court has discretion to disregard an arbitration agreement if the proceeding is core and presents a "severe conflict" with the Bankruptcy Code. In deciding whether the class plaintiff-debtor in the new cases should have been obliged to arbitrate, *Hill* therefore provided the legal precedent, but the facts in that case were "easily distinguished," Judge Pooler said.

Because the creditor conceded that the issue was core, Judge Pooler was only required to analyze whether Congress intended for the statutory right to a discharge to be non-arbitrable, thus giving the bankruptcy court discretion to refuse to compel arbitration.

Judge Pooler said that discharge is the "foundation" and the "central purpose" of bankruptcy. Therefore, arbitrating a claimed violation of the discharge injunction would "seriously jeopardize" the proceeding because (1) the discharge injunction is integral to providing a fresh start, (2) the claim was made in "an ongoing bankruptcy matter," and (3) the bankruptcy court's equitable power to enforce its own injunctions is "central to the structure of the Code."

Perhaps undercutting *Hill*, Judge Pooler said that the "putative class action does not undermine this conclusion" because the automatic stay in *Hill* had become moot by closing the debtor's bankruptcy case.

Attempting to distinguish *Hill*, Judge Pooler said that violation of the discharge injunction, as opposed to an automatic stay violation, offends "the central goal of bankruptcy," contrasted with a violation of the automatic stay, which is no longer in effect in a closed case.

Further, Judge Pooler said the discharge injunction was "still eligible for active enforcement," compared with the automatic stay, which had lapsed. Judge Pooler did not consider that damages could be sought for a violation of the automatic stay by reopening a closed bankruptcy case.

Without citation of authority, Judge Pooler said that the discharge injunction is "enforceable only by the bankruptcy court and only by a contempt citation." Arbitration therefore presented "an inherent conflict with the Bankruptcy Code," Judge Pooler said, because "the bankruptcy court alone has the power to enforce the discharge injunction."

Having found an "inherent conflict," Judge Pooler quickly concluded that the bankruptcy judge did not abuse his discretion in ruling out arbitration.

What Remains of *Hill*?

It is at least arguable that *Hill* should have required Judge Pooler to impose arbitration. Since the Second Circuit was not sitting *en banc*, her three-judge panel could not overrule *Hill*.

In *Hill*, the issue was also core, but the appeals court required arbitration, overruling the two lower courts.

The *Hill* court concluded that arbitration would not "seriously jeopardize the objectives of the Bankruptcy Code," in part because the automatic stay "is not so closely related to an injunction that the bankruptcy court is uniquely able to interpret and enforce." In the March 7 opinion, Judge Pooler neglected to note that the discharge injunction can be raised as an affirmative defense in any court.

Hill also found significance in the fact that the plaintiff's bankruptcy case had been closed. However, the debtor's case also had been closed in the appeal before Judge Pooler, but the bankruptcy judge had reopened the case to permit the filing of the class action.

Hill, therefore, may be limited in the future to class actions in district court seeking redress for violations of the automatic stay. *Hill* might not require arbitration if the debtor alone seeks damages for an automatic stay violation under Section 362(k), and *Hill* might not apply to a class action in bankruptcy court seeking redress for an ongoing violation of the automatic stay.

The March 7 decision presents an opportunity for the Second Circuit to sit *en banc*, either to set aside Judge Pooler's opinion or overrule *Hill* outright. However, *en banc* rehearing is exceedingly rare in the Second Circuit. Stay tuned nonetheless.

The opinion is *Credit One Bank NA v. Anderson (In re Anderson)*, 16-2496 (2d Cir. March 7, 2018).

Wages & Dismissal

Dissenter contends that the majority misread the circuit's own precedent.

Ninth Circuit Creates Split on Appellate Standard for 'Consumer Debt' Determination

Either creating a circuit split or accentuating an existing split, a divided panel of the Ninth Circuit disagreed on the standard of appellate review on appeal from an order from the bankruptcy court deciding whether an obligation is a consumer or business debt under Section 707(b)(1).

The issue is akin to the question in *U.S. Bank NA v. The Village at Lakeridge LLC*, 15-1509 (Sup. Ct.), where the Supreme Court will decide this term whether the standard of appellate review for non-statutory insider status is *de novo* or clearly erroneous, or a combination of both.

The appeal in the Ninth Circuit turned in large part on that court's own precedent in *Zolg v. Kelly (In re Kelly)*, 841 F.2d 908, 911 (9th Cir. 1988). The majority and the dissent couldn't even agree on what *Kelly* meant.

The majority read *Kelly* to mean that a home mortgage can be either a consumer or business debt, depending on the "primary purpose" of the loan. The dissent understands *Kelly* to mean that a home mortgage, as a matter of law, is always a consumer debt. The majority and dissent also disagree about the appellate standard prescribed by *Kelly*.

The Facts

A man who lived in Jackson, Wyo., had worked 25 years for a luxury hotel chain, earning $225,000 a year. Hoping for advancement to a more senior executive position, he applied for a job at a luxury resort in Aspen, Colo. Although offered a job in Aspen for $300,000, he could not afford either to rent or buy a home in Aspen, where home prices are higher than in Jackson.

The new employer sweetened the offer by granting him a $500,000 mortgage toward the purchase of a home in Aspen. The new employer also gave him a guaranteed annual bonus to cover the below-market interest on the loan.

He took the job, but his wife and children remained in Wyoming. The home he purchased in Aspen was too small for his entire family. He continued using banks in Wyoming and did not move the registration of his car to Colorado.

The man considered the house in Aspen to be a "placeholder" because his new employer was planning to develop a new resort in Jackson, allowing him to move back to Wyoming and join his family.

After the economy crashed in 2008, the new employer terminated plans for the new resort in Wyoming. Abandoning hope of returning to Wyoming, he sold his home in Jackson, and his family joined him in Aspen.

Four years after taking the job in Aspen, the man resigned and later filed a chapter 7 petition, owing $550,000 on the loan from his employer.

The employer moved to dismiss the chapter 7 petition for abuse under Section 707(b)(1), contending his debts were primarily consumer, thus making him ineligible and requiring him to convert the case to either chapter 13 or chapter 11 if he wanted a discharge eventually.

The bankruptcy judge held a trial and denied the motion to dismiss, concluding that the Colorado mortgage was a business debt, making him eligible for chapter 7 because his debts overall were "primarily" business debts. On appeal, the Ninth Circuit Bankruptcy Appellate Panel upheld the bankruptcy court.

The Majority Opinion

Writing for herself and Circuit Judge Marsha S. Berzon, Circuit Judge Morgan Christen upheld the BAP in an opinion on Oct. 16 that appears to mean that characterization of a debt as consumer or business is a fact to be found by the trial court and reviewed for clear error, not a legal conclusion that an appellate court can review *de novo* based on undisputed facts.

The employer contended that appellate review should be *de novo* because the underlying facts were undisputed. The employer also argued that a home mortgage is always a consumer debt. Judge Christen disagreed on both counts.

Judge Christen interpreted *Kelly* to mean that a court must divine the "primary purpose" of a debt in deciding whether the obligation is consumer or business. *Kelly* held, in her view, that home mortgages are usually but not always consumer debts. She disputed the dissenter's understanding of *Kelly* to mean that home mortgages are always consumer debts.

The debtor's "multiple motives" for taking the mortgage required the bankruptcy court to engage "primarily" in a "factual, rather than legal, inquiry." Since the decision in the bankruptcy court was essentially a factual inquiry, the appellate standard is clear error, Judge Christen said.

Judge Christen admitted that the courts are split on the standard of review, with the Eighth Circuit BAP also holding "that the purpose of a debt is a factual finding reviewed for clear error." The Fifth and Tenth Circuits, she said, hold to the contrary.

Judge Christen cited a number of undisputed facts to buttress the bankruptcy court's conclusion that the mortgage primarily had a business purpose. She therefore concluded that the bankruptcy court did not clearly err in finding that the mortgage was "undertaken for a business purpose connected with furthering his career, rather than a personal, family or household expense."

The Dissent

Circuit Judge Jacqueline H. Nguyen dissented, saying that the majority applied "the wrong standard of review, creating a circuit split in the process."

Judge Nguyen interpreted *Kelly* as meaning, "in no uncertain terms," that the trial court makes a predominantly legal determination subject to *de novo* review when the facts are not in dispute. She counted the Fourth, Fifth, Sixth and Tenth Circuits as also holding that the characterization of consumer debt is subject to *de novo* review.

Beyond the appellate standard, Judge Nguyen said that the majority were wrong on the merits, because she understood *Kelly* to mean that "all loans to purchase a home are consumer debt."

Finality

Like the BAP, the appeals court addressed the question of whether denial of a motion to dismiss under Section 707(b) is a final order eligible for appeal to the circuit.

Without dissent from Judge Nguyen, Judge Christen followed the "majority of circuits" by holding that denial of a motion to dismiss under Section 707(b) is a final order because it conclusively determines a discrete issue resolving the debtor's eligibility for a discharge in chapter 7.

Judges Christen and Nguyen were both appointed by President Barack Obama.

In a similar case, *Bushkin v. Singer (In re Bushkin)*, 15-1285, 2016 BL 236937 (B.A.P. 9th Cir. July 22, 2016), the Ninth Circuit BAP classified living expenses as business debts if they were intertwined with a profit motive. The appeal to the circuit in *Bushkin* was being held in abeyance pending the decision in this case. To read ABI's discussion of *Bushkin*, click here.

The opinion is *Aspen Skiing Co. v. Cherrett (In re Cherrett)*, 873 F.3d 1060 (9th Cir. Oct. 16, 2017).

New York judge rules that the* IRS Handbook *is not controlling on auto expenses for the means test.

On the Means Test, a Single Debtor Can Take Deductions for Two Cars

On an issue dividing the lower courts, Bankruptcy Judge Alan S. Trust of Central Islip, N.Y., ruled that a single individual can claim a deduction for two automobiles in calculating the means test to determine whether the debtor's case represents "presumptive abuse."

The U.S. Trustee filed a motion to dismiss, contending that the debtor could take a deduction for only one automobile. If one of the deductions were eliminated, the debtor would have failed the means test, and his case would have been dismissed for presumptive abuse under Section 707(b)(2) unless he were to convert to chapter 13.

In his Jan. 11 opinion, Judge Trust analyzed the case as a question of statutory construction.

On line 11 of Form 122A-2, the debtor claimed ownership of two cars. On line 12, he listed auto expenses of $616, the exact amount shown on the IRS Local Standards for the New York metropolitan area for someone who owns two cars.

The trustee argued that the court instead should follow the *IRS Handbook*, which allows a single person a deduction for only one car.

Judge Trust said that Section 707(b)(2)(A)(ii)(1) does not tell the court to refer to the *IRS Handbook*. Rather, he said, the subsection says the deduction "shall be" determined by the National and Local Standards. The Local Standards applicable to autos allow a deduction for one or two autos "and [do] not expressly limit a single-person household debtor's operation costs to one vehicle," the judge said.

The "fact that the *IRS Handbook* could be read to conflict with the statute and official form is irrelevant for a presumed abuse case, because Congress did not expressly build the *IRS Handbook* into the statute nor did the Judicial Conference of the U.S. build the *IRS Handbook* into the official form," Judge Trust said.

Consequently, Judge Trust found no presumed abuse because he allowed the single debtor with no dependents to take deductions for the two autos he owned. He held that "the *IRS Handbook* is not controlling and in fact would be at odds with the Means Test as defined, none of which limit a single-person-household debtor to one vehicle expense where the debtor actually owns or leases two or more vehicles."

The opinion is *In re Addison*, 16-74856, 2018 BL 10506 (Bankr. E.D.N.Y. Jan. 11, 2018).

On dismissal before chapter 13 confirmation, the debtor gets undistributed funds, not a creditor with a valid state court levy.

Section 1326(a)(2) Overrides a Levy Under State Law

On an issue where the courts are split, a district judge in Virginia upheld the bankruptcy court's ruling that a chapter 13 trustee must return undistributed funds to the debtor, rather than honor a garnishment under state law, if the case was dismissed before a plan was confirmed.

Owing a state agency more than $74,000 for child support arrears, a man filed a chapter 13 petition. After filing, he sent about $3,000 to the trustee. With the debtor unable to craft a confirmable plan, the bankruptcy court dismissed the case.

After dismissal and while the trustee was still holding the $3,000, the state agency served a garnishment order on the trustee. The debtor objected, contending he was entitled to a return of the funds under Section 1326(a)(2).

When the trustee sought instructions, the bankruptcy court decided that the money should go to the debtor. The state agency appealed and obtained a stay pending appeal.

In an opinion on Oct. 19, District Judge Norman K. Moon of Lynchburg, Va., agreed with the bankruptcy judge.

Judge Moon framed the question as being whether the court should follow Section 1326(a)(2) or honor an otherwise valid levy under state law.

Eliminating exceptions that do not apply when a chapter 13 case is dismissed before confirmation, Judge Moon quoted Section 1326(a)(2) to say that the trustee must "return any such payments . . . to the debtor . . . ." That language, he said, "is determinative."

To the state agency's argument that the termination of the automatic stay on dismissal allows a levy on the debtor's property, Judge Moon said that Section 362 "does not contradict or muddle Section 1326(a)(2)'s statement about who gets the funds."

Next, the state argued that the trustee was obliged to comply with state law under 28 U.S.C. § 959(b). The state's argument failed under the Constitution's Supremacy Clause, Judge Moon said, because state law contradicts the mandate of Section 1326(a)(2).

Finally, Judge Moon justified his conclusion by referring to policy as reflected in *Harris v. Viegelahn*, 135 S. Ct. 1829, 1835 (2015), where the Supreme Court said that a debtor should not be penalized for pursuing chapter 13 voluntarily.

The opinion is *Commonwealth of Virginia v. Beskin*, 17-028 (D. Va. Oct. 19, 2017).

Large student loans do not justify dismissal of a chapter 13 case when chapter 11 is the only alternative, Bankruptcy Judge Janet S. Baer says.

Chicago Judge Erases Chapter 13 Debt Limits on Student Loans

If an individual's debts are principally student loans, there should be no debt limit in chapter 13, according to Bankruptcy Judge Janet S. Baer of Chicago.

In her Dec. 27 opinion, Judge Baer created a bankruptcy remedy where none otherwise would exist for an individual who is swamped by student loans but would be ineligible for chapter 7.

The chapter 13 debtor owed about $570,000 on student loans and another $22,500 on credit cards. He was living paycheck to paycheck, Judge Baer said. His monthly take-home pay of some $2,700 left him with about $475 in disposable income.

Under an income-based repayment plan, the debtor had been repaying his student loans at the rate of $268 a month. If he continued the payments for 25 years, any unpaid balance would be forgiven. The amount of his monthly payment would increase or decrease depending on a rise or fall in his income.

The trustee moved to dismiss, because the debtor's unsecured liabilities exceeded the maximum of $394,725 in "noncontingent, liquidated, unsecured" debt permitted in chapter 13 by Section 109(e).

Claiming that the student loans were contingent, the debtor argued that he was within the chapter 13 debt limit. He contended that the student loans were contingent because a portion could be forgiven in the future.

Judge Baer didn't buy the contingent argument. In the Seventh Circuit, a debt is noncontingent "if the event giving rise to liability has already occurred." The debt, she said, came into existence when the debtor signed the loan agreement. "It is the possibility of forgiveness that is contingent," the judge said, "not the debt itself."

Nonetheless, Judge Baer said, Section 109(e) by itself does not require dismissal. That section only contains chapter 13 eligibility standards.

Dismissal is governed by Section 1307(c), which says that the court "may" convert to chapter 7 or dismiss for "cause." It then lists 11 nonexclusive grounds representing dismissal for cause. Failure to meet the debt limit in Section 109(e) is not one of the listed factors.

Analyzing whether there was cause to dismiss, Judge Baer surveyed the evolution of chapter 13. Citing legislative history, she said that the debt limits were added "to keep debtors with large businesses from filing chapter 13 cases." The debt limits shunt owners of large businesses into chapter 11, where there are more creditor protections.

Concern for creditor protection does not exist when an individual debtor has large educational debt, Judge Baer said. Indeed, unsecured creditors of student loan debtors would prefer chapter 13 because they might realize some recovery compared to chapter 7. Student loan lenders would not be harmed because student loans ordinarily are not discharged in chapter 13. In addition, caselaw allows a debtor to put student loans in a separate class with potentially higher payments than those to unsecured creditors.

Judge Baer noted how the unsecured debt limit in chapter 13 has risen only 7.6% a year since 1978, while the cost of post-secondary education has risen 20.7% annually. The result has been an explosion in student loan debt, a fact that did not exist in 1978 with adoption of the Bankruptcy Code.

Judge Baer found no "cause" for dismissal, in part because the "express language of Section 1307(c) does not require the court to dismiss." Furthermore, not dismissing would be in the best interest of creditors, the estate and the debtor.

The debtor, she said, can remain current on his student loans in chapter 13 while he pays some of his future earnings to general unsecured creditors.

If the debtor were ineligible for chapter 7, the debtor would have no viable bankruptcy alternative absent chapter 13, since conversion to chapter 11 would impose "substantial fees" on the debtor. In addition, Judge Baer said, chapter 11 entails "'too cumbersome a procedure' that is simply not suited for a reality such as his."

The opinion is *In re Pratola*, 578 B.R. 414 (Bankr. N.D. Ill. Dec. 27, 2017).

With no circuit authority, lower courts are split on the fate of standing trustees' fees when a chapter 13 case is dismissed before confirmation.

No Statutory Fees for Standing Chapter 13 Trustees if Dismissal Precedes Confirmation

With no authority as yet from the courts of appeals, the lower courts are divided on the right of a standing trustee to retain his or her statutory fees if a chapter 13 case is dismissed before confirmation.

Bankruptcy Judge Mary Ann Whipple of Toledo, Ohio, decided that the "plain language" of Section 1326(a)(2) takes precedence over 28 U.S.C. § 586(e), which "lacks such clarity," she said.

The case involved joint chapter 13 debtors who paid about a $10,500 to the standing chapter 13 trustee. The plan was never confirmed, and the case was dismissed. The bankruptcy court approved the trustee's final report and dismissed the case, calling for the trustee to retain about $900 in statutory fees and return the remainder to the debtors.

One of the debtors sought reconsideration, disallowance of the trustee's statutory fees, and disgorgement of the fee that the trustee had retained.

In her Sept. 29 opinion, Judge Whipple said that the *Handbook for Chapter 3 Standing Trustees*, published by the Executive Office of the U.S. Trustees, provides no guidance. If a chapter 13 case is dismissed before confirmation, the *Handbook* says that the standing trustee must reverse the payment of the percentage fee "if there is controlling law in the district requiring such reversal."

The *Handbook* is equivocal because, as Judge Whipple said, the two controlling statutes point in different directions.

Section 1326(a)(2) says that if a plan is not confirmed, "the trustee shall return any [payments made by the debtor] not previously paid out and not yet due and owing to creditors . . . to the debtor, after deducting any unpaid claim allowed under Section 503(b)."

Seemingly to the contrary, Section 586(e) provides that the standing trustee "shall collect such percentage fee from all payments received by [the standing trustee] under plans in the cases under" chapters 12 and 13.

Judge Whipple said that none of the courts of appeals had resolved the conflict in the two sections, and the lower courts are in disagreement. She said there is no controlling law in her district.

In deciphering which statute to follow, Judge Whipple said that the "plain language of Section 1326 is clear." When a chapter 13 case is dismissed before confirmation, she said that use of the word "shall" requires the standing trustee "to return all such payments, including the statutory percentage fee being held by the trustee, after deducting any allowed administrative expense claims."

By comparison, Judge Whipple said that Section 586(e)(2) "lacks such clarity," in part because it deals with collection but not ultimate disposition.

Consequently, Judge Whipple granted the motion for reconsideration, modified the dismissal order, and required the trustee to pay the statutory fee to the debtor.

The opinion is *In re Lundy*, 15-32271, 2017 BL 347466 (Bankr. N.D. Ohio Sept. 29, 2017).

Plans & Confirmation

Split decision allows a lender to take property out of an estate automatically.

Eleventh Circuit Requires No Objection to Overturn a Final Confirmation Order

In the words of the dissenter, the Eleventh Circuit penned an opinion on Dec. 11 "that will impede the effectiveness of our bankruptcy system and will undermine its purpose."

The majority held that property covered by Georgia's pawn statute, although remaining in the debtor's possession, automatically drops out of the estate once the redemption period elapses. Even a chapter 13 plan is incapable of paying the lender's claim in full and allowing the debtor to retain his car.

More surprisingly, the majority held that the title lender was not required to file an objection to confirmation of the plan. Although the lender also did not appeal confirmation of the plan, the majority nonetheless held that the confirmed plan did not bind the creditor because the lender had previously filed a motion to declare that the car was no longer estate property.

The decision has a number of shortcomings, among them the majority's lack of discussion of Section 541(b)(8), which gives only limited protections to pawn brokers and title lenders. The opinion does not explain why a confirmed plan is not binding and thereby insinuates that a creditor need not oppose confirmation if a related issue is in litigation.

The majority opinion, written by a circuit judge appointed by President Donald Trump, means that states can pass laws eviscerating debtors' rights under the Bankruptcy Code by taking property automatically out of the estate. The opinion also says that state laws prevail unless Congress has shown an intent for the Bankruptcy Code to be paramount.

The Typical Title Loan

The debtor obtained a loan before bankruptcy, secured by the title to his car, but he retained possession of the car. Before the redemption period elapsed under state law, the debtor filed a chapter 13 petition. The debtor did not pay off the title loan within the additional 60 days provided by Section 108(b).

Georgia's automobile pawn statute gives the borrower a 30-day grace period after maturity to redeem the car. If not redeemed, title automatically passes to the lender.

After the additional 60 days had run, the lender filed a motion to declare that the car was no longer property of the estate and to modify the automatic stay permitting repossession of the car.

The debtor opposed the motion, which was not decided before the bankruptcy court confirmed the chapter 13 plan.

The lender had filed a secured claim. Approved by a confirmation order that the lender did not appeal, the plan provided for paying the claim in full with interest at 5%.

At the hearing on the stay relief motion after confirmation, the lender conceded that it had not objected to confirmation. The bankruptcy judge denied the stay relief motion, holding that the car remained property of the estate even after expiration of the extended redemption period. The bankruptcy court also held that the lender was bound by the confirmed plan.

The district court affirmed, holding that the chapter 13 plan could modify the lender's rights. To read ABI's discussion of the district court opinion, click here.

The Eleventh Circuit reversed in a Dec. 11 opinion by Circuit Judge Kevin Newsom. Judge Newsom was Articles Editor for the *Harvard Law Review*. After clerking on the Ninth Circuit, he clerked on the Supreme Court for Justice David H. Souter.

The Plan Was Not Binding

Judge Newsom first ruled that the plan was not binding because the title lender had not "slept on its rights" by failing to object to confirmation of the plan.

"[O]n the unique facts of this case," Judge Newsom said, the lender's motion to modify the stay "adequately preserved its position." He said there was "no substantive difference between the styled-as-such [objection to confirmation] that the dissent would seemingly require and the motion for relief [from the stay that the title lender] actually filed."

The lender "put the *substance* of its position . . . squarely before the bankruptcy court," Judge Newsom said. [Emphasis in original.] He went on to say that the lender was not required to file a confirmation objection to preserve the contention that the car was no longer estate property, because that issue "was adequately teed up" in the stay relief motion.

Although Judge Newsom said the facts of the case were "unique," his opinion could be interpreted to mean that previously filed pleadings in chapter 11 or 13 cases will suffice as confirmation objections, although not denominated as such. Evidently, the bankruptcy judge must scour the docket for pleadings raising issues that might also pertain to confirmation.

Even if the lender had preserved the issue, Judge Newsom's opinion does not explain why the appeal was not moot as a consequence of the confirmation order that the lender did not appeal.

The Car 'Dropped Out' of the Estate

Next, Judge Newsom held that the car "dropped out" of the estate by "the 'automatic' operation of Georgia's pawn statute." He said that a "clear majority" of lower courts have held that property subject to a pawn statute can cease automatically to be estate property.

Judge Newsom cited *Butner v. U.S.*, 440 U.S. 48, 55 (1979), and *Barnhill v. Johnson*, 503 U.S. 393, 398 (1992), for the proposition that property interests are created and defined by state law. However, he did not mention *Barnhill's* more important holding that federal law nonetheless determines the time of a transfer, an issue not discussed but pertinent to the case at hand.

Since state law automatically divests an owner of title, Judge Newsom said that the Bankruptcy Code could alter the outcome "only if we find some clear textual indication that Congress intended that result."

The "likeliest candidate," Judge Newsom said, was the automatic stay. Section 362(a), though, "has no application to the particular circumstances of this case," he said.

Although conceding that "some courts" have held that the automatic stay tolls an unexpired redemption period, Judge Newsom cited Section 108(b) as making the automatic stay inapplicable. Were it otherwise, he said, the general would control the specific, and Section 108(b) would be superfluous.

Although the automatic stay prevents creditors from prying assets out of the estate, Judge Newsom said "it does not separately prevent those assets from evaporating on their own — as here, 'automatically' — pursuant to the ordinary operation of state law."

Next, Judge Newsom said that Section 541 does not freeze estate property as of the filing date. The statute, he said, "neither clearly says nor unambiguously implies . . . that a bankruptcy estate, once created, necessarily remains static."

Finally, Judge Newsom held that Section 1322(b)(2) "has no field of application in this case." Although that section allows a chapter 13 plan to modify the claims of secured creditors, it did not apply because the car was no longer estate property by the time of confirmation.

Joining Judge Newsom's opinion was District Judge Federico A. Moreno from the Southern District of Florida, sitting by designation.

The Dissent

Circuit Judge Charles R. Wilson, appointed by President Bill Clinton, dissented, saying this "should be an easy case," because "a confirmed chapter 13 bankruptcy plan enjoys a preclusive, binding effect."

The law, he said, "required an objection before plan confirmation, not a retroactive recasting of motions as objections."

Judge Wilson pointed to the lender's concession in bankruptcy court and the bankruptcy judge's consequently finding that the lender had not filed an objection to confirmation. Reviewed for clear error, that finding, he said, "is insurmountable." He also said there was "ample evidence to support the fact that [the lender] *affirmatively declined* to object." [Emphasis in original.]

Therefore, Judge Wilson said he would have ruled that the lender was "bound by the confirmed plan."

Taking the stay relief motion as a confirmation objection, Judge Wilson said, means that "judges will need to scour the docket prior to each confirmation hearing."

Next, Judge Wilson cited *United Student Aid Funds Inc. v. Espinosa*, 559 U.S. 260 (2010), for the idea that even an "illegal" plan provision binds a creditor.

With regard to the question of estate property, Judge Wilson said that "state law cannot operate to alter the bankruptcy estate after its creation — and it certainly cannot serve to dispossess the bankruptcy estate of property."

On the filing of the chapter 13 petition, the lender had a secured claim that the debtor could modify under Section 1322(b)(2). Congress, Judge Wilson said, "provided no mechanism for property of the estate to evaporate."

Judge Wilson pointed to Section 541(b)(8) as authority for the idea that the car remained estate property. That section was added along with the BAPCPA amendments in 2005 to give additional protections to pawn brokers and title lenders.

Section 541(b)(8) says that estate property does not include tangible property, other than written evidences of title, if the property is collateral for a loan, the property is in the possession of the lender, the debtor has no obligation to repay the loan, and the debtor has not redeemed the property within the time provided by state law.

Judge Wilson said that the section would have applied if the lender were in possession of the car, but that was not the case.

The majority cited Section 541(b)(8), but as evidence of a situation where property can drop out of the estate automatically. Arguably, Congress intended for Section 541(b)(8) to be the only circumstance when a title lender or pawn broker can automatically obtain title to property after bankruptcy, and that section by its terms was inapplicable to the case at hand.

Overview

The majority opinion gives states the ability to write laws automatically taking property out of a bankruptcy estate. Theoretically, states could make reorganization impossible in chapter 13 or chapter 11 by transferring all manner of property automatically to lenders or other creditors.

By requiring specific evidence that Congress intended for the Bankruptcy Code to override state law, the majority would make bankruptcy law less uniform and more a reflection of the idiosyncrasies of state law. Judge Newsom seemed to import rules regarding implied repeal of federal statutes to cases involving federal preemption of state law.

The majority opinion in some ways resembles *WD Equipment v. Cowen (In re Cowen)*, 849 F.3d 943 (10th Cir. Feb. 27, 2017), where the Tenth Circuit held that passively holding an asset of the estate, in the face of a demand for turnover, does not violate the automatic stay in Section 362(a)(3) as an act to "exercise control over property of the estate." The majority opinion and *Cowen* both chip away at the primacy of the Bankruptcy Code and diminish debtors' rights and remedies.

The issue decided in *Cowen* is on direct appeal to the Tenth Circuit in *Davis v. Tyson Prepared Foods Inc. (In re Garcia)*, 17-3247 (10th Cir.), where the debtor will presumably ask for *en banc* argument or rehearing. For ABI's discussion, click here.

A debtor who does not redeem a car is not without relief. Presumably, the loan typically would be far smaller than the value of the car, thus allowing the debtor to mount a constructive fraudulent transfer suit against the lender. Nonetheless, the cost of an avoidance suit will be greater than and in addition to the cost of confirming a plan. Notably, a pawn broker or title lender entitled to retain property is still subject to an avoidance action under Section 541(b)(8).

The opinion is *Title Max v. Wilber (In re Wilber)*, 876 F.3d 1302 (11th Cir. Dec. 11, 2017), petition for rehearing *en banc* denied Feb. 14, 2018.

On direct appeal, Seventh Circuit upholds Bankruptcy Judge Thorne by allowing chapter 13 debtors to retain anticipated refunds from earned income tax credits.

Seventh Circuit Allows Anticipated Tax Refunds to Be Offset by Expenses in Chapter 13

Affirming Bankruptcy Judge Deborah L. Thorne on direct appeal, the Seventh Circuit held that a chapter 13 debtor can prorate an earned income tax credit in calculating disposable income and may offset the tax refund income with "reasonably necessary expenses to be incurred throughout the year."

The appeals court rejected the chapter 13 trustee's argument that the tax credit should be turned over in full to allow an extra payment to creditors, without deduction for any expenses.

The Poverty Level Debtor's $4,000 Tax Credit

A single mother of three children, the below-median income debtor had an annual income of about $30,000, well below the median income threshold of $87,000 in Chicago. Calculating projected monthly income, the debtor included a proration for her anticipated earned income tax credit of about $4,000 a year.

After several amendments to her schedules, the debtor proposed a 48-month plan paying her creditors $74 a month, an amount equal to her calculation of monthly disposable income. Creditors would receive a total of about $6,000. In other words, the plan would have paid creditors three or four times more were the tax refunds earmarked in full for creditors, without deduction.

In calculating disposable income, the debtor in substance included several one-time expenses that she could not incur or pay without using the earned income tax credit, such as buying beds for her sons, who were sleeping on air mattresses. The appeals court said that the additional expenses allowed the debtor to "retain some, or even all, of her tax credits."

Even with the extra income from the tax refund and the additional expenses, Judge Thorne found that the debtor had "a pretty skinny budget overall."

The chapter 13 trustee objected to confirmation, arguing that the debtor should turn over the entire amount of the earned income tax refund when received to fund additional payments to creditors.

Consolidating three chapter 13 cases raising identical issues, Judge Thorne overruled the objections and confirmed the debtors' plans in March 2017. Judge Thorne later certified an issue for direct appeal. The Seventh Circuit agreed to hear the direct appeal, saying there was no authority from the Supreme Court or the Seventh Circuit saying whether tax credits are disposable income.

Interestingly, the trustee and the debtor agreed that tax credits are disposable income. Prompting a dissent from one judge on the panel, the appeals court nonetheless went on to decide the next question: Can a debtor prorate tax credits to be offset by anticipated expenses?

The Seventh Circuit Opinion

In his March 22 opinion, Circuit Judge Joel M. Flaum agreed with the parties and held that tax credits are included in "currently monthly income," as defined in Section 101(10A)(A) and referred to in Section 1325(b)(1).

Nonetheless, Judge Flaum said that including tax credits within currently monthly income "does not mean that the debtor must pay the entire tax credit to the trustee as disposable income."

To retain some or all of the tax refunds, the trustee argued that the debtor must file a motion to amend the plan every time a refund comes in. Judge Flaum said that Judge Thorne rejected that idea "to alleviate the burdens that the motion-to-modify process imposes on trustees, debtors, and the court."

Judge Flaum likewise rejected the argument, relying on *Hamilton v. Lanning*, 560 U.S. 505 (2010), where the Supreme Court adopted a "forward-looking approach" and said that "the court may account for changes in the debtor's income or expenses that are known or virtually certain at the time of confirmation."

Judge Flaum said that Judge Thorne "properly allowed *Lanning* to calculate [the debtor's] projected disposable income," because her receipt of the tax credit refund was "virtually certain."

On the other hand, Judge Flaum said, the trustee's argument "is just another version of the rigid mechanical approach the Supreme Court rejected in *Lanning*." In contrast, Judge Thorne's approach of offsetting expenses against anticipated tax refunds "is exactly the kind of forward-looking approach that the Supreme Court endorsed in *Lanning*."

In a two-page opinion, Circuit Judge Daniel A. Manion concurred in part and concurred in the judgment, but not in a fashion undercutting the holding regarding the treatment of expenses to offset tax refunds.

Judge Manion said the circuit should not have accepted the case because the trustee and the debtor agreed on the issue that Judge Thorne certified for direct appeal. However, he concurred with the remainder of the opinion, holding "that the bankruptcy court did not abuse its discretion in overruling the trustee's objections to the debtor's chapter 13 plan." He would have expressed no opinion "on whether the earned income tax credit qualifies as income under the Bankruptcy Code" because there was "no adverse briefing on the issue and the resolution would not affect the outcome."

The opinion is *Marshall v. Blake*, 17-2809 (7th Cir. March 22, 2018).

Courts are also split on whether a five-year plan begins on confirmation or on the first chapter 13 plan payment.

Colorado Judge Differs with Two Circuits on Chapter 13 Payments Beyond Five Years

Disagreeing with the Third and Seventh Circuits, Bankruptcy Judge Elizabeth E. Brown of Denver held that the bankruptcy court lacks discretion to allow a final payment on a chapter 13 plan more than five years after the first plan payment.

A couple confirmed a chapter 13 plan obligating them to pay about $900 a month for five years. Less than a year after confirmation, the husband lost his job. The court approved a modified plan lowering the monthly payment to $10, with a proviso that the couple file amended schedules and an amended plan within 30 days after the husband got a new job.

When the husband was employed again, they informed their bankruptcy lawyer, but he had forgotten about the proviso.

After the couple completed their plan payments, the chapter 13 trustee remembered the proviso, analyzed their tax returns, and calculated a $17,000 shortfall had the couple amended the plan on time.

The debtors and the trustee agreed to a stipulation allowing the couple to pay off the $17,000 over several months after the final plan payment. Without advance approval from the court, the couple went ahead and paid the additional $17,000 so they could obtain a chapter 13 discharge.

In her Jan. 23 opinion, Judge Brown declined to approve the stipulation but converted the case to chapter 7, where the couple nonetheless may obtain a discharge.

Judge Brown tackled two major questions on which the courts are split. First, she was tasked with deciding when the clock on the five years begins to run. If the period begins with the first payment after confirmation, the $17,000 payment would have fallen within the five-year window and she would have approved the stipulation, giving them a chapter 13 discharge.

Unfortunately for the debtors, Judge Brown sided with those courts that start the clock running with the first payment after filing, thus causing the $17,000 payment to occur beyond five years.

If the five years begins running on the first payment after confirmation, debtors would be saddled with "additional burdens," Judge Brown said, because they would be making monthly payments for more than five years, since confirmation usually does not occur at the first confirmation hearing. We recommend reading Judge Brown's opinion in full text to appreciate her reasoning for deciding that the clock begins running on the first plan payment after filing.

Judge Brown was therefore required to address the second question: Does the court have discretion to allow a final payment beyond five years?

The Third and Seventh Circuits have found discretion to allow a final payment after five years. *See In re Klaas*, 858 F.3d 820 (3d Cir. 2017); and *Germeraad v. Powers*, 826 F.3d 962 (7th Cir. 2016). For ABI's discussion of those cases, click here and here.

Judge Brown instead adopted the conclusions of the Tenth Circuit Bankruptcy Appellate Panel and several bankruptcy courts that do not permit payments outside of five years. Although Judge Brown was technically not bound by the Tenth Circuit BAP, ruling otherwise would have assured a reversal were she appealed.

Again, we recommend reading the opinion in full on the issue of discretion to make a late payment.

Even if she had sided with the circuit courts, Judge Brown said she would not have changed her ruling.

The debtors were not blameless, she said, because they made lower payments for three years after the plan should have been modified to increase the monthly payments. The debtors, she said, were "not directly culpable for this failure because they timely informed their attorney."

Nevertheless, she said, the clients "must be held accountable for the acts and omissions of their attorney."

Judge Brown also said she did not want to "send a message to other debtors that they are free to ignore plan requirements when it suits them and then cure the default . . . if discovered by the trustee or some other party."

The opinion is *In re Humes*, 11-39684, 2018 BL 35274 (Bankr. D. Colo. Jan. 23, 2018).

Dissenter argues that suing in bankruptcy court was sufficient disclosure to avoid judicial estoppel.

Ninth Circuit Demands Amended Schedules to Avoid Judicial Estoppel

In a nonprecedential opinion, the majority on a Ninth Circuit panel held that disclosure to a bankruptcy judge is not enough. A lawsuit by a chapter 13 debtor against a third party must be disclosed in amended schedules to avoid invocation of the doctrine of judicial estoppel.

The dissenter would have held that disclosure to the bankruptcy judge made judicial estoppel inapplicable. She said that the "majority elevates form over substance."

A couple filed a chapter 13 petition in 2010 and got their discharges in 2016. In 2012, they sued in bankruptcy court, contending that a nonjudicial foreclosure violated state laws. After a bench trial, the bankruptcy judge gave judgment to the debtors.

The district court reversed and was upheld by the majority in an unsigned Ninth Circuit opinion on Aug. 29.

In a two-page opinion, the majority said that a debtor's inadvertence or mistake can be remedied by amending schedules and thereby avoiding judicial estoppel.

Saying that "bankruptcy is a form-driven process," the majority upheld dismissal on the basis of judicial estoppel because the debtors "'deceived the bankruptcy court,' which confirmed a plan that did not account for those assets." The majority do not say whether the plan was confirmed before or after the debtors sued in bankruptcy court.

Circuit Judge Jacqueline Nguyen dissented, even though the majority said its opinion was "not precedent" and "not appropriate for publication."

Once "their claims became cognizable," Judge Nguyen said, in her dissenting opinion of slightly more than two pages, that the debtors "disclosed them in the most conspicuous way possible — by actually litigating the claims in a bench trial before the bankruptcy court." She went on to say, "No one suggests that the bankruptcy court was misled."

Judge Nguyen said that the "only winner" was the "alleged bad actor in the estopped lawsuit."

By saying that the debtors should have amended their schedules, Judge Nguyen said that "the majority literally elevates form over substance. Yet, bankruptcy law is driven not by forms but by equitable principles."

Given the elevation of amended schedules to such importance in the pantheon of judicial estoppel, the case should be reheard *en banc* or before the panel.

Doubtless, the chapter 13 trustee was aware of the suit and was therefore in a position to require amending the plan, if relief was of a type that might help general creditors. In contrast, amending the schedules would have been a formalistic gesture since the two most important players, the judge and the chapter 13 trustee, were aware of the suit and its implications for the chapter 13 plan, if any.

The opinion is *Meyer v. Northwest Trustee Services Inc.*, 15-35560, 2017 BL 303335 (9th Cir. Aug. 29, 2017).

Eleventh Circuit inveighs against harming innocent creditors by invoking judicial estoppel.

En Banc, Eleventh Circuit Narrows Applicability of Judicial Estoppel in Bankruptcy

At the urging of one of the judges on the original panel, the Eleventh Circuit sat *en banc* and reversed two of its prior decisions by holding that a court must consider all the facts and circumstances before invoking the doctrine of judicial estoppel. To prevent a defendant from reaping an "unjustified windfall," the intentional failure to list a claim belonging to a bankrupt no longer results in the automatic application of judicial estoppel.

Even after the Sept. 18 opinion by Circuit Judge Jill Pryor, the Eleventh Circuit still has not gone as far as the Fifth Circuit when the New Orleans-based court sat *en banc* and functionally held in *Reed v. City of Arlington*, 650 F.3d 571 (5th Cir. 2011), that a defendant in a lawsuit cannot assert judicial estoppel to inflict harm on a bankruptcy trustee and innocent creditors based on a debtor's shortcomings.

The Facts

A woman initiated an employment discrimination suit two years before filing a chapter 7 petition. The employer learned about the bankruptcy and filed a motion to dismiss based on judicial estoppel, because the debtor had not scheduled the lawsuit among her assets. The debtor modified her schedules to list the claim, and the chapter 7 trustee retained the debtor's litigation counsel as special counsel to pursue the suit on behalf of the estate.

The debtor then converted her case to chapter 13 and confirmed a plan, but the chapter 13 case was dismissed when the debtor failed to make plan payments.

Invoking judicial estoppel, the district court dismissed the discrimination suit. Recognizing that it was bound by Eleventh Circuit precedent, the appeals court's three-judge panel upheld dismissal in February 2016 in an unsigned, 32-page *per curiam* opinion.

One of the three judges on the panel, Circuit Judge Gerald B. Tjoflat, wrote a special concurrence that reads like a dissent. He urged the appeals court to rehear the case *en banc* and overrule two Eleventh Circuit precedents that he believed were "wrongly decided." Anyone confronted with an issue involving judicial estoppel should study Judge Tjoflat's 78-page concurrence from last year, because it reads like a treatise discussing everything there is to know on the subject.

The appeals court granted rehearing *en banc*, heard argument in February and reversed its own precedents in Judge Pryor's 33-page opinion.

'Mockery' No Longer Automatic

Judge Pryor began by reaffirming the circuit's general rule that judicial estoppel applies when a litigant takes inconsistent positions and intends "to make a mockery of the judicial system." Her opinion focused on the mockery element because the debtor unquestionably took inconsistent positions by originally omitting the suit from her schedules.

Under the circuit's *Barger* and *Burnes* decisions from 2003 and 2002, respectively, Judge Pryor said that the mockery element was conclusively established by a debtor's nondisclosure, "even if the plaintiff corrected his bankruptcy disclosures after the omission was called to his attention and the bankruptcy court allowed the correction without penalty."

Judge Pryor devoted her opinion to explaining why the court was reversing *Barger* and *Burnes* and holding that the court instead "should consider all the facts and circumstances," including the "plaintiff's level of sophistication, his explanation for the omission, whether he subsequently corrected the disclosure, and any action taken by the bankruptcy court concerning the nondisclosure." She said that "voluntariness alone does not necessarily establish a calculated attempt to undermine the judicial process."

In refusing to impose judicial estoppel reflexively, Judge Pryor seemed largely motivated to avoid giving "an unjustified windfall" to "an otherwise liable civil defendant," in the process harming "innocent creditors." She recognized that *pro se* debtors may not understand how the requirement for disclosing contingent and unliquidated claims also means claims that the debtor holds, not just claims against the debtor.

Judge Pryor explained why courts should not automatically apply judicial estoppel even in chapter 13 cases. Because the debtor must satisfy the best interests test to confirm a plan, creditors in chapter 13 would be harmed just like in chapter 7 if a claim by the debtor is treated as worthless.

Is a *Cert* Petition Next?

Judge Pryor said there is a split of circuits even after abandoning *Burnes* and *Barger*. Like her court now holds, the Sixth, Seventh and Ninth Circuits previously ruled that the "mockery" element requires showing more than an intention not to disclose.

The Fifth and Tenth Circuits, she said, take the opposite view by endorsing "the inference that a plaintiff who omitted a claim necessarily intended to manipulate the judicial system."

Judge Pryor may have overstated the circuit split.

The *en banc* opinion in *Reed*, written for the Fifth Circuit by Circuit Judge Carolyn King, laid down a "general rule that, absent unusual circumstances, an innocent trustee can pursue for the benefit of creditors a judgment or cause of action that the debtor fails to disclose." She also said that judicial estoppel must be applied "flexibly" to achieve "substantial justice," a principle that Judge Tjoflat advocated in his concurrence in the Eleventh Circuit's original decision last year.

In substance, the applicability of judicial estoppel is now virtually irrelevant in the Fifth Circuit when a trustee is prosecuting a previously undisclosed claim for the benefit of creditors. The Fifth Circuit also endorsed the idea of precluding a culpable debtor from benefitting from successful prosecution by directing any recovery exclusively toward creditors.

Therefore, the Fifth Circuit's pre-*Reed* automatic invocation of judicial estoppel may no longer be good law in that circuit. Even if it is, the principle has little relevance after *Reed*, which permits recoveries on undisclosed claims to benefit innocent creditors.

Consequently, the Tenth Circuit may be the only circuit functionally at odds with four other circuits. As such, there may not be a fully developed, entrenched split warranting a grant of *certiorari*. For lack of a final order, a *certiorari* petition also would be premature at this juncture because the circuit remanded for more than ministerial duties.

The *Amicus* in the Eleventh

Supporting the debtor, J. Erik Heath of San Francisco submitted an *amicus* brief in the Eleventh Circuit on behalf of the National Association of Consumer Bankruptcy Attorneys. In addition to explaining how Eleventh Circuit precedent had gone beyond the purpose of judicial estoppel, he recommended adopting the approach in *Reed* by granting a trustee standing to pursue a claim not available to a debtor in view of judicial estoppel.

Unfortunately, Judge Pryor did not cite *Reed* or consider how that case might inform the relief available on remand. Although the Eleventh Circuit "may not have explicitly gone the route of *Reed*," Heath told ABI in an email that he believes it's "part of the result." He also praised the appeals court for overruling *Barger* and thereby allowing "trustees to escape judicial estoppel."

Remand to the Panel

When a circuit court reverses, it ordinarily remands to the trial court. But not here.

Judge Pryor remanded the case to the original three-judge panel "to consider whether the district court abused its discretion in applying judicial estoppel *and to resolve any other remaining issues*." [Emphasis added.]

The mandate to consider other issues should allow the three judges to opine on a result like *Reed*, where creditors can benefit but the debtor cannot.

To read ABI's discussion of the panel decision from February 2016, click here.

The opinion is *Slater v. U.S. Steel Corp.*, 12-15548, 2017 BL 327629, 130 FEP Cases 727 (11th Cir. Sept. 18, 2017).

Compensation

In the Fifth Circuit, chapter 7 trustees
lock in higher compensation.

Fifth Circuit Holds that Chapter 7 Trustees Presumptively Get Statutory Commissions

The Fifth Circuit sided with the Seventh by holding that the statutory commission for a chapter 7 trustee in Section 326(a) is presumptively reasonable and must be allowed by the bankruptcy court except in exceptional circumstances that "should be a rare event."

Since the 2005 BAPCPA amendments to Section 330, Circuit Judge Leslie H. Southwick said in his Jan. 26 opinion that two approaches have developed regarding the allowance of commissions for a chapter 7 trustee. Led by the Seventh Circuit, some courts, he said, hold that the sliding-scale commissions in Section 326(a) are "not simply a maximum but also a presumptively reasonable fixed commission." Some of those courts nonetheless say that the commission can be adjusted in "extraordinary circumstances."

Other courts do not view the commission rate as presumptively reasonable but allow compensation, functionally speaking, after applying the "reasonableness" standards in Section 330(a)(3).

Judge Southwick explained that the 2005 amendments removed a chapter 7 trustee from the professionals explicitly subject to the Section 330(a)(3) factors. Those standards still apply to chapter 11 trustees and other professionals.

Although Section 330(a)(1)(A) still says that a trustee must be allowed "reasonable compensation" for "actual, necessary" services, the BAPCPA amendments also added Section 330(a)(7), which provides that in "determining the amount of reasonable compensation to be awarded to a trustee, the court shall treat such compensation as a commission, based on Section 326."

While Judge Southwick did not say so, the amendments generally were viewed as ensuring that a trustee in a lucrative case would receive the maximum commission to make up for "no asset" cases entailing nothing more than the $60 flat fee under Section 330(b).

Judge Southwick decided to follow the Seventh Circuit, believing that the amendments established a "commission-based award" as opposed to the "compensation-based awards" granted pre-BAPCPA. To continue fixing "reasonable" compensation after BAPCPA, he said, would give "little practical effect to the amended language."

Judge Southwick held, "Section 330(a)(7) therefore treats the commission as a fixed percentage, using Section 326 not only as a maximum but as a baseline presumption for reasonableness in each case."

He recognized that "Section 330 still allows a reduction or denial of compensation," but only in a "rare event" where "'exceptional' is the key."

The opinion is *LeJeune v. JFK Capital Holdings LLC (In re JFK Capital Holdings LLC)*, 16-31151, 2018 BL 27630 (5th Cir. Jan. 26, 2018).

Split grows on whether 'substantial contribution' claims are limited to chapters 9 and 11.

"Substantial Contribution" Claim Allowed in Chapter 13

Swimming against the tide and deepening a split of authority, courts in Michigan granted an administrative claim to a creditor for making a "substantial contribution" in a chapter 13 case, when Section 503(b)(3)(D) only explicitly authorizes claims of that type in chapters 9 and 11.

As retained counsel for a chapter 7 trustee, a law firm objected to an exemption claimed by husband and wife debtors in annuities worth about $100,000. Before the objection was adjudicated, the debtors converted the case to chapter 13. The firm was not retained in the chapter 13 case.

When the chapter 13 trustee didn't pursue the objection, the law firm did. Ultimately, the bankruptcy court disallowed the exemption. As a result, the debtors were forced to amend their plan and provide for 100% payment to unsecured creditors.

The law firm then sought allowance of an administrative claim for having made a substantial contribution to the chapter 13 case.

The bankruptcy court in Michigan allowed the "substantial contribution" claim in the amount of about $23,000 for the lawyers' work during the chapter 13 case, relying on *Mediofactoring v. McDermott* (*In re Connolly North America LLC*), 802 F.3d 810 (6th Cir. Sept. 21, 2015), where the Sixth Circuit held that bankruptcy courts have discretion to allow an administrative claim to a creditor in chapter 7 who made a substantial contribution.

On appeal, the debtors argued it was error to allow a "substantial contribution" claim in chapter 13, because Section 503(b)(3)(D) only explicitly authorized allowance of an administrative claim for making a "substantial contribution in a case under chapter 9 or 11 of this title." The debtors also contended that *Mediofactoring* was not controlling because that case involved chapter 7, and they were in chapter 13.

Relying on *Mediofactoring*, District Judge Paul D. Borman of Detroit rejected the debtors' arguments in an opinion on Nov. 15 and upheld the bankruptcy court's allowance of a "substantial contribution" claim.

Mediofactoring, according to Judge Borman, stands for the proposition that use of the word "including" in Section 503(b) "confers discretion on a bankruptcy court to award administrative expenses on a case-by-case basis, and that the express mention of Chapter 9 and Chapter 11 in

Section 503(b)(3)(D) does not negate that fact." He also said, "Nothing about the statutory interpretation in [*Mediofactoring*] is unique to the Chapter 7 context."

Judge Borman said that a "substantial contribution" claim is allowable outside of chapters 9 and 11 depending upon "the totality of the pertinent facts, and the relevant equitable considerations."

There was "no question," Judge Borman said, that the law firm conferred a substantial benefit because creditors stand to recover 100% as a result of disallowance of the exemption claim. Because the chapter 13 trustee did not object to the exemption, the lawyers benefitted the estate when no one else was willing to do so.

Judge Borman also rejected the argument that *Lamie v. U.S. Trustee*, 540 U.S. 526, 124 S. Ct. 1023, 157 L. Ed. 2d 1024 (2004), bars allowance of the administrative claim. There, the Supreme Court held that Section 330(a)(1) precludes allowance of compensation to a debtor's counsel from estate funds if the attorneys were not retained under Section 327.

Lamie, Judge Borman said, dealt with payment of compensation under Section 330(a)(1), while the case before him was based on Section 503(b), "a different statutory provision entirely." He said there was no authority for the notion that *Lamie* "has anything to do with Section 503(b)(3)(D)."

Recently, a bankruptcy court in California followed *Mediofactoring*, joined the minority, disagreed with the Third Circuit, declined to follow its own Bankruptcy Appellate Panel, and found discretion to allow a "substantial contribution" claim in chapter 7. *In re Maqsoudi*, 566 B.R. 40 (Bankr. C.D. Cal. April 3, 2017). For ABI's discussion of *Maqsoudi*, click here. To read about *Mediofactoring*, click here.

The opinion is *Sharkey v. Stevenson & Bullock PLC (In re Sharkey)*, 17-11237, 2017 BL 409909 (E.D. Mich. Nov. 15, 2017).

'Deemed Allowed' Claims

ROCHELLE'S DAILY WIRE

Do 'deemed allowed' claims have* res judicata *effect in 'asset' cases?

No *Res Judicata* Effect for 'Deemed Allowed' Claims in 'No Asset' Cases

The Fifth Circuit concluded that an uncontested proof of claim in a "no asset" chapter 7 case cannot be grounds for invocation of *res judicata* against a third party.

In addition to Section 502, there may be other grounds for reaching the same result, as discussed at the end of this analysis.

The Facts

A company filed a chapter 7 petition after being sued for architectural copyright infringement. Initially, the trustee believed there would be no assets and notified creditors that it was unnecessary to file proofs of claim. The trustee later decided there might be distributable assets and notified creditors that they should file claims within 90 days.

The plaintiff in the copyright suit filed a proof of claim for $83 million. Later, however, the trustee filed a "no asset report" and notified creditors accordingly. No one ever filed an objection to the copyright claim.

The copyright plaintiff demanded that the debtor's insurer pay the face value of a $6 million insurance policy. When the insurance company refused, the plaintiff filed suit in district court for breach of contract, claiming to be a beneficiary of the insurance policy. The plaintiff contended that the debtor's liability on the policy was *res judicata* because the proof of claim was deemed allowed under Section 502(a), which provides that a proof of claim is "deemed allowed, unless a party in interest . . . objects."

The district court granted summary judgment for the insurance company dismissing the complaint and was upheld in the Fifth Circuit's March 24 opinion by Circuit Judge Edith H. Jones. She said the case presented "an intriguing question of statutory interpretation."

Judge Jones' *Ratio Decidendi*

Judge Jones said that "the necessity for creditors to file and the courts to adjudicate claims depends on the existence of assets in the debtor's estate." She also said the "Bankruptcy Rules plainly contemplate pretermitting claims allowance and objection procedures when there are no distributable assets."

Beyond the statute, Judge Jones said the official forms and accompanying instructions "explain that proofs of claim need only be filed in asset-holding bankruptcy cases."

Because objections to claims are not mandatory under Bankruptcy Rule 3007(a), Judge Jones concluded that no "party in interest," including the insurance company, "had any reason to ascertain that [the plaintiff] had filed a proof of claim, much less object to the superfluous claim."

"Section 502 would be significantly transformed," Judge Jones said, if it required that parties in interest "monitor, object to, and litigate proofs of claim that need not even be filed." Were that true, "sureties, guarantors, general partners, and other entities that might share liability for claims against debtors would risk suffering adverse judgments in the form of 'deemed allowed' claims."

Judge Jones distinguished a Ninth Circuit opinion that gave preclusive effect to a "deemed allowed" claim because it did not involve a no-asset case.

Judge Jones held that a "deemed allowed" claim does not have *res judicata* effect in a no-asset case when creditors were not told to object to claims and "no bankruptcy purpose would have been served by the bankruptcy court's adjudicating" the claim.

The opinion had another holding of note. The insurance company argued that the bankruptcy court lacked jurisdiction to adjudicate the claim because it would have had no conceivable impact on the nonexistent estate.

Judge Jones held that the bankruptcy court had subject matter jurisdiction, although the Bankruptcy Code gave the court discretion over the claim-allowance process since it was a no-asset case.

What About Asset Cases?

Judge Jones' opinion might be interpreted to imply that a deemed allowed claim does have *res judicata* effect whenever there are assets for distribution. However, the opinion does not say that explicitly.

When there are minimal assets, mounting claim objections might not be justifiable economically from the trustee's vantage point. Further, third parties may lack notice of potential *res judicata* effects. Indeed, a third party like an insurance company might not even know that a potentially insured claim was filed. Although an insurance company might have a defense under the policy for lack of notice of the claim, other potentially liable third parties might not have similar rights.

If deemed allowed claims have *res judicata* effect in asset cases, Section 502 would become a trap for the unwary third party liable on a claim against a debtor.

In asset or no-asset cases, another court presented with the same facts might explore whether *res judicata* is even applicable to deemed allowed claims, since claim preclusion requires a final order. It is at least questionable whether the absence of an objection is equivalent to a final order, given that there was no judicial action affirming the validity of the claim.

Finality is another issue. In chapter 7 cases, there may be no deadline for claim objections. Indeed, a closed case conceivably could be reopened to permit a claim objection.

Therefore, it might be said that a deemed allowed claim is neither an order nor is it final, thus precluding the invocation of *res judicata*.

Judge Jones' opinion does not discuss the elements of *res judicata*, but she appears to assume that the doctrine applies. Another court might explore whether *res judicata* is applicable when the party allegedly in privity with the debtor lacks notice or an opportunity to defend.

The opinion is *Kipp Flores Architects LLC v. Mid-Continent Casualty Co.*, 852 F.3d 405 (5th Cir. March 24, 2017).

Exemptions

Fourth Circuit avoids a result that would have left some debtors ineligible for any exemptions.

Three Circuits Approve Extraterritorial Application of a State's Exemptions

Joining the Eighth and Ninth Circuits and handing down another debtor-friendly opinion, the Fourth Circuit cleaned up some of the mess that Congress made in Section 522(b)(3)(A) regarding exemptions claimed by individuals who change their domicile before filing bankruptcy.

The May 4 opinion by Circuit Judge Robert B. King rejected plausible interpretations of the statute that could leave some debtors ineligible for any exemptions, state or federal.

The debtor moved to West Virginia from Louisiana four months before filing bankruptcy. Utilizing Louisiana's exemption statute, he claimed exemptions for about \$3,500 of personal property located in West Virginia.

The trustee objected to the exemptions, contending that Louisiana exemptions could not be applied extraterritorially in view of the Supreme Court's presumption against extraterritoriality. The bankruptcy court allowed the exemptions and was upheld on appeal by District Judge Irene M. Keeley of Clarksburg, W.Va.

Again upholding the exemptions in the circuit court, Judge King characterized Judge Keeley's opinion as "well reasoned" and "comprehensive." To read ABI's discussion of Judge Keeley's opinion, click here.

The Statutory Mess

Attempting to prevent abuse, Congress made a hash out of Section 522(b)(3)(A) and compounded the problem by adding the so-called hanging paragraph, which, Judge King said, "has been the subject of some dispute in the bankruptcy courts."

Generally, a debtor is eligible for exemptions in the state where the debtor had been domiciled for 730 days before bankruptcy. To deter exemption shopping by people who would move within two years before bankruptcy to take advantage of another state's more generous exemptions, Section 522(b)(3)(A) provides that the debtor must take exemptions from the state where he or she resided for the largest part of the 180-day period before the 730-day period.

The statute had a problem, however, because Section 522(b)(3)(A) would leave some debtors eligible for no exemptions. To fill the gap, Congress added the hanging paragraph, which allows the debtor to claim federal exemptions specified in Section 522(d) if (b)(3)(A) makes a debtor ineligible for any state's exemptions.

The Case at Hand

The trustee conceded that the debtor could invoke Louisiana exemptions under Section 522(b)(3)(A) for property located in Louisiana. However, the trustee disputed the claim for exemptions covering the debtor's property in West Virginia, even though Louisiana does not limit the application of its exemptions to Louisiana residents or to property in Louisiana.

The trustee argued for the presumption against extraterritoriality, also known as the anti-extraterritoriality approach, under which a bankruptcy court may not give extraterritorial effect to any state's exemption laws. His theory would have precluded the debtor from using Louisiana law to exempt property in West Virginia.

The Fourth Circuit's Analysis

Judge King said that "almost all courts" have rejected the trustee's theory because it "would lead to nonsensical results." An example: Debtors who move would be ineligible for exemptions because they likely would have no property in their former domicile, the only state in which they could have exemptions under the anti-extraterritoriality approach. Judge King said that the only bankruptcy court to adopt this theory was "promptly overturned on appeal."

The second minority view, called the preemption approach, would permit a debtor to apply a state's exemption laws to nonresidents and out-of-state property, even if state law does not allow extraterritorial effect. Like Judge Keeley, Judge King rejected the idea. If "Congress had intended to override state laws limiting the use of exemption schemes to in-state residents or in-state property, it would not have placed the hanging paragraph in Section 522(b)(3)," he said.

The preemption approach, he said, would make the hanging paragraph applicable only to debtors who had resided in foreign countries.

Judge King adopted the so-called state-specific approach, which is followed by the Eighth and Ninth Circuits and a majority of courts. He said it best embodies congressional intent and the bedrock principle that "exemptions are entitled to the most liberal construction in favor of the debtor."

Judge King said there were no principles of Louisiana law that would bar out-of-state debtors from utilizing Louisiana's exemption statute. He also rejected the trustee's reliance on the Supreme Court's presumption against extraterritoriality.

Citing Fourth Circuit precedent, Judge King said that the presumption does not apply to conduct that occurs largely within the U.S. Therefore, he allowed the debtor to rely on Louisiana law and exempt property in West Virginia.

A Proposal to 'Fix' Section 522

In the circuit court, *pro bono* co-counsel for the debtor was Eugene Wedoff, the immediate past president of American Bankruptcy Institute and a former bankruptcy judge in Chicago.

In a message to ABI, Judge Wedoff said that "Section 522 is very much in need of a Congressional 'fix.'"

Judge Wedoff believes that Congress should "make the debtor immediately subject to the exemption law of the state to which a debtor has moved, but cap the homestead exemption and perhaps other very large exemptions for two years after the move at the level set by the debtor's former state of domicile."

Judge Wedoff said that his proposal would "eliminate the 'millionaire's loophole' that Congress was concerned about in BAPCPA without creating the confusion caused by applying a state's exemptions to debtors who are no longer domiciled in that state."

The "simplest fix," Judge Wedoff said, would be "a set of uniform federal exemptions, but that is very unlikely to be politically possible."

The opinion is *Sheehan v. Ash*, 17-1867 (4th Cir. May 4, 2018).

After rehearing, the Fifth Circuit rediscovers the snapshot rule by giving finality to exemptions in chapter 7.

Reversing Itself, Fifth Circuit Panel Reinstates Finality to Exemptions in Chapter 7

In a remarkably short time, a panel of the Fifth Circuit saw the error in its ways, vacated an opinion handed down on July 19, and held that exempt property on the filing date does not lose its exempt status even if it is converted to nonexempt property after the filing of a chapter 7 petition.

The *per curiam* opinion on Sept. 5 removes a cloud of perpetual uncertainty that had been hanging over chapter 7 debtors in the Fifth Circuit. For seven weeks, when the July opinion was good law, a chapter 7 debtor who liquidated exempt property was in peril even if the case had been closed and the time for objecting to exemptions had long since passed.

The new opinion establishes two principles in the Fifth Circuit. As we will discuss later, the holding in *In re Frost*, 744 F.3d 384 (5th Cir. 2014), is now limited to chapter 13 cases, and *In re Zibman*, 268 F.3d 298 (5th Cir. 2001), does not apply to cases where the time for objecting to exemptions has elapsed.

The Facts

The case involved a couple who filed a chapter 7 petition with about $130,000 in an individual retirement account, or IRA. They scheduled the IRA as exempt under Texas law. There were no objections to the claimed exemption, and the trustee eventually issued a no-asset report.

Starting a few days before filing and continuing for seven months, the couple withdrew all the money from the IRA, spent most of it on living expenses, and did not reinvest any proceeds in another IRA.

Learning that the IRA had been liquidated and not reinvested, the trustee demanded that the couple turn over the IRA proceeds, because Texas law provides that withdrawals from an IRA must be reinvested in another IRA within 60 days to retain their exempt character. When the trustee made her demand, the debtors still held about $30,000 in proceeds from the IRA.

The bankruptcy judge ruled in favor of the trustee and required the couple to turn over the $130,000. The district court affirmed.

The Original Panel Opinion

The original panel opinion from July was based largely on *Frost*, where a couple owned a home when they filed a chapter 13 petition. Later, they sold the home but did not reinvest the proceeds in another exempt homestead. Without saying in the opinion whether the case was in chapter 7 or 13, the Fifth Circuit held in *Frost* that the proceeds lost their exempt status, relying in part on *Zibman*, discussed below.

Lower courts were divided on whether *Frost* also applied to chapter 7 cases. Some courts believed that *Frost* should apply only in chapter 13 cases because Section 1306(a)(1) brings after-acquired property into the estate. Since there is no counterpart in chapter 7, those courts would not invoke *Frost* in chapter 7 cases.

The original panel opinion in July, written by Circuit Judge Edward C. Prado, resolved the issue by holding that *Frost* applied equally in chapter 7. The appeals courts developed the notion of conditionally and unconditionally exempt property.

Unconditionally exempt property, like an IRA or a homestead, could become conditionally exempt on being sold or liquidated. If proceeds were not reinvested in exempt property within the time permitted by state law, the conditionally exempt money would lose its exempt character.

Arguably splitting with every other circuit and seemingly abandoning the snapshot rule, the original panel opinion in effect held that exemptions never become final even if the time for objection has run out.

The original opinion was important because it meant that debtors in Texas and perhaps elsewhere could not take money from an IRA until after the chapter 7 case was closed. It also meant that a chapter 7 debtor in Texas could not sell an exempt homestead after filing because it would lose the exemption if the proceeds were not reinvested in a new homestead within six months.

Even after the chapter 7 case had been closed, a trustee could reopen the case and demand turnover. Following the July decision, it was unclear how long debtors were required to hold exempt property even after a chapter 7 case was closed.

The Motion for Rehearing

On August 2, the husband moved for panel rehearing and rehearing *en banc*, supported by an *amicus* brief filed by Prof. Christopher G. Bradley of the Univ. of Kentucky College of Law, retired Bankruptcy Judge Leif M. Clark, and attorneys Stephen W. Sather and Michael Baumer, both of Austin.

The last brief on the rehearing petitions was filed on Aug. 21. Without holding oral argument, the panel issued its 14-page *per curiam* opinion on Sept. 5, withdrawing the prior opinion, reversing the bankruptcy court, remanding the case, and denying the petition for rehearing *en banc*. In effect, the panel reversed its prior opinion and allowed the debtors to retain all proceeds from the liquidated IRA.

The Rationale after Rehearing

Originally mandated by the Supreme Court in *White v. Stump*, 266 U.S. 310 (1924), and largely ignored in the prior opinion, the new opinion reaffirmed the snapshot rule, which in substance provides that exemptions are fixed on the filing date. The appeals court then examined *Frost* and *Zibman*, ultimately limiting the holdings of both.

Zibman, which predated *Frost*, concerned debtors who sold their exempt homestead two months before filing a chapter 7 petition but did not reinvest the proceeds in another home. The appeals court held that the proceeds lost their exempt status because the Texas statute protects only a homestead, not proceeds of a homestead.

The new opinion then did what *Frost* did not do: It limited the holding to chapter 13 because after-acquired property is not brought into a chapter 7 estate. The new opinion characterized the IRA proceeds as a newly acquired property interest.

Since the time for objecting to exemptions had expired, the new opinion said "there was no means by which the [debtors'] newly acquired property interest [in the IRA proceeds] could become part of the chapter 7 estate."

The new opinion emphasized how *Zibman* dealt with debtors who had sold their home before filing, giving them only a conditional exemption on the filing date. The new opinion thus limits *Zibman* to situations where an exempt asset is sold before bankruptcy but not reinvested in another exempt asset within the time allowed by state law.

Finality of Exemptions Emphasized

The new opinion helps debtors generally because the appeals court emphasized the finality resulting from the lack of objections to exemptions.

The debtors had liquidated some of the IRA before filing, thus giving the trustee an opening to demand turnover of those moneys, based on *Zibman*. Nonetheless, the new opinion allowed the debtors to retain even those proceeds. Because the trustee "did not timely object to the claimed exemption," she "could not contest the exemption's validity after the time for objection passed," the opinion says.

Consequently, the new opinion also limits *Zibman* to cases where the time for objection to exemptions has not elapsed.

The new opinion emphasizes the differences between chapters 7 and 13. The *per curiam* opinion says the two chapters "are not meant to always yield the same results."

With regard to after-acquired property, the opinion holds that "a new property interest the debtor acquires after filing for bankruptcy becomes part of the estate in a chapter 13 case but does not become part of the estate in a chapter 7 case, even if the debtor acquires the new property by transforming a previously exempted asset into a nonexempt one."

The debtor was represented by William P. Haddock from Pendergraft & Simon LLP in Houston.

To read ABI's coverage of the July opinion and the motion for rehearing, click here and here.

The opinion is *Hawk v. Engelhart (In re Hawk)*, 871 F.3d 287 (5th Cir. Sept. 5, 2017).

Selling a home after filing chapter 7
does not destroy the homestead exemption.

Fifth Circuit Expands *Hawk* to Permit Sale of a Home After a Chapter 7 Filing

In *Hawk v. Engelhart (In re Hawk)*, 871 F.3d 287 (5th Cir. Sept. 5, 2017), the Fifth Circuit held that property in an exempt individual retirement account on the filing date does not lose its exempt status if it is converted to nonexempt property after the filing of a chapter 7 petition. In other words, the snapshot rule is a shield for the debtor, not a sword in the hands of a trustee.

In a March 7 opinion, the Fifth Circuit expanded *Hawk* to cover homesteads, thus allowing a chapter 7 debtor to sell a home after filing but not lose the exemption even if the proceeds were not reinvested in another house.

The debtor, who waived his discharge, owned a home in Texas on the filing date. There were no objections to the claimed homestead exemption. With the bankruptcy court's approval seven months after filing, the debtor sold his home for $364,000, but he did not reinvest the proceeds in another home within the six-month window in Texas for maintaining an exemption in the proceeds. Instead, the debtor used the proceeds to pay some of his debts.

The chapter 7 trustee mounted an adversary proceeding against the debtor and the recipients of the proceeds, contending that the proceeds belonged to the estate because they lost their exempt status six months after the sale.

The bankruptcy judge ruled that the proceeds were exempt because the home was exempt on the filing date. The district court reversed before the Fifth Circuit decided *Hawk*, and the debtor appealed.

In the Fifth Circuit, the trustee argued that *Hawk* was inapplicable because that case involved a retirement account, not a homestead.

In a *per curiam* opinion on March 7, the Fifth Circuit reversed the district court and reinstated the judgment of the bankruptcy court dismissing the trustee's lawsuit. The Fifth Circuit saw "no reason why *Hawk*'s analysis should not also apply to Texas's homestead exemption." The court said that the "proceeds" rule under the Texas exemption statute "expands rather than limits the scope of the exemption."

In terms of policy, the circuit court said that fixing the exemption once and for all on the filing date avoids "the uncertainty that the trustee's position would inject into the large number of chapter 7 cases that bankruptcy courts confront."

In *Hawk*, the three-judge panel on the Fifth Circuit granted rehearing and set aside the opinion it had filed only seven weeks earlier. To read ABI's discussion, click here.

The opinion is *Lowe v. DeBerry (In re DeBerry)*, 17-50315 (5th Cir. March 7, 2018).

Splitting with the Sixth Circuit, the Tenth Circuit BAP does not require equity to claim a homestead exemption.

Homestead Exemption Must Be Paid in Full Before a Sale Is Permitted, BAP Says

Laying the groundwork for a split of circuits, the Tenth Circuit Bankruptcy Appellate Panel built on *Czyzewski v. Jevic Holding Corp*., 137 S. Ct. 973 (2017), and *Law v. Siegel*, 134 S. Ct. 1188 (2014), by holding that a chapter 7 trustee cannot scheme with secured creditors to sell a home out from underneath a debtor without paying the homestead exemption in full, even when there is little or no equity in the property above secured debt.

If there is another appeal and the Tenth Circuit rules the same way, there will be a split with the Sixth Circuit on the question of whether a debtor can claim a homestead exemption without having any equity in the property. A split would also enable the Supreme Court to decide whether a trustee can sell a home without paying a homestead exemption in full.

Unless the Sixth Circuit reverses course or the Supreme Court takes up the issue, individuals who file chapter 7 petitions in four states are at risk of losing their homes even if the sale price will not pay their exemptions in full. Homeowners in six states are shielded from the same fate unless the Tenth Circuit reverses the BAP.

The Trustee's Scheme to Generate Fees at the Debtor's Expense

In two chapter 7 cases filed about the same time, the debtors each owned homes, which they scheduled as having values somewhat less than the sum of mortgages and tax liens on the properties. The debtors claimed homestead exemptions, however.

The trustee appointed in both cases found buyers who were offering to pay about $5,000 more than the encumbrances on both properties. The trustee also negotiated a stipulation with the Internal Revenue Service where the government consented to the sale of the properties and agreed to carve out $10,000 in each case for distribution to unsecured creditors. In addition, the IRS agreed to a further $60,000 reduction in the government's recovery on its tax liens in each case by allowing the trustee to pay his fees and the real estate broker's commissions from the sale proceeds.

If the sales had been approved, the debtors would have received nothing for their homestead exemptions, while the trustee and broker together would have taken home more than $60,000 for their services in each case. Unsecured creditors would have recovered only $10,000 in each case.

For the debtors, the proposed deal was worse than simply losing their homes without anything for their homestead exemptions. The government's agreement to carve out $10,000 for unsecured creditors and allow payment of the fees would have increased the debtors' nondischargeable tax debts and left them with no equity to apply toward the purchase of new residences.

The future looking bleak, the debtors both prevailed on the bankruptcy judge to convert their cases to chapter 13. Conversion mooted the trustee's incipient sale motions. In both cases, the bankruptcy judge upheld the debtors' homestead exemptions, over the trustee's objections. The conversion to chapter 13 mooted the trustee's appeals from the homestead exemption rulings.

Following conversion, the chapter 7 trustee filed applications for allowances of more than $30,000 in compensation in each case for himself and his counsel. In an encyclopedic opinion on Dec. 14, 2016, Chief Bankruptcy Judge R. Kimball Mosier of Salt Lake City ruled that a trustee cannot sell an individual debtor's home without paying the homestead exemption in full, in cash.

Citing Section 330(a)(4)(A), Judge Mosier denied the fee applications because the trustee's services were not necessary, did not benefit the estate, and "could work a substantial harm on the debtors if they were approved." In substance, he explained why he would not have approved the sales had the debtors not converted the cases to chapter 13. To read ABI's discussion of Judge Mosier's opinion, click here.

The trustee appealed to the Tenth Circuit BAP but lost again in a Nov. 30 opinion by Bankruptcy Judge Sarah A. Hall. The BAP reached the same result in barring a trustee from selling overencumbered property, albeit on somewhat narrower grounds than Judge Mosier.

Abandon, Don't Sell Without Equity

To determine whether the trustee was entitled to compensation, Judge Hall analyzed Section 330(a)(4)(A), which bars the allowance of compensation if the services "were not reasonably likely to benefit the debtor's estate [or] necessary to the administration of the case."

Regarding the necessity of the trustee's services, Judge Hall held that "abandonment of the homesteads would have better comported with a chapter 7 trustee's ultimate duties and responsibilities." The Bankruptcy Code, abundant caselaw, and the *Handbook for Chapter 7 Trustees* promulgated by the Office of the U.S. Trustee Program "emphatically" supported the bankruptcy court's decision, Judge Hall said.

Judge Hall cited the *Handbook* for the proposition that a trustee should abandon property when liquidation would not produce a "meaningful" distribution for unsecured creditors. Similarly, she cited caselaw holding that a sale of fully encumbered property is generally prohibited, to prevent trustees from generating fees for themselves in a sale that produces nothing for unsecured creditors.

With regard to the Bankruptcy Code, Judge Hall said that equity for unsecured creditors "is what authorizes a trustee to exercise his powers of sale under Section 363 in the first place, because liquidation should not be for the benefit of the estate's secured creditors." Although a carve-out for unsecured creditors might be appropriate in some circumstances, she said that an agreement with a secured creditor to create equity "is suspect and presents opportunities for collusion."

Since the proposed sale would have benefitted primarily the trustee and secured creditors, Judge Hall concluded that the services were not necessary in the administration of the estates.

Again unsuccessfully, the trustee contended that his services were nonetheless reasonably likely to benefit the estate.

On that issue, Judge Hall said that the bankruptcy court's finding of lack of benefit to the estate was not reversible error, "regardless of whether its legal determinations were correct or incorrect."

The trustee argued that his services benefited the estate, based on the notion that the debtors lacked equity and were not entitled to homestead exemptions.

Under Utah and federal law, exemptions must be liberally construed in favor of debtors, Judge Hall said. Under Utah law, she said that debtors are entitled to homestead exemptions even if they have no equity in their homes. The exemption, she said, arises from title and possession, although the exemption is limited in dollar amount.

Therefore, the trustee was not entitled to compensation under Section 330(a)(4)(ii) because there was no benefit to the estate, since the trustee should have abandoned the properties.

The trustee also argued there could have been benefit to the estate because he could have sold the properties under Section 363(f).

There was no *bona fide* dispute, and therefore no ability to sell under Section 363(f)(4), because, Judge Hall said, the bankruptcy court had upheld the debtors' homestead exemptions, among other things.

Similarly, there was no right to sell under Section 363(f)(5), which would have applied were the debtors compelled to accept monetary satisfaction for their interests.

The Utah exemption statute does not permit a sale unless the price would pay the exemption in full. The trustee therefore could not have sold under Section 363(f)(5), thus shutting the door to the idea that the trustee could have conferred benefit on the estate.

Judge Hall upheld the denial of all the trustee's requested fees by saying it made "no sense whatsoever to sell the homesteads and incur administrative expenses [of about $60,000 in each case] in order to get only $10,000 to unsecured creditors and at the same time deny debtors their homesteads."

"All bankruptcy professionals," she said, "must exercise billing judgment."

Significant Circuit Splits in the Offing

If the trustee appeals again and if the Tenth Circuit affirms, there will be a split of circuits on two major issues.

In *Brown v. Ellmann (In re Brown)*, 851 F.3d 619 (6th Cir. March 20, 2017), the Sixth Circuit decided a strikingly similar case with a diametrically opposite result. In *Brown*, the debtor had owned an overencumbered home, but she did not initially claim a homestead exemption. Instead, she originally signaled her intention to surrender the house.

The trustee in *Brown* cobbled together a deal to sell the home for less than the first mortgage. The first mortgagee agreed to take a haircut on the senior mortgage, carve out $6,000 for the second mortgagee, and leave a small surplus for unsecured creditors. The debtor later claimed an exemption and opposed the sale, unsuccessfully.

The Sixth Circuit upheld the sale, holding that the debtor was not entitled to claim a homestead exemption under Michigan without equity in the property. Aside from the distinction that the two cases arose under the exemption laws of different states, the Tenth Circuit BAP split with the Sixth Circuit on the validity of a homestead exemption in the absence of equity in the property.

More fundamentally, the Sixth Circuit allowed selling a home out from underneath a debtor without paying the homestead exemption in full, whereas the Tenth Circuit BAP would not allow a sale under analogous circumstances.

Brown also widened a split in its own right by holding that a sale order is not automatically mooted by Section 363(m) if the appellate court can grant some relief without affecting the validity of the sale.

The Tenth Circuit BAP cited to *Brown* in passing, but without addressing in depth how the two cases reached fundamentally different results.

To read ABI's discussion of *Brown*, click here.

Jevic and *Siegel* Influence the BAP

The BAP buttressed its conclusions by referencing two recent Supreme Court decisions.

In a passing reference, the BAP said that "*Jevic* stands for the proposition that neither the parties, nor the courts, are free to circumvent the Bankruptcy Code's rules and policies regarding priorities and distributions through manipulation of substantive and procedural protections." The reference to *Jevic* in a footnote shows that the high court's decision on limiting structured dismissal informs the result in other contexts, such as exemptions.

The BAP also cited *Law v. Siegel* for the idea that homestead exemptions are "sacrosanct" and can be denied "only on statutory bases enumerated in the Bankruptcy Code."

Although the BAP case was not "strictly analogous" to *Law v. Siegel*, Judge Hall said the effect was the same: "to deprive debtors of their homestead exemptions on a basis other than one enumerated in the Code."

Moreover, she said, the debtors had not been accused of any fraudulent behavior, like the debtor in *Law v. Siegel*. The "scheme" to sell the homes by negotiating with the IRS was "nothing more than an attempt to do indirectly what the Bankruptcy Code and Utah exemption statutes prevent him from doing directly."

On behalf of the National Consumer Bankruptcy Rights Center and the National Association of Consumer Bankruptcy Attorneys, Tara A. Twomey submitted an *amicus* brief on behalf of the debtors.

The opinion is *Jubber v. Bird (In re Bird)*, 577 B.R. 365 (B.A.P. 10th Cir. Nov. 30, 2017).

Even if an exemption is lost after filing, a Code provision must bring property into the estate, Fourth Circuit holds.

Fourth Circuit Conflicts on Loss of Chapter 7 Exemptions after Filing

Unlike the Fifth Circuit, an exemption that the Fourth Circuit takes away with one hand, it gives back with the other, as District Judge James K. Bredar of Baltimore explained in his Aug. 29 opinion.

A man filed a chapter 7 petition owning a home as tenants by the entireties with his wife, who did not file. The husband claimed an exemption in the home under Section 533(b)(3)(B), which applies to an interest in entireties property that is exempt from process under state law.

After bankruptcy, the wife died, and the trustee claimed that her death brought the home into the estate since there was no longer entireties ownership. The bankruptcy judge ruled against the trustee, and Judge Bredar affirmed, albeit on a somewhat different theory.

Using the so-called snapshot test, Judge Bredar said that most courts hold that a postpetition change in the character of exempt property does not change the status of the property. The Fourth Circuit, however, holds otherwise.

In *Birney v. Smith (In re Birney)*, 200 F.3d 225 (4th Cir. 1999), the appeals court held that an exemption in entireties property lapses after bankruptcy as a consequence of divorce or death of the spouse. But that "does not end the inquiry," the Fourth Circuit said. *Id.* at 228.

Even if an exemption lapses after bankruptcy, the *Birney* court said, there still must be a provision in the Bankruptcy Code to "bring the property into the estate." *Id.*

Like the circuit court in *Birney*, Judge Bredar found no Code provision that would bring previously exempt entireties property into a chapter 7 estate based on an event after filing. "Although the Bankruptcy Code provides several mechanisms by which a debtor's interest in property acquired postpetition becomes part of the bankruptcy estate, none apply here," he said.

Unlike chapters 11, 12 and 13, nothing generally brings property into a chapter 7 estate that is acquired after filing. Significantly, *Birney* held that a survivor does not "inherit" entireties property on the death of a spouse, thus making Section 541(a)(5)(A) inapplicable. That section brings property into the estate if the inheritance was within 180 days of filing.

Upon his wife's death, the debtor became the sole owner of the home in fee simple. However, Judge Bredar, like in *Birney*, said that the fee simple interest was not estate property because Section 541(a)(1) only reaches property interests "as of the commencement of the case."

Although the debtor lost his entireties exemption on his wife's death, Judge Bredar upheld the result in bankruptcy court by ruling that the home was not brought into the chapter 7 estate.

The opinion is *Bellinger v. Buckley*, 17-068, 2017 BL 303887 (D. Md. Aug. 29, 2017).

Debtors have standing for a motion compelling a trustee to abandon.

Trustee Can't Evict Debtors in Advance of Selling Their Home, Sixth Circuit Rules

The Sixth Circuit established an important precedent protecting individual debtors by declaring they can't be evicted from their home simply because the trustee tenders a check representing the full value of the homestead exemption.

The circuit's decision on July 14 made law on seemingly obvious questions about the debtors' standing and the right to occupy a home before sale. Like here, there will sometimes be no direct precedent because no one previously will have had the temerity to raise questions with obvious answers.

A couple filed a chapter 7 petition, listing their home as worth $108,000, encumbered by a $91,500 mortgage. Alleging that the property was really worth about $200,000, the trustee filed a motion asking the bankruptcy judge to evict the couple, saying that he could not sell the property while they were living there.

The debtors cross moved for an order compelling the trustee to abandon the home on the theory that the home had inconsequential value for creditors. At the hearing on the dueling motions, the trustee tendered the debtors a check for $7,500, representing the full amount of their Tennessee homestead exemption.

Bankruptcy Judge Nicholas W. Whittenburg of Chattanooga, Tenn., held an evidentiary hearing and took appraisal testimony from both sides. He vouched for the debtors' appraisal, concluding that the property was worth only $108,000. He also said that the trustee had six months to find a buyer and that properties are often sold with tenants in residence. Judge Whittenburg therefore granted the debtors' motion to compel abandonment and denied the motion to evict.

The trustee appealed and lost again in district court. The trustee lost a third time in the Sixth Circuit, in an opinion authored by Circuit Judge Ronald Lee Gilman.

The trustee contended that the debtors lacked standing to compel abandonment. Using a result-oriented approach, Judge Gilman said that being allowed to keep their home gave them a "practical stake" in the outcome, thus conferring standing. He also said that their homestead exemption was not the debtors' only remedy in the face of a motion to evict, thus countering the trustee's argument that tendering the $7,500 check was the only relief to which they were entitled. The debtors' alternate remedy, he said, was to seek abandonment.

Judge Gilman said that the debtors also had Article III standing because evicting them "would surely constitute injury-in-fact."

Turning to the merits, Judge Gilman found "no authority for the proposition that the trustee can tender the debtors the homestead exemption and cause them to 'skedaddle.'" There was, he said, "no basis in precedent or in the Bankruptcy Code."

On the question of value to support the conclusion of inconsequential value, Judge Gilman invoked the "clear error" standard and said the record was "replete with evidence" supporting the debtors' valuation.

W. Thomas Bible, Jr. represented the debtors, while Tara A. Twomey of the National Consumer Bankruptcy Rights Center filed an *amicus* brief on behalf of the debtors.

The opinion is *Jahn v. Burke (In re Burke)*, 863 F.3d 521 (6th Cir. July 14, 2017); rehearing *en banc* denied Aug. 17, 2017.

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Late-Filed Tax Returns

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

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

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

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

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

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

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

The Third Circuit Case

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

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

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

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

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

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

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

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

The opinion is *Giacchi v. U.S. (In re Giacchi)*, 856 F.3d 244 (3d Cir. May 5, 2017).

Automatic Stay

For an 'egregious' stay violation, medical evidence of emotional distress is not required.

Willful Stay Violation Can Justify Damages for Emotional Distress, Third Circuit Says

The Third Circuit joined a growing number of courts that allow damages for emotional distress resulting from a willful violation of the automatic stay under Section 362(k)(1).

In his April 10 opinion, Circuit Judge Michael J. Melloy did not need to decide whether "financial injury is a necessary predicate to recovery for emotional distress" because the debtors incurred $2,600 in attorneys' fees as a result of the stay violation. Judge Melloy was sitting by designation from the Eighth Circuit.

The 'Egregious' Stay Violation

The individual debtors' landlord had locked them out of the premises, where they operated a daycare business. He also physically threatened the wife and threatened to sue the debtors' new landlord unless he terminated their lease and they renewed a lease with him.

According to Bankruptcy Judge Thomas P. Agresti of Erie, Pa., the stay violation was the "most egregious" he had seen during his tenure on the bench. He said the debtors' testimony about having nightmares and becoming depressed was "compelling."

In addition to $2,600 in attorneys' fees, Judge Agresti awarded $7,500 for emotional distress and $40,000 in punitive damages against the debtors' landlord. Judge Agresti was upheld in district court and again in the Third Circuit, where the appeals court said the stay violations were "patently egregious."

Emotional Distress Damages Are 'Actual'

The landlord contended in the Third Circuit that damages for emotional distress are not "actual damages" and are thus not permitted under Section 362(k)(1). That section provides that "an individual injured by any willful violation of [the automatic stay] shall recover actual damages, including costs and attorneys' fees, and, in appropriate circumstances, may recover punitive damages."

Judge Melloy said that the Third Circuit had not yet decided whether "actual damages" includes damages for emotional distress. He said that the First, Ninth and Eleventh Circuits permit emotional distress damages for willful stay violations.

The Seventh Circuit, he said, was "skeptical" about emotional distress damages but "might" permit an award "where the plaintiff is already seeking damages for financial injury." A district court in Ohio ruled in 2005 that emotional distress damages do not qualify as "actual damages."

Although Section 362(k)(1) is "indisputably ambiguous," Judge Melloy concluded that "Congress intended the automatic stay to protect both financial and non-financial interests." He therefore joined "the growing number of circuits" by concluding that "actual damages" includes damages resulting from emotional distress.

Judge Melloy did not decide "whether financial injury is a necessary predicate" to damages for emotional distress because the debtors incurred $2,600 in attorneys' fees.

Since debtors will invariably incur some attorneys' fees after a stay violation, the Third Circuit opinion seems to mean that emotional distress damages will be available, at least where the stay violation was egregious.

The Sufficiency of the Evidence

The landlord contended that the debtors had not proven that the stay violation caused the debtors' emotional distress because they introduced neither medical documentation nor expert medical testimony.

Judge Melloy declined to "adopt a bright-line rule requiring" corroborating medical evidence, "at least where a stay violation is patently egregious." In those circumstances, he said that "a claimant's credible testimony alone can be sufficient to support an award of emotional-distress damages."

Likewise, the debtors were not required to show causation with "absolute precision" when the stay violation was "so egregious that a reasonable person could be expected to suffer some emotional harm."

Since the bankruptcy court awarded "a comparatively modest $7,500" for emotional distress, Judge Melloy said the damages were not unduly speculative."

Punitive Damages

Judge Melloy said that the $40,000 punitive damage award "comports with due process," given that the "repeated stay violations" were "sufficiently reprehensible."

Since actual damages were about $10,000, the 4-1 ratio between punitive and actual damages was "in line with awards previously deemed acceptable by the Supreme Court" and was not so excessive as to be unconstitutional.

The opinion is *Zokaites v. Lansaw (In re Lansaw),* 853 F.3d 657 (3d. Cir. April 10, 2017).

California judge won't bar the debtor from settling for more than the original $6 million in compensatory damages while forsaking $40 million in punitive damages earmarked for public interest groups.

Judge Refuses to Vacate Opinion Socking a Bank with $40 Million in 'Punies'

In March, Bankruptcy Judge Christopher M. Klein of Sacramento, Calif., imposed more than $46 million in compensatory and punitive damages on a bank for foreclosing and evicting a couple from their home although the lender knew they had filed a chapter 13 petition expressly to halt foreclosure. The judgment included $40 million in punitive damages for what Judge Klein called a "Kafkaesque nightmare of stay-violating foreclosure." *Sundquist v. Bank of America NA*, 566 B.R. 563, 571 (Bankr. E.D. Cal. March 23, 2017).

Months later, the parties reached a confidential settlement requiring the judge to expunge his opinion from the public record. Judge Klein said the proposed settlement created a "hostage standoff" that he characterized as "a naked effort to coerce this court to erase the record."

In an opinion on Jan. 18, Judge Klein's response to vacating his opinion was "No chance. No dice."

The Genesis of the Settlement

The parties responded to the $46 million judgment with cross motions for rehearing. The bank claimed there was evidence justifying total exculpation. The debtors countered with arguments that they should be entitled to more than $9 million in compensatory damages.

Mediation ensued and resulted in a proposed settlement giving the debtors an undisclosed amount totaling considerably more than Judge Klein's $6 million judgment.

In his March opinion, Judge Klein had earmarked the $40 million in punitive damages for five California law schools and two nonprofit groups to "be used only for education in consumer law and delivery of legal services in matters of consumer law." The settlement called for the law schools and nonprofit groups to receive about $300,000.

There was a catch: The settlement would require Judge Klein to vacate his March opinion, which excoriated the bank for its contemptuous behavior. Although the parties could have settled between themselves without court approval, they needed the judge's blessing to vacate his opinion.

The intended recipients of the punitive damages opposed vacating the opinion but took no position on the settlement otherwise. Judge Klein took the settlement under submission in October, with the question of vacating his March decision being a primary sticking point.

Judge Klein handed down his decision on Jan. 18. He crafted an elegant solution designed to ameliorate the lender's legitimate concerns while leaving his opinion on the public record, available for citation by other judges in other cases.

The Hostage Standoff

As a result of his opinion in March, Judge Klein said "the situation is now bigger than the" debtors. The "public-interest component cannot be ignored" because "some things are not appropriate to sweep under the carpet."

Under *American Games Inc. v. Trade Products. Inc.*, 142 F.3d 1164 (9th Cir. 1998), Judge Klein said he had equitable discretion to vacate his opinion, or not. Once decisions have been entered after trial, he said that attempts to "'buy and bury' adverse judgments are viewed with caution."

In deciding how to exercise discretion, Judge Klein said the record did not suggest "that the facts constitute an anomalous or isolated incident that might unfairly besmirch an otherwise upstanding defendant." He said the lender had shown no remorse, made no apology, made no promise to reform, and had not accepted responsibility for its actions.

"To name and to shame [the lender] on the public record in an opinion that stays on the books serves a valuable purpose casting sunlight on practices that affect ordinary consumers," Judge Klein said. Under the circumstances, the proper method for erasing the opinion is to reverse it on appeal, he said.

The Solution

Releases in the agreement would alleviate any concern on the part of the bank that the debtors might mount another lawsuit after collecting the settlement. On the other hand, Judge Klein said the bank had legitimate concerns, although remote, that the doctrine of issue preclusion (sometimes called offensive collateral estoppel) might enable a third party to sue the lender and contend that some of the issues were decided in the $46 million judgment.

To contour a solution giving the bank the protection it legitimately needed, Judge Klein undertook an extensive analysis of the Restatement (Second) of Judgments. In that respect alone, his opinion is worth reading in full text.

To give the parties most of what they wanted, Judge Klein said he would vacate the portion of his judgment awarding damages to the debtors while closing the adversary proceeding "without dismissing the adversary proceeding and without erasing the opinion." Vacating the damage award would remove finality and preclude a third party from raising a claim of issue preclusion.

To add belt and suspenders, Judge Klein said his order on the motion to vacate the judgment would provide that the legal and factual issues were not "sufficiently firm to be accorded preclusive effect."

Judge Klein granted the parties' wish by keeping the terms of settlement secret. He did say that the debtors would receive a "substantial premium" over the original award of about $6 million.

The "public interest" component of the original punitive damage award would be "indirectly honored in the settlement" because the debtors obliged themselves to give about $300,000 to the consumer advocacy programs.

The opinion is *Sundquist v. Bank of America NA (In re Sundquist),* 14-2278, 2018 BL 17263 (Bankr. E.D. Cal. Jan. 18, 2018).

ROCHELLE'S DAILY WIRE

Circuits split on power of bankruptcy courts to impose punitive or criminal contempt sanctions.

Bankruptcy Courts Cannot Impose Punitive Contempt Sanctions, District Judge Says

Confronting an issue where the circuit courts are divided and the Second Circuit has been silent, Vermont's Chief District Judge Geoffrey W. Crawford decided that bankruptcy courts lack "statutory and inherent powers" to impose punitive contempt sanctions.

The Sanctions in Bankruptcy Court

In three chapter 13 cases, the bankruptcy court had imposed a total of $375,000 in sanctions on a mortgage servicer for billing debtors for fees without first filing the required notices under Bankruptcy Rule 3002.1(c). Previously, the servicer had been "chastised" by a bankruptcy judge in North Carolina for violating the rule. In one of the three cases, the servicer had already agreed to pay a $9,000 sanction for sending erroneous mortgage statements for three years, but it did not halt the practice.

The bankruptcy judge said that the $9,000 sanction two years earlier had failed to achieve its intended remedial effect of deterring the servicer from sending out "inaccurate account statements." Since she had given the servicer "an opportunity to bring its practices in line with the mandates of Rule 3002.1," the bankruptcy judge felt that "the time has come for 'the imposition of severe sanctions.'"

To read ABI's report on the bankruptcy court opinion, click here.

The servicer appealed and won in Judge Crawford's Dec. 18 opinion.

The Bankruptcy Court's Limited Powers

To arrive at an award of $75,000, the bankruptcy judge had relied on Bankruptcy Rule 3002.1(i)(2), which authorizes the court to "award other appropriate relief." For the remaining $300,000, the bankruptcy court used Section 105(a) and the court's inherent powers.

Addressing whether the bankruptcy court indeed possessed power, Judge Crawford said that the circuits "have been deeply divided for many years on the question of whether bankruptcy courts have power to punish criminal contempts or impose punitive sanctions." The Second Circuit, he said, has not addressed the question.

Judge Crawford then summarized the evolution of the bankruptcy court's contempt powers under the Bankruptcy Rules, as influenced by the Supreme Court's 1982 decision in *Northern Pipeline*. The current iteration of the rules governing contempt — Bankruptcy Rules 9020 and 9014 — impose procedural rules but "provide no source of substantive authority," the judge said.

On the question of power, Judge Crawford said "that the prevailing trend in the development of bankruptcy law over recent years has been to place ever-tightening limits on bankruptcy courts' contempt authority." He said that "the better-reasoned authorities favor the narrower construction of the bankruptcy court's statutory and inherent punitive sanction power."

Judge Crawford was persuaded by the Ninth Circuit, which "held that neither Section 105 nor the bankruptcy court's inherent authority were proper sources of authority for the imposition of a serious punitive sanction." *In re Dyer*, 322 F.3d 1178 (9th Cir. 2003). He also found favor with the Fifth Circuit's holding that bankruptcy courts lack constitutional power to exercise criminal contempt power. *In re Hipp Inc.*, 895 F.2d 1503 (5th Cir. 1990).

Judge Crawford found fault with the logic of the First and Eighth Circuits, which were more liberal in vesting punitive power in bankruptcy courts.

Although the bankruptcy court may lack power in itself to address serious misconduct, Judge Crawford ended his opinion by mentioning that the district court has power to impose criminal contempt sanctions.

On remand, Judge Crawford said the bankruptcy court may "refer the matter to the district court" if it determines "that exercise of that authority would be appropriate." Alternatively, he said, the bankruptcy court "may take steps to enforce its orders short of punitive sanctions of the scope and type imposed in these cases."

The opinion is *PHH Mortgage Corp. v. Sensenich*, 16-256, 2017 BL 452882 (D. Vt. Dec. 18, 2017).

Lender cannot hide behind a disclaimer to avoid sanctions for violating the discharge injunction, Ninth Circuit BAP holds.

BAP Upholds $119,000 in Contempt Sanctions; Tells Lender to Modify Its Forms

The Ninth Circuit Bankruptcy Panel used an opinion upholding $119,000 in compensatory damages to declare that a lender must change its standard forms for borrowers who have received a discharge, and that it cannot use a boilerplate disclaimer to disguise a willful violation of the discharge injunction.

The BAP also interpreted Ninth Circuit opinions to mean that a bankruptcy court can award punitive damages so long as they are "relatively mild."

The debtors owned a home that they scheduled for surrender to the lender. They moved out, the debtors received their discharges, and the lender later obtained an order modifying the automatic stay.

After the debtors received their discharges, the mortgage lender began calling and writing for the next two years, until the lender finally began foreclosure proceedings.

After two years of dunning letters and calls, the debtors reopened their case and filed a motion to hold the lender in contempt of the discharge injunction, employing Ninth Circuit law, which holds that someone who commits a knowing violation of the discharge injunction under Section 524(a)(2) can be held in contempt under Section 105(a).

At a hearing with witnesses, the lender conceded it was aware of the discharge. The remaining issues at trial were the lender's intent and damages.

Among other defenses, the lender contended it had no liability because some of the correspondence was required by state and federal regulations. Other correspondence included a disclaimer, which said that the lender was making no effort to collect if the debtor was in bankruptcy or had received a discharge.

One of the debtors testified that the lender called two or three times a day for a year after discharge and that she answered the call about 20 times. Based on documents and testimony, the bankruptcy judge found that the lender made 100 calls and sent 19 letters. The judge granted $119,000 in compensatory damages ($1,000 for each call and letter) for emotional distress based on the debtors' testimony, among other things, that the lender's attempts to collect caused physical ailments and almost broke up their marriage.

The bankruptcy court did not impose punitive damages. The judge said he "probably" would have imposed punitive damages but did not believe he had the authority under Ninth Circuit law.

The lender appealed to the BAP, and the debtors cross appealed the denial of punitive damages.

In a Dec. 22 opinion for the BAP, Bankruptcy Judge Robert J. Faris upheld the $119,000 damage award but reversed and remanded, with instructions allowing the bankruptcy judge to enter final judgment for "relatively mild noncompensatory fines," issue proposed findings for the district court on punitive damages, or refer the contempt issue to the district court.

Judge Faris held that the calls and letters were knowing and willful violations of the discharge injunction, despite the lenders' defenses. He recognized a tension between discharge and the lender's obligation to give the debtors notices of foreclosure.

To resolve the tension, Judge Faris said that the lender may communicate but "only to the extent necessary to preserve or enforce its lien rights, and may not attempt to induce the debtor to pay the debt." In that regard, he upheld the bankruptcy court's findings that the communications "went far beyond what was necessary" to protect lien rights and were "meant to induce" the debtors to make payments after discharge.

Even if some of the notices did not violate the discharge injunction, Judge Faris agreed that the bankruptcy court "correctly noted that the cumulative effect of all of the letters demanding money created the perception that [the debtors] needed to pay" the lender.

With regard to the disclaimer, Judge Faris saw no reason for the lender to obscure the fact, which it knew, that the debtors had received a discharge. He said the lender gave no reason why it sent "generic" notices when it knew the debtors were discharged. He said the lender "could and should prepare notices that are consistent with the known legal status of borrowers."

The failure to use proper notices, he said, reflected either incompetence, which he doubted, or "a deliberate effort to induce confused borrowers to pay discharged debts."

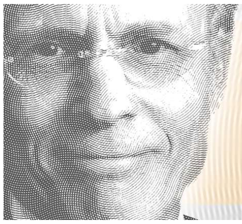
On the debtors' cross appeal, Judge Faris said that some bankruptcy judges have interpreted *Knupfer v. Lindblade (In re Dyer)*, 322 F.3d 1178 (9th Cir. 2003), to mean that bankruptcy courts may only impose "relatively mild noncompensatory fines."

Other bankruptcy courts have found power to impose punitive damages that are "relatively mild."

However, they are characterized, Judge Faris said the Ninth Circuit allows awards that are "relatively mild."

Without saying how the bankruptcy judge should rule, Judge Faris remanded with instructions to consider imposing a fine or punitive damages that are "relatively mild." Alternatively, the bankruptcy court could make proposed findings and recommend that the district court enter judgment for punitive damages or refer the matter to the district court to consider criminal contempt.

The opinion is *Ocwen Loan Servicing LLC v. Marino (In re Marino)*, 577 B.R. 772 (B.A.P. 9th Cir. Dec. 22, 2017).



Section 105(a) was utilized because Section 1301 is silent on sanctions.

Monetary Sanctions Are Available to Remedy Violations of the Co-Debtor Stay

Courts are split on whether there is power to impose sanctions for violations of the co-debtor stay under Section 1301. Chief Bankruptcy Judge Thad J. Collins of Cedar Rapids, Iowa, decided there is power and imposed sanctions under Section 105(a).

A wife filed a chapter 13 petition, but the husband did not. After the wife's bankruptcy, the power company got a judgment in small claims court against the non-bankrupt husband for about $2,500 and began garnishing his salary for the debt that both of them owed.

After the order for relief, Section 1301 enjoins any action "to collect all or any part of a consumer debt of the debtor from any individual that is liable on such debt with the debtor," except in situations not applicable to the case at bar.

Despite being notified twice about the co-debtor stay, the power company continued garnishing. Garnishment only halted when the debtor initiated contempt proceedings in bankruptcy court. In total, the power company garnished almost $900.

The debtor said she missed plan and mortgage payments as a result of the garnishment. Eventually, the power company agreed that the garnishment had been improper and gave the money back.

The debtor nonetheless sought recovery of damages and attorneys' fees. The power company argued that damages and fees are not recoverable because there is no statutory basis under Section 1301, unlike Section 362.

In his June 26 decision, Judge Collins said the courts are split. Some disallow damages because there is no enabling provision in Section 1301. Other courts award damages under Section 1301, relying on the notion that the co-debtor stay is intended to protect the debtor.

Judge Collins followed courts in a third category that employ Section 105(a) to impose sanctions, finding it "appropriate to carry out and give meaning to Section 1301." He relied on Section 105 because Section 1301 itself does not authorize damages and Section 362 is inapplicable.

Judge Collins awarded $1,500 for "emotional upset and needless stress" incurred by the husband and wife for being forced to miss mortgage and plan payments. He also awarded $1,400 in attorneys' fees.

The opinion is *In re Tucker*, 16-1127, 2017 BL 219854 (Bankr. N.D. Iowa June 26, 2017).

Municipal Debt Adjustment & Puerto Rico

Judge refuses to issue declaratory judgments about Puerto Rico's use of tax revenues.

No Quick Exit for Any Creditors from Puerto Rico's Financial Mess, Judge Says

The New York district judge overseeing Puerto Rico's debt restructuring in substance said that no one will hit a home run through litigation and take home all the marbles. Instead, the Jan. 30 opinion by District Judge Laura Taylor Swain has the effect of forcing creditors of all stripes to participate in mediation and slog through the process of plan negotiation and confirmation.

Since May will be the first anniversary of Puerto Rico's debt restructuring under the Puerto Rico Oversight, Management, and Economic Stability Act, or PROMESA (48 U.S.C. §§ 2161 *et. seq.*), some creditor groups have sought a quick exit, especially since Hurricane Maria destroyed the island's infrastructure last September, along with any progress toward debt adjustment.

The creditor group with perhaps the best odds of staging a quick victory was the holders of general obligation bonds, sometimes known as constitutional debt because the bonds carry the island commonwealth's full faith and credit. Holders of the bonds, known as GO bonds, contend they are entitled to full and timely payment, even "in times of economic scarcity."

The GO bondholders therefore filed an adversary proceeding in which they contended that certain tax revenue cannot be used for any purpose other than the payment of constitutional debt and must be segregated for them alone. In response, Puerto Rico filed a motion to dismiss, which Judge Swain granted in her 19-page opinion on Jan. 30.

Judge Swain divided the claims for relief into two categories: She dismissed about a third for failure to state a claim on which relief could be granted. She dismissed the remainder for lack of subject matter jurisdiction.

The first category includes claims for declaratory judgments that certain tax revenues cannot be used for any purpose other than the payment of constitutional debt and must be segregated. Although they arose from a live, otherwise justiciable controversy, Judge Swain said they ran afoul of Section 305 of PROMESA and therefore failed to state a claim.

Section 305 prohibits the court from interfering with any of Puerto Rico's governmental powers or income unless the "Oversight Board consent or the plan so provides." Granting declaratory relief with respect to segregating tax revenue, Judge Swain said, would "result in declarations and injunctions that would directly restrict" Puerto Rico's use of tax revenue.

Because there was no consent by the Board and no plan, Judge Swain dismissed that portion of the complaint for failure to state a claim because "Section 305's prohibition is not limited to remedies that are directly coercive," she said.

In the second category, the claims ask the judge to rule that certain tax revenue is not Puerto Rico's property; the island commonwealth is a mere conduit; constitutional debt is secured by statutory liens; certain tax revenues are "special revenues" that can be applied only in compliance with provisions of chapter 9 that are applicable under PROMESA; and using certain tax revenue other than in payment of constitutional debt would be an unconstitutional taking of property.

Judge Swain said the second group of claims did not pass constitutional muster and therefore failed to state a claim because there was no "case or controversy."

Although the bondholders were seeking declaratory judgments, not injunctions, Judge Swain explained that "even significant disagreement" by itself does not state a claim unless there is "a specific live controversy of sufficient immediacy and reality to warrant the issuance of a declaratory judgment."

According to Judge Swain, there is no case or controversy because those claims sought "abstract declarations of the parties' respective relationships to the subject revenues, without application of the relief to resolve any current concrete dispute." Thus, the judge said, they "seek advisory opinions and do not frame justiciable controversies."

On the claim about unconstitutional takings, Judge Swain said that Puerto Rico has not made any "final decision" about how to treat the taxes in question. The takings claim, she said, "is not ripe for adjudication."

Judge Swain therefore dismissed the claims in the second category for lack of subject matter jurisdiction given the absence of a constitutional case or controversy.

Since Judge Swain dismissed the adversary proceeding, the bondholders can appeal to the First Circuit. Even if Judge Swain was wrong about the second category and there is a live controversy, those claims might also run afoul of Section 305 because they could have the effect of tying up the commonwealth's tax revenue before a plan is approved.

The opinion is *ACP Master Ltd. v. Commonwealth of Puerto Rico (In re Financial Oversight and Management Board for Puerto Rico)*, 17-189 (D. P.R. Jan. 30, 2018).

Circuit court bars lawsuit by one Puerto Rico bondholder group against another.

First Circuit Interprets PROMESA's Automatic Stay Broadly, Reverses District Court

The First Circuit mended a gaping hole torn in the side of the automatic stay by reversing a decision in February by a district judge in Puerto Rico interpreting PROMESA, the federal law to alleviate Puerto Rico's financial crisis.

In an 11-page *per curiam* opinion concluding an expedited appeal, the First Circuit adopted an expansive reading of the word "control" to hold that a lawsuit by bondholders was enjoined by PROMESA's automatic stay. The appeals court handed down its decision on April 4, the same day it held oral argument.

The First Circuit's decision is the latest in a series of back-and-forth opinions exploring the similarities between the automatic stays in PROMESA and the Bankruptcy Code.

The Dispute Between Bondholder Groups

Within days after the Supreme Court held in June that Puerto Rico is precluded from adopting local laws to ameliorate the insolvencies of its units, the President signed the Puerto Rico Oversight, Management, and Economic Stability Act, or PROMESA. The high court also held that the commonwealth's instrumentalities are ineligible for municipal debt adjustment under chapter 9 of the Bankruptcy Code.

PROMESA contains a broad automatic stay modeled after Section 362 of the Bankruptcy Code. Both statutes bar actions to "control" property of the debtor, not just those that attempt to gain possession of estate property.

Immediately after the adoption of PROMESA, the commonwealth defaulted on $817 million in general obligation bonds but continued to pay so-called COFINA bonds, which are secured by revenue from sales and use taxes.

Holders of general obligation bonds filed suit in July in federal district court in San Juan under PROMESA, referring to their bonds as "constitutional debt" backed by the island's full faith, credit and taxing powers. Relying on Puerto Rico's Constitution, they argued that their debt must be paid from all revenue sources before COFINA bonds.

The general obligation bondholders sought a declaration and injunction that would bar Puerto Rico from using sales and use taxes to pay COFINA bonds.

Puerto Rico and the COFINA bondholders filed motions contending that the lawsuit was automatically enjoined by Section 405, the automatic stay under PROMESA that expires on May 1.

Because he believed that the general obligation bondholders were not attempting to collect on a claim and were only seeking a declaration and injunction, District Judge Francisco A. Besosa ruled on Feb. 17 that the automatic stay did not preclude the suit from proceeding.

Established under PROMESA, the Financial Oversight & Management Board appealed, along with COFINA bondholders. Indicating that a reversal was possible, if not likely, the First Circuit expedited the appeal on March 17 and invited the appellants to file a motion for a stay pending appeal. The circuit court entered a stay three days later.

The First Circuit's Opinion

Contrary to the conclusion by the district court, the circuit court said that the general obligation bondholders were seeking an injunction that would compel Puerto Rico to default on the COFINA bonds by barring the commonwealth from using sales and use taxes to pay those bonds. The *per curiam* opinion said that Congress "could hardly have envisioned" that one group of bondholders, "during the stay period" to end on May 1, would "dispossess the other by driving its bonds into default."

Next, the panel construed the word "control," as used in PROMESA's automatic stay, and said it mimics the same word in Section 362. Like the term in the Bankruptcy Code, "control" is interpreted "quite broadly."

"From this expansive understanding of 'control,'" the circuit court reversed the district court, imposed the stay on the general obligation bondholders' suit, and held that "the stay applies to litigation seeking declaratory and injunctive relief at least where, as here, the express purpose of the lawsuit is to preclude the Commonwealth from using its own funds as it sees fit."

What Does It Mean?

The April 4 opinion is the second time the First Circuit has addressed the breadth of PROMESA's automatic stay. The first decision was in January in *Peaje Investments LLC v. Garcia-Padilla*, 845 F.3d 505 (1st Cir. Jan. 11, 2017). There, the appeals court equated the two statutes when it concluded that lack of adequate protection is reason for vacating the automatic stay, although the lack of adequate protection is not among the enumerated grounds in PROMESA like it is in Section 362(d)(1).

On the other hand, the First Circuit ruled that PROMESA is different from the Bankruptcy Code because PROMESA has no provision like Section 362(g) that puts the burden of proof on the debtor for everything except the debtor's equity in the property. Consequently, the appeals court put the entire burden on the creditor to show "cause," including lack of adequate protection.

Therefore, *Peaje* seems to mean that the two automatic stays are similar, although not identical. Subtle differences in language may or may not lead to different results.

A month later, District Judge Besosa appeared to construe PROMESA's automatic stay more narrowly. If nothing more, the circuit's reversal precludes litigants from arguing that Judge Besosa's decision is authority for a narrow construction of the automatic stay under Section 362.

The First Circuit's newest decision may have been driven by PROMESA's avowed objective of fostering consensual restructurings. Notably, the appeals court appeared repulsed at the notion that one group could force a default on other bondholders.

Prior to May 1, the contending creditor groups are intended by PROMESA to negotiate among themselves and with Puerto Rico on consensual restructurings. If voluntary negotiations fail, Puerto Rico can then initiate a court-supervised debt adjustment similar to chapter 9 municipal bankruptcy.

The April 4 decision might be an effort to keep the parties focused on negotiations by precluding any creditor group from attempting to gain the upper hand through litigation. Perhaps the main takeaway from the April 4 opinion is the notion that PROMESA, like cases in chapters 9 and 11, should focus primarily on negotiations rather than litigation to achieve a global debt adjustment.

In the final analysis, the April 4 decision was a relatively terse, hurriedly issued, *per curiam* opinion. Perhaps it's best not to read too much into the opinion aside from the direct holding about "control."

To read ABI's discussion of the First Circuit's PROMESA decision in January, click here. For District Judge Besosa's February opinion, click here.

The opinion is *Financial Oversight and Management Board v. Lex Claims LLC*, 853 F.3d 548 (1st Cir. April 4, 2017).

Can plaintiffs sue Puerto Rico government officials in their individual capacities? Two district judges disagree.

District Judges Starkly Disagree on the Scope of the PROMESA Automatic Stay

Two district judges in Puerto Rico starkly disagree about the applicability of the automatic stay to "ordinary course" litigation against commonwealth officials.

On April 30, District Judge William G. Young of Boston, sitting in Puerto Rico by designation, held that the automatic stay under the Puerto Rico Oversight, Management, and Economic Stability Act barred a suit against a commonwealth governmental official in his individual capacity, even though Puerto Rico itself was not named as a defendant.

Saying he "disagrees" with Judge Young, Chief District Judge Gustavo A. Gelpí ruled on May 14 that the automatic stay does not apply. He allowed a plaintiff to recover a judgment against a government official in his individual capacity.

Although the two cases are procedurally distinguishable, the First Circuit may be tasked with deciding whether Puerto Rico can hide behind PROMESA to halt lawsuits having nothing to do with the island's insolvency.

The Newest Case

In Judge Gelpí's case, a prisoner sued non-governmental third parties for inadequate medical care. The defendants included Puerto Rico governmental officials in their official and individual capacities. Much later, the plaintiff accepted a $50,000 settlement without specifying how the settlement would be apportioned among the defendants. Two weeks before Puerto Rico initiated its financial restructuring under PROMESA (48 U.S.C. §§ 2161 *et. seq.*), Judge Gelpí directed the defendants to pay the $50,000 within 90 days.

When Puerto Rico began its restructuring on May 3, 2017, PROMESA imposed an automatic stay by incorporating Section 922(a) of the Bankruptcy Code. That section automatically enjoins a suit against a government "officer" that "seeks to enforce a claim against" the government.

In the process of paying $40,000 after commencement of the PROMESA proceedings, the non-governmental defendants said that Puerto Rico had agreed the pay the remaining $10,000. Puerto Rico did not object to the statement but filed a notice regarding the automatic stay.

Months later, the plaintiff filed a motion seeking to compel Puerto Rico to pay the remaining $10,000.

Judge Young's Earlier Case

Judge Young ruled on a suit by several individuals seeking money damages for wrongful incarceration in violation of the U.S. Constitution and local law. Knowing that PROMESA would bar suit for damages against the commonwealth, the plaintiffs only sued individuals in their personal capacities.

Admitting that a decision either way would be "unfair," Judge Young decided to apply the stay, saying the complaint was among "the types of suits contemplated by PROMESA that require an automatic stay because the defense is funded" by the government of Puerto Rico.

Judge Gelpí's Analysis

The statute underlying both cases was a commonwealth law giving Puerto Rico the right but not the obligation to defend and indemnify governmental officials sued in their individual capacities. In Judge Gelpí's case, Puerto Rico had agreed long before bankruptcy to defend and indemnify the one official who was still liable on the judgment in his individual capacity.

Puerto Rico argued that PROMESA's automatic stay applied because the commonwealth had indemnified the official for a judgment against him in his individual capacity. Judge Gelpí disagreed, holding that the stay "does not apply to individual capacity claims," even when Puerto Rico has agreed to defend and indemnify.

Judge Gelpí followed his decision from August 2017, where he held that PROMESA's automatic stay did not apply to a $2 million lawsuit against Puerto Rico's superintendent of police for a police shooting that was claimed to be "a reckless and grossly negligent use of excessive force." *Guadalupe-Baez v. Pesquera*, 269 F. Supp. 3d 1 (D.P.R. 2017).

Judge Gelpí bolstered his decision by reference to Puerto Rico's sovereign immunity under the Eleventh Amendment and First Circuit authority holding that defense of a suit is not a waiver of immunity. If Puerto Rico is not being sued when it defends an official, he theorized that "it is not liable for any awards or settlements." Since the government is not liable, the stay does not apply because the plaintiff is not collecting a claim against the commonwealth.

Judge Gelpí disagreed with Judge Young on two counts. First, he disagreed with the notion that PROMESA contemplates an automatic stay covering officials in their individual capacities. Second, he was not persuaded by the argument that recruiting government workers would be harmed by permitting individual-capacity suits to proceed. He said that the effect on recruitment "is a matter for the Commonwealth to consider when agreeing to represent officials . . . and [settle] on their behalf." It is not a matter for the court to consider, he said.

Judge Gelpí therefore held that he had power to compel the individual to pay the judgment in his personal capacity because the indemnification agreement was between the official and the government, not between the government and the plaintiff. However, the judge conceded that he did not have power to compel the government to pay the settlement.

To read ABI's report on Judge Young's case, click here. For Judge Gelpí's decision from last year, click here.

The opinion is *Colon-Colon v. Negron-Fernandez*, 14-1300 (D.P.R. May 14, 2018).