Disclosure Statement

Published by the Bankruptcy Section of the North Carolina Bar Association • Section Vol. 36, No. 2 • April 2015 • www.ncbar.org

The Chair's Comments

Dear Members of the Bankruptcy Section:

It is difficult to believe that my term has reached its midpoint.

Looking at the year thus far, we have had a number of accomplishments, capped by the tremendously successful annual meeting in Asheville. Thanks to Andy Tarr, his committee, and the Bar staff, we once again pulled off an immensely informative and impressively organized CLE for our members. Based on member comments, it is safe to say that our membership was quite satisfied with the effort. This will be our last time at the Grove Park for at least the next session or two, and it was nice to see our time there end (for now) with such a great seminar.

As a group, our committees continue their work. One committee that has been quite active is the Legislative Committee. Margaret Westbrook and Jeremy Browner have kept us up to speed on a number of developments at the General Assembly and nationally. Recently, with the assistance of Trip Adams and others, we were presented with the opportunity to give meaningful input on a new rendition of the fraudulent transfers act and will take up that issue at the February Council meeting.

As discussed at earlier Council meetings, we have been asked to give our support to the Bankruptcy Administrator system. Earlier this year, it looked as though the Bankruptcy Administrator system would be under attack nationally. I am pleased to say that it now appears that the BAs and their staffs are in no immediate danger. We will keep our collective eye on this situation, though, and will let the membership know if membership assistance is needed.

Finally, thank you to Oliver Carter, Ben Waller, and J.P. Cournoyer for their tireless work in producing yet an-

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In Memoriam: The Hon. Randy D. Doub

By Dean Rich Leonard

When I joined the Bankruptcy Court in 1992 and began to travel regularly to New Bern to handle the cases in that division, one of the trustees there immediately caught my attention. He was unfailingly courteous and impeccably prepared, yet he was very aware of the difficult straits in which many of the debtors in his cases found themselves and treated them with the utmost respect. Although he never shied away from litigating an issue, he was always open to finding an amicable resolution. That was the beginning of my relationship of more than two decades with Randy Doub. When several years into my judgeship he drew one of the most complex cases I ever handled, I was impressed by his intellectual prowess as he litigated one difficult issue after another against some of the top lawyers in the area.

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April 2015

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The Chair's Comments, *continued from the front page*

other quality publication. We are lucky to have such a dedicated committee, and we are lucky to have people willing to devote the time to creating informative and timely articles for us.

Thank you for all of the hard work!

Bob Gourley, Jr.

Robert H. Gourley, Jr. practices with Gourley & Griffin, P.A. in Statesville and Morrisville. He represents clients in Ch. 7 and Ch. 13 cases and also handles a variety of financial matters. Bob received his J.D. from Chapel Hill in 1992 after attending college there as a Morehead Scholar.

Overheard on the Listserv

"The U.S. Supreme Court released its opinion in *North Carolina Bd. Of Dental Examiners v. FTC* today." - Jeremy Browner

"Some debtors' attorneys have fewer cases because of the decline in bankruptcy filings. Some are thinking about adding a practice niche. With the uncertainty concerning the future of attorney involvement in residential real estate closings, and the new settlement statements and CFPB requirements, I think I'd steer clear of residential real estate closings as a practice area, but as the Food Lion says, "that's just my two cents…."" - Martin Hunter

"All those debtor attorneys with an increased case load please raise their hands. I am shoveling driveways in the neighborhood this morning for a few extra bucks." - James Henderson

"I'm too old and out-of-shape to shovel driveways. I've begun scrounging for scrap metal and roadside aluminum cans. If y'all don't file 'em, I can't fight 'em." - Frank Drake

"I'm taking up teeth whitening." - Jeff Cook

"While the State Bar takes up the gnashing of teeth." - Billy Brewer

"I own a few dark suits, and I'm used to people in distress. Maybe I could make some money by helping out at a funeral home." - Martin Hunter

"I am not so sure about that Martin—Everytime I ask my good friend Cecil Burton of Burton Funeral Services in Shelby about how things are going he tells me that "business is dead.""
- O. Max Gardner III

"And Cecil is the last man to let you down." - Robert E. Price, Jr.

News and Announcements

Congratulations to the following attorneys who have recently been certified by the N.C. State Bar as specialists in Consumer Bankruptcy:

Brian Behr, Bankruptcy Administrator's Office, EDNC
Erich Fabricius, Fabricius & Fabricius, PLLC
Erik Harvey, Liao Harvey PC
Koury Hicks, The Law Offices of John T. Orcutt
Charlie Livermon, Poyner Spruill, LLP
Kristen Nardone, Davis Nardone, Attorneys at Law
Benson Pitts, Pitts, Hay & Hugenschmidt, P.A.

In Memoriam, continued from the front page

One of the few good things to come out of the 2005 BAPCPA was the allocation to our court of a third judgeship. No one was ever more awestruck at taking the federal bench than Randy; he simply could not believe that such good fortune had come his way. I was almost as happy. As much as I enjoyed my time in the Wilson courthouse, fourteen years of commuting had grown wearying, and I was happy to cede that facility to him and relocate to the Raleigh courthouse. We quickly became close friends and collaborative colleagues. Our personal political views were not closely aligned, but as often happens in the judiciary, our judicial perspective on most issues matched closely. In common with all of the judges who have served on our court, we shared a belief that we should apply the law as consistently in our respective courtrooms as possible when we could do so without surrendering our independent judgment. We also shared a total commitment to our families, and we often noted that his two fine sons were almost precisely the same age when he came on the court as my two oldest boys had been when I arrived earlier.

In one of the fortuities of federal judicial administration, because Judge Small and I had already served our seven-year terms in the position, he became the chief judge within his first year. No one ever worked harder at mastering the intricacies of court administration, or came to enjoy it more. He dug deeply into case data and court budgets and was full of creative suggestions about how we could do things better. He treasured the interactions required of a chief judge with other judges at all levels, Administrative Office officials, trustees, lawyers, and court staff. He appreciated the importance of ceremonial sessions of court and planned them meticulously. The rest of us just followed his script. He loved the court as an institution, and he was paternally proud of the accomplishments of any of us who worked there.

Beneath his pleasant demeanor and "Aw shucks" attitude, he was a wily politician. Although not popular in some quarters, he made the correct calculus that if the Bankruptcy Court was to have only two locations, the second one should be further east in a larger city to better serve the district. Remarkably, in the darkest days of the federal budget, he made it happen. His legacy for the court is the fine building he envisioned and found the resources to build, and whose design and construction he meticulously oversaw. His political skills were also beginning to be noticed nationally. He had recently been named the co-chair of the powerful Legislative Committee of the National Conference of Bankruptcy Judges, walking the halls of Congress to monitor proposed legislation and building relationships with our representatives.

In the odd way in which history repeats itself, his trajectory followed that of Judge Moore, who also spent years planning and building a courthouse before his time to enjoy the result was tragically cut short. The call that Saturday morning that he had not awakened took my breath away, but was also not totally unexpected. Although never publicized, I knew that he had undergone two serious heart procedures during his judgeship, with the underlying problem never satisfactorily resolved. Internally, we fretted and worried about him a great deal.

When Judge Frank Dupree was in his last days and colleagues bemoaned how different the court would be with him absent, he would always smile and say, "Another patriot will rise." But whoever that person is, he or she will start their career in the considerable shadow of a fine jurist and exceptional man. It was my honor and privilege to sit beside him.

Dean J. Rich Leonard, former United States Bankruptcy Judge for the Eastern District of North Carolina, assumed the role of dean at Campbell University's Norman Adrian Wiggins School of Law on July 15, 2013.

Section 548 and the "Indirect Benefit" Theory

By Jim Angell and Nicholas Brown

It is a fundamental principle of bankruptcy law that a transfer of property from an insolvent debtor to a transferee who has not provided reasonably equivalent value in return is subject to avoidance for the benefit of the debtor's bankruptcy estate. Specifically, Section 548(a)(1)(B) provides that "(t)he trustee may avoid any transfer…of an interest of the debtor in property … that was made or incurred on or within 2 years before the date of the filing of the petition, if the debtor voluntarily or involuntarily (B) (i) received less than a reasonably equivalent value in exchange for such transfer or obligation; and (ii)(I) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation; (II) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital; or (III) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured…."

The analysis under the above statute focuses on the consideration received by the debtor, not on the value given by the transferee. The purpose of fraudulent transfer law is the preservation of the debtor's estate for the benefit of its unsecured creditors. What constitutes reasonably equivalent value must be determined from the standpoint of the debtor's creditors.

Fraudulent transfers may include deeding real property to a relative without adequate consideration, making payments to a shareholder, or conveying a gratuitous lien on nonexempt property. In a number of instances, transferees receive money from the debtor in payment of debts of another or in consideration of value passing to a party other than the debtor ("third-party transfers").

The Indirect Benefit Theory

Third-party transferees, who receive money from the debtor in payment of debts of another or for value passing to another, are vulnerable to avoidance based on the "reasonably equivalent value" prong found in 11 U.S.C. 548(a)(1)(b)(i). Because reasonably equivalent value is determined based on the consideration received by the debtor, in these instances the debtor's estate is depleted by the transfer and the transfer is avoidable. In certain instances, indirect value may be shown by incremental value accruing to a shareholder for transfers made for the benefit of wholly-owned subsidiaries. (This is because the resulting increase in the value of the subsidiary's stock provides value, although the result is questionable if the subsidiary is insolvent since the value may inure to the benefit of the subsidiary's creditors, not the parent-debtor.) In other instances, defendants have contended that there was an "indirect benefit" that accrued to the benefit of the debtor as a result of the transfer to the third-party that provided "reasonably equivalent value" to the debtor.

In the Fourth Circuit, the leading case on the "indirect benefit" theory is **Harman v. First Am. Bank (In re Jeffrey Bigelow Design Group, Inc.)**, 956 F.2d 479 (4th Cir. 1992). In **Bigelow**, the bankruptcy trustee sued a bank to recover pre-petition payments that the debtor made to the bank in payment of its shareholders' debts. The debtor's shareholders had opened a line of credit at the bank in their individual names but the debtor made the loan repayments. The trustee argued that the loan repayments were made for less than reasonably equivalent value because the debtor was not obligated to the bank, nor had the debtor received any benefit from the bank in exchange for the payments. In ruling against the trustee, the court determined that the transaction as a whole conveyed value to the debtor, albeit indirectly.

Specifically, the court found that the shareholders were contractually obligated by virtue of a stock subscription agreement to take out the line of credit in their names for the benefit of the debtor, and that the loan proceeds were paid directly to the debtor. The court viewed the shareholders, in essence, as a conduit for obtaining a loan for the debtor that the debtor could not obtain on its own. As to some of the loans, the debtor had executed a promissory note to the shareholders that mirrored the amount, interest rate and payment terms of the shareholders' loan, thereby establishing the debtor's obligation to repay its shareholders for the bank loan. Taken together, the court ruled that the debtor received reasonably equivalent value because the debtor enjoyed the benefit of the loan proceeds and a reduction in indebtedness to its shareholders in exchange for each payment. In this way, the court found that the payments resulted in an *indirect benefit* to the debtor.

In **Bigelow** the benefits to the debtor from the payments were tangible and direct. The loan proceeds were received by the debtor, and the debtor formalized its obligation to pay back the loan by executing a promissory note to its shareholders.

In support of its holding, **Bigelow** relied on **Rubin v. Manufacturers Hanover Trust Co.**, 661 F.2d 979 (2d Cir.1981), a case decided under the Bankruptcy Act. In **Rubin**, the debtors sold money orders through independent sales agents. The debtors provided loan guaranties and security to a bank which financed the money orders for its sales agents. The court deemed these guaranties and security essential to the debtors' operations. Although the trustee contended that the increased liability of the debtors for advances to the sales agents did not confer a benefit to the debtors, the court found that they provided an "indirect benefit" to the debtors by facilitating the sales of money orders. The court then remanded the case to the district court to first determine the value of this indirect benefit, and secondly to compare the value of the indirect benefit to the value relinquished by the debtor to ultimately determine whether "fair consideration" (the standard under the Bankruptcy Act) was received for the increased obligations.

Recent Application in the Eastern District of North Carolina

The indirect benefit theory was asserted in recent decisions arising out of the Tanglewood Farms, Inc. of Elizabeth City bankruptcy case (Case No. 10-06719-8-RDD). In each case, the bankruptcy trustee sought to avoid transfers made by the debtor to a creditor of the debtor's shareholder.

In **Angell v. Morris (In re Tanglewood Farms, Inc. of Elizabeth City)**, 2014 Bankr. LEXIS 3141 (Bankr. E.D.N.C. July 24, 2014), the debtor's shareholder borrowed funds from a friend for the express purpose of keeping the debtor's business going. The friend wrote a check to the principal shareholder that was deposited in his personal bank account, and, within a matter of days, mostly transferred to the debtor, which used the funds for operating expenses. The trustee sued to recover the payments made by the debtor to the shareholder's friend, arguing that the debtor did not receive reasonably equivalent value because the debtor had no obligation to the shareholder's friend. Relying on **Bigelow**, the shareholder's friend argued that the debtor indirectly benefitted from the transfer because it received some of the loan proceeds. Because the loan proceeds could be traced from the shareholder's friend to the debtor, the debtor received an indirect benefit from the payments, although there was no formal loan documentation between the shareholder's friend and the shareholder. The court granted partial summary judgment in favor of the shareholder's friend, determining that the debtor obtained an indirect benefit in the form of the loan proceeds it had previously received. The trustee was limited in recovery to the amount of payments which exceeded the value of the indirect benefit.

The question of indirect benefit was again at issue in **Angell v. Open Grounds Farm, Inc. (In re Tanglewood Farms, Inc. of Elizabeth City)**, 2014 Bankr. LEXIS 2446 (Bankr. E.D.N.C. June 5, 2014). In this case, the debtor's shareholder rented farmland from the defendant-landlord. The debtor made certain rent payments to the landlord. The shareholder sold his crops to the debtor, a grain dealer, which then sold the crops to its third party customers. At issue in **Open Grounds Farm** was whether the debtor's payment of its shareholder's rent constituted a constructively fraudulent transfer. The landlord argued that, although the debtor was not contractually obligated to pay the rent, the debtor indirectly benefitted from the rent payments because, had the rent not been paid, the landlord would have enforced its lien on the crops, thereby preventing the shareholder from selling his crops to the debtor. In essence, the landlord argued that the debtor's business would have suffered if its shareholder lost his ability to harvest and sell crops.

The court declined to find an indirect benefit and granted summary judgment in favor of the trustee. The court determined that the landlord did not convey value in the form of money or property to the debtor. The debtor owed no contractual obligation to the landlord, nor did the debtor own or lease the land for which rent was paid. Rather, the landlord's release of a crop lien upon receipt of rent payments was a benefit to the landowner. Further, there was no evidence that the debtor received a reduction in the purchase price for the crops or some other credit from the debtor's shareholder in exchange for paying land rent. At the time of this writing this matter is on appeal to the United States District Court.

The Importance of an "Exchange"

While transferees may argue that there was an "indirect benefit" to the debtor, the existence of an indirect benefit does not in and of itself mean that the debtor "received ... a reasonably equivalent value in exchange for such transfer or obligation." An important element of Section 548 is that the "reasonably equivalent value" is given "in exchange" for the transfer, *i.e.*, that the indirect benefit is given as consideration for the transfer by the debtor. The necessary implication is that the consideration transferred by the debtor and the indirect benefit must be part of the same transaction. Thus, if the debtor receives a benefit which is not contingent upon or received "in exchange" for the transfer, the indirect benefit theory should not apply. As the Bankruptcy Court for the District of Maryland aptly described in **Rosen v. Moreno (In re Rood)**, 2011 Bankr. LEXIS 1708 (Bankr. D.Md. Feb. 11, 2011), "any 'property' that a [debtor] would have enjoyed, regardless of [the transfer], cannot be regarded as property received 'in exchange for' the transfer or obligation." The **Bigelow** court's findings regarding the shareholder's obligation to obtain the line of credit for the benefit of the debtor and the "mirror notes" support the contention that the debtor did not suffer a depletion of its assets when the payments were made to the bank and that the value received by the debtor was reasonably equivalent to the amount of the payments.

The facts in **Bigelow** are compelling, and its holding should be narrowly construed. **Bigelow** states that "[i]f the consideration given to the third person has ultimately landed in the debtor's hands, or if the giving of the consideration to the third person otherwise confers an economic benefit upon the debtor, then the debtor's net worth has been preserved, and [the statute] has been satisfied—provided of course, that the value of the benefit received by the debtor approximates the value of the property or obligation he has given up." **Bigelow** should not be read so broadly as to do away with the "in exchange for" component of Section 548 – under the facts in the **Bigelow** case, the reduction of the debtor's obligations under the mirror notes or the stock subscription agreement support the conclusion that the debtor realized a benefit upon making payments to the bank.

Furthermore, from the perspective of the debtor's creditors, the payment of another's loan obligation causes the debtor's net worth to decline if the payment is not "in exchange for" the indirect benefit realized by the debtor. Section 548(d)(2) explicitly states that "value" includes satisfaction or securing of a present or antecedent debt of the debtor. Section 548(a) expressly permits the avoidance of an "obligation incurred by the debtor." These two statutes imply that the debtor may not simultaneously assume an obligation to a third party and make payment of the obligation for the "indirect benefit" theory to apply. **Bigelow** and **Rubin** should be read to hold that the debtor must itself receive an indirect benefit in consideration for the transfer at issue. To hold that payment of a third-party's debt for which the debtor is not obligated results in an "indirect benefit" to the debtor, even where the proceeds were previously paid to the debtor, is in contravention to Sections 548(d)(2) and 548(a) and results in diminution of the estate from the standpoint of the debtor's creditors.

Conclusion

The applicability of the indirect benefit theory as a defense to a fraudulent transfer action is fact-specific. Parties in fraudulent transfer proceedings should examine whether the debtor received an indirect benefit "in exchange for" the transfer at issue. Then, the court must value the benefit received by the debtor to determine whether the debtor received reasonably equivalent value in exchange for the transfer. Generally, absent a corresponding reduction in a debtor's antecedent debt in exchange for the transfer, the "indirect benefit" theory should fail.

Jim Angell is a Partner with Howard, Stallings, From, Hutson, Atkins, Angell & Davis, P.A. in Raleigh and is a Board Certified Business Bankruptcy Specialist.

Nicholas Brown is an Associate with Howard, Stallings, From, Hutson, Atkins, Angell & Davis, P.A. in Raleigh.

Pro Bono/Public Service Corner

By Victoria Wright

I've been privileged to experience the genuinely caring nature of the members of our North Carolina bankruptcy bar for over 20 years. I quickly learned that our Bar is noted for fair-dealing, cooperation, warmth, and collegiality; different from other bar groups and other bankruptcy bars. We genuinely care about one another and about helping our communities.

I know that those who do pro bono work or are community volunteers don't do so for recognition. But I submit that setting out Bankruptcy Section members' public service and pro bono activities as a regular feature here in the *Disclosure Statement* can accomplish more than just recognition: It can be a catalyst and encourage your colleagues to get involved.

There's nothing wrong with (and much that's helpful in) being recognized for your service, or for wanting to have your colleagues recognized. If you wish, please help by listing your involvements anonymously and I will forward any inquiries to you for private contact. For instance, if you're doing a credit education class at your church, posting it may inspire others to do the same. As a reminder, we have a great PowerPoint presentation on this that was designed for college freshmen but it can be used for many groups.

So please, send me news about the good things you and your colleagues are doing! We can all benefit from hearing good news, speaking of which…

- A Western District attorney who wishes to remain anonymous tells me her policy is to take one pro bono Chapter 7 a month. She also provides her card and offers services to *pro se* clients who she sees in court when she thinks she can help them and has helped several people in that way, which she plans to continue as she sees the need.
- Robert Lefkowitz (Lefkowitz Law Firm,Winston-Salem) has taken a reverse mortgage case in which the bank is attempting to foreclose on the wife after the death of her husband. The bank's representative allegedly pushed the widow to transfer her interest in the marital residence to her terminally-ill spouse because the couple did not qualify for the reverse mortgage without the transfer. The bank representative allegedly assured the couple that the wife would not lose the house under the reverse mortgage if the husband pre-deceased her.
- Heather Culp and Matt Crow (Essex Richards, P.A., Charlotte) regularly volunteer through Legal Services of Southern Piedmont and Legal Aid of North Carolina in which they have each filed several pro bono bankruptcy cases. Heather also files free cases for certain clients she hears from directly who are just scraping by.
- Congratulations to Lifetime Achievement honoree Trawick "Buzzy" Stubbs, Dean J. Rich Leonard, and Director David Mills on the newly-opened Stubbs Bankruptcy Clinic at Campbell Law School!
- If you're not in Legal Aid of North Carolina's Lawyer on the Line program, please consider getting on board this year. As a benefit, you receive **free** CLE courses!

Victoria Wright is Director of Financial Education at Hummingbird Credit Counseling and Education.

ABI's Recommendations for Chapter 11 Reform

By George F. Sanderson III & Lauren Miller Golden

Last December, the American Bankruptcy Institute's Commission to Study the Reform of Chapter 11 released a 400-page report on recommended changes to Chapter 11 of the Bankruptcy Code. ABI formed the Commission in 2012 to evaluate business reorganization laws in light of the challenging economic climate and the perception that the costs and complexities associated with filing Chapter 11 have made Chapter 11 filings substantially less viable for businesses experiencing financial difficulty. The Commission's report explores the current environment in which financially distressed companies operate and evaluates whether the current bankruptcy system is—or is not—working as well as it could.

The Commission's study touched on the following themes: 1) a perceived increase in the number and speed of asset sales under section 363 of the Bankruptcy Code; 2) a perceived decrease in reorganizations that are not merely a vehicle for prepackaged 363 sales; 3) a perceived decrease in recoveries to unsecured creditors; and 4) a perceived increase in the costs associated with Chapter 11. Many of the Commission's recommendations are aimed at addressing these concerns.

363 Sales

One of the Commission's most interesting recommendations relates to sales involving substantially all of the debtor's assets. The new provision would be called "Section 363x." The provision would subject the traditional 363 sale to longer timetables and subject sales within sixty days of filing to greater judicial scrutiny. The Commission's goals with this recommendation are to give debtors more breathing room and to allow a meaningful amount of time for parties in interest to evaluate the debtor's assets. Sales within sixty days of filing would be permitted only in limited circumstances when absolutely necessary to preserve "significant" value.

Even with the new restrictions, the bankruptcy court would still have the power to order sales free and clear of liens. The Commission acknowledged that unsecured carve-outs are frequently negotiated, but the Commission did not recommend making these carve-out arrangements mandatory. Secured lenders would retain their ability to credit bid. Although the Commission recognized that credit bids may have a "chilling effect" on competitive bidding, the Commission recommends reinforcing auction and competitive sale procedures to mitigate this effect.

Trustees & Estate Neutrals

The Commission recommends keeping the current debtor-in-possession model, but with a few tweaks. The Commission recommends that a distressed company's current officers and board continue to be permitted to manage and operate the debtor. The Commission also recommends retaining the current grounds for removing the debtor from possession and appointing a Chapter 11 trustee. Notably, however, the Commission recommends formalizing a lower burden of proof for motions to appoint a trustee—a preponderance of the evidence standard. Codifying the standard would resolve a current split amongst courts.

The Commission recognized that court-appointed bankruptcy examiners have played a crucial role in some of the largest Chapter 11 cases to date. Under current law, their role is limited to an investigatory function—particularly to investigate if the debtor is being mismanaged.

Although the Commission recognized their utility, the Commission also recognized that bankruptcy examiners may result in substantial cost to the estate. To curtail the expense associated with examiners and to maximize the utility of a neutral third party, the Commission proposes eliminating the concept of examiners under section 1104(c). Instead, the Commission recommends a more flexible court-appointed "estate neutral"—i.e., an individual who may be appointed depending on the particular needs of the debtor or its stakeholders to assist with certain aspects of the case. Given the unique vantage point of the estate neutral, the Commission recommends expanding the role of the estate neutral from the current examiner role and allowing the estate neutral to also facilitate dispute resolution and reduce information asymmetries.

As is the case with bankruptcy examiners now, and subject to certain exceptions, the estate neutral would not be permitted to: (i) propose a Chapter 11 plan; (ii) act as a mediator in any matter affecting the case; (iii) initiate litigation on behalf of the debtor or the estate; or (iv) operate the debtor's business.

The Commission recommends that, unlike bankruptcy examiners currently, the appointment of an estate neutral would not be mandatory for any particular circumstances. The Commission also rejected a proposed standard that would require an estate neutral to serve the interests of all stakeholders in a bankruptcy. The Commission does recommend a requirement for court-approved budgets to curtail any excessive estate neutral fees or fees of professionals retained by the estate neutral.

Valuation Information Packages

The Commission recommends that debtors be required to compile (not file) the following:

1) Tax returns for the three years prior to filing;

2) Annual financial statements for the prior three years;

3) Most recent independent appraisals of material assets; and

4) All business plans or projections prepared within the two prior years that were previously shared with prepetition creditors.

This information would be available upon request. Requesting parties would be required to execute a confidentiality agreement.

Other Highlights

A few of the other notable recommendations from the report include:

- The Commission proposes reducing the appointments of official committees to represent the interests of unsecured creditors.

- The Commission did not suggest any material changes to the claims trading and disclosure requirements. The Commission did recommend that courts be allowed to designate votes that are exercised "in a manner manifestly adverse to the economic interests of the other creditors in the class."

- The Commission did not take a position on jurisdictional issues but stated: "[the] Commission, and all those interested in the efficient operation of the U.S. bankruptcy system, look forward to further clarity with respect to the scope of the bankruptcy court's authority to hear and finally determine bankruptcy-related issues."

- The Commission recommends eliminating section 1129(a)(10) in its entirety—this is the rule that at least one impaired creditor class must vote to accept a company's Chapter 11 plan. The Commission opined that this provision tends to delay confirmation and ultimately increases costs. The Commission also opined that this provision gives secured creditors an opportunity for unfair gamesmanship, and may result in value destruction.

- The Commission's changes would alter the method for valuing certain payments made to creditors.

- The Commission did not recommend significant changes to evaluating the cost and fees associated with bankruptcy professionals.

Criticisms

Proponents of the Commission's findings think the prevalence of secured debt has given lenders too much control in a Chapter 11 proceeding. As a result, supporters of the Commission's proposals opine that too many cases end in a quick asset sale rather than a meaningful operational-reorganization.

Other commentators have criticized the Commission as biased in favor of bankruptcy professionals and creating a system that results in longer, more lucrative cases. In particular, the Commission's report has raised concerns among lenders. The Commercial Finance Association and Loan Syndication and Trading Association issued the following joint statement: "Indeed, many of the report's recommendations are solutions in search of a problem. Moreover, some of the recommendations would undermine the Bankruptcy Code's fundamental protections for secured creditors' rights — protections that are central to the success of our bankruptcy system."

The Commission's recommendations are not legally binding. Members plan to present their recommendations to Congress, but it is unclear whether and on what timetable Congress may consider the proposals.

George F. Sanderson III is a litigation partner and ***Lauren Miller Golden*** is a litigation associate at Ellis & Winters LLP in Cary. Their practice includes creditors' rights and bankruptcy litigation in addition to complex commercial litigation.

/S/taying Within The Lines: Compliance With Local Bankruptcy Rule 5005

By Brian Behr

From applications to writs and everything in between, pleadings and other documents filed with our bankruptcy courts are no longer required to bear the physical or "wet-ink" signature of the filer or represented party. Instead, these documents may now be signed electronically (e.g. /s/John Hancock). Pursuant to the Local Rules of our courts, electronic filing is mandated, and as a result e-signatures have become a near-ubiquitous part of modern practice. However, practitioners should tread with caution when filing papers that bear the "/s/," as the failure to comply with the requirements regarding such filings can result in the imposition of significant monetary sanctions.

The local bankruptcy rules of all three districts require the Filing User (i.e., the attorney filing the document electronically) to obtain the original "wet-ink" signature on all electronically filed documents that require original signatures. *See* E.D.N.C. LBR 5005-4(7), M.D.N.C. LBR 5005-4(7) and W.D.N.C. LBR 5005-1(e). The following documents are subject to the original "wet-ink" signature requirement: petitions, lists, schedules, statements, amendments, affidavits, verifications, and other documents that require verification under Fed. R. Bankr. P. 1008 or an unsworn declaration as provided in 28 U.S.C. § 1746. The preceding list is by no means exhaustive, and readers are urged to review the rule carefully. The Filing User must maintain the documents bearing the original "wet-ink" signature for a period of four years after the closure of the case and are required to produce the originals upon the court's request. *Id.*

When counsel files a document electronically containing a "/s/" they are certifying, *inter alia*, that all persons required to sign the document have either signed the document or authorized their signing of the document prior to its electronic filing. Furthermore, by using a "/s/" counsel certifies that they have in their possession the original document bearing the "wet-ink" signature that is an exact replica of the electronically filed document. *See* E.D.N.C. LBR 5005-4(8), M.D.N.C. LBR 5005-4(8) and W.D.N.C. LBR 5005-1. A false certification subjects counsel to sanctions pursuant to Fed. R. Bankr. P. 9011.

Issues relating to compliance with these rules are likely to arise in the context of whether a debtor has physically signed a bankruptcy petition, schedule, or statement of financial affairs that contains an omission or misstatement. **In re Moore**, 2012 Bankr. LEXIS 4770, Case # 11-03465-8-JRL (Bankr. E.D.N.C. Oct. 10, 2012), a fairly recent case out of the Eastern District, provides a good example of such a circumstance. In **Moore**, the Chapter 7 trustee initiated an adversary proceeding objecting to the debtor's discharge on the basis that the debtor had made numerous misstatements and omissions within his statement of financial affairs and schedules. During the trial, the debtor "testified repeatedly that he did not remember signing off on information as presented in the electronically filed petition." *Id.* The Court, pursuant to E.D.N.C. LBR 5005-4(7), required debtor's counsel to produce the original "wet-ink" signature documents. Upon review of the original "wet-ink" signature documents, the Court determined they were not an exact replica of the electronically filed versions. *Id*. While debtor's counsel had produced the original schedules and statement of financial affairs bearing the "wet-ink" signature of the debtor, the Court found that the originals contained numerous hand-written amendments. *Id.* The Court further found that counsel did not have an original "wet-ink" document that was an exact replica of the electronically filed documents. The Court ruled that this conduct was in violation of E.D.N.C. LBR 5005-4(7) and, as a result, formally reprimanded counsel and issued a $2,000.00 monetary sanction. *Id*.

In order to comply with Local Bankruptcy Rule 5005, prudent counsel should endeavor to do the following:

- prior to the electronic filing of any document that requires a "wet-ink" signature, counsel should ensure that an exact replica of the document bearing a "wet-ink" signature exists in his or her possession;
- counsel should be aware that popular electronic case filing programs may, as a default setting, date the electronic signature as the date of filing or printing, which is incorrect—counsel need to ensure that the date of the electronic signature version is the date the original "wet-ink" signature was made on the document;
- counsel should have in place document retention procedures to ensure that documents subject to the rule are retained for the applicable four-year period; and
- counsel should be aware that the Bankruptcy Administrator and trustees may request that the Court require counsel to produce the original documents bearing "wet-ink" signatures.

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Are Domain Names and Telephone Numbers Property of the Estate?

By Jamie H. Stone

Understanding the Controversy

Whether it's for the purpose of providing collateral to secure DIP financing, being able to sell assets in a Section 363 sale, or determining whether a preferential transfer or fraudulent conveyance has occurred, how a court views a debtor's property rights in domain names and telephone numbers will determine how those assets can be used and conveyed in bankruptcy. The issue has arisen in various contexts in bankruptcy cases, with courts producing a range of results.

The heart of the controversy centers around the fact that on the one hand, both a domain name and a telephone number are issued and serviced by either a registrar or a telephone company and thus have attributes of a contract for use and services; on the other hand, both are also susceptible to increasing in value in the hands of the user and, particularly with a domain name, may represent the goodwill associated with a business. Thus, they also resemble a property interest in the hands of the user. In **Network Solutions, Inc. v. Umbro Intern., Inc.**, 259 Va. 759, 772 (2000), the court noted that both telephone numbers and domain names are "products of contracts for services [and that] neither one exists separate from its respective service that created it and that maintains its continued viability." (internal citation omitted.) In **Kremen v. Cohen**, 337 F.3d 1024 (9th Cir. 2003), the Ninth Circuit Court of Appeals explained that, "Someone who registers a domain name decides where on the Internet those who invoke that particular name – whether by typing it into their web browsers, by following a hyperlink, or by other means – are sent. Ownership is exclusive in that the registrant alone makes that decision. Moreover, like other forms of property, domain names are valued, bought and sold, often for millions of dollars, and they are now even subject to in rem jurisdiction [under 15 U.S.C. § 1125(d)(2), also known as the Anticybersquatting Consumer Protection Act]." *Id*. at 1030 (internal citation omitted). Courts have similarly recognized that the user of a telephone number can add significant value to the number through advertising and in developing customer familiarity over time. *See, e.g.,* **In re Pers. Computer Network, Inc.**, 97 B.R. 909, 910 (N.D. Ill. 1989).

Defining Property Interests

Property interests are defined under state law, but bankruptcy law determines which property will be included in property of the estate. *See* **In re Larry Koenig & Assoc., LLC**, 2004 WL 3244582, *6 (Bankr. M.D.La. 2004) (citing **Butner v. United States**, 440 U.S. 48, 55 (1979)); 11 U.S.C. § 541. In **In re Larry Koenig & Assoc., LLC**, the court applied Louisiana law which defined property as the "exclusive right to control an economic good, corporeal or incorporeal; it is the name of a concept that refers to the rights and obligations, privileges and restrictions that govern the relations of men with respect to things of value." *Id*. at *6. Noting the expansive definition of property rights in that state, the court determined that both a domain name and the contractual right to use it were property under Louisiana law and were property of the estate under 11 U.S. C. § 541. *Id*. at *7.

In **Kremen v. Cohen**, the court looked to the definition of property under California law, which included "every intangible benefit and prerogative susceptible to possession or disposition." 337 F.3d at 1030. The court went on to apply a three-part test requiring that there be "an interest capable of precise definition" which is "capable of exclusive possession or control," and that the "putative owner . . . establish[] a legitimate claim to exclusivity." *Id.*

Courts Finding Property Rights in Domain Names and Telephone Numbers

Several courts have concluded that domain names and telephone numbers constitute an intangible property right. *See, e.g.,* **Kremen v. Cohen**, 337 F.3d at 1030; **In re Sheppard's Dental Centers, Inc.**, 65 B.R. 274, 278 (Bankr. S.D.Fl. 1986) (including telephone numbers used by debtor before bankruptcy within those assets subject to Section 363 sale, together with "other similar intangible property"). Other courts have recognized that a property interest exists but have not clearly identified the nature of that interest. For example, in **Darman v. Metropolitan Alarm Corp.**, 528 F.2d 908, 910 (1st Cir. 1976), the court allowed the Chapter XI receiver (under the former Bankruptcy Act) to transfer "rights in the [telephone] numbers" because while the debtor's interest in the numbers was "undoubtedly subject to the paramount rights of the telephone company, the [debtor] plainly h[eld] a right of user[*sic*] superior to others."

Courts Finding No or Limited Interest in Domain Names and Telephone Numbers

On the other end of the spectrum, several courts have found that there is not a property interest created in a telephone number or domain name. In **Slenderella Systems of Berkeley, Inc.**, 286 F.2d 488, 489-90 (2d Cir. 1961), the Second Circuit decided, under the former Bankruptcy Act, that it did not have summary jurisdiction to determine the debtors' petition for an order enjoining the telephone company from changing the telephone numbers assigned to those debtors, or alternatively, to require the telephone company to furnish the new numbers to people calling the old numbers. The court found that under the California tariffs, rules, and regulations applicable to public utilities, and under the terms of the contracts, the debtors had no "proprietary right in the number." Rather, the debtors had a "license to use a specific telephone number . . . ." *Id.* at 490; *see also* **In re Best Re-Mfg. Co.**, 453 F.2d 848, 849 (9th Cir.

1971) (holding that the telephone number was not property of the estate but leaving open the question of whether the debtor had a contractual right to continued service).

The Fifth Circuit Court of Appeals explicitly disagreed with the holding in **Slenderella**, noting that bankruptcy laws take precedence over conflicting state laws, including the "self-serving" tariffs. **In re Fontainebleau Hotel Corp.**, 508 F.2d 1056, 1059 (5th Cir. 1975). Asserting that "[r]ight of use is surely the most important attribute of possession," the court held that it had summary jurisdiction to enjoin the telephone company from discontinuing service unless it was paid on unpaid bills. *Id*. at 1059.

In **Network Solutions, Inc. v. Umbro Intern., Inc.**, the Supreme Court of Virginia decided the issue of whether a domain name could be garnished under Virginia law. The court held that a garnishment of the domain name would equate to an impermissible garnishment of the services provided by the domain name registrar. 259 Va. at 770–2. Relying on this decision, in an appeal from the bankruptcy court, the District Court in **In re Alexandria Surveys Int'l, LLC**, 500 B.R. 817, 821-22 (E.D.Va. 2013), determined that, under Virginia law, the user of a telephone number or domain name does not have a property interest in that phone number or domain name. Thus, the court held that the Chapter 7 trustee could not sell the phone numbers and domain name used by the debtor because the bankruptcy estate had no interest in that property. *Id.* at 822. Alternatively, the District Court posited that if anything, the debtor had a possessory interest in the use of the phone numbers and domain name, created by its contracts with the communications provider. This possessory interest was lost when the trustee failed to timely assume the contracts with the communications provider under 11 U.S.C. § 365(d)(1). *Id.* The decision was appealed to the Fourth Circuit, which affirmed based on an issue of standing, but declined to address the substantive issue regarding the nature and extent of a debtor's property rights in telephone numbers and domain names. **Alexandria Consulting Grp., LLC v. Alexandria Surveys Int'l LLC**, 2014 WL 7388325 (4th Cir. Dec. 30, 2014).

Status of the Law in the Fourth Circuit

The status of the law in the Fourth Circuit and in North Carolina on these issues remains unclear. The Supreme Court of North Carolina has stated that the term property "means, in reference to the thing, whatever a person can possess and enjoy by right; and, in reference to the person, he who has that right to the exclusion of others is said to have the property." **Mial v. Ellington**, 134 N.C. 131 (1903). While this definition appears to be relatively broad, it is not as broad as the definition applied in **Kremen v. Cohen**. Further, it leaves open for interpretation what it means to "possess" or "enjoy by right" or to hold a right "to the exclusion of others." The Fourth Circuit, in **Harrods Ltd. v. Sixty Internet Domain Names**, 302 F.3d 214, 227-32 (4th Cir. 2002), broadly construed the provisions of the Anticybersquatting Consumer Protection Act to allow *in rem* jurisdiction over domain names with regards to certain claims brought under that Act as well as under other federal trademark laws. This decision may indicate a willingness to view domain names with the attributes of property rather than as a purely contractual interest.

While guidance can be gleaned from the decisions arising out of other jurisdictions, bankruptcy practitioners should be aware of the uncertain status of the law when making strategic decisions in bankruptcy cases where the outcome will turn on whether telephone numbers and domain names are property of the bankruptcy estate.

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NC Title Lien Perfection Without Borrowers' Cooperation

By Franklin Drake

My secured lender clients sometimes contact me in desperation because they believe they cannot get their liens recorded on North Carolina car titles. Their borrower-clients are not cooperating. Sometimes borrowers will fail to complete the paperwork necessary for an NC title to be issued in their names, upon vehicles bought with money my clients loaned them. Sometimes "clear" titles somehow get issued, without lenders' liens on them. The result is that the lenders cannot get their liens properly recorded with the DMV. They know unrecorded liens on titled vehicles are dangerous. Unlike mortgages on land, which generally must be recorded before they're enforced, unrecorded liens on titled vehicles are valid even if they're not recorded with the DMV. An unrecorded motor vehicle lien can, however, be defeated by sale.

The Headache

The problem usually arises only when the collateral for the loan bears a title certificate, like a car or truck. It does not occur when the collateral is non-titled "chattels" (like office equipment) or when the collateral is land. If the collateral is land, lenders usually won't disburse loan proceeds until the mortgage or deed of trust is recorded. (Oddly, lenders are careful not to disburse a $25,000.00 home equity loan until their mortgage is recorded, yet they will quickly disburse the same $25,000.00 on a car loan with no assurance their lien will be filed timely.)

> When the collateral is non-titled chattels, the borrower's cooperation simply isn't needed. If the collateral is consumer goods (*i.e.,* for personal, family, or household use) without a certificate of title, lien perfection is automatic. No certificate of title exists, and no filing is needed to perfect the lien. If the collateral is <u>non</u>-consumer goods without a certificate of title (*e.g.,* office equipment), the lender can e-file a UCC-1 financing statement with the North Carolina Secretary of State. Borrowers' signatures on UCC-1s have not been required since 2001. The borrower's cooperation is not required to perfect the lender's lien in these situations.

The Cause

Very often, the problem stems from the fact that the lender expects the borrower to diligently file all needed DMV paperwork so as to record the lender's lien when the new title application is filed. In other words, lenders want "the fox to guard their chicken for them," and are disappointed when the fox proves unreliable. Lenders are frustrated when their borrower drags his feet, or sometimes just refuses to cooperate. There are usually several reasons for this.

> New titles mean highway use taxes, title issuance fees, and troublesome lines at the DMV office. In North Carolina, the DMV does not even mail the new title to the owner if a lien is recorded on it; the new title gets mailed to the lender instead. Despite enduring the nuisance and cost of the DMV, the new owner does not even see the reward of a new title in hand.
>
> Sometimes the lender's lien somehow gets "left off" the DMV title application. As a result, the lender finds a "clear" title has been issued to the borrower, with no lien recorded on it. Worse, the borrower may fail or refuse to hand over that "clear" title, or to sign the DMV Form MVR-6, "Lien Recording Application." Neither will the borrower sign a new DMV Form MVR-1, "Title Application."

Sometimes months pass while the lender fruitlessly pesters the borrower to hand over the "clear" title or to get its lien recorded on a title transfer. The borrowers may or may not make their payments while they ignore the lenders' pleas. Eventually, the lender throws in the towel and either contents itself with no filing (ignores the problem) or calls a lawyer in desperation.

However, there is another solution.

The Remedy

The solution lies in N.C. Gen. Stat. § 20-58(a)(2). It has been there for years, too often unknown and underused. Lenders can use it without having to pay a lawyer, if they know how. Here is how:

- Stop trying to pester the borrower into cooperating. He has your money, he has his new car, and he now has amnesia about returning your calls for his help.
- Determine (i) whether the car's title has never been transferred into the borrower's name or not and (ii) whether a "clean" title has been incorrectly issued
- If the vehicle has incorrectly been issued a "clean" title, download and complete a fresh NC DMV Form MVR-6 "Lien Recording Application".
- If the vehicle has not been transferred into the borrower's name AND if there is no unsatisfied lien still on the "upstream" title still in the seller's name, download and complete a fresh DMV Form MVR-1, "Title Application."

- Complete the selected form with the borrower's name and address, the vehicle's description, your own name and address as lienholder, and the like. The borrower's signature is required in the "Disclosure Section" of each form. It is the lack of that signature that has been the real hold-up to this point. However, N.C. Gen. Stat. § 20-58(a)(2) allows the lender to dispense with the need for the borrower's signature. In place of the borrower's signature, the lender simply signs its own name. That signature gets notarized as usual.

- Create an "Affidavit of Explanation," telling the whole sordid story to the DMV. Attach a (redacted) copy of the loan agreement. Attach a (redacted) copy of the loan proceeds check (if any) or the ACH wire transfer information. Have the Affidavit signed by a lender's representative and notarized. The purpose is to explain to the DMV how and why the problem arose, and that the borrower will not cooperate in recording the lender's lien. If you want a model "fill-in-the blank" affidavit, contact the author.

- File the MVR-1 or MVR-6 with the Affidavit and any exhibits with the DMV. Be ready to pay the title issuance filing fee of $15.00. If there are unpaid highway use taxes or unpaid sales taxes, advance those too. Charge them to the borrower's account. You do not need to surrender the incorrectly issued "clear" title in order to obtain the new title.

- If you have access to the DMV Headquarters in Raleigh or to the DMV offices in Charlotte, you can file the papers in person and pay an additional $75.00 "Instant Title Fee." That means the lien is filed immediately AND you walk out of the DMV with a new title in hand. No waiting for the mail is required. The new title is still in the borrower's name, but the lender's lien now appears on it.

The Result

Mission accomplished. The borrower is eliminated from the whole process. The DMV will send the borrower a letter, telling him any old "clear" title is now voided. No, your lien will not "date back" to the loan note date. It will bear the current date, but it is far better than no filing at all. The borrower will probably call you to cuss you out. Relish the experience.

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Monetizing Debtors' Interests in Partnerships and LLCs

By Rebecca A. Fiss

When the owner of an interest in a business association becomes a bankruptcy debtor, her interest in the business becomes part of the bankruptcy estate. *See, e.g.*, **In re Shearin**, 244 F.3d 346, 349-51 (4th Cir. 2000). In many situations, especially in a Chapter 7 case or under a Chapter 11 liquidating plan, the trustee or debtor-in-possession ("DIP") needs to convert this business interest into cash. In other circumstances, the trustee or DIP wishes to assume the contractual agreement and continue in the business as usual. Whatever the situation, the trustee or DIP often faces opposition from the other business owners, whose interests may not align with those of the bankruptcy estate.

Decisions in this area of law can be messy, in part because business agreements are complex and varied and also because trustees and DIPs might pursue a number of different strategies to maximize the value of the business interest. Two elements often turn out to be determinative in these cases: first, whether the court finds the business agreement to be an executory or non-executory contract; and second, whether the court deems a particular element of the agreement or state law to be an *ipso facto* clause—that is, a provision triggered by the debtor's bankruptcy filing that attempts to terminate or modify the agreement. This article will focus on decisions in the Fourth Circuit regarding debtors' interests in partnerships and limited liability companies ("LLCs").

Executory Versus Non-executory Contracts

While the Bankruptcy Code does not define "executory contract," the Fourth Circuit has adopted the so-called Countryman definition, deeming a contract executory if "the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing performance of the other." Vern Countryman, "Executory Contracts in Bankruptcy: Part I," 57 *Minn. L. Rev.* 439, 460 (1973); *see* **Gloria Mfg. Corp. v. Int'l Ladies' Garment Workers' Union**, 734 F.2d. 1020, 1022 (4th Cir. 1984) (adopting the "Countryman definition"). Several decisions have considered the executory/non-executory distinction key, and have spent significant energy categorizing agreements as one or the other.

A notable Fourth Circuit decision in this area of law is **In re Catron**, 158 B.R. 624 (Bankr. E.D.Va. 1992), *aff'd*, 158 B.R. 629 (E.D.Va. 1993), *aff'd*, 25 F.3d 1038 (4th Cir. 1994) (per curiam). The debtor in **Catron** owned an interest in a general partnership dedicated to developing a shopping center. The partnership agreement ("PA") provided that if a member filed for bankruptcy, the filing would trigger an option in favor of the remaining partners to purchase the bankrupt partner's interest and continue the business. When the debtor-partner filed for Chapter 11, the remaining partners sought relief from the automatic stay to purchase the debtor's interest in the partnership. The DIP opposed the motion, implying (without stating) that he wished to assume the PA and continue in the business.

Under the majority rule, PAs are executory contracts. *See* **In re Catron**, 158 B.R. 629, 634. Thus, under most circumstances, a trustee or DIP could choose to assume or reject the PA under Section 365(c). In this case, however, the bankruptcy court held that the PA was a "personal services contract" and therefore could not be assumed or assigned by the debtor under Section 365(c)(1). Because a partnership is fundamentally "based upon the personal trust and confidence of the partners," the court reasoned, "the [PA] is essentially a contract for personal services, which renders it also nondelegable and nonassumable." **In re Catron**, 158 B.R. 624, 627 (citations omitted). The debtor, who formerly shared with his partners the goal of furthering the shopping center enterprise, now had "assumed the business of a [DIP] and fors[aken] allegiance to any one enterprise in order to follow the mandates of the Bankruptcy Code." *Id.* at 628. Thus, Catron the DIP was essentially a separate entity from Catron the pre-petition partner and could not assume the PA. In this situation, where the non-debtor partners were excused from accepting performance from a DIP or trustee, Section 365(e) did not invalidate the *ipso facto* clause in the PA and the partners' purchase option remained enforceable. The bankruptcy court granted the partners' motion for relief from stay, allowing them to buy out the debtor.

Unlike the decades-old **Catron**, the cases featuring debtors with interests in LLCs are fairly recent, in part because LLCs are comparatively modern business entities. Because of the relative lack of case law on LLC operating agreements, bankruptcy courts have had to be inventive. In contrast with the general rule deeming PAs to be executory contracts, courts analyzing LLC operating agreements ("OAs") have adopted a case-by-case approach.

In **In re Tsiaoushis**, 383 B.R. 616 (Bankr. E.D.Va. 2007), *aff'd*, No. 05-15135, 2007 WL 2156162 (E.D.Va. July 19, 2007), the debtor owned an interest in a LLC that owned real estate and operated a restaurant on the premises. The OA provided that, upon bankruptcy of a member, the LLC would be dissolved and promptly liquidated. The Chapter 11 trustee wished to enforce those provisions and liquidate the LLC. The manager of the LLC opposed the motion, arguing that the OA was an executory contract and that the automatic dissolution clause was an unenforceable *ipso facto* provision.

The court held that there was no per se rule governing the classification of OAs as executory or non-executory contracts, and that in this case the OA was not an executory contract. *See id.* at 620. The OA merely provided the structure for management of the company, and the debtor was a mere member with no managerial responsibilities, thus he had no unperformed duties. Further, despite the manager's argument to the contrary, the OA made clear that members owed no real fiduciary duty to the LLC or the other members: "The failure to perform a remote and speculative fiduciary duty, if one exists, is not a 'material breach excusing the performance of the other'" and so does not create an executory contract. *Id.* at 619 (footnote omitted). The court concluded that because the OA was not an executory contract, Section 365(e)(1) did not apply and the provisions calling for dissolution and liquidation of the LLC were "valid and fully enforceable." *Id.* at 621.

Another recent decision, **In re Warner**, 480 B.R. 641 (Bankr. N.D.W.Va. 2012), provides for an interesting comparison with **Tsiaoushis**. In this case, the debtor owned a one-sixth interest in a LLC that held title to his family's farm. The OA provided that the LLC would be dissolved upon the bankruptcy of a member unless the remaining members unanimously agreed otherwise. The Chapter 7 trustee commenced an adversary proceeding seeking a declaration that the OA required dissolution of the LLC. The defendants responded with a "resolution" that the debtor had been dissociated from the company and that the LLC would continue to operate.

The court stated that the key to determining the trustee's rights was to determine whether the OA was an executory contract. If the OA is an executory contract, the court explained, "the panoply of rules in [Section] 365 apply to affect" the trustee's rights and powers. *Id.* at 649. For example, if a contract is executory, Section 365(e) operates to invalidate *ipso facto* provisions that prevent the bankruptcy estate from receiving the benefit of the contract. The executory/non-executory distinction is significant even if a trustee failed to assume a contract, the court said, in part because a trustee could still potentially enforce provisions of the OA if it was not executory; by contrast, he could not enforce provisions of an unassumed executory contract. *Id.* at 650.

Here, the court held, the OA was not an executory contract. Factors relevant to the determination "include whether the [OA] imposes remote or hypothetical duties, requires ongoing capital contributions, and the level of managerial responsibility imposed on the debtor." *Id.* at 651. The debtor was not a manager of the LLC, never contributed capital, had no obligation to provide personal services, and could withdraw at any time. Nonetheless, the *ipso facto* provision dissolving the LLC upon the debtor's bankruptcy filing was invalid under Section 541(c), because it would prevent the full range of the debtor's rights regarding the LLC from becoming property of the estate. The court rejected the trustee's argument that he had "expanded rights" when it came to liquidating assets to realize value for the estate, holding that "[t]he Trustee steps into the Debtor's shoes and succeeds to all his rights under the [OA]." *Id.* at 656. The court acknowledged "that a trustee holding a debtor's interest in a LLC is in a knotty position to realize value for the estate." *Id.* at 657. However, the trustee had other options for monetizing the interest: he might be able to redeem the debtor's interest, appoint a receiver to operate the company, or exercise his right to seek judicial dissolution under the OA and state law. *Id.* (As to the non-debtor members, the court held that the their attempt to dissociate the debtor from the LLC violated the automatic stay.)

There is no easy way to reconcile the holdings of **Tsiaoushis** and **Warner**, given that both courts concluded that the OAs were non-executory. The court in **Tsiaoushis** relied on Section 365(e) to conclude that the dissolution clause was valid and never cited Section 541. The **Warner** court, meanwhile, referred to **Tsiaoushis** on multiple occasions without acknowledging a disagreement.

In re Klingerman

In re Klingerman, 388 B.R. 677 (Bankr. E.D.N.C. 2008), decided by Judge Thomas Small, is North Carolina's only significant decision in this area of law. Klingerman, as Chapter 11 DIP, brought an adversary proceeding to judicially dissolve and wind up an LLC in which he held an interest. The defendant, who was also a LLC member, countered that under the OA and North Carolina law, the plaintiff-DIP ceased to be a member of the LLC upon filing for bankruptcy and therefore he lacked standing to seek dissolution. (The defendant cited a North Carolina statute, now codified at N.C.G.S. § 57D-3-02, which provides that a person ceases to be a member of a LLC upon filing a voluntary bankruptcy petition.) Unlike the courts in **Catron**, **Tsiaoushis**, and **Warner**, the **Klingerman** court did not address whether the OA was an executory contract. Instead, relying on Section 541(c), the court held that the debtor's right to petition for dissolution was a noneconomic interest in the LLC, and a clause in the OA could not prevent that interest from becoming property of the estate. Judge Small rejected a decision from the Eastern District of Virginia, **In re Garrison-Ashburn**, L.C., 253 B.R. 700 (Bankr. E.D.Va. 2000), which held that a LLC member's bankruptcy estate only held the limited rights of an assignee of the debtor's interest. The **Klingerman** court explained, "Section 541(c) provides that *all* of the debtor's interest passes to the estate *notwithstanding* applicable nonbankruptcy law that effects a modification or termination of the debtor's interest upon the commencement of a bankruptcy case." **Klingerman**, 388 B.R. at 678 (emphasis in original). Allowing operation of a statute to convert a debtor's membership interest into that of an assignee modifies or terminates the interest and is invalid under Section 541(e). The court concluded, "Mr. Klingerman's rights and interest in the LLC, economic and non-economic, became property of the estate," and the DIP thus had standing to pursue dissolution of the LLC. *Id.*

Rights of First Refusal

Cases dealing with a right of first refusal ("ROFR")—that is, cases where the OA or PA purports to require the trustee to offer the debtor's interests to the other members before selling it to a third party—are a particularly interesting subcategory of this area of law. If the ROFR might prevent the trustee from maximizing the value of the business interest for the estate, need she comply with it? Two cases, **In re Grablowsky**, 180 B.R. 134 (Bankr. E.D.Va. 1995), and **In re Ichiban, Inc.**, Case No. 06-10316-RGM, 2014 WL 2937088 (E.D.Va. June 30, 2014), both say no, but engage in quite different analyses to arrive at that conclusion.

In **Grablowsky**, the PAs in a pair of related limited partnerships provided that if a person ceased to be a general partner, including by filing for bankruptcy, the remaining general partners had a ROFR as to the interest of the terminated partner. In liquidating the debtors' Chapter 7 estate, the trustee had negotiated the sale of the debtors' interest in the limited partnerships to some of the remaining general partners. Before the sale was consummated, however, a third party signaled its willingness to make a higher offer, and the trustee sought leave to sell the interests to the highest bidder. The court acknowledged, citing **In re Catron**, 158 B.R. 624 (Bankr. E.D. Va. 1992), that if the trustee sought to assume the PAs, he could not do so. *See* **In re Grablowsky**, 180 B.R. at 136. However, the court held the ROFR provisions invalid as *ipso facto* clauses triggered by the debtors' bankruptcy filing and directed the trustee to sell the partnership interests to the highest bidder. The court declined to rule on whether the PAs were executory contracts, arguing that the issue was irrelevant. *See id.* at 136 ("[W]hile the application of executory contract principles may make sense in connection with management issues, it does not make sense in the definition of property interests." (citation and quotation marks omitted)). The court held that the estate was "entitled to any bonus that may arise from [selling the interests]; only in that way can the Trustee realize the greatest value of the assets for the estate." *Id.* at 138.

In **In re Ichiban, Inc.**, the Chapter 7 trustee moved to sell the debtor's interest in a LLC to the highest bidder at a public auction. The LLC objected, citing its OA which provided for a two-tiered ROFR: first to the LLC, then, if not exercised by the LLC, to its members. Unlike the **Grablowsky** court, the court in **Ichiban** addressed the executory contract issue—specifically, whether a ROFR included in a LLC's OA was an executory contract that could be assumed or rejected. The court concluded that, in this case, the ROFR was an executory contract. However, the court drew a distinction between the particular ROFR at issue in this case and what it called a "naked right of first refusal." A "naked" ROFR, the court said, "is a right on the part of the non-selling member to purchase the selling member's interest where the [ROFR] automatically expires upon the failure to affirmatively exercise the [ROFR] within a reasonable period of time and the non-selling member, upon exercising the [ROFR], has no obligation other than to pay the purchase price." *Id.* at *2. That type of ROFR is not an executory contract, given that the failure of a non-selling member to exercise his right certainly does not constitute a material breach. "Nor does it become an executory contract upon exercise of the [ROFR] because the only performance required of the non-selling member is the payment of money." *Id.* By contrast, in **Ichiban** the OA imposed separate, unperformed duties on the LLC and its members, culminating in a transaction that was "exhaustively formulated with numerous steps and obligations." *Id.* For example, if the LLC chose not to exercise its own ROFR, it was required to give notice to the non-selling members before their ROFR could commence; failure to do so would result in a material breach. Members were also required to hire two appraisers if they could not agree on a sales price. The court thus held that in this case, the ROFR was an executory contract which was rejected by the Chapter 7 trustee. Accordingly, the court granted the trustee's motion to sell the interest to the highest bidder.

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Can't Touch This: Mandatory Abstention in the Wake of Stern v. Marshall

By Bethany A. Corbin

The poetic prose of Bob Dylan unintentionally captured the essence of modern bankruptcy jurisdiction with this simple observation: the times they are a changin'. In the past four years, the foundation of bankruptcy jurisdiction has been permanently altered by the violent earthquake known as **Stern v. Marshall**. Cracked and falling apart piece by piece, the pillars supporting bankruptcy judges' authority have begun to crumble and disintegrate, leaving bankruptcy enthusiasts to wonder whether the system may altogether collapse. In the post-**Stern** world, bankruptcy judges must not only grapple with the two-tiered structure of statutory vs. constitutionally core and non-core claims, but must now also face a quiet threat lurking in the shadows: mandatory abstention. This article analyzes the circumstances under which bankruptcy judges are required to abstain from hearing a case in light of **Stern**, thus exposing yet another wrinkle in the constantly evolving structure of bankruptcy jurisdiction.

I'm Too Sexy For This Case: Understanding Mandatory Abstention

The term "abstention" generally refers to a judicially-created doctrine designed to respect and delineate the boundaries between the state and federal judiciary. Pursuant to this doctrine, a judge will refuse to hear a case that intrudes upon the powers of another court. At its most basic level, abstention prohibits state courts from issuing federal constitutional rulings and limits the power of federal judges to adjudicate state law claims. In the context of bankruptcy cases, however, abstention is statutory, not judicial. *See* 28 U.S.C. § 1334(c). This statutory framework illuminates two categories of abstention when faced with bankruptcy claims: (1) mandatory abstention; and (2) permissive abstention.

Mandatory abstention seeks to strike a balance between the competing interests of federal bankruptcy courts and state courts. In its simplest form, mandatory abstention prevents federal courts from hearing non-core matters that can be timely adjudicated in a pending state court action. *See* **In re Mercer's Enters., Inc.**, 387 B.R. 681, 684 (Bankr. E.D.N.C. 2008). Requests for mandatory abstention must arise by motion of a party and may not be raised *sua sponte* by the court. Because mandatory abstention strips a bankruptcy court of its power to adjudicate a claim over which it possesses federal subject matter jurisdiction, the doctrine may only be invoked if six elements are satisfied: (1) a party has timely submitted a motion to abstain; (2) the cause of action is based upon a state law claim; (3) the action is a non-core proceeding (i.e. the action is "related to" the bankruptcy proceeding but does not "arise in" or "arise under" a Title 11 case); (4) the bankruptcy court would not otherwise have jurisdiction over the action outside of Section 1334; (5) the action was already pending in state court when the bankruptcy case was filed; and (6) the action may be timely adjudicated in the state court. *See* **In re Constr. Supervision Servs., Inc.**, Ch. 11 Case No. 12-00569-8-RDD, Adv. No. 12-00111-8-RDD, 2012 WL 2993891, at *3 (Bankr. E.D.N.C. July 20, 2012); **In re Mercer's Enters., Inc.**, 387 B.R. at 684. Failure to prove any element of this test eliminates mandatory abstention as a remedy.

In the absence of mandatory abstention, a court may nevertheless choose to permissively abstain from adjudication of a case. While mandatory abstention applies solely to non-core proceedings, permissive abstention is available for core claims. This voluntary form of abstention may be exercised "in the interest of justice, or in the interest of comity with State courts or respect for State law." 28 U.S.C. § 1334(c)(1). When determining whether permissive abstention is appropriate, bankruptcy courts in North Carolina employ a twelve-factor test that includes examination of the applicable law, the closeness of the claim with the main bankruptcy case, feasibility of severing the claims, the burden on the bankruptcy court's docket, concerns regarding forum shopping, and the extent to which state law issues dominate over bankruptcy issues. *See* **In re Pettus Props., Inc.**, Ch. 11 No. 10-31632, Adv. No. 11-3213, 2012 WL 956915, at *3 (Bankr. W.D.N.C. Mar. 20, 2012); **In re Freeway Foods of Greensboro, Inc.**, 449 B.R. 860, 879 (Bankr. M.D.N.C. 2011); **In re Newell**, 424 B.R. 730, 735-36 (Bankr. E.D.N.C. 2010). Thus, permissive abstention is within the discretion of the bankruptcy court and is used primarily for core proceedings.

Where the Wild Things Are: Core vs. Non-Core Claims

As evidenced by the third prong of the mandatory abstention test and the structure of permissive abstention, Section 1334(c) must be read in conjunction with 28 U.S.C. § 157(b), which delineates the distinction between core and non-core claims. This seemingly artificial divide between categories of bankruptcy actions arose in response to the Supreme Court's decision in **Northern Pipeline Construction Co. v. Marathon Pipe Line Co.**, 458 U.S. 50 (1982), which stated that judicial power could only be vested in an independent judiciary protected by Article III safeguards. In other words, because bankruptcy judges did not qualify as Article III judges, Congress did not have the power to grant them broad jurisdiction over state-created private rights of action arising independent from the bankruptcy proceeding. Faced with this holding, Congress passed the Bankruptcy Amendments and Federal Judgeship Act of 1984, which identified two categories of bankruptcy proceedings—core and non-core—in an effort to amend the bankruptcy court's jurisdictional reach.

Core proceedings encompass those claims that are directly related to the bankruptcy court's central functions. These claims must either "arise in" or "arise under" a Title 11 case. *See* 28 U.S.C. § 157(b). To be considered a core proceeding, the claim must not be able to exist in law in the absence of the Bankruptcy Code. Thus, a proceeding is core only if it invokes a substantive right created by federal bankruptcy law. All core proceedings may be heard by a bankruptcy judge, who possesses authority to enter final judgment on the merits.

On the other hand, a claim is considered non-core if it is simply related to the underlying bankruptcy case. *See* 28 U.S.C. § 157(c). A proceeding is related to a bankruptcy case if the outcome of the action could conceivably have an effect on the administration of the bankruptcy estate. A non-core claim thus exists outside the bankruptcy action and is one that can be asserted in the absence of the Bankruptcy Code. A non-core claim, however, may not be finally adjudicated by the bankruptcy court absent the parties' consent. Rather, barring consent the bankruptcy judge may only submit proposed findings of fact and conclusions of law to the district court for review.

Round and Round Here We Go Again: A Brief Recap of Stern

Although the bifurcated structure of bankruptcy jurisdiction into core and non-core claims existed peacefully for almost three decades, the Supreme Court reshaped the structure of bankruptcy authority overnight with its decision in **Stern**. According to **Stern**, it is no longer sufficient for bankruptcy judges to simply categorize proceedings as statutorily core or non-core. Instead, bankruptcy courts must analyze both the statutory and constitutional foundations for jurisdiction. This two-step inquiry limits bankruptcy judges to adjudicating claims that fall within one of two categories: (1) those that arise in the bankruptcy case itself; and (2) those that necessarily would be resolved in the claims allowance process. While a bankruptcy court may acquire jurisdiction by satisfying either prong, failure of both prongs restricts a bankruptcy judge to the entry of proposed findings of fact and conclusions of law for the district court's review. Therefore, although Section 157 sets forth the statutory foundation for bankruptcy jurisdiction, the Supreme Court has imposed a second layer of analysis by requiring compliance with constitutional standards.

Leave the Pieces When You Go: Mandatory Abstention in Light of Stern

The confusion and controversy surrounding **Stern** and its recently decided progeny, **Executive Benefits Insurance Agency v. Arkison**, has forced bankruptcy judges and practitioners to question the implications of these decisions on the doctrine of mandatory abstention. Specifically, **Stern** left unresolved the question of whether bankruptcy courts must abstain from adjudicating statutorily core but constitutionally non-core proceedings. Although North Carolina courts have not yet addressed the issue, bankruptcy courts across the country recognize that the constitutional inquiry implicated in **Stern** does not figure into the mandatory abstention analysis. In other words, mandatory abstention is dictated solely by a proceeding's classification as statutorily core or non-core.

The Bankruptcy Court for the Southern District of New York succinctly summarized this principle when it held that **Stern** and **Executive Benefits Insurance Agency** did not re-write Section 157 to transform **Stern** claims into statutorily non-core proceedings. **In re Residential Capital, LLC**, 515 B.R. 52, 66 (Bankr. S.D.N.Y. 2014). Rather, the court explained that the statutory and constitutional inquiries are separate and distinct. A constitutionally non-core claim will not require a bankruptcy court to abstain from adjudication altogether, it merely limits it to issuing proposed findings of fact and conclusions of law.

Similarly, the Southern District of Texas articulated that **Stern**'s imposition of a constitutional test "does not alter the statutory test for determining whether a proceeding is core." **Shipley Garcia Enters., LLC v. Cureton**, No. M-12-89, 2012 WL 3249544, at *10 (S.D. Tex. Aug. 7, 2012). The test for statutorily core claims remains whether the case arises in or arises under a Title 11 case. **Stern**, by its very language, does not implicate questions of subject matter jurisdiction. While **Stern** prohibits bankruptcy courts from entering final judgment on certain counterclaims deemed to be constitutionally non-core, "it did not rewrite the statute and reclassify those claims as 'related to' proceedings" under Section 157(c)(1) or Section 1334(c). *Id.*

The Bankruptcy Court for the Northern District of Iowa espoused similar reasoning in its 2012 case, **In re Civic Partners Sioux City, LLC**, Ch. 11 Case No. 11-00829, Adv. No. 11-9045, 2012 WL 761361 (Bankr. N.D. Iowa Mar. 8, 2012). The court held that the additional layer of analysis imposed by **Stern** was not required when examining the basis for mandatory abstention. *Id.* at *7. In support of this argument, the court noted that the language in **Stern** was purposefully concise and limited so as to emphasize the narrowness of its holding. By its express terms, **Stern** only examined the constitutional foundations for bankruptcy authority and "did not strike the entire structure in 28 U.S.C. § 157 allocating the division of authority into core and non-core proceedings." *Id.* at *8. Therefore, an analysis of mandatory abstention turns solely on the classification of a proceeding as statutorily core or non-core. The constitutional analysis set forth in **Stern** is inapplicable.

The reasoning espoused by the Bankruptcy Court for the Southern District of New York, the Southern District of Texas, and the Bankruptcy Court for the Northern District of Iowa is inherently sound. **Stern** deals solely with the authority of a bankruptcy judge to enter a final judgment on the merits, and does not alter the statutory classifications of claims as core or non-core. When faced with a **Stern** claim (i.e., a proceeding that is statutorily core but constitutionally non-core), North Carolina courts should refrain from mandatory abstention and engage solely in an analysis of permissive abstention, if applicable. A claim's categorization as constitutionally non-core is immaterial to its statutory classification as core. Because mandatory abstention deals solely with a proceeding's statutory description, **Stern** is irrelevant to the abstention inquiry.

Conclusion

Cases addressing mandatory abstention in the aftermath of **Stern** have come to an easily understandable conclusion: **Stern** is entirely separate and has no bearing on the doctrine of mandatory abstention. Rather, the only question is whether the claim itself is statutorily core. The fact that a claim may be constitutionally non-core is irrelevant to the mandatory abstention inquiry. Therefore, a claim that is statutorily core under Section 157 but only related to the bankruptcy case would still result in the claim being treated as overall core for mandatory abstention. Thus, only the claim's categorization under Section 157 matters for the abstention analysis.

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Western District Case Summaries

By Sara Ash and Derick Henderson

In re Gaddy, Case No. 14-40346 (Bankr. W.D.N.C. Oct. 22, 2014) (Whitley, J.)

Issue: Whether a debtor's second vehicle can be exempted as a "tool of the trade" under N.C.G.S. Section 1C-1601(a)(5) when it is primarily used for business purposes but is a standard vehicle with no special modifications or equipment necessary for business purposes.

Short Answer: No. The exemption provided by N.C.G.S. section 1C-1601(a)(5) for tools of trade cannot be used by a debtor to exempt a vehicle because the state legislature wrote a separate exemption specifically for a vehicle.

Summary:

The chapter 13 debtors claimed exemptions in two automobiles: a Jeep under N.C.G.S. Section 1C-1601(a)(3) (providing an exemption of up to $3,500 in value in "one motor vehicle") and a Ford truck under N.C.G.S. Section 1C-1601(a)(5) (providing an exemption of up to $2,000 "in value in any implements, professional books, or tools of the trade of the debtor or the trade of a dependent of the debtor"). The Ford truck was a standard pickup with no special modifications or equipment, but it was used primarily for the business purpose of delivering large, plastic water-tanks. The trustee objected to the debtors' exemption of the truck as a "tool of the trade."

The question of whether a debtor's second vehicle constitutes a "tool of the trade" was an issue of first impression before the court. Finding no state court decisions on the issue, the court looked to an analogous case in the Eastern District of North Carolina where a debtor hauled boats using his truck. **In re Trevino**, 96 B.R. 608, 610 (Bankr. E.D.N.C. 1989). In that case, the court held that the truck was not a "tool of the trade" but, rather, a "motor vehicle," and it could not qualify as a tool unless it was at least specifically modified for the trade. Similarly, the Fifth Circuit Court of Appeals found in **In re Belsom** that a school bus was not a tool of the trade. 434 F.3d 774, 776 (5th Cir. 2005). Tools were distinguished from vehicles under Louisiana exemption statutes as they are in North Carolina. The Fifth Circuit reasoned that, because the statute provided a specific exemption for one motor vehicle per debtor, the motor vehicle exemption trumped the general language of the tools exemption and to find otherwise would be to write a second motor vehicle exemption for the debtor.

Here, the court recognized that the Supreme Court of North Carolina held to the principle that "when two statutes arguably address the same issue, one in specific terms the other generally, the specific statute controls." **High Rock Lane Partners, LLC, v. NC DOT**, 336 N.C. 315, 322, 735 S.E.2d 300, 305 (2012) (citations omitted). Accordingly, the court concluded that the specific statute for automobiles is the proper way to exempt a truck. The court reasoned that omitting "automobiles" from the tools exemption and writing a separate and explicit exemption for automobiles means that the state legislature did not intend for automobiles to be considered tools of the trade. Therefore, the court sustained the trustee's objection to the debtor's claim of exemption under N.C.G.S. Section 1C-1601(a)(5), holding that the debtor's truck did not qualify as a tool of the trade because it was a standard automobile without special modifications for business purposes.

In re Meshell, Case No. 13-30694 (Bankr. W.D.N.C. Sept. 26, 2014 (Beyer, J.)

Issue: Whether a debtor with a tight budget can be permanently excused from paying her mortgage conduit in order to avoid the cost associated with the chapter 13 trustee's commission on the conduit mortgage payments.

Short Answer: No. A tight budget and the additional cost of the trustee's commission alone do not show the good cause and extraordinary circumstances necessary to justify excusal from the conduit system under Local Rule 3003-1(b) & (c).

Summary:

After filing a chapter 13 plan, the debtor filed a motion seeking permission to temporarily make her mortgage payments directly to the mortgagee rather than through her plan payments to the chapter 13 trustee. The debtor sought the temporary exclusion from the conduit system because she was attempting to modify her mortgage, and she proposed to begin paying her mortgage conduit upon its permanent modification. The court confirmed the debtor's plan and granted her motion for temporary exclusion.

After the mortgage modification was complete, the debtor filed a motion seeking permanent exclusion from the conduit system because of a tight budget due to decreased income and medical problems. The debtor lost approximately $13 per month, and she sought to pay her mortgage directly in order to avoid paying the chapter 13 trustee's additional commission of approximately $27 per month on the conduit payments.

The court established the conduit system by administrative order effective July 1, 2009, and later added the system to the local rules. Local Rule 3003-1(b) requires mortgages to be paid through the conduit system unless the court orders otherwise. Local Rule 3003-1(c)(1) allows debtors to be excused from the conduit system if they can show good cause and extraordinary circumstances. The

Rule also states that the additional cost of the trustee's statutory commission is by itself insufficient grounds for excusal.

The court found that a debtor in a bankruptcy case with a tight budget is not an extraordinary circumstance. The court reasoned that all debtors who file chapter 13 now have notice of the mandatory conduit system, and allowing debtors with arguably tighter budgets to be excused would force other debtors to carry more of the burden in supporting the district's chapter 13 cases. Further, there are other ways to adjust one's budget to make a chapter 13 plan feasible, and Rule 3003-1(c)(1) specifically provides that avoiding paying the trustee's commission is not a valid basis to be excused from conduit payments. Therefore, the court denied the debtor's motion to be permanently excused from the conduit system.

In re Protection Systems Technologies, Inc., Case No. 13-31778 (Bankr. W.D.N.C. Dec. 24, 2014) (Whitley, J.)

Issue: Whether the Court can allow a debtor's attorney's claim for fees incurred for the pre-petition, joint representation of the debtor, its majority shareholders, and a separate corporation formed by the majority shareholders when material conflicts of interest were present and the representation primarily benefitted the non-debtor parties.

Short Answer: No. The debtor's attorney's claim for fees must be disallowed because the attorney could not make a showing of good faith and inherent fairness when the claim is based on joint representation with non-debtors whose interests materially conflict with the debtor's interests.

Summary:

The Chapter 11 Debtor, Protection Systems Technologies, Inc. ("PST"), was owned by Futch (34%), Stout (33%) and Taylor (33%). In 2008, the shareholders had a falling out that led to Futch and Stout creating a separate company, BnW Real Estate, LLC. As majority shareholders of PST, Futch and Stout caused PST to assign its contract to purchase a building to BnW and to lease the premises to BnW, and they diverted PST business to BnW. When Taylor found out, Futch and Stout terminated his employment and shut him out of managing PST. Taylor sued.

In the state court suit, Taylor accused Futch and Stout of breaching fiduciary duties to him as a minority shareholder by usurping corporate opportunities of PST. Taylor sought the judicial dissolution of PST in order to cash out his equity interest. PST, BnW, Futch, and Stout were all represented by McNaughton & Associates, LLC. The court ruled for Taylor, finding that the majority shareholders did breach a special duty that caused him injuries distinct from any possible injury to other shareholders. Therefore, the court concluded that Taylor had individual actions for breach of fiduciary duty against Futch and Stout as majority shareholders and not just a shareholder derivative action. Rather than dissolve PST, the court awarded Taylor a money judgment equal to his distributive share of the company equity. The defendants appealed, and PST filed a Chapter 11 bankruptcy.

PST sought leave to continue its state court appeal, and it proposed that McNaughton continue to represent all of the defendants. PST argued that the judgment liabilities of Futch and Stout were shareholder derivative claims of the company itself and, therefore, belonged to the bankruptcy estate, not Taylor. PST further argued that it was legally obligated by its by-laws to indemnify Futch and Stout since the claims were asserted against them as directors of PST. In opposition, Taylor argued that PST had no indemnity obligations because the liabilities owed to him by Futch and Stout were founded on state law fiduciary duties of majority shareholders, not director obligations or derivative claims. Taylor further sought a ruling that collections against BnW, Futch, and Stout were not stayed by PST's bankruptcy. He also pointed out the conflicts of interest between PST, BnW, Futch, and Stout and asserted that McNaughton was ineligible to represent PST under 11 U.S.C. Section 327. Because of the conflicts of interest, a Chapter 11 Trustee was appointed. The Trustee determined that the state court appeals would negatively impact the creditor body even if successful. Ultimately, the above issues were never decided because the parties reached a settlement and a consensual Chapter 11 plan.

The undecided issues came to light again when Taylor objected to McNaughton's proof of claim for $25,145.00 in fees due from its representation of the defendants in the state action. McNaughton's invoice billed the whole amount to PST and did not distinguish between services rendered for PST, BnW, Futch, or Stout. Taylor argued that (1) PST had no legal obligation to pay the legal expenses of Futch, Stout, and BnW, and (2) PST had paid more than its share to McNaughton before it filed bankruptcy.

The facts above rebutted the presumed validity of McNaughton's proof of claim, shifting to McNaughton the burden to prove the amount and validity by a preponderance of the evidence. Further, because McNaughton was found to be an insider of the debtor, it had the additional burden of showing the inherit fairness and good faith of the challenged transaction.

The court found that BnW was a separate corporation created by Futch and Stout to exclude Taylor and to misappropriate corporate opportunities of PST. Thus, the court concluded that PST had no liability for the fees of BnW. The court further found that, due to the conflicting interests of PST and BnW, any payments PST had made for the fees of BnW were likely a Section 548 fraudulent conveyance rendering McNaughton's claim as unallowable under Section 502(d).

The court held that PST had no obligation or authority to pay Futch and Stout's legal fees because the state court had found that the two exceptions to the general rule against direct shareholder suits as defined by the Supreme Court of North Carolina were satisfied. Shareholders may bring an individual action for breach of fiduciary duty when (1) the wrongdoer owed them a special duty and (2) they suffered personal injury distinct from the injury sustained by the corporation. **Barger v. McCoy Hillard & Parks,** 346 N.C. 650, 659, 661, 488 S.E.2d 215, 219, 221 (1997). Here, Futch and Stout owed Taylor a fiduciary duty as a minority shareholder and Taylor suffered injuries separate and distinct from that of the company. The bankruptcy court further found that Taylor did not follow the statutory procedure required for a derivative action, so the state court judgment could not arise from such an action. In addition, even if the state court action had been a derivative claim, the North Carolina Statutes prohibit a corporation from indemnifying a director found liable to the corporation, liable for an improper personal benefit, or liable for acts clearly in conflict with the best interest of the corporation. Moreover, PST's own bylaws prohibited indemnification of a director for misconduct in his duties. Because Futch and Stout created a new company to loot the old, PST could not indemnify them either under state law or the company bylaws. Furthermore, Futch and Stout had expressly waived all claims in the confirmed plan.

Finally, the court held that PST had no further obligation to McNaughton even for its own fees because (1) the conflict of interest compromised McNaughton's representation and (2) PST already paid a disproportionate share of McNaughton's bill. Simply put, the court found that McNaughton was representing both the alleged victim and the alleged thieves, and PST had already paid significant sums for work that benefited others and no longer benefited PST since the judgment was for an equitable interest subordinate to the claims of PST's creditors.

In re Nitzsky, Case No. 14-30499 (Bankr. W.D.N.C. Sept. 18, 2014) (Beyer, J.)

Issue: Whether a creditor can enforce a state court Judgment in an Action for Summary Ejectment, where the Debtor filed for bankruptcy after the entry of the Summary Ejectment but before the ten-day period to appeal the Summary Ejectment has expired.

Short Answer: No. A creditor cannot enforce a Summary Ejectment entered prior to the bankruptcy but before the ten-day period to appeal the Summary Ejectment has expired because a creditor in that situation has not obtained a "judgment for possession" pursuant to the meaning of section 362(b)(22) before the Debtor filed for bankruptcy.

Summary:

In November 2013, the Debtor entered into a lease agreement with the Creditor. Subsequently, the Debtor defaulted on rent payments. As a result, the Creditor initiated proceedings to evict the Debtor per the summary ejectment process provided for under North Carolina law. On March 17, 2014, the Creditor was awarded the Summary Ejectment. Pursuant to N.C. Gen. Stat. 7A-228, the Debtor had ten days to appeal the Summary Ejectment, which would have stayed eviction proceedings pending a *de novo* appeal before a North Carolina district court judge. The Debtor did not appeal the Summary Ejectment and filed for Chapter 13 relief on March 27, 2014, the last day on which the Debtor could appeal the Summary Ejectment. The Creditor filed an Application to the Court for Judicial Assistance Determining that 11 U.S.C. 362(b)(22) Applies.

The court first held that Congress intended a "judgment for possession" in the context of 11 U.S.C. 362(b)(22) to mean a judicial order that was final and non-appealable. The court noted that pursuant to 11 U.S.C. 362(a)(3), the automatic stay applies to a state court judgment to evict a tenant for non-payment of rent unless an exception is otherwise provided for in the Bankruptcy Code. The exception to this rule is in section 362(b)(22), which provides that the automatic stay will not apply to an eviction proceeding of a residential tenant provided the landlord or creditor obtained a "judgment for possession" before the tenant/debtor files bankruptcy. The court held that, in accordance with the common meaning of "judgment," a court order must be final and non-appealable to meet the definition of judgment for possession under section 362(b)(22).

The court further held that a judgment in action for summary ejectment secured under North Carolina law that is subject to appeal, but has not been appealed before a debtor files bankruptcy, does not qualify as a judgment for possession. The court held that a judgment in an action for summary ejectment is not final when it is subject to appeal and therefore does not qualify as a judgment for possession under section 362(b)(22) because it is not a final and non-appealable order.

In re Caillaud, Case No. 13-30835 (Bankr. W.D.N.C. Oct. 21, 2014) (Whitley, J.)

Issue: Whether a debtor's bad faith and misrepresentations are sufficient to withhold an exemption.

Short Answer: No. Under both federal and North Carolina state law, a debtor's bad faith and misrepresentations do not constitute grounds to withhold an exemption.

Summary:

Debtor filed a voluntary petition for Chapter 7 Bankruptcy on April 19, 2013. The first meeting of creditors was held on May 22, 2013. Two days later, Debtor's father died intestate, leaving Debtor and her two siblings and his sole heirs. Debtor and her siblings sold their father's residence and received net sale proceeds of $28,225.40. Acting as coadministrator of her father's estate, Debtor disbursed a portion of the sale proceeds to herself. Debtor did not disclose the home sale transaction to the Trustee. The Trustee only became aware of the sale while conducting a real property records search in April 2014. Debtor's counsel informed the Trustee that the Debtor received only $6,000 from the transaction. The Trustee requested the Debtor's bank statements and demanded that she turn over the $6,000. The Trustee alerted Debtor's counsel that the failure to notify the Trustee of the distribution and the subsequent conversion of estate funds for her own use constituted grounds to revoke her discharge. Debtor's counsel later informed the Trustee that the Debtor received a much larger amount than previously indicated. During Debtor's subsequent 2004 examination, she admitted to withdrawing "close to $16,000" from her father's estate account, and advised the Trustee that she was unable to turn over her inheritance to the bankruptcy estate, presumably having dissipated the funds.

Debtor moved to amend her exemptions on June 30, 2014. According to Debtor, she had $4,980.72 in available exemptions she wished to use to offset a portion of the funds she received from her father's estate. The Trustee objected, arguing that the Debtor's false representations and omissions regarding her inheritance and her conversion of property of the bankruptcy estate funds constituted bad faith and that therefore the Court should deny her motion to amend exemption elections.

The parties agreed that the Supreme Court's decision in **Law v. Siegel,** 134 S.Ct. 1188 (2014) applied to the case. In **Siegel**, the Court considered whether bankruptcy courts possessed the power, either by statute or equity, to deny or surcharge a debtor's exemptions as a result of debtor misconduct. The Supreme Court determined that, absent specific statutory authority, bankruptcy courts do not have the power to deny a debtor's exemptions. Likewise, decisions post-**Siegel** uniformly hold that bankruptcy courts lack equitable power to deny leave to amend or disallow a claimed exemption based on bad faith. The Court held that, in light of **Siegel**, it was without statutory or equitable power under federal law to deny an exemption based on a debtor's bad faith or misconduct.

The Supreme Court in **Siegel** made clear, however, that "when a debtor claims a state-created exemption, the exemption's scope is determined by state law, which may provide that certain types of debtor misconduct warrant denial of the exemption." **Id.** at 1196-97. Because Debtor's claimed exemption was under N.C. Gen. Stat. 1C-1601(a)(2), the Court turned to North Carolina law to determine whether the Debtor's bad faith and misrepresentations were sufficient to withhold an exemption claimed under state law. The North Carolina General Statutes provide only three means by which a debtor may waive a personal property exemption: (1) transfer of property allocated as exempt; (2) written waiver, after judgment, approved by the clerk or district court judge; or (3) failure to assert the exemption after notice to do so pursuant to N.C. Gen. Stat. 1C-1603. The Court concluded that in light of the lack of other North Carolina authority that would waive a debtor's exemptions, combined with long-standing precedent that exemptions are to be applied liberally, wrongful actions by debtors had little bearing on their eligibility to claim state law exemptions. Consequently, the Court overruled the Trustee's objection and permitted Debtor to amend her exemptions to use her remaining $4,980.72 available under N.C. Gen. Stat. 1C-1601(a)(2).

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Eastern District Case Summaries

By Matthew Houston, Ike Johnston, and Travis Sasser

***In re Bate Land & Timber, LLC*, Case No. 13-04665-8-SWH (Bankr. E.D.N.C. Jan. 15, 2015) (Humrickhouse, J.)**

Issues:

1. Whether a debtor's plan is feasible under §1129(a)(11) and proposed in good faith under § 1129(a)(3) where a debtor proposes to satisfy a claim entirely via a "dirt-for-debt" plan?

2. Whether, under a partial "dirt-for-debt" plan, the debtor's surrender of a portion of the collateral securing a creditor's claim constitutes the "indubitable equivalent" of the secured claim?

Short Answers:

1. Yes. Where a debtor proposes to "pay a claim solely through a dirt for debt," the plan meets § 1129(a)(11). Further, where the totality of the circumstances supports a finding that the debtor had valid reasons for the classes created in its plan, the plan will satisfy § 1129(a)(3).

2. Possibly. In a partial dirt-for-debt plan, the debtor's surrender of a portion of the collateral securing a creditor's claim may constitute the "indubitable equivalent" of the secured claim where the property, valued at its "highest and best use," provides value equal to or in excess of the secured claim.

Summary: The debtor in a Chapter 11 case presented its plan of reorganization to the court for confirmation, while a secured creditor moved for relief from stay with respect to its secured claim of approximately $15,000,000. In its plan, the debtor proposed to surrender several parcels of real property collateral to satisfy the secured creditor's claim. The secured creditor objected to confirmation of the plan on the basis that the plan was not feasible under § 1129(a)(11), was not filed in good faith under § 1129(a)(3), and was not fair and equitable under § 1129(b).

Specifically, the secured creditor argued that the debtor's plan was not feasible under § 1129(a)(11) because it proposed to amortize the debt, thereby indicating that the debtor was unable to generate sufficient funds to make the amortized payments. However, in overruling this objection, the court explained that "[i]f the debtor chooses to pay [the secured creditor's] claim solely through dirt for debt, § 1129(a)(11) clearly is satisfied." Further, the secured creditor's objection with respect to good faith under § 1129(a)(3) was based on the argument that the debtor "created impaired accepting classes solely in order to achieve bankruptcy protection and thwart [the secured creditor's] foreclosure attempts." In rejecting these arguments, the court reasoned that, with respect to the first argument, the debtor had repaid a significant portion of its debt to the secured creditor, and the debtor had legitimate reasons for the classes in its plan. With respect to the second argument, the court noted that the debtor had reasonably financed the purchase of a tractor prior to bankruptcy to enable to debtor to conduct its operations and that, therefore, the purchase and subsequent classification of the party financing the tractor purchase was not improper. Moreover, the court concluded that the debtor properly executed a promissory note evidencing amounts it owed for prior legal services and that the execution of such a note did not indicate bad faith.

Finally, in concluding that the plan *could* comply with § 1129(b) depending upon the real property the debtor proposed to surrender to the secured creditor, the court noted that a partial dirt-for-debt plan may satisfy § 1129(b) where the surrendered property is sufficiently valuable to satisfy the secured creditor's claim. With respect to the properties the debtor proposed to surrender, the court evaluated competing appraisals of the properties and concluded that the "best and highest" use of the properties was that of residential development based on their physical possibility, legal permissibility, and financial feasibility. Based upon the competing appraisals, the court reached a valuation for the properties at $8,843,000.00 - less than the secured creditor's claim. However, as the debtor's plan contained a contingency to surrender additional collateral upon the court's finding of whether the original properties constituted the "indubitable equivalent" of the creditor's claim, the court granted the debtor additional time to identify the additional properties necessary to constitute the "indubitable equivalent" of the secured claim. The court further denied the secured creditor's motion for relief based on the court's determination that the secured creditor was fully secured.

***In re Province Grande Olde Liberty, LLC* (*Levin v. Province Grande Olde Liberty, LLC*), Adv. Pro. 13-00122-8-RDD, Case No. 13-01563-8-RDD (Bankr. E.D.N.C. Dec. 5, 2014) (Doub, J.)**

Issues:

1. Whether a court may recharacterize a creditor's debt claim as an equity contribution where all or most factors support a finding that the debt was, in fact, an equity contribution?

2. Whether such a claim should be equitably subordinated to other claims absent fraud, bad faith, or other improper conduct?

Short Answers:

1. Yes. In accordance with the court's powers to carry out the Bankruptcy Code, it may recharacterize a debt claim as an equity contribution where the applicable factors apply.

2. No. Absent fraud, bad faith, or other improper conduct, a court should not equitably subordinate a claim.

Summary: The plaintiffs filed a complaint against the defendants in an adversary proceeding, requesting that the court recharacterize the claim of PEM Entities, LLC ("PEM"), subordinate that claim to the plaintiffs' claims in the debtor's bankruptcy, and avoid certain allegedly fraudulent transfers from the debtor. The plaintiffs moved for summary judgment in the case. Specifically, certain minority members of the debtor created PEM for the purpose of purchasing the promissory note secured by the debtor's real property, which was being foreclosed on by the bank, and contributed $300,000 to PEM for this purpose. PEM also borrowed money to finance the purchase of the debt, including a loan from the bank selling the promissory note. In evaluating the plaintiffs' claim that PEM's claim (i.e., the debt purchased from the bank) should be recharacterized as an equity contribution, the court noted that the eleven *Dornier Aviation* factors determining whether recharacterization is appropriate include (1) names for instruments of indebtedness, (2) presence of fixed maturity dates and payment schedules, (3) fixed interest rates and payments, (4) repayment sources, (5) adequacy of capitalization, (6) identities of interest between creditor and stockholder, (7) security for the advances, (8) corporation's ability to obtain financing from other sources, (9) subordination of advances to outside creditors, (10) use of advances for capital asset acquisition, and (11) present of sinking fund to provide repayments. *See In re Official Comm. of Unsecured Creditors for Dornier Aviation (N. Am.), Inc.,* 453 F.3d 225, 231(4th Cir. 2006).

In reviewing these factors, the court specifically found that, in this case, (1) the debt instrument was a "settlement agreement," (2) the debt had no established maturity date, interest rate, or payment schedule, (3) the debtor was not adequately capitalized, (4) all but one of the members of PEM was an insider of the debtor, (5) the debt was secured by a note and deed of trust, (6) there was no evidence the debtor could receive outside funding, (7) there was no evidence the claim was subordinated or used to purchase additional capital assets, and (8) there was no evidence of a fund established to repay the contributions. In light of these conclusions, the court recharacterized PEM's claim as an equity contribution, though the court held that the plaintiffs' entitlement to the benefit of the recharacterization was dependent upon pending state-court litigation.

With respect to the plaintiffs' request that the PEM claim be equitably subordinated to their own, the court noted that equitable subordination is governed by 11 U.S.C. § 510 and that the court's equitable powers only arise where the claim is fraudulent or a claimant acts in bad faith or otherwise improperly. With respect to the PEM claim, the court concluded that insufficient evidence existed to find fraud, bad faith, or improper conduct because the negotiation of the settlement agreement was an arm's length transaction and that the recharacterization of the REM claim was insufficient to justify a finding that the claim should be subordinated. Thus, the court rejected the plaintiffs' request to equitably subordinate the PEM claim.

Finally, the court rejected the plaintiffs' fraudulent transfer claim for lack of standing as applicable law provides only for such claims to be brought by the debtor or trustee – not individual creditors.

***In re Jeffrey*, Case No. 14-03558-5-SWH (Bankr. E.D.N.C. Aug. 29, 2014) (Humrickhouse, J.)**

Issue: Whether sanctions against a creditor are appropriate pursuant to the court's contempt power where the creditor refuses to comply with a turnover order.

Short Answer: Yes. Where a creditor refuses to comply with a turnover order, the court is empowered to impose sanctions on the creditor, including for attorneys' fees.

Summary: On June 19, 2014, the debtor filed a Chapter 13 bankruptcy petition. Prior to the debtor's petition, on June 10, 2014, a secured creditor holding a lien on the debtor's car repossessed the car. After the court granted the debtor's subsequent motion for a turnover order with respect to the car, the secured creditor refused to comply with the order. The debtor delivered a copy of the turnover order to the creditor, and the debtor's counsel also repeatedly explained to the creditor that it was required to return the car. However, the creditor refused to do so absent a payment of $2,000.00. The creditor also provided false information regarding its contact information to the debtor's counsel.

Because of the creditor's refusal to return the car, the debtor was required to hire a taxi to travel to and from work and was forced to delay the start date for her second job by over a month, thereby causing the debtor significant financial distress. In light of these actions, the court granted the debtor's motion to hold the creditor in contempt and to sanction the creditor. The court again ordered the return of the car, cancelled the balance due on the debtor's note to the secured creditor, ordered the secured creditor to cancel its lien on the car and to return the title to the debtor, and ordered the creditor to pay $7,500.00 to the debtor for attorneys' fees and other expenses and damages.

***In re Evans*, Case No. 10-05397-8-DMW (Bankr. E.D.N.C. Jan. 5, 2015) (Warren, J.)**

Issue: Whether life insurance proceeds the male debtor became entitled to post-confirmation because of the female debtor's death were a part of the Chapter 13 bankruptcy estate, and if so, whether the receipt of the funds constituted a substantial and unanticipated change in post-confirmation financial conditions warranting modification of the confirmed Chapter 13 plan?

Short Answer: Yes. The life insurance proceeds payable to the male debtor became property of his Chapter 13 estate, and receipt of the death benefit funds was a substantial and unanticipated change in his post-confirmation financial conditions warranting plan modification.

Summary: The debtors purchased two life insurance policies in July, 1995. The male debtor was the beneficiary of the female debtor's policy. Beginning around 1999, the female debtor suffered extensive medical problems and was unable to work full-time. Around 2007, the female debtor was diagnosed with aggressive metastatic breast cancer and underwent treatment. The debtors filed a joint petition for relief under Chapter 13 on July 7, 2010. The female debtor was between cancer treatments at the time of filing, and her doctors had not given her an estimate of her life expectancy at that time. At the § 341 Meeting of Creditors on August 2, 2010, the debtors testified that the female debtor was disabled but did not elaborate.

The female debtor died on April 23, 2014, and the male debtor filed a Notice with the Court on May 7, 2014, indicating that he was entitled to receive life insurance proceeds as a result of his wife's death. The gross value of the insurance payout was $200,000.00, and after payment of a policy loan and funeral home expenses, the male debtor received a net amount of $169,796.29. The Chapter 13 Trustee filed a Motion to Modify the debtor's confirmed plan. Relying on *Carroll v. Logan*, 735 F.3d 147 (4th Cir. 2013), the Court concluded that § 1306(a) brought the life insurance proceeds into the Chapter 13 bankruptcy estate. Pursuant to *Murphy v. O'Donnell (In re Murphy)*, 474 F.3d 143 (4th Cir. 2007), the Court concluded that the male debtor's receipt of $169,796.29 qualified as a substantial change and that the change had been unanticipated.

The Court relied on the male debtor's testimony that, at the time of plan confirmation, no individual involved in this case had reason to expect the female debtor would not have survived beyond the plan's commitment period. Not until late 2011 was the female debtor given an estimated two years to live. The Court rejected the argument that the Trustee could have anticipated the circumstances from the debtors' Schedules and record in the case. The Court also concluded that it was not inequitable to require the life insurance proceeds to be paid into the plan. Accordingly, the Court granted the Trustee's Motion to Modify requiring the male debtor to pay into the plan a lump sum sufficient to pay in full the allowed unsecured claims that are either joint debts or in his name only.

***In re Harris*, No. 14-04458-5-RDD (Bankr. E.D.N.C. Dec. 24, 2014) (Doub, J.)**

Issue: Whether an above-median-income Chapter 13 debtor, in calculating Disposable Monthly Income pursuant to 11 U.S.C. § 1325(b)(3), may only deduct from Current Monthly Income the lesser of the actual home and vehicle payments or the corresponding IRS Local Standards.

Short Answer: Yes. Above-median-income debtors are only entitled to deduct the lesser of the actual home and vehicle payments or the corresponding IRS Standards when calculating Disposable Monthly Income on Form B22C.

Summary: The Debtors filed a Chapter 13 case and filed the required Form B22C to determine the Debtors' Disposable Monthly Income. The Debtors calculated their household income to be above the median family income for comparably sized households in North Carolina. The Debtors listed a monthly disposable income under 11 U.S.C. § 1325(b)(2) of negative $737.57. To arrive at the monthly disposable income figure of negative $737.57, the Debtors took several deductions including: (1) On Line 25B for their mortgage/rent expense, the Debtors did not deduct anything where the Debtors' average monthly payments for their residence was $1,357.67 and the IRS Local Standard was $885.00; (2) On Line 28 for transportation ownership/lease expense, the Debtors deducted $354.62 for net ownership/lease expense where the Debtors' average monthly payment for their 2010 Hyundai Elantra was $162.38 and the IRS Local Standard was $517.00; (3) On Line 47 for deductions for debt payment, the Debtors deducted the sums of $162.38 for the 2010 Hyundai Elantra and $1,357.67 for their residence; and (4) On Line 48 for the cure amount for secured claims, the Debtors deducted $78.76 representing 1/60th of the cure amount of their prepetition mortgage arrears.

The Trustee filed an Objection to Confirmation and Motion to Dismiss and requested that the Court deny confirmation of the Debtors' proposed plan for failure to comply with the "projected disposable income" requirement of 11 U.S.C. § 1325(b) because an above-median-income debtor is only entitled to deduct the lesser of their actual home and vehicle payments or the corresponding IRS Standards. The Trustee further contended that if a debtor's actual home or vehicle payments exceed the IRS Standards, then the debtor may deduct additional amounts over and above the amounts of the IRS Standards, but only upon a showing that such deductions are reasonable and necessary and as a special circumstance under § 707(b)(2)(B). The Court held that the IRS Local Standard home and vehicle allowances serve only to operate as a "cap" on the amount the Debtors may deduct when their average monthly payments exceed the IRS. Thus, the Debtors were entitled to deduct the IRS Standard "cap" amount of $885.00 on Line 25B and nothing on Lines 47 and 48. Further, the Court held that the Debtors could deduct only the applicable amount actually expended for the corresponding IRS Standards when the Debtors' actual vehicle payment is lower than the national standard. Thus, the deduction on Line 28 should have been $162.38, and no further deduction should be taken on Line 47. The Court granted the Trustee's Motion to Dismiss, which was stayed for seven days to allow the Debtors to file an amended Form B22C in accordance with the Court's rulings.

***In re Frank*, No. 12-06722-8-SWH (Bankr. E.D.N.C. Oct. 23, 2014) (Humrickhouse, J.)**

Issue: Whether the rights of a secured claim holder could be modified where the secured claim was secured by two adjacent lots – one containing a house and outbuilding and the other containing a swimming pool connected to the house by a walkway – and the claim was alleged to be secured by property other than the debtor's principal residence and thus was not subject to the anti-modification provision of 11 U.S.C. § 1322(b)(2).

Short Answer: No. Despite the fact that a swimming pool was located on the remote parcel away from the lot containing the residential building, the "mortgage documents control" approach indicated that both parcels were intended to be used as the debtor's principal residence as evidenced in the deed of trust and rider executed at the time of the granting of the security interest in the real property. Thus, the claim was secured only by a security interest in real property that is the debtor's principal residence and the rights of the secured claim holder could not be modified under § 1322(b)(2).

Summary: The Debtor filed a Chapter 13 case and filed a motion seeking to determine the applicability of 11 U.S.C. § 1322(b)(2) and proposing to alter the treatment of the secured claim holder by bifurcating the secured claim, stripping down the lien, and modifying treatment of the mortgage claim. The claim was secured by two lots owned by the Debtor, one containing the Debtor's house and an outbuilding and the other being an adjacent lot that was undeveloped except that the Debtor installed on it a swimming pool and a walkway and fence that connected the pool to the house located on the first lot.

The first lot containing the house was acquired by the Debtor in December 2004. The second lot containing the pool was acquired by the Debtor in July 2005. In 2007, the Debtor granted to the secured claim holder a Deed of Trust on both lots to secure a promissory note. The Deed of Trust contained legal descriptions of both lots. The Deed of Trust was accompanied by only one rider, and "Adjustable Rate Rider," which contained the statement: "Borrower shall occupy, establish, and use the Property as Borrower's principal residence." The Debtor testified at hearing that he had the swimming pool installed for his personal and family use and that it was installed prior to the recordation of the 2007 Deed of Trust that encumbered both lots.

The Debtor's motion argued that only the first lot could be considered as the "debtor's principal residence", that the second lot containing the pool is a separate lot which is not used as the Debtor's principal residence, and that the secured claim was therefore not subject to the anti-modification provision of § 1322(b)(2). The Debtor further supported the motion with an appraisal that would have enabled bifurcation and stripping of the secured claim holder's lien. The Court determined that the "mortgage documents control" approach was applicable as both the Debtor and the secured claim holder had manifested expectations that both lots were to be used as the Debtor's principal residence. The legal descriptions of both lots were contained in the Deed of Trust and there was a statement in the Adjustable Rate Rider that the Debtor would use the property as a principal residence.

The Court found that there were no changed circumstances with regard to the use of the property as the Debtor had in fact used both lots as a principal residence ever since the execution of the Deed of Trust. The Court further found that the evidence indicated that the adjacent lot containing the pool was seamlessly integrated in the Debtor's use of his residence and acted as an expanded back yard and recreation area in connection with the residence. The Court concluded that both lots were currently, and at all relevant times had been used as, the Debtor's principal residence. The Court denied the Debtor's motion to modify the rights of the secured claim holder as doing so would be inconsistent with the anti-modification provision of § 1322(b)(2).

***In re Martish*, No. 14-02975-5-DMW (Bankr. E.D.N.C. Jan. 12, 2015) (Doub, J.)**

Issue: Whether collection costs and unpaid interest that accrued for approximately 15 years on a student loan claim that was disallowed but determined to be nondischargeable in a prior bankruptcy proceeding were properly claimed and allowed in a later bankruptcy case.

Short Answer: Yes. Collection costs and unpaid interest that accrued on a student loan for approximately 15 years from the debtor's prior bankruptcy case were nondischargeable components of the student loan claim and were properly claimed in the later bankruptcy case.

Summary: The Debtor filed two bankruptcy cases, the first in 1998 and the second in 2014. The Debtor was obligated on a student loan claim that had been guaranteed by a guaranty agency and was transferred to the guaranty agency upon the Debtor's pre-petition default. The Debtor filed an objection to a student loan claim in 1999 on the basis that the claim was filed past the bar date for claims, and an order was entered disallowing the proof of claim. The 1998 bankruptcy case was converted to Chapter 13 and the Debtor received a discharge in 2001. The student loan creditor began garnishment proceedings following the discharge, and the Debtor objected to the garnishment. The Debtor's objection was heard at an administrative hearing in 2002. At the 2002 hearing, the Debtor's objection was denied by a written order finding that the student loan claim was nondischargeable despite the claim being disallowed for not being timely filed.

The Debtor filed another Chapter 13 in 2014. The student loan creditor filed a timely proof of claim, and the Debtor objected to the claim. This time the Debtor objected to the claim on the basis that the collection costs assessed against the student loan were discharged in the 1998 bankruptcy and that payments received since 1998 had been misapplied. All payments that the Debtor had submitted to the student loan since 2002 had been applied to collection costs and accrued unpaid interest by the creditor pursuant to federal regulations. Because the Debtor had continued to carry an outstanding balance and had continued accruing interest on the student loan, no portion of any payment received by the creditor had been applied toward the principal balance.

The Court found that it was bound by the 2002 decision of the Administrative Court which found that the collection costs regarding the student loan claim were nondischargeable. The Court further found that certain federal regulations dictated that the guaranty agency was required to impose collection costs on the student loan obligation. The Debtor presented no evidence to disprove the amounts owed to the guaranty agency for collection costs or amounts due under the obligation, including amounts for post-petition accrued interest. Further, the Debtor presented no legal authority or factual evidence to support the allegation that the collection claim was unenforceable as a penalty or was otherwise dischargeable. The Court held that the collection costs assessed by the guaranty agency against the Debtor and the unpaid accrued interest were nondischargeable and that the inclusion of these costs in the 2014 proof of claim was proper. The Court noted that neither the 1999 disallowance of the first proof of claim nor the 2001 discharge affected the collection costs and post-petition interest because the items were both nondischargeable. The Court denied the Debtor's objection to claim and allowed the proof of claim as filed.

***Angell v. Faison (In re Faison*, 518 B.R. 849 (Bankr. E.D.N.C. 2014) (Humrickhouse, J.)**

Issues:

1. Whether a filed lis pendens can defeat the bankruptcy estate's position in real property based on 11 USC §544(a)?

2. Whether an ex-spouse's unperfected interest in an LLC can defeat the bankruptcy estate's position under 544(a)?

3. Whether a lis pendens filed more than 1 year pre-petition combined with a renewed motion for a declaration of separate property in state court in the 12 months pre-petition creates an avoidable preference under 547(b)?

Short Answers:

1. The lis pendens renders the bankruptcy estate's position inferior to the outcome of the state court proceeding as regards real property.

2. The bankruptcy estate's position was superior to a spouse's unperfected interest in an LLC.

3. Because the lis pendens was filed more than 1 year pre-petition, there was no avoidable preference despite the timing of the renewed motion for a declaration of separate property in the 12 months pre-petition.

Summary: Lindy and Bill executed a premarital agreement on March 11, 1988, and married on March 26, 1988. After marriage, the couple acquired parcels of real property held as tenants by the entireties (the "Subject Properties"). Additionally, the couple created Pheasant Field Farm, LLC, of which Bill held 80% and Lindy held 20%. The couple separated in 2009, and a state court proceeding was commenced for, among other things, equitable distribution of property. Lindy sought an unequal distribution of marital and divisible property. Lindy filed Notices of Lis Pendens related to the Subject Properties. A divorce judgment was entered November 15, 2010. Bill filed an answer in the state court proceeding, asserting that although property was acquired during the marriage, its ownership was controlled by the terms of the premarital agreement, which substantially limited or barrred Lindy's claims for equitable distribution. On September 22, 2010, Bill filed a motion for a declaration of separate property pursuant to the premarital agreement. He renewed the motion on January 17, 2013.

Lindy filed for chapter 7 on July 22, 2013. The chapter 7 trustee initiated the adversary proceeding to seek a determination that, pursuant to 11 U.S.C. § 544(a), Bill's interests in the Subject Properties and the LLC was inferior to the interests of the bankruptcy estate. In the alternative, the chapter 7 trustee asserted that the lis pendens combined with Bill's motion for declaration of separate property resulted in an avoidable preference. The Court held that the filing of the lis pendens by Lindy resulted in the bankruptcy estate's position being inferior to the outcome of the state court proceeding as to the real property. The Court held that as to the 20% interest in the LLC, the estate's position was superior to Bill's because Bill had not perfected his interest in the 20% with a financing statement. The Court also held that there was no avoidable preference because the lis pendens had been filed more than 12 months pre-petition.

***Brantley v. Citifinancial, Inc. (In re Brantley)*, Case No. 13-00483-8-DMW (Bankr. E.D.N.C. Jan. 15, 2015) (Warren, J.)**

Issues:

1. Whether the bankruptcy court has an independent duty to determine the reasonableness and fairness of a settlement agreement between parties?

2. Whether money awarded to a debtor as compensation for emotional distress inflicted by a creditor's improper conduct can be properly exempted as "compensation for personal injury"?

Short Answers:

1. The Court has an independent duty to evaluate the reasonableness of settlements.

2. Damages arising from a stay violation could not be exempted, at least under the facts before the Court.

Summary: Chapter 13 debtors filed a complaint against Citifinancial, alleging actual and punitive damages for violations of the automatic stay and North Carolina state law regulating creditor conduct. A settlement agreement was reached in which the defendant agreed to pay to the debtor $49,000. The debtors amended their Schedule C to claim that amount as exempt under the "personal injury" exemption. The Court denied the motion to settle on the grounds that "a bankruptcy judge may not simply accept [the proponent's] word that the settlement is reasonable, nor may [the judge] merely 'rubber stamp' a proposed settlement without an individual determination that the settlement is reasonable." *In re Ionosphere Clubs,*156 B.R. 414, 426 (S.D.N.Y. 1993). The Court held that $49,000 was disproportionate to the "alleged stay violations and alleged inconveniences, such as nausea and anxiety."

Even after having denied the motion to settle, the Court turned to the question of whether such an award could properly be exempted as "compensation for personal injury." There were two components to this question. First was the absence of any objection to the amended Schedule C a bar to the Court considering the validity of the claimed exemption. It was no such bar, the Court held. "Hoping that the trustee will not 'catch' an improperly claimed exemption is not the mark of an honest debtor who seeks a discharge."

The second component to the exemption question concerned whether an award of damages for violations of the automatic stay and various state law collection statutes (even when those damages cite various anxiety-related physical manifestations) can ever be properly exempt as being in the nature of personal injury. The Court's opinion is inconclusive on this point and primarily criticizes the absence of any specific testimony or allegations in the pleadings that the distress symptoms of the debtors were the result of a personal injury inflected upon them. At the very least, the Court writes, the complaint should have "separate[d] the proceeds into what may be for actual damages…versus what portion is meant to represent punitive damages related to Plaintiff's emotional distress." Even with sufficient testimony and a parsing out of how the settlement award was apportioned between damages and sanctions, the Court's skepticism is undisguised that a relatively benign violation of the automatic stay could ever rise to the level of personal injury.

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Middle District Case Summaries

By Jennifer B. Lyday and Tonya L. Urps

***In re ES2 Sports & Leisure, LLC*, Case No. 14-10412 (Bankr. M.D.N.C. September 11, 2014) (Kahn, J.)**

Issue: Whether a creditor was entitled to an administrative expense claim pursuant to 11 U.S.C. § 503(b)(1)(A) for the estate's use of its leased equipment between the petition date and the date the equipment was abandoned by the Trustee pursuant to § 554(b).

Short Answer: No. The creditor was not entitled to payment of its administrative expenses because the arrangement between the creditor and the debtor was not a 'true lease' as defined by N.C.G.S. § 25-2-401(2). Instead, it was a disguised secured transaction which does not give rise to an administrative expense claim under 11 U.S.C. § 503(b)(1)(A).

Summary: The debtor filed a petition for relief under Chapter 7 of the Bankruptcy Code on or about April 15, 2014. Prior to the bankruptcy, the debtor conducted its primary business through the lease of certain personal and real property commonly known as "Forest Oaks Country Club." The debtor entered into an equipment lease with Leasing Innovations in connection with its operation of the premises. While styled as a "lease", the arrangement provided for monthly payments and was non-cancelable during its entire forty (40) month term. Additionally, the debtor had the option of purchasing the equipment at the end of the lease term for $1.00.

A lessor may obtain an administrative expense claim under 11 U.S.C. § 503(b)(1)(A) when property that is owned by the lessor is used by the trustee for "the actual, necessary costs and expenses of preserving the estate…." However, as a threshold matter, the Court had to determine if the equipment was the subject of a true lease. If the equipment lease was not a true lease, but was instead a disguised secured transaction, then the creditor would not be entitled to an administrative claim. Whether or not an agreement is a true lease or a disguised secured transaction is governed by N.C.G.S. § 25-1-203. The issue is determined by the facts of each case.

The Court, applying a two part test established by § 25-1-203, ruled that the equipment lease was a per se disguised secured transaction because the lease was not terminable by the debtor/lessee during the term of the lease, and the $1.00 purchase option at the end of the lease was for a nominal amount. The Court went on to note that the creditor, as the holder of a security interest in the leased equipment, never requested adequate protection or relief from the stay at any time prior to the trustee's abandonment of the equipment, and was therefore prohibited from requesting an allowance of an administrative claim in the guise of lease payments.

Finally, the court noted that even if the equipment lease had been a true lease, the creditor would not have been entitled to an administrative expense claim because there was no evidence that the trustee actually used the equipment after the petition date. The creditor's administrative claim was therefore denied.

***Robinson v. Worley (In re Worley)*, Case No. 13-50180 (AP No. 13-06081) (Bankr. M.D.N.C. September 18, 2014) (Aron, J.)**

Issue: Whether a Chapter 7 debtor should be denied a discharge pursuant to 11 U.S.C. §§ 727(a)(2), (4), and (5) on the grounds that the debtor made a false oath or account and failed to satisfactorily explain a loss of assets.

Short Answer: Yes. Denial of the debtor's discharge was warranted due to the debtor's false oath in valuing the debtor's interest in a real estate investment trust, but not on other grounds because the debtor adequately explained a loss of assets.

Summary: The debtor had an extensive background in finance. In the early 2000s he made numerous real estate investments throughout the southeast, including a $65,000.00 capital contribution to fund Gemini Land Trust, LLC ("Gemini"). After several of the debtor's investments failed, the debtor filed a petition for relief under Chapter 7. In his schedules, the debtor claimed that the value of his interest in Gemini was only $2,500.00 even though the debtor's initial capital contribution to Gemini was $65,000.00. The Robinsons, plaintiffs in a pending Florida lawsuit against the debtor [relating to a real property dispute], filed an adversary complaint objecting to the debtor's Chapter 7 discharge. They alleged that he had intentionally undervalued his interest in Gemini and had failed to explain the disposition of certain assets.

The Court found the Robinsons carried their burden of proof with respect to the debtor's valuation of Gemini and denied the debtor's discharge pursuant to § 727(a)(4). The Court concluded that the $2,500.00 valuation of Gemini was a material misrepresentation and inconsistent with the debtor's knowledge. The debtor impermissibly disregarded his initial capital contribution to Gemini despite his extensive background in finance and experience interpreting financial documents. [However, denial of the debtor's discharge was not warranted on the basis that the debtor failed to explain a loss of assets, since the Court was satisfied with the debtor's explanations as to the disposition of the funds.]

***In re Dean*, Case No. 13-11577 (Bankr. M.D.N.C. September 26, 2014) (Kahn, J.)**

Issue: Whether the Court should grant the United States relief from an order allowing the debtors' objection to an IRS claim because service of the objection upon the IRS was insufficient, the United States was the real party in interest to be noticed, and the United States should have been served with the objection pursuant to Bankruptcy Rule 9014(b).

Short Answer: No. Service of the objection upon the IRS pursuant to Bankruptcy Rule 3007(a) was sufficient and satisfied due process. The IRS was the proper party in interest, not the United States. Further, Rule 9014(b) did not apply.

Summary: The United States was incorrect in its contention that the debtors' objection should have been served pursuant to Bankruptcy Rule 9014(b) (Contested Matters). While an objection is a contested matter, the language of Rule 9014(a) makes it clear that Rule 9014 does not apply to all contested matters. The opening language of Rule 9014(a), "in a contested matter in a case under the Code <u>not otherwise governed by these rules</u>" (emphasis added), clearly contemplates that there are some types of contested matters which are otherwise governed by the Bankruptcy Rules. An objection to a proof of claim is one type of contested matter that is "otherwise governed by the Bankruptcy Rules," as Rule 3007(a) provides that an objection to claim is not commenced by motion, but rather, by an objection in writing which shall be delivered to the claimant.

In this case, the debtors properly served their objection upon the IRS under Rule 3007, as the IRS identified itself in its proof of claim as the proper party to be noticed in matters affecting its claim. The United States appointed the IRS as its agent to receive service of process with respect to the objections to the claim, and as such, the IRS is the real and proper party in interest with respect to the IRS tax claim. Moreover, the mailing of a copy of the objection to the claim and the notice of hearing to the IRS, both by regular mail and email, provided the IRS with sufficient notice to satisfy due process. For these reasons, relief from the order allowing the debtors' claim objection was denied.

***Thomas v. Causey (In re Causey)*, Case No. 13-10833 (AP No. 13-02071) (Bankr. M.D.N.C. October 1, 2014) (Kahn, J.)**

Issue: Whether a state court judgment was entitled to collateral estoppel effect in a creditor's subsequent nondischargeability action, and whether the state court judgment was nondischargeable pursuant to 11 U.S.C. § 523(a)(4).

Short Answer: Yes. The state court judgment was entitled to collateral estoppel effect because (1) the issue in question in the adversary proceeding was identical to the issue actually litigated in the state court action, (2) the state court action resulted in a final judgment on the merits, and (3) the parties in the adversary proceeding were the same as in the state court action. Moreover, the debt created by the state court judgment was nondischargeable because the jury's verdict in the state court judgment conclusively established the elements of a claim for defalcation in a fiduciary capacity under § 523(a)(4).

Summary: Prior to the debtor's Chapter 7 bankruptcy, the creditor, a beneficiary of a trust, filed a lawsuit against debtor, the trustee for the trust. The creditor alleged that although the trust provided for mandatory distribution of trust income and discretionary distribution of trust corpus to the creditor, the debtor diverted the distributions for her own use. The debtor's actions deprived the creditor from the actual amount of trust income from 2002-2008, depleted the trust corpus, and lowered future trust income. The creditor obtained a judgment and award in the amount of $504,069, which included actual and punitive damages and attorney's fees. The jury verdict made various specific findings, including that the debtor breached a fiduciary duty to the creditor, took advantage of a position of trust and confidence in order to bring about the depletion of the trust, and did not act openly, fairly, and honestly in bringing about trust distributions.

When the debtor filed for Chapter 7 relief, the creditor instituted an adversary proceeding seeking to except the debt created by the judgment from the debtor's discharge. The creditor further requested that the debtor be collaterally estopped from re-litigating the issues of breach of fiduciary duties, constructive fraud, and punitive damages with respect to § 523(a)(4).

In concluding that the state court judgment was entitled to collateral estoppel effect, the Court compared the elements of a claim for defalcation while in a fiduciary capacity under § 523(a)(4) with the state court judgment and instructions given to the jury. The Court concluded the issues in the two proceedings were identical and thus the debtor was collaterally estopped from relitigating these issues. The Court also concluded the debt created by the state court judgment was non-dischargeable under § 523(a)(4). In particular, the Court focused on the fact that the state court judgment included an award of punitive damages due to the existence of malice and willful and wanton conduct on the part of the debtor. The Court found such award of punitive damages sufficiently established the requisite level of intent required to find defalcation as contemplated by the Bankruptcy Code.

***In re Page*, Case No. 13-51224 (Bankr. M.D.N.C. October 7, 2014) (Aron, J.)**

Issue: Whether a Chapter 13 case should be dismissed for lack of good faith filing under 11 U.S.C. §§ 1325(a)(7) and 1307(c).

Short Answer: Yes. Dismissal of the Chapter 13 case for lack of good faith was warranted due to the debtors' bad prepetition conduct, the timing of their petition, their motive for filing, their intent to defeat ongoing state court litigation, the manner in which they accumulated debt, their dishonesty with the Court, and their questionable eligibility for Chapter 13 relief.

Summary: In this joint chapter 13 case, a creditor, the ex-husband of the female debtor, objected to the confirmation of the debtors' proposed Chapter 13 plan contending that the plan did not account for his two priority domestic support obligation claims and that the plan was not proposed in good faith. The ex-husband's claims were based on two state court contempt orders requiring the female debtor to pay her ex-husband's attorney's fees which he incurred after the female debtor willfully violated the terms of the parties' separation agreement and pursued a frivolous appeal to the North Carolina Court of Appeals.

The Court noted that every debtor who files bankruptcy under Chapter 13 is required under 11 U.S.C. §§ 1325(a)(7) and 1307(c) to file in good faith. In this case, the totality of the circumstances clearly showed the debtors filed their petition in bad faith. The female debtor testified that the purpose of filing Chapter 13 was to discharge the attorney's fees owed to her ex-husband. The timing of the petition, filed two days after the second contempt order was issued, further showed the debtors' intent to defeat the state court litigation. In addition to the timing and motive, the female debtor engaged in persistent and wrongful pre-petition behavior by which she accumulated a large amount of attorney's fees that she made no effort to pay. Further, the debtors were not honest with the Court, as they failed to schedule the amount owed to the female debtor's ex-husband under the first state court contempt order. Finally, the Court considered the debtors' questionable eligibility to file for Chapter 13 relief, as the debtors had a negative net income in excess of $5,000.00 per month at the time of filing. After weighing these factors, the Court dismissed the debtors' Chapter 13 case for failure to file in good faith.

***Ollie-Barnes v. Internal Revenue Service (In re Ollie-Barnes)*, Case No. 09-82198 (AP No. 14-09004) (Bankr. M.D.N.C. November 6, 2014) (Kahn, J.)**

Issue: Whether the IRS tax claims against a debtor were discharged in a Chapter 13 case when the Trustee mistakenly listed the IRS allowed claims as $0.00 in the Report of Filed Claims but the debtor failed to object to the claims, the debtor's plan provided for full payment of the IRS tax claims, and the tax returns had been filed beyond their last permitted due date.

Short Answer: No. The Trustee's mistake in listing the IRS allowed claims as $0.00 in the Report of Filed Claims did not cause either disallowance or discharge of the claim in bankruptcy. Because the debtor's plan provided for the IRS tax claims to be paid in full, the claims were not discharged because they were not paid in full as required by the confirmed plan. Moreover, the IRS tax claims were excepted from the debtor's discharge pursuant to § 523(a)(1)(B)(ii) because the tax returns had been filed beyond their last permitted due date.

Summary: The debtor filed a petition for relief under Chapter 13 in 2009. The debtor's plan provided that any timely filed priority claims of the IRS would be paid in full. The IRS timely filed three distinct proofs of claim for debts owed to the IRS for tax years 1993, 1995, 1998, 1999, 2000, and 2001. No objections to the claims were filed.

The first IRS claim, claim #6-1, filed on March 26, 2010, listed $7,231.36 in unsecured priority tax debts for the periods 2000 and 2001, and $26,960.75 in general unsecured tax liabilities for the remaining years. The second IRS claim, claim #7-1, filed on March 29, 2010, also listed $7,231.36 in unsecured priority tax debt and $26,960.75 in general unsecured tax liabilities. Finally, the third IRS claim, claim #7-2, filed on April 8, 2010, listed $0.00 in priority tax liabilities and $0.00 in unsecured general claims. In the Trustee's Report of Filed Claims, the Trustee mistakenly listed the IRS allowed claim as $0.00.

In July, 2013, the bankruptcy case was completed and the Court entered a final decree. In September, 2013, however, the debtor reopened her case and commenced an adversary proceeding against the IRS for violations of the discharge injunction. The debtor alleged she was receiving communications from the IRS concerning the collection of pre-petition taxes. The debtor contended that upon completion of her plan, all of the debt owed to the IRS was discharged. However, the debtor based completion of her plan on satisfaction of the IRS claim #7-2, which was $0.00, and did not account for payment of the IRS claim #6-1. In its answer, the IRS explained that claim #7-2 was an attempt to erase claim #7-1, which was a duplicate of claim #6-1. The IRS did not amend or withdraw claim #6-1, and intended to have claim #6-1 survive. As a result, the IRS denied that the debts owed to the IRS under claim #6-1 were completely discharged.

The IRS moved for summary judgment arguing that its claims should be excepted from the debtor's discharge pursuant to § 523(a)(1)(B)(ii), which excepts from discharge taxes for which a return had been filed beyond its last permitted due date. The discharge exception applies only to late returns filed within two years before the petition was filed. The IRS argued, however, that the discharge exception applied as to all of its pending tax claims against the debtor because the two year look back period was tolled during the pending of a prior bankruptcy case.

The IRS noted that prior to the current bankruptcy, the debtor had been in bankruptcy two other times, in 2003 and 2004. The 2003 bankruptcy lasted from March 31, 2003 through March 23, 2004. The 2004 bankruptcy lasted from May 20, 2004 until August 29, 2008. Thus, the debtor was out of bankruptcy for less than five months between filing tax returns for 1993, 1998, 1999, 2000, 2001, and the current case. As such, the Court found it appropriate to apply the equitable tolling of the two-year look back period of § 523(a)(1)(B)(ii) in order to avoid a result that allowed the debtor to hide assets from tax liability through numerous petition filings. Accordingly, summary judgment was granted in the IRS's favor, and the debtor's tax liabilities were excepted from the debtor's discharge.

***Smith v. SunTrust Bank (In re Smith)*, Case No. 13-81362 (AP No. 14-09039) (Bankr. M.D.N.C. December 8, 2014) (Kahn, J.)**

Issue: Whether the debtor was estopped from claiming that she was not liable to pay the balance of a home equity loan, which, although obtained pre-petition by her ex-husband by forging the debtor's signature on the loan documents, the debtor later ratified by entering into a loan modification agreement with the creditor and by agreeing to assume the loan obligation as part of her divorce proceedings.

Short Answer: Yes. The debtor knowingly adopted the obligations under the loan when she entered into a modification agreement with the creditor, when she acknowledged her obligation to make payments on the loan, and when she consented that she would be responsible for loan payments as part of her divorce proceedings.

Summary: In 2002, the debtor's ex-husband obtained a home equity loan by forging the debtor's signature on the loan documents. When the parties divorced in 2008, the debtor agreed to become responsible for payments under the loan after a one-year period of payments by her ex-husband. SunTrust, the holder of the loan, offered the debtor a modification of the loan, which the debtor signed. Under the modification agreement, the debtor was listed as the sole borrower, and the debtor acknowledged that the loan was secured by a lien on her home and that there were "no defenses, adjustments, or offsets to the [debtor's] obligation to pay under the terms of the [loan]." After the debtor failed to make payments on the loan, she filed for Chapter 13 relief. The debtor later brought an adversary proceeding against SunTrust, seeking, inter alia, that the modification agreement was void for lack of consideration and that SunTrust's claims against the bankruptcy estate involving the loan be disallowed. The debtor also asserted claims against SunTrust for unfair and deceptive trade practices and unjust enrichment. The debtor's ex-husband intervened in the adversary proceeding and filed a motion to dismiss.

The Court noted that all of the debtor's claims were predicated upon the loan being unenforceable against the debtor due to the forgery of her signature by her ex-husband. Thus, if the loan was in fact an enforceable obligation of the debtor, the debtor's claims necessarily failed. The court concluded that the loan was in fact enforceable against the debtor because the debtor knowingly ratified her obligations under the loan when she signed the modification agreement with SunTrust and when she agreed to assume the loan payments as part of her divorce proceedings. Therefore, the debtor was estopped from denying the enforceability of her obligations under the loan, and the Court dismissed each of the debtor's claims for relief in the adversary proceeding.

In re Drake, **Case No. 09-52371 (Bankr. M.D.N.C. January 6, 2015) (Aron, J.)**

Issue: Whether a creditor should be sanctioned for violations of the automatic stay when the creditor continued sending billing notices to the debtors after being notified by the Chapter 13 Trustee that such notices violated the automatic stay.

Short Answer: Yes.

Summary: The debtors filed a petition for relief under Chapter 13 on November 23, 2009. The debtors owned a 2009 Hyundai subject to a lien held by Truliant. Pursuant to the debtors' plan, the Chapter 13 Trustee disbursed monthly payments to Truliant and completed the payments on March 30, 2014. Once the payments were completed, Truliant continued sending billing notices to the debtors. Counsel for the debtors contacted the Trustee, and the Trustee sent a letter to Truliant on August 14, 2014, stating that the billing notices were a violation of the automatic stay and asking Truliant to refrain from sending such notices in the future.

Despite the Trustee's letter, Truliant sent yet another billing notice to the debtors. Truliant also reported a delinquency on the male debtor's credit report. In September, 2014, the debtors filed a motion for sanctions against Truliant alleging willful violations of 11 U.S.C. § 362(a)(3) and the Fair Credit Reporting Act, 15 U.S.C. § 1681 *et seq*. Truliant explained that it relied on internal procedures to comply with the Bankruptcy Code, including mailroom procedures to handle bankruptcy notices and computer coding to prevent sending automatic billing notices to debtors in bankruptcy. However, when Truliant transferred to a new computer system in 2011, the computer coding seemingly failed to transfer to every bankrupt customer's account. Truliant admitted to the violations of the stay but disputed that its actions were intentional or merited sanctions.

The Court rejected Truliant's 'computer did it' argument by noting that Truliant had actual notice of the debtors' bankruptcy because it timely filed a proof of claim and received monthly payments from the Trustee. Moreover, even if the computer system failed to alert Truliant, the Trustee's letter sufficiently placed Truliant on notice that it was violating the automatic stay. Despite the Trustee's letter, Truliant continued to send billing statements to the debtors. The Court granted the debtors' motion for sanctions which included actual damages, attorney's fees, and punitive damages to be assessed for every month that Truliant failed to correct its notation on the debtors' credit report.

Harvey v. Dambowsky (In re Dambowsky)**, Case No. 13-81410 (AP No. 14-09010) (Bankr. M.D.N.C. January 6, 2015) (Kahn, J.)**

Issues: (1) Whether the Court has subject matter jurisdiction to liquidate the creditors' state law claims in the context of a nondischargeability action; (2) Whether the Court, as a non-Article III court, has the statutory and constitutional authority to liquidate and enter a final judgment with respect to any amounts determined to be nondischargeable without the creditors' consent; (3) If the Court does have jurisdiction and authority, whether the Court nevertheless should abstain from liquidating the creditors' state court claims; and (4) Whether the creditors have a right to a trial by jury under the Seventh Amendment to the United States Constitution in connection with a dischargeability action.

Short Answer: (1) Yes. The Court has subject matter jurisdiction to liquidate the creditors' state law claims in a dischargeability action because dischargeability actions fall within the Court's subject matter jurisdiction as proceedings "arising in" a case under Title 11.

(2) Yes. The Court, as a non-Article III court, has constitutional authority to liquidate and enter a final judgment with respect to any amounts determined to be dischargeable, without the creditors' consent.

(3) No. Permissive abstention was not warranted because judicial economy concerns did not weigh against the court issuing a final judgment in this case.

(4) No. The creditors did not have a right to a jury trial in a nondischargeability proceeding.

Summary: The creditors filed an adversary proceeding against the Chapter 7 debtor seeking to except certain state law claims from the debtor's discharge, or, in the alternative, barring the debtor's discharge altogether. The debtor counterclaimed, requesting that the Court liquidate the amount of any damages determined to be nondischargeable. The creditors moved to dismiss the counterclaim asserting that the Court lacked subject matter jurisdiction to liquidate the underlying non-bankruptcy state law claims. In the alternative, the creditors argued that dismissal of the counterclaim was appropriate under the principles of permissive abstention.

The Court held that bankruptcy courts have subject matter jurisdiction to liquidate claims in the context of dischargeability actions. This is because a proceeding to liquidate a previously unliquidated debt is at the "core" of the federal bankruptcy power, and even though it is "not based on any right expressly created by title 11," it nevertheless "would have no existence outside of bankruptcy." Therefore, liquidation proceedings fall within the court's "arising in" jurisdiction. The Court also held that bankruptcy courts have clear statutory authority to hear and to determine the amount and extent of claims in the context of a dischargeability action because discharge and dischargeability actions are specifically listed as core proceedings under 28 U.S.C. § 157(b)(2)(I) and (J).

The Court noted that even though a debtor's legal liabilities are based upon and arise out of non-bankruptcy state or federal law, Congress can entirely withdraw such claims from judicial cognizance in the form of providing a bankruptcy discharge to the debtor. Since it is beyond question that Congress is empowered to remove these types of claims from judicial cognizance by granting a bankruptcy discharge, it would be incongruous to conclude that Congress cannot delegate the determination of specific claims that will be excepted from the discharge to a bankruptcy court.

The Court also held that permissive abstention was not warranted with respect to liquidating the creditors' state court claims. Because the creditors had to present all the evidence sufficient to liquidate the underlying claims in the context of the dischargeability determination, the creditors' request to have a second trial in the state court over the amount of damages would be less, rather than more, economical. Finally, the creditors had no right to a jury trial in connection with their claims being liquidated in the context of a nondischargeability proceeding because such action lies within the equitable powers of the bankruptcy court.

***Dept. of Human Services v. Boyd (In re Boyd)*, Case No. 13-06084 (AP No. 13-06084) (Bankr. M.D.N.C. January 8, 2015) (Aron, J.)**

Issue: Whether a debt owed to a county was nondischargeable pursuant to 11 U.S.C. § 523(a)(2)(B) when the debtors intentionally violated the county's assistance program for obtaining food stamps and Medicaid coverage.

Short Answer: Yes and No. The debt owed to the county by the female debtor was nondischargeable, since she had taken the actions at issue, while the debt owed by male debtor was dischargeable.

Summary: The debtors filed a petition for relief under Chapter 7 on July 26, 2013. Prior to the bankruptcy filing, the female debtor stayed at home and took care of her four children. The male debtor had been employed as a restaurant manager prior to losing his job in 2010. The female debtor first applied for food stamps through the county in 2009. In order to continue receiving food stamp benefits, applicants must complete a recertification form every six months to determine continued eligibility. The female debtor completed and signed all of the recertification documents, and the male debtor never signed any of the forms. Between 2010 and 2012, the female debtor submitted six food stamp recertification forms. The female debtor also applied for Medicaid coverage in 2011 and submitted three enrollment forms between 2011 and 2012. On these applications, the female debtor did not disclose any source of income beyond the male debtor's unemployment, the male debtor's child support, and family contributions.

During the period of his unemployment, the male debtor enrolled in Rowan-Cabarrus Community College under a job-training program to learn to work on computers. The male debtor began working on computers and received compensation. From 2011 through 2012, the male debtor's income steadily increased as a result of his work. The male debtor diligently kept records of his income and received 1099 forms. He completed his taxes using TurboTax and fully disclosed his income. However, the female debtor did not disclose the male debtor's income when she applied to the county for assistance. The county was then made aware of the discrepancies between the recertification forms and the income that the couple had disclosed to the IRS.

The county initiated an Adversary Proceeding objecting to the debtors' discharge of $12,838.00 in food stamp overpayments and $22,628.13 in Medicaid overpayments pursuant to 11 U.S.C. § 523(a)(2)(B) (false financial statements). The Court found the food stamp recertification forms completed by the female debtor were statements of the debtors' financial condition, were materially false when submitted, and were reasonably relied upon by the county when extending benefits to the debtors. Moreover, the Court found that the female debtor was aware of the male debtor's income when she completed the forms, but failed to disclose such income with the intent to deceive the county. For these reasons, the Court held the food stamp and Medicaid overpayments were nondischargeable debts as to the female debtor pursuant to § 523(a)(2)(B). The county did not present any evidence that the male debtor had any knowledge of the information that the female debtor included in the recertification forms, and the marital relationship was not enough to impute the female debtor's fraud to the male debtor. Therefore, the overpayments were dischargeable debts as to the male debtor only.

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