Concurrent
Breakout

Current Developments in Bankruptcy Litigation

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Recent Trends in Bankruptcy Litigation

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Litigation is a common occurrence in bankruptcy cases, whether it is to recover fraudulent or preferential transfers or simply to determine how much a creditor is owed by the debtor. This paper discusses some of the trends seen in the past year in bankruptcy litigation.

I. Settlement Agreements

Cadle Co. v. Mims (In re Moore), 608 F.3d 253 (5th Cir. 2010) (Smith, J.).

Sale versus Settlement: Fifth Circuit remands order approving a settlement to consider whether an auction and sale would have been a better use of business judgment.

In this litigation, the Cadle Company asserted various theories of fraudulent transfers, veil piercing and reverse veil piercing against the debtor in state court before the individual filed a chapter 7 bankruptcy case. Upon the bankruptcy filing, all litigants assumed that the claims were either stayed, became property of the estate or both. During the course of the bankruptcy case, the Cadle Company offered to purchase the claims from the chapter 7 trustee, but the parties could never reach an agreement on the terms of a sale. Eventually, the trustee reached an agreement to settle the claims with the debtor and its affiliates for $37,000.00. The Cadle Company objected to the settlement, arguing that it was willing to pay more to purchase the claims from the estate, rendering the settlement less than "fair and equitable." The bankruptcy court overruled the objection, concluding that the trustee could not sell the claims, and that the settlement agreement was fair and equitable and should be approved. The district court affirmed.

On appeal, the Fifth Circuit explained that the claims became property of the debtor's bankruptcy estate, by virtue not only of section 541(a) but also of section 544(b). The latter provision allows the trustee to succeed in the interests of its unsecured creditors who hold rights under state law to pursue the debtor for fraudulent conveyances. In short, the Court concluded that all claims asserted by the Cadle Company prior to the bankruptcy became property of the estate and, thus, could be sold like any other item of property under section 363 of the Bankruptcy Code. The court further noted that the equitable remedy of a constructive trust could be transferred with the underlying claims (which were held to be property of the estate).

Having concluded that the claims were property of the estate, the Fifth Circuit went on to state that the bankruptcy court abused its discretion by refusing to consider the possibility that a sale of certain causes of action—as opposed to a settlement of those claims—would produce a better result for the estate. Said the court, "The proposed settlement was a disposition of estate assets, and Cadle's overbid required the court to consider the appropriateness of an auction and § 363 sale procedures." In the event that the bankruptcy court determines that an auction is in the best interest of the estate, noted the court of appeals, "the bankruptcy court must assess the transaction as both a proposed sale under § 363 and a proposed compromise under rule 9019."

Sherman v. Lamothe, 608 F.3d 212 (5th Cir. 2010) (Garza, J.).

Debtor who paid $1.85 million under a settlement agreement was not entitled to contribution from other settling parties.

In this matter, the debtor was sued, along with several of its employees, for various trade secret violations. The lawsuit was resolved by a settlement agreement in which the debtor and the employees agreed to be jointly and severally liable for payment of the settlement amount. In addition to payments, the defendants agreed to certain injunctive relief against each individual. The chapter 7 trustee for the debtor paid the settlement amount and then moved in the bankruptcy court for contributions from the co-defendant employees. The bankruptcy court denied the trustee's request, and the district court affirmed.

In this appeal, the Fifth Circuit agreed with the lower courts, noting that Texas courts have not extended the doctrine of equitable contribution—applicable to contracts involving guaranty and surety obligations—to other contracts and settlement agreements. The Fifth Circuit explained that it was unwilling to extend the doctrine to this settlement agreement because, unlike a guaranty or surety agreement, this particular settlement agreement contained "individually tailored injunctions" for each employee, and the employees held different interests in the debtor, making it highly unlikely that all parties entered into the settlement agreement with the understanding that they would each be responsible for a proportionate share of the monetary settlement amounts.

Am. Prarie Construction, Co. v. Hoich, 594 F.3d 1015 (8th Cir. 2010) (Riley, J.).

Primary purpose of disputed settlement agreement is frustrated while appeal was pending.

This appeal arose from an agreement ostensibly reached on the courthouse steps just before a confirmation hearing in the debtor's chapter 11 case. The agreement was supposed to be between North Central Construction (NCC), a creditor and mechanic's lien holder, and Tri-State Financial, a plan proponent and special entity formed for the sole purpose of providing funding to the debtor through the plan. The parties reached an agreement on the courthouse steps before the plan confirmation hearing, and the terms were read into the record without objection. However, John Hoich, the individual representative for Tri-State Financial, was not present at the hearing or during the courthouse steps negotiations. Efforts to memorialize the agreement (as requested by the bankruptcy court) failed, and Tri-State Financial refused to perform under the terms of the agreement. No plan was confirmed, and the case was converted to chapter 7.

Meanwhile, NCC pursued Hoich and Tri-State Financial in the district court for their breach of the agreement, and the district court entered judgment in favor of NCC for just over $2 million. The parties appealed and cross-appealed, but Tri-State Financial filed bankruptcy while that appeal was pending. In *American Prairie Construction Company v. Hoich,* 560 F.3d 780 (8th Cir. 2009), the Eighth Circuit reversed the judgment as to Hoich (the appeal of the judgment as to Tri-State Financial was severed in light of its bankruptcy filing), and found that because he was not present during negotiations and had not authorized anyone to bind him to the terms, the agreement could not be enforced against him.

This opinion disposed of the appeal as to Tri-State Financial (by now, the stay as to Tri-State Financial was lifted). However, since the Eighth Circuit rendered its first ruling, *see supra*, several events transpired: the debtor failed to obtain plan confirmation, the case was converted, the debtor's primary assets were sold, and NCC settled with the chapter 7 trustee for payment of its claims.[1] Reviewing the merits of NCC's breach of contract claim, the Court of Appeals concluded that there was never a meeting of the minds, because both parties assumed that Hoich would be a party to the agreement. As the Eighth Circuit concluded in its 2009 opinion, the agreement was not binding as to Hoich, and so the parties failed to reach a meeting of the minds on this critical term. Further, the Eighth Circuit noted that the agreement had not been approved by the bankruptcy court pursuant to Bankruptcy Rule 9019. Finally, the Eighth Circuit explained that the intervening events frustrated the primary purpose for the ostensible settlement agreement between NCC and Tri-State Financial. Accordingly, said the Eighth Circuit, even if there had

[1] The ostensible settlement agreement contemplated Tri-State Financial's purchase of NCC's claims in exchange for NCC's support of the plan and agreement to dismiss its state foreclosure actions.

been a meeting of the minds, and even if the parties had obtained approval of the bankruptcy court, the agreement would still be unenforceable, as the parties were excused from performance under principles of frustration. The judgment was therefore reversed as to Tri-State Financial, and NCC's cross-appeal for attorneys' fees was dismissed as moot.

II. Preference, Fraudulent Transfer and D&O Causes of Action

Martinez v. Hutton (In re Harwell), --- F.3d --- (11th Cir. Dec. 29, 2010) (Hull, J.)
Debtor's attorney was not a "mere conduit" and, thus, *was* potentially liability for the debtor's fraudulent transfers.

In the months leading up to the debtor's bankruptcy filing, a creditor obtained a $1.3 million judgment against him in Colorado and began collect efforts in Florida. Around the same time, the debtor negotiated buy outs from two companies in which he owned interests. The buy-out proceeds from those companies were paid into the trust account for the debtor's attorney (Hutton), and then transferred out the same day to the debtor, his family and various preferred creditors. In some instances, Hutton even went to the bank himself to make sure that the checks cleared. After the debtor's bankruptcy case was converted to a chapter 7 case, the trustee commenced a lawsuit against Hutton, contending that he was an "initial transferee" for purposes of § 550(a)(1) and, thus, personally liable for the fraudulent transfers paid out of Hutton's firm trust account in the months leading up to the bankruptcy filing.

For summary judgment purposes, the bankruptcy court assumed that Hutton was the "mastermind" behind the transfers in and out of his law firm's trust account. Concluding that Hutton was *not* an initial transferee, however, the bankruptcy court granted summary judgment in Hutton's favor. The district court affirmed, and the trustee appealed to the Eleventh Circuit.

In this opinion, the court of appeals reviewed its precedential history concerning the "mere conduit" defense[2] and vacated summary judgment, explaining that: (a) Hutton *was* an "initial" transferee under the literal and plain meaning of § 550(a)(1); and (b) under the facts assumed by the bankruptcy court for summary judgment purposes, Hutton did *not* qualify for the equitable "mere conduit" defense. Said the Court: "In the vast majority of cases, a client's settlement funds transferred in and out of a lawyer's trust account will be just like bank transfers, and lawyers as intermediaries will be entitled to mere conduit status because they lack control over the funds. . . . However, under the particular circumstances of this case and given the bankruptcy court's assumptions about Hutton's major role in the fraudulent transfer of these funds in issue, Hutton is not entitled to summary judgment in his favor based on the mere conduit or control test."

United Rentals, Inc. v. Angells, 592 F.3d 525 (4th Cir. 2010) (Traxler, J.)
It is no defense to an avoidance action that defendant *could have had offset rights* if it had not received the preferential payments.

The debtor in this case was a subcontractor who entered into agreements with United Rentals, a third-tier subcontractor, for rental equipment. The instant action concerned alleged

[2] *See generally Nordberg v. Sanchez (In re Chase & Sanborn Corp.),* 813 F.2d 1177 (11th Cir. 1987); *Nordberg v. Societe Generale (In re Chase & Sanborn Corp.)*, 848 F.2d 1196 (11th Cir. 1988); *IBT Int'l Inc. v. Northern (In re Int'l Admin. Servs., Inc.),* 408 F.3d 689 (11th Cir. 2005); *Andreini & Co. v. Pony Express Delivery Servs., Inc. (In re Pony Express Delivery Servs., Inc.),* 440 F.3d 1296 (11th Cir. 2006).

preferential payments made to United Rentals pre-petition. United Rentals argued that it gave new value in exchange for such payments in the form of "indirect transfers" – either because United Rentals released its rights to obtain payments through the surety bonds in place, or because it relinquished its rights to perfect its bond claim rights.

The court held that the facts did not support the application of these "indirect transfer" theories, noting that the surety never obtained an equitable lien (*i.e.,* the general contractor did not fall behind in payments to the debtor), so the relinquishment of rights to seek payment on the surety bond did not constitute new value. Also, the court found that United Rentals never *actually* took steps under state law to perfect its bond claim rights for the unpaid invoices. Because United Rentals never had perfected bond claims under applicable North Carolina state law, the court held that the release of bond claim rights, without more, did not constitute new value given in exchange for the preferential payments. In short, the court held that the new value defense was unavailable to "as-yet unsecured" transferees who merely relinquish potential, but unasserted, rights to assert bond claims.

Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Secs. LLC, 429 B.R. 423 (Bankr. S.D.N.Y. 2010) (Lifland, J.)

Preliminary injunction warranted to stay non-debtor claims against non-debtors defendants.

Irving Picard, the SIPA trustee for the Madoff estates, filed a complaint against several defendants known simply as the "Picower Defendants," and asserted claims for fraudulent transfers, preferences, turnover and similar state law claims. While Picard was involved in extensive settlement discussions with the Picower Defendants, he learned that certain Madoff victims (the "Florida Plaintiffs") had filed class action lawsuits against the same Picower Defendants in Florida courts. Because the class action suits threatened to frustrate the negotiations with the Picower Defendants, he sought to enjoin the Florida Plaintiffs from continuing their class action suits in Florida. While the Court acknowledged that the lawsuits in Florida may not technically be property of the SIPA estates,[3] the "injuries alleged, as well as the purported source of those injuries, are common to the [SIPA claimants]." 429 B.R. at 433.

Said the Court: "While section 362(a)(1) of the Code typically stays proceeding against the debtor, courts have consistently utilized section 105 to extend section 362 to third-party actions against non-debtor entities when a claim against the non-debtor will have an immediate adverse economic consequence for the debtor's estate." Applied to this litigation, the Court found the Florida lawsuits to be particularly threatening to Picard's settlement discussions with the Picower Defendants, which, the Court noted, promised to achieve significant dollars to all SIPA claimants, including the Florida Defendants. Accordingly, the Court enjoined the Florida lawsuits "to preserve the integrity of the SIPA proceedings and the Trustee's settlement

[3] *See generally Highland Capital Mgmt. LP v. Chesapeake Energy Corp. (In re Seven Seas Petroleum, Inc.,,* 522 F.3d 575 (5th Cir. 2008) (finding that the claims asserted by the bondholders were not claims belonging to the estate).

negotiations for the benefit of the [SIPA] estate and all of its customers' claimants." 429 B.R. at 436.[4]

In re Landmark Fence Co., 424 B.R. 461 (Bankr. C.D. Cal. 2010) (Jury, J.).

Alter ego claims, as estate property, were assignable to the Committee for prosecution.

In this case, the debtor-in-possession sought to assign its rights in alter ego claims against the debtor's principal to the official creditors' committee to allow the committee to pursue such claims. Objecting to the motion was a class of former employees who asserted rights to pursue the debtor's principal for his unfettered control over the company and decisions to force overtime without adequate pay and benefits. The court rejected the employees' arguments, distinguishing between the acts which led to the employees' injuries (the debtor's actions to set long hours without fair compensation, which was at the direction of the debtor's principal) and the acts of the debtor's principal which resulted in the looting of the company and gave rise to the alter ego causes of action. After explaining the distinction, the court granted the motion to allow the Committee to proceed.

In re Downey Fin. Corp., 428 B.R. 595 (Bankr. D. Del. 2010) (Sontchi, J.).

Proceeds of a D&O policy were not property of the estate, even though the policy provided some coverage to the debtor.

Certain officers and directors sought a determination that proceeds from a D&O policy were not property of the estate or, in the alternative, for relief from the automatic stay. The policy in this case was a "wasting" policy, which provided: (1) direct coverage to the directors and officers; (2) "entity coverage" to the debtor for any damages caused to it from the covered claims; and (3) "indemnification coverage" to the debtor for its own costs incurred to indemnify the officers and directors in excess of the $1 million retention. Before the commencement of the bankruptcy case, the debtor had paid $558,000 to a law firm to represent the debtor, the officers and the directors in certain pre-petition class action and derivative action lawsuits. The class action suits were dismissed before the commencement of the bankruptcy case, but the derivative action suits were still pending when the bankruptcy case was filed. Once the bankruptcy case was filed, the debtor stopped covering legal costs related to the derivative action. The directors and officers sought coverage under the policy, but first sought a determination that the proceeds were not property of the estate or, if the court determined that the proceeds were property of the estate, the directors and officers sought relief from the automatic stay for cause.

The court acknowledged that several courts are split on whether insurance proceeds are property of the estate. Generally, Delaware bankruptcy courts have held that proceeds *may be* property of the estate "when there is coverage for the directors and officers ***and the debtor*** . . . [and] the depletion of the proceeds would have an adverse effect on the estate to the extent the policy actually protects the estate's other assets." *See id.* at 604 (quoting *In re Allied Digital Techs. Corp.,* 306 B.R. 505, 512 (Bankr. D. Del. 2004)) (emphasis added). Here, the policy at

[4] *But see Mokuba N.Y. LLC v. Pitts (In re Pitts),* 2009 Bankr. LEXIS 4023 (Bankr. E.D.N.Y. Dec. 8, 2009) ("While it is clear from *Queenie* that the Second Circuit has not implicitly rejected *A.H. Robins*, it is equally clear that the application of this exception does not apply in our case. In our case, there is no risk to any reorganization if the stay is not extended to the Corporate Defendants because the Debtor is liquidating. The imposition of liability against the Corporate Defendants only serves to fix liability against the Corporate Defendants at this point, and will not hamper the bankruptcy proceedings pending before this Court.").

issue did provide coverage to the debtor in the form of entity coverage and indemnification coverage. Thus, the court considered whether the depletion of proceeds to defend the officers and directors would adversely affect the debtor's estate. The court first found that there were no direct claims still pending against the debtor. It further found that because the debtor had not yet exceeded its $1 million retention for indemnification costs, the debtor would not be entitled to reimbursement from the policy proceeds for any additional costs incurred to defend its officers and directors. In sum, the depletion of proceeds to cover the officers and directors would not deplete any proceeds that would be available to the debtor under the entity coverage or indemnification coverage. Thus, the officers' and directors' use of insurance proceeds would not have an adverse effect on the debtor's estate. For that reason, the court held that the proceeds were not property of the estate.

In re Netbank, Inc., 424 B.R. 568 (Bankr. M.D. Fla. 2010) (Funk, J.)

Former CEO held not to be an "insider" where trustee failed to allege that transfer was made, or the underlying obligation incurred, before CEO's resignation.

In this case, the debtor filed its bankruptcy petition on September 28, 2007. Some eleven months before the bankruptcy filing, the debtor entered into a separation agreement with its then-CEO. Under that agreement, dated October 3, 2006, the debtor agreed to make a $2.9 million payment to its former CEO upon the effective date of his resignation. The CEO resigned on October 5, 2006, and he received payment of $2.9 million on the same date. The chapter 7 trustee filed a complaint against the former CEO, arguing that he was an insider for purposes of the preference payments and, thus, the transfer occurred within the applicable one-year look-back period. The former CEO moved to dismiss for failure to state a claim, arguing that the payment was made *after* his resignation and, thus, he was not an insider at the time when the transfer occurred. The Trustee responded that the CEO arranged for the transfer during his term as CEO. For that reason, the trustee argued, the CEO was insider for purposes of section 547(b)(4)(B), and the payment could be avoided as a preference.

The bankruptcy court rejected the "arrangement date" approach, finding support from *Barnhill* to adopt a bright line approach instead. Under the approach espoused by this court, a preference defendant's insider status is determined on the "exact date" of the transfer, not when the payment may have been arranged, negotiated or agreed to. In this case, the trustee failed to allege that the payments were received prior to the effective date of the CEO's resignation. For that reason, the court dismissed the trustee's claim, concluding that the trustee failed to allege that the transfer was made or incurred while the defendant was still an insider of the debtor.

In re TSIC, Inc., 428 B.R. 103 (Bankr. D. Del. 2010) (Gross, J.)

Determination of insider status on the "arrangement date" is consistent with BAPCPA.

This case, like *Netbank* and *TransTexas Gas*, focused on whether a severance payment made to an insider within the look-back period under 11 U.S.C. § 548 may be avoided as a fraudulent transfer. Richard Thalheimer was the majority shareholder, chairman of the board of directors and chief executive officer for 25 years until his ownership fell below 50% in 2002. Shortly thereafter, in October of 2002, he entered into an employment agreement with the company, which contained a severance package. By 2006, the company's board was controlled by a private equities group who sought to replace Thalheimer as the CEO. The parties reached an agreement, effective December of 2006, when Thalheimer resigned. The separation agreement provided for a total severance package of $6,055,000, but, for tax reasons, Thalheimer

did not receive payment under the severance package until April 2007. The debtors commenced their chapter 11 cases on February 19, 2008, and sought to avoid the severance payments to Thalheimer by a complaint filed on December 31, 2008. At issue here were whether the severance payments were made within the two year look-back period (*i.e.,* whether the time of transfer is when the obligations were incurred or actually made), and whether Thalheimer was an insider for avoidance purposes.

Noting that section 548 provides for the avoidance of pre-petition payments "made or incurred" within the two year look-back period, the court first concluded that the debt was *incurred* in December 2006 (through the separation agreement), when the debtor agreed on the amount and structure of the severance payments to be made to Thalheimer. Said the court, to hold otherwise would allow insiders to "orchestrate the timing of the transfer, *i.e.,* the payment of severance benefits, to occur after resignation when they were no longer insiders."

Next, the court considered whether Thalheimer was an insider when the payment obligations were incurred or payments made. Noting that the main purpose of amending section 548 in 2005 was "to protect creditors and the assets of the estate from excessive bonuses, loans, and payouts made to corporate insiders outside the ordinary course of business," and relying upon *In re TransTexas Gas Corp.,* 597 F.3d 298 (5th Cir. 2002), the court held that the date of the employment agreement (in 2002) determines whether a transferee is an insider for purposes of section 548. In this case Thalheimer was both a director and an officer (and, thus, a statutory insider) when he entered into the employment agreement with the debtor in 2002.

Concluding that Thalheimer's resignation and waiver of future claims could not serve as consideration of reasonably equivalent value, and that the payment of severance benefits were not ordinary course payments, the court granted the debtors' motion for summary judgment and ordered Thalheimer to repay his severance benefits to the estate.

In re Citron, 428 B.R. 562 (Bankr. E.D.N.Y. 2010) (Trust, J.)

Payments made to the state under a plea agreement may be avoidable as preferential.

This case was filed on March 27, 2008, after the debtors reached plea agreements with the State of New York to settle felony charges against both the husband and wife. A creditor obtained authority to pursue this action which sought to avoid certain pre-petition payments made to the State of New York under the plea agreements. The husband paid $75,000.00 in a lump sum payment on or around the date his plea agreement was accepted by the state court, which was days before the petition date. The wife pled guilty and agreed to pay a $175,000 fine through monthly payments to be made during her three-year probation. Her plea agreement was accepted in December 2007, and she made the initial payment of $9,000.00 on that date. Other than the initial payment, however, she was unable to make any other monthly payments other than a single $5,000 payment on the same date of her husband's sentencing in March 2008.

The court entered summary judgment in favor of the plaintiff with respect to the $5,000 payment from March 2008, and in favor of the State of New York with respect to the $9,000 payment from December 2007. The court concluded that the initial $9,000 payment was made outside the 90-day preference period and could not be construed as a fraudulent transfer, given that it was reviewed by a court and accepted as part of an arms' length agreement. On the other hand, the bankruptcy court found the $5,000 payment to be a preference not given contemporaneously with any "new value." Any "new value" received by the wife, noted that court, would have been received in December of 2007, when her plea agreement was approved by the criminal court and when she was sentenced. The court further rejected the State's

argument that the plea agreement provided "new value" in the form of credit, explaining that the single payment of $5,000 was not a regularly scheduled payment under the plea agreement.

As to the husband's $75,000 lump sum payment made days before the petition date, the court reserved a determination for trial, explaining that the payment *could be* a contemporaneous exchange for new value if the trial evidence provided that the value received by the debtors from the plea agreement was reasonably equivalent to the $75,000.00 paid by the debtor. Specifically, the court noted that, at trial, the parties should introduce evidence of the potential maximum prison sentences and monetary fines available for the crimes charged against the debtor, and the "quantitative value of avoiding these potential terms of incarceration and fines, in order to determine what money or money's worth in goods, services or new credit [the debtor-husband] received in exchange for his plea agreement for Section 547(c)(1) and 547(c)(2) purposes." *Id.* at 575-76.

Wahoski v. Classic Packaging Co. (In re PillowTex Corp.), 427 B.R. 301 (Bankr. D. Del. 2010) (Carey, J.).

Debtors' more frequent payments to its vendors may be defended as "ordinary course."

The liquidating trustee sought to avoid payments made by the debtors to one of its suppliers. The supplier moved for summary judgment on the grounds that payments were made in the ordinary course of business. The trustee pointed to the payment history between the debtors and this supplier, and argued that for reasons to be determined, the debtors began making more frequent and, in some cases, early payments during the preference period, demonstrating the debtors' preference for this supplier over other pre-petition creditors. The supplier argued that while it may be true that the debtors began making early and more frequent payments during the 90 day preference period, those payments could be explained by an incentive offered by the supplier to discount invoices by 1% if paid within 10 days, which was an incentive program in place for years prior to the petition date but only utilized by the debtors during the preference period.

The court declined to rule on summary judgment. However, what makes this case notable is the court's explanation that a change in the debtors' timing of payments may not defeat the ordinary course defense, "***so long as the change was not made pursuant to overly zealous collection efforts***" by the supplier. *Id.* at 309 n.9 (citing *In re Montgomery Ward, LLC*, 348 B.R. 662, 679 (Bankr. D. Del. 2006)). For purposes of summary judgment, however, the court was not convinced of the reasons for the change in timing of payments by the debtors. Thus, summary judgment was denied.

In re Mercedes Homes, Inc., 431 B.R. 869 (Bankr. S.D. Fla. 2010) (Hyman, J.).

Plan's releases of claims against directors and officers were appropriate and did not prevent confirmation.

Certain interest holders objected to a chapter 11 plan, arguing that the D&O releases included in the plan violated section 524(e)'s prohibition against non-debtor releases. The bankruptcy court here noted that, while several courts including the Fifth Circuit do not allow non-debtor releases in chapter 11 plans, "this is not the majority view." Instead, the court explained that non-debtor releases are permitted as part of a plan, "if the debtor establishes that the releases are necessary or appropriate to carry out the purposes of Chapter 11." Here, the court applied the seven-factor test enunciated in *In re Dow Corning, Corp.,* 280 F.3d 648, 658 (6th Cir. 2002): (1) there is an identity of interest such that a suit against the non-debtors is

essentially a suit against the estate; (2) the non-debtor releasees make substantial contributions under the plan; (3) the injunction or release is essential to the success of the reorganization; (4) the impacted class has overwhelmingly voted to accept the plan; (5) the plan provides a mechanism to pay for all, or substantially all, of the class or classes affected by the release or injunction; (6) the plan provides an opportunity for those non-settling claimants to pursue a recovery; and (7) the court makes specific factual findings that support its conclusions regarding the fairness or necessity of the releases.

Among the court's many findings were the fact that the plan contained a reservation to allow the objecting claimants to pursue recoveries against certain non-debtors in their capacity as ESOP administrators and trustees, but not in their capacities as directors and officers of the debtors. On this point, the court found that any claims against the D&O's would be derivative claims belonging to the estate, and that any recovery from such claims would not produce sufficient amounts to reach the objecting interest holders. Additionally, the court found that the releasees possessed knowledge and experience necessary to ensure a successful reorganization, and that the same parties held claims which they waived in order to allow recoveries to other unsecured creditors. Based on these findings and circumstances, as well as some additional circumstances described in the opinion, the court concluded that the plan could be confirmed over the objection to the non-debtor releases.

III. Class Action Lawsuits in Bankruptcy?

Wilborn v. Wells Fargo Bank, N.A. (In re Wilborn), 609 F.3d 748 (5th Cir. 2010) (Reavley, J.)
Bankruptcy courts may certify class actions against lenders under the right circumstances.

A group of chapter 13 debtors filed adversary proceedings against Wells Fargo, claiming that the bank charged fees pursuant to the underlying home mortgage loan documents without disclosing them to the bankruptcy court or seeking approval under 11 U.S.C. § 506(b) and Bankruptcy Rule 2016. The results of such charges were that the debtors would complete their chapter 13 plans and obtain a discharge only to find themselves in default to Wells Fargo for the fees accumulated during the pendency of their chapter 13 bankruptcy cases. The named plaintiffs sought: (i) declaratory judgment that such fees were *per se* unreasonable; (ii) disgorgement of fees; (iii) injunctions from similar charges in the future without bankruptcy court approval; and (iv) sanctions. The Bankruptcy Court certified a class action against Wells Fargo, which included all chapter 13 debtors in the Southern District of Texas who filed their cases between November 16, 2002, and November 16, 2007, who had mortgages serviced and/or held by Wells Fargo, and who were charged fees by Wells Fargo during the bankruptcy case which were neither approved by the bankruptcy court nor disclosed to the court, the debtor and other parties in interest. Wells Fargo took a direct appeal to the Fifth Circuit, basing its appeal on jurisdictional and procedural challenges to the certification order.

First, on the issue of jurisdiction, Wells Fargo argued that one bankruptcy judge lacks the authority to certify a class of debtors whose cases are assigned to different judges within the same jurisdictional district. The Fifth Circuit disagreed, explaining that, contrary to Wells Fargo's contention, 28 U.S.C. § 157(a) does not restrict the *scope* of bankruptcy jurisdiction, but only restricts the *placement* of jurisdiction within the bankruptcy courts. Thus, where bankruptcy jurisdiction exists in 28 U.S.C. § 1334(b), the fact that a general standing order places the bankruptcy case before a particular bankruptcy judge does not prevent another federal court, including a different bankruptcy judge, from exercising bankruptcy jurisdiction over matters related to another bankruptcy case.

As an ancillary issue related to Wells Fargo's jurisdictional argument, the Fifth Circuit noted that while courts have disagreed over the authority of one bankruptcy court to certify multi-debtor class actions and the geographic scope of such authority, there has been no expression of congressional intent precluding class actions of multiple debtors. Said the Fifth Circuit, "if bankruptcy court jurisdiction is not permitted over a class action of debtors, Rule 7023 is virtually read out of the rules."

Finally, the Fifth Circuit explained that class actions "promote efficiency and economy in litigation and permit multiple parties to litigate claims that otherwise might be uneconomical to pursue individually." Finding that these principles are no less compelling in the bankruptcy context, the Court of Appeals held that a bankruptcy court *does* have authority to certify a class action of multiple debtors whose petitions are filed within its jurisdictional district, provided that the prerequisites under Federal Rule 23 are satisfied.

Turning to that issue, the Court explained that the class must meet the four baseline requirements of Federal Rule 23(a)—numerosity, commonality, typicality, and adequacy of representation—while also satisfying one of the requirements of Rule 23(b). The Fifth Circuit determined that the circumstances of this case rendered certification under Rule 23(b) improper. Specifically, the Court found that the differing circumstances in each individual bankruptcy case rendered the reasonableness of the charges a fact-specific inquiry, not a class-oriented decision. For that reason, the class failed the predominance and superiority tests under Rule 23(b)(3). For similar reasons, the Court of Appeals held that the class could not be certified under Rule 23(b)(2), because it was impossible to determine, as a class-wide issue, whether the monetary damages sought were incidental to the injunctive relief requested. For those reasons, the Fifth Circuit vacated the class certification order.

Just over one month after the Fifth Circuit issued this opinion, a different bankruptcy judge in the Fifth Circuit issued an order certifying a class under Rule 23(b)(2) against Countrywide Home Loans, Inc. *See Rodriguez v. Countrywide Home Loans, Inc. (In re Rodriguez),* 432 B.R. 671 (Bankr. S.D. Tex. 2010). There, Judge Isgur narrowed the class definition to include only those fees charged by Countrywide without court authorization (ignoring individualized issues of notice and agreements), and limited certification to injunctive relief—*i.e.,* enjoining Countrywide from collecting further amounts until the debtor receives credits for the fees charged in violation of the Bankruptcy Code and Bankruptcy Rule 2016(a). Among the many distinguishing factors, Judge Isgur pointed to evidence presented regarding Countrywide's internal database.

Hacienda Heating & Cooling, Inc. v. United Artists Theatre Co. (In re United Artists Theatre Co.), 410 B.R. 385 (Bankr. D. Del. 2009) (Walsh, J.)

Class action to determine (on a class-wide basis) the adequacy of notice and effect of discharge was held to be maintainable.

On November 18, 1999, a recipient of a "junk fax" advertisement filed a class action complaint against United Artists and others for violations of the Telephone Consumer Protection Act (TCPA) by sending "junk faxes" to approximately 90,000 facsimile recipients. In September 2000, United Artists and its affiliates filed for bankruptcy protection in Delaware. The named plaintiff in the TCPA action filed a "class proof of claim" in UA's bankruptcy case and obtained relief from the automatic stay to pursue the TCPA class action in Arizona. During the course of discovery in the TCPA action, a non-debtor co-defendant produced the telephone database used for the junk fax distribution. United Artists then used this

database to distribute notices of its bankruptcy proceedings. The TCPA litigation proceeded to summary judgment, and the Arizona Court awarded the class plaintiffs $28.8 million, plus prejudgment interest.

This opinion addresses the next step of the class action: whether the class claims were discharged in United Artists bankruptcy case. The movant sought certification of a second class, defined to be the same members as the first class. The purpose of the second class, however, was to obtain a ruling from the Bankruptcy Court that the notice given by United Artists was insufficient to bar the class members' claims. The Bankruptcy Court found, as with the first class, that the second class satisfied the requirements of Federal Rule 23(a) (numerosity, typicality, commonality, and adequacy of representation). At issue was whether the second class could be maintained under one of the provisions of Rule 23(b).

The named plaintiff argued that the second class could be maintained under Rule 23(b)(2) because the complaint merely sought declaratory relief. United Artists argued that the class action could not be maintained under Rule 23(b)(2) because the declaration would impose substantial liability on United Artists if the Court determined that the discharge was not effective as to the putative class members. The Court concluded that United Artists misunderstood the nature of the relief sought by the class complaint. Said the Court, "[t]he fact that this Court's subsequent ruling may have a collateral economic consequence does not change the nature of [the plaintiffs'] request." The Court noted that the damages had already been set by the Arizona Court. The present complaint, reasoned the Court, merely sought a ruling on the effect of the notice and the ability of the putative class members to collect those damages in light of the debtors' discharge. As such, the Court concluded that the class was maintainable under Rule 23(b)(2) and entered an order certifying the class.

IV. Lien Validity, Perfection and Priority

Drown v. Wells Fargo Bank, N.A. (In re Scott), 424 B.R. 315 (Bankr. S.D. Ohio 2010) (Hoffman, J., Caldwell, J., and Brown, J.)[5]

Properly executed and duly perfected mortgages were unavoidable, despite defects in the conveyance deeds to the debtor mortgagors.

Two chapter 7 trustees administering several chapter 7 estates commenced adversary proceedings against the debtors' mortgage lenders seeking to avoid the mortgage liens granted by the debtors. Common to each of the debtors was alleged defects in the deeds conveying title to them. For that reason, the trustees argued that the debtors lacked legal title to grant to the lenders as security for their loans. It was undisputed that under Ohio state law, a grantor who conveys real property pursuant to a defective deed is still deemed to convey equitable title. In this case, even assuming that the debtors held only equitable title to their respective properties, they each granted their respective lenders a mortgage interest in their equitable title.

In these consolidated adversary proceedings, all three bankruptcy judges agreed that the liens could not be avoided under the trustees' strong arm powers. Said the Bankruptcy Courts: "Under Ohio law, no one—including judicial lien holders and bona fide purchasers—can avoid or otherwise take free of perfected interests in real property." Thus, even assuming that the debtors never obtained legal title in their respective properties (a fact conceded by the lenders

[5] Several cases with the same legal issue were consolidated and tried before a three-bankruptcy judge panel.

only for summary judgment purposes), the Courts granted summary judgment in favor of the lenders.

Wells Fargo Home Mortgage, Inc. v. Richardson (In re Brandt), 434 B.R. 493 (W.D. Mich. 2010) (Bell, J.)

Mortgage was avoidable for failing to list the plat in the deed of trust.

In this case, the District Court affirmed the Bankruptcy Court's holding that a recorded deed of trust may be avoided under 11 U.S.C. § 544(a)(3) if the deed of trust failed to reference a specific plat in the property's legal description because, under applicable state law, the lack of a plat reference precluded the trustee from having actual notice of the mortgage.

The facts were undisputed in this case. Wells Fargo recorded a deed of trust that listed the street address and tax parcel identification for the property, but failed to attach a legal description containing metes and bounds or references to the subdivision and plat. It was also undisputed that the subdivision plat for the debtor's neighborhood had been recorded. Wells Fargo disputed the Bankruptcy Court's construction of the Michigan recording act and Land Division Act (LDA). According to the LDA, once a subdivision plat has been recorded in the county property records, all subsequent conveyances of property within that subdivision must make reference to the particular plat subject to the conveyance.

Wells Fargo argued that the LDA could not render its mortgage defective because the statute contradicted the recording act, which permitted, but did not require, instruments to describe properties according to their subdivision plat. The District Court disagreed, concluding that the two acts must be read together. Because the stated purpose of the LDA was "to promote proper surveying and monumenting of land subdivided and conveyed by accurate legal description," and the Michigan recording act provided that other acts may provide additional recording requirements, the Court concluded that the LDA imposed such an additional requirement to describe properties by their recorded plat. In other words, no mortgage in Michigan is valid unless the deed of trust provides a legal description referencing the plat subject to the mortgage. Because the mortgage in this case failed to do so, it failed to put a hypothetical good faith purchaser on notice of Wells Fargo's mortgage interest. As a result, the mortgage was avoidable under section 544(a)(3) of the Bankruptcy Code.

In re DeMay International, LLC, 431 B.R. 164 (Bankr. S.D. Tex. 2010) (Bohm, J.)

Mechanic's lienholder wins priority fight with debtor's primary secured lender.

Several months before the commencement of a chapter 11 case, the debtor's electrical contractor took steps under Texas law to perfect a mechanic's lien on the debtor's leased premises for unpaid work it had performed for the debtor. The Bankruptcy Court found that the fixtures, wires, panels and other equipment installed by the contractor were "removable" tenant fixtures such that the liens could attach under Texas law. The real property where the equipment had been installed was owned by an unrelated landlord and leased to the debtor under a long-term lease. During the course of the bankruptcy case, the Court entered an order extending the time to assume or reject the lease, but the order was not entered until two weeks after the 120 day deadline under section 365(d)(4). Eventually, the debtor sold the property free and clear of all liens. The asset purchase agreement and order approving the sale provided for the contractor's liens to attach to an escrow fund, which would be paid to the contractor upon the resolution of the debtor's claim objection. The primary secured lender intervened in the claim objection and argued that its liens should attach to the escrow fund with a higher priority than the contractor's

lien. The lender argued that the contractor's liens (1) did not attach to the equipment because such equipment belonged to the landlord, not the debtor; and (2) were invalid inasmuch as they attached to the leasehold because the debtor failed to obtain an extension before the 120 days expired under section 365(d)(4) of the Bankruptcy Code.

The Court rejected both arguments. First, the Court held that mechanics' liens attach to leaseholds, leasehold improvements and removable. Because the equipment installed by the contractor fell within the classification of removable tenant fixtures, the property subject to the mechanics' liens was property of the bankruptcy estate, not the landlord. Second, as the Supreme Court explained in *Espinosa*, an order is valid and binding, even if legally incorrect, so long as the complaining party received notice and an opportunity to object. Here, while the Court did not enter the order extending the debtor's deadline to assume or reject the lease until two weeks after the deadline had expired, the primary secured lender was aware of the motion to extend and failed to object prior to its entry. Finally, the Court already found that the liens attached to property of the estate when it entered the sale order. Because the primary secured lender also failed to object to the entry of that order, and because that order provided for the contractor's liens to attach to the escrow funds, the Court overruled the lender's claim objections, and concluded that the liens in the escrow funds were valid and had greater priority than those asserted by the lender.

V. Courts' Reliance Upon Testifying Experts

In re Pac. Lumber Co., 584 F.3d 229 (5th Cir. 2009) (Jones, J.)

Bankruptcy Court's analysis of the conflicting expert valuations was not clearly erroneous.

One of the critical questions for this confirmation battle was the value of the secured noteholders' collateral, as the debtors and plan proponents sought to cramdown a plan by paying the noteholders that amount. The Bankruptcy Court's findings of fact and conclusions of law included 30 pages dedicated to the witnesses' testimony and their respective appraisals and reports.[6] In the Bankruptcy Court's Findings, the Bankruptcy Court gave the most weight to the plan proponents' expert, whom the Court found to be the only witness with extensive experience in valuing timberlands. His valuation analysis included computerize models generated by "Woodstock," the industry-standard software, and his projections took into account the growth rate for each species of timber, the costs of harvesting compared to the prices realized for each species, and the practical realities of what timbers could legally and logistically be grown and harvested within each plot of land. The report contained three different scenarios for a 50 year model period, which the Court found to be the industry standard for a model in light of the 45-year growth cycle for the debtors' timbers. The secured noteholders appealed.

In 2009, the Court of Appeals for the Fifth Circuit rendered the *Pacific Lumber* opinion, concluding that the Bankruptcy Court's valuation process was appropriate and not clearly erroneous. Judicial determinations of value, noted the Court of Appeals, "is not an exact science,

[6] See generally Findings of Fact and Conclusions of Law Regarding (a) Confirmation of MRC/Marathon Plan; (b) Denial of Confirmation of the Indenture Trustee Plan and (c) Denial of the Motion to Appoint a Chapter 11 Trustee, at pp. 31-61 (Bankr. S.D. Tex. June 6, 2008) [Bankr. Case No. 07-20027, Doc. No. 3088], available at https://ecf.txsb.uscourts.gov/ (the "Findings").

[but] it remains an integral part of the bankruptcy process."[7] Having concluded that the Bankruptcy Court's determination of the secured noteholders' collateral was appropriate, and that the reorganized debtors would pay the noteholders that amount in cash on the effective date of the plan, it followed that the plan satisfied the "indubitable equivalence" prong and could be forced on the noteholders over their objections.[8]

In re North Valley Mall, LLC, 432 B.R. 825 (Bankr. C.D. Cal. 2010) (Albert, J.)

The *Till*[9] formula approach and chapter 11 real estate cases.

Experts are also used in bankruptcy cases to opine on an appropriate rate of interest a debtor must pay to its secured creditors under a proposed a plan that forces new loan terms on an objecting secured creditor. In *North Valley Mall,* the debtor owned a 243,800 square foot "power center" with 29 retail suites and adjacent undeveloped land allocated for future development. The retail center was at 59.5% capacity on the petition date and had been facing financial problems since its anchor tenant filed its own bankruptcy case and vacated its space, leaving a hole in the retail center. The debtor's and lender's respective appraisals were not far off. The central issues in this confirmation dispute were (i) what interest rate to assign to the loan modifications proposed in the plan; and (ii) whether the plan was feasible.

Turning to the rate needed to satisfy section 1129(b)(2)(A)(i) to make the plan "fair and equitable," the Court applied a *Till*-like formula, while acknowledging that "[t]here is a world of difference between the collateral in *Till* (a truck) in a Chapter 13 case and the [commercial real estate] collateral in the case at bench." Nevertheless, the Court found that "a formula approach is appropriate to 'build up' a rate that can be said to approximately compensate for the level of risk proposed under the plan." The Court was persuaded by the debtor's expert, who surveyed actual market participants, including institutional lenders, for a multiple-tiered loan package to arrive at a "blended rate."

Based on the evidence at hand and considering additional risks perceived by the lender in this case, the Court found the market rate to be 8.512% or rounded to 8.5% to be an appropriate rate. On feasibility, the Court noted that "a sizeable paydown of the loan or accumulation of substantial cash which will assist the refinancing on favorable terms" may satisfy feasibility requirements. In this case, the Court acknowledged that at 8.5%, the experts' projections showed that money would be tight for the first and second year. However, assuming that the debtor could obtain a new anchor tenant within 24-36 months—an assumption found to be reasonable based on testimony from both experts—the Court found that the debtor would become cash flow positive by year three of the plan. Further, the Court found credible the testimony that the debtor's equity holders were willing and able to infuse additional funds, as needed, to cover operational shortfalls in the first couple of years. Based on this evidence, the Court found that

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[7] 584 F.3d at 248-49 (quoting *Matter of Sandy Ridge Dev. Corp.,* 881 F.2d 1346, 1354, *reh'g denied,* 889 F.2d 663 (5th Cir. 1989)).

[8] *See also Matter of ScoPac,* 624 F.3d 274 (5th Cir. 2010) (reversing an ancillary order of the Bankruptcy Court, under which the Bankruptcy Court determined that noteholders were not entitled to liens and superpriority claims on the proceeds from post-petition sales ($29.7 million) of the noteholders' collateral and also credited the noteholders' superpriority claim by the payments made ($8.9 million) to the noteholders' professionals, and ordering the reorganized debtors to pay an additional $29.7 million to the noteholders above and beyond the amounts already paid under the confirmed plan).

[9] *See generally Till v. SCS Credit Corp.,* 541 U.S. 465, 124 S. Ct. 1951, 158 L. Ed. 2d 787 (2004).

the debtor's projections were reasonably and reliably conservative because they took into account necessary capital expenditures without relying upon additional sources of cash that were not reasonably foreseeable. Thus, the Court concluded that the plan could be confirmed.

Carrier Corp. v. Buckley (In re Globe Mfg. Corp.), 567 F.3d 1291 (11th Cir. 2009) (Cudahy, J.)[10]

Expert witnesses were insufficient to prove the "industry standard" for terms of payment as an affirmative defense to preference actions.

While this opinion did not involve a real estate debtor, it demonstrates another use for expert witnesses—to establish defenses to preference actions. In this preference action, the trustee successfully obtained a judgment against a trade creditor who received two payments pre-petition. The creditor offered expert witnesses' testimony to demonstrate the "ordinary" course defense. *See* 11 U.S.C. § 547(c)(2).

Before the commencement of the bankruptcy case, the debtor and trade creditor had entered into an agreement under which the creditor installed a climate control system in exchange for six monthly installment payments. The creditor received two of these installment payments within the preference period, and each payment was made 28 days late. The chapter 7 trustee filed a complaint against the creditor to recover those two payments. In response, the creditor asserted two primary defenses that were addressed in the Court's opinion: (1) that it *could have* asserted liens had it not received the two payments; and (2) that the installment payments, though late, were made in the ordinary course of business. The Court of Appeals affirmed the judgment against the creditor, holding that the creditor's *unasserted* lien rights were insufficient to establish an actual security interest. Without an actual security interest, said the Court, the payments gave the creditor more than it would have received under a hypothetical chapter 7 liquidation.

With respect to the ordinary course defense, the Court reiterated that it was the creditor's burden to "characterize the payment practices of its industry with specificity, and present specific data to support its characterization." To meet this burden, the creditor presented uncontroverted testimony of two witnesses—an engineer and a regional manager. The Court found that neither of the creditor's witnesses was qualified to testify about the industry standard of payment terms, however, because neither witness was responsible for issuing invoices or processing payments. Thus, neither witness had first-hand knowledge that the late payments were ordinary for the creditor's industry. Finding no evidence of the parties' past dealings with each other and no reliable evidence of the standard timing for payment within the industry, the Court of Appeals affirmed the judgment against the creditor.

In re WGMR, Inc., 435 B.R. 423 (Bankr. S.D. Tex. 2010) (Paul, J.)

Appraisals based on comparable sales are unreliable for uniquely located real estate.

One ground for relief from the stay is that the debtor lacks equity in the property and the property is not necessary for an effective reorganization. *See* 11 U.S.C. § 362(d)(2). In this case, the secured creditor moved for relief based on several grounds, including the debtor's lack of equity in its collateral. Both sides presented appraisals based on comparable sales in the

[10] The Honorable Richard D. Cudahy, United States Circuit Judge for Seventh Circuit, sitting by designation.

downtown Houston area. The Bankruptcy Court disregarded these appraisals, however, concluding that the property in dispute was "uniquely located" and not properly appraised based on the sales comparables method. Said the Court, "Debtor's property is uniquely located, and its location and site characteristics do not support its valuation on the assumption that space in downtown Houston is a fungible commodity." Accordingly, the Court denied the creditor's motion for relief from the stay under section 362(d)(2), but granted relief instead for cause under section 362(d)(1), finding that the case was filed in bad faith.[11]

In re Aubuchon, 2010 Bankr. LEXIS 765 (Bankr. N.D. Cal. Mar. 4, 2010) (Morgan, J.)
Junior lien on residential real estate could not be stripped in light of equity available to secured junior lien in part.

In this case, the debtors sought to "strip off" their home equity loan and pay their junior lender nothing under their chapter 13 plan. The debtors and junior lender each submitted testimony of two appraisers who conducted comparisons of recent home sales in the surrounding areas. According to the debtors' appraiser, the residence lacked any equity over the senior lien holder's claim. According to the junior lender's appraiser, however, the home had substantial equity over the senior lien to partially secure the junior lien. Relying on Ninth Circuit precedent in *In re Zimmer,* 313 F.3d 1226 (9th Cir. 2002), the Bankruptcy Court concluded that the junior lien remained subject to the anti-modification provision of section 1322(b)(2) if the junior lien was at least partially secured. *See also Nobleman v. Am. Svgs. Bank,* 508 U.S. 324, 331-32, 113 S.Ct. 2106, 124 L.Ed.2d 228 (1993). After reviewing the reports and testimony of both appraisers, the Court favored the lender's valuation over the debtors' valuation. In its reasoning, the Court explained that the debtors' appraiser placed too much reliance on MLS reports while the lender's appraiser actually contacted the listing agent for each home used in his comparisons and made adjustments to those properties based on the MLS information *and* the listing agents' descriptions of the properties.[12]

VI. Claims Litigation

Rederford v. US Airways, Inc., 589 F.3d 30 (1st Cir. 2009) (Lynch, J.).
If an equitable remedy *may be* reduced to monetary damages, it is a dischargeable claim.

Years after confirmation of U.S. Airways' chapter 11 plan, a former employee pursued her pre-petition action for wrongful termination under the Americans with Disabilities Act ("ADA"). Her claim was based on her 2002 termination after a 24 year career with the company. The bankruptcy petition was filed shortly after she began her pursuit in the EEOC and its state counterpart in Rhode Island. She received notice of the bankruptcy filing and filed a

[11] *See also In re Knight Energy Corp.,* 2009 Bankr. LEXIS 1841 (Bankr. N.D. Tex. June 26, 2009) (denying motion for relief from stay under 11 U.S.C. § 362(d)(2), without making a precise finding of value, finding such precision to "be futile, since it would not be binding at the confirmation hearing, pursuant to section 506(a), and since there could be a dramatic change in oil and gas prices between now and the confirmation hearing that could greatly impact value," and instead giving the debtors an opportunity to propose a plan with a reasonable likelihood of being confirmed).

[12] *But see In re Malamatos,* 2010 Bankr. LEXIS 3184 (Bankr. S.D. Cal. Sept. 13, 2010) (Mann, J.) (granting the debtors' lien stripping motion, finding that the debtors' appraiser took the more relevant factors into account, including the condition and location of the debtors' home as compared to the houses used for the appraisal).

proof of claim for her wrongful termination claim, alleging over $1 million in actual damages, plus fees, costs and punitive damages. The debtor objected to her claim, but the claimant did not respond (despite receiving notice) due to her mistaken belief that she would be entitled to collect under the debtor's insurance policy either way. The bankruptcy court entered an order disallowing her claim, and the plan was confirmed the next day.

The claimant then received a right-to-sue letter from the EEOC,[13] and she commenced the instant lawsuit in federal district court. The debtor moved to dismiss on the basis that the ADA claim had been disallowed by bankruptcy court order and the suit was barred by the discharge injunction. The claimant argued that her relief was not a "claim" as defined in the Bankruptcy Code, because she merely sought reinstatement of her old job, which was strictly an equitable remedy that could not be replaced with the payment of money. *See* 11 U.S.C. § 101(5)(B) (defining "claim" as a "right to an equitable remedy for breach of performance if such breach gives rise to payment . . ."). The Court disagreed, finding that ADA claims, like Title VII claims, could be satisfied with "front pay," or compensation for lost wages. Based on this reasoning, the Court concluded that the former employee's claim had been discharged and could not be pursued against the now-reorganized debtor. Accordingly, the district court's dismissal order was affirmed.

National Union Fire Insurance Co. v. VP Buildings, Inc., 606 F.3d 835 (6th Cir. 2010) (Kennedy, J.).

Claims that become due in the future are not "actual" and, thus, are not entitled to administrative priority.

The movant here provided workers' compensation insurance to the debtors before and following the commencement of their chapter 11 cases in 2000. Pursuant to the insurance contracts, the insurer was responsible for the *immediate* payment of the injured workers' claims, but the debtors were ultimately responsible for reimbursing the insurer for benefits actually paid out over time. In this matter, National Union had been paying out benefits for injuries that occurred during the bankruptcy case. However, the plan confirmed in 2003 did not provide any special treatment for National Union's reimbursement claims. In 2007, National Union moved for the allowance of an administrative expense priority for its future obligations to pay benefits, noting that those injuries have already occurred and, thus, the claims may be estimated based on actuarial reports. The bankruptcy court denied the request, holding that (1) the actual amount of National Union's reimbursement rights could not be calculated until the underlying benefits were actually paid; and (2) the payment of benefits cannot be "necessary for the preservation of the estate" where the estate no longer exists. The district court affirmed, and National Union brought this appeal.

The court of appeals explained that this case could not be decided on a clean slate, citing *In re HNRC Dissolution Co.,* 371 B.R. 210, 225-26 (E.D. Ky. 2007), *aff'd by* 536 F.3d 683 (6th Cir. 2008) (per curiam). Based on *HNRC*, the court concluded that "National Union's claim will not be 'actual' until it has made a payment and seeks reimbursement from the insured, which will typically occur years post-confirmation." 606 F.3d at 839. The court of appeals rejected National Union's argument to distinguish this case from *HNRC* on the basis that its claims had

[13] She did not receive a similar letter from the Rhode Island Human Rights Commission, because that commission dismissed her action after she failed to seek a determination from the bankruptcy court whether the relief sought had been disallowed and/or discharged.

been reduced to an arbitration award. Said the court of appeals, "The arbitration process may have tested the parties' actuarial estimates, but it did not change the nature of the claim to 'actual' total due by the debtors during the pendency of the bankruptcy estate." *Id.*

Finally, the court of appeals declined to consider National Union's argument that *HNRC* was wrongly decided in light of *Reading Co. v. Brown*, 391 U.S. 471, 88 S.Ct. 1759, 20 L.Ed.2d 751 (1968), noting that "we are bound by the prior panel's decision." While Judge Cook, in a concurring opinion, urged the court of appeals to consider this matter *en banc*, National Union's request for a rehearing was denied. *See* 2010 U.S. App. LEXIS 18420 (6th Cir. Aug. 31, 2010).

In re Texans CUSO Ins. Group, LLC, 421 B.R. 769 (Bankr. N.D. Tex. 2009) (Houser, J.)

Debtor failed to prove grounds to vacate or modify arbitration award.

In this adversary, one of the debtor's former principals sought confirmation of a favorable pre-petition arbitration award against the debtor. The central dispute concerned the proper calculation of the former CEO's contractual earn-out following the debtor's institution of a new program for calculating commissions. Under the employment agreement, the parties agreed to submit their disputes to binding arbitration, which was conducted through an agreed upon "neutral accountant." After reviewing the parties' contentions and considering the employment agreement and relevant accounting principles, the neutral accountant entered her award in favor of the former principal. The former principal's actions to confirm the arbitration award were stayed by the debtor's bankruptcy, so the principal sought confirmation of his arbitration award from the bankruptcy court.

The bankruptcy court found that the arbitration award could only be modified or vacated upon the debtor's showing of some statutory bases for modification or vacatur. To that end, the debtor argued that: (1) the award should be modified due to "evident material miscalculations;" or (2) the award should be vacated because the neutral accountant exceeded her authority and/or re-wrote the employment agreement by issuing the arbitration award. The bankruptcy court, however, rejected these theories, finding that the neutral accountant's calculations were based on her own interpretation and applications of undisputed facts. Further, the bankruptcy court found that the neutral accountant's interpretation of disputed terms of the agreement was logically based on sound principles. Finally, the bankruptcy court was not convinced that the neutral accountant re-wrote the underlying agreement, instead deferring to the neutral accountant's interpretation of disputed and ambiguous provisions. Accordingly, finding that the debtor failed to demonstrate the existence of grounds to vacate or modify the award, the bankruptcy court entered this order confirming the arbitration award in favor of the former principal.

In re Siller, 427 B.R. 872 (Bankr. E.D. Cal. 2010) (Klein, J.).

Pre-petition judgment for attorneys' fees did not preclude debtor from objecting to claim.

Before the commencement of this bankruptcy case, the debtors racked up $12 million in legal fees related to a decade-long lawsuit. The litigation eventually settled, but not before prompting the present dispute between the debtors and its lawyers over the amount of legal fees incurred. The fee dispute went to arbitration, where the panel determined that the debtors breached their contingency fee contract and were liable for the full amount requested. The panel awarded $12 million in fees, plus additional costs and interest. A state court then entered judgment affirming the arbitration award. The debtors filed their bankruptcy cases and immediately objected to the claims under 11 U.S.C. § 502(b)(4). Under that provision, claims

may be disallowed "if such claim is for services of an insider or attorney of the debtor, [and] such claim exceeds the reasonable value of such services."

The debtors and law firms filed motions and cross-motions for summary judgment. The bankruptcy court found summary judgment to be improper and explained that state court judgment could not be preclusive of the "reasonableness" inquiry under section 502(b)(4). Said the court, claims for pre-petition attorneys' fees are subject to not one *but two tiers of scrutiny for reasonableness*. First, section 502(b)(1) considers whether the claim is enforceable under applicable state law. The bankruptcy court held that the arbitration award and state court judgment already decided the state law standard, and, thus, the issue was precluded. But even assuming the claim is enforceable under state law, the court explained that the claim remains subject to a second level of scrutiny under section 502(b)(4), which "was not and could not have been resolved in the prebankruptcy proceedings" because this second layer of scrutiny concerns "the federal interest of assuring equitable distribution of assets in a collective proceeding." In short, the "reasonableness" standard under section 502(b)(4) is a distinct issue that could not have been "actually litigated" outside of bankruptcy. For that reason, the court denied summary judgment, concluded that a trial should go forward on the claim objection and coined the adage: "Hell hath no fury like lawyers stiffed on $12 million in fees."

In re Good, 428 B.R. 235 (Bankr. E.D. Tex. 2010) (Rhoades, J.).

Debtor was precluded from objecting to claim on basis of value of collateral after arguing in support of plan confirmation that the same creditor was oversecured.

In this case, a creditor filed a secured claim asserting that it was oversecured. The debtors filed a chapter 11 plan, proposing to keep the collateral and pay the creditor out over time. The creditor objected to the plan on several grounds, including feasibility. To establish feasibility and prove its ability to cram down the plan over the creditor's objection and non-consent, the debtors argued that the value of the claimant's collateral exceeded the amount of its claim. While the creditor conceded—even argued—that it was oversecured, it objected to the debtors' valuations, arguing that its collateral was not as valuable as the debtors contended and that its equity cushion was shrinking rapidly and could be non-existent within months after confirmation. Accepting the debtors' appraisal as accurate, the Court found that the plan was feasible and entered orders confirming the debtors' plan.

The plan allowed the debtors to pursue claim objections post-confirmation. Months after confirmation, the debtors objected to the same creditor's claim – this time arguing that the claim was vastly *under*-secured, because the value of the collateral had depreciated by 75% since confirmation. The creditor responded that the debtors were barred from re-litigating the issue of valuation, as the plan fixed the value of the collateral for purposes of feasibility and treatment of the claim. Noting that the claims administrative process often includes a determination of the value of collateral securing the claim, the Court explained that issue here was whether that particular issue had already been decided. Said the Court, if confirmation depended on a determination that the creditor was oversecured as of the confirmation date, then the debtors were bound to the valuation argued at confirmation. While the debtors contended that the claim was to be valued as of the "effective date" under the plan, the court found no authority to allow the debtors to reduce the claim post-confirmation after arguing for purposes of confirmation that the creditor was protected by a significant equity cushion. "The Fifth Circuit has rejected approaches to valuation that would unbalance the bankruptcy process by tipping it in favor of the debtor." Because the Court had already ruled on the value of the creditor's collateral as a

determination necessary for plan confirmation purposes, the Court concluded that the debtors were judicially and collaterally estopped from contradicting a valuation determination which they already won. Accordingly, the Court entered summary judgment in favor of the creditor and overruled the debtors' objection.

In re Bayou Group, LLC, 431 B.R. 549 (Bankr. S.D.N.Y. 2010) (Drain, J.).

Unofficial committee's pre-petition work in laying the framework for an efficient chapter 11 liquidation was a "substantial benefit" warranting allowance of fees and costs.

In *Adams v. Marwil (In re Bayou Group),* 564 F.3d 541 (2d Cir. 2009), the Second Circuit affirmed the bankruptcy court's decision to leave a "federal equity receiver" in place as the debtor-in-possession, denying the U.S.T.'s motion to appoint a chapter 11 trustee. The Second Circuit found that Jeff Marwil's continued management of the debtors' affairs was in the best interest of the estates and their creditors.

This case discusses whether the architects of the strategy to appoint Marwil were entitled to be paid from the estate as administrative expenses. The appointment of Marwil was the brainchild of a group of creditors/investors who formed an unofficial committee months before the bankruptcy case commenced. The committee's by-laws made clear that their expressed goals were to become an official committee in any bankruptcy case filed by or for the debtor, and that they would research potential claims to recover assets and find a suitable candidate to act as a receiver or managing member capable of marshaling the debtors' assets for equitable distribution to all creditors. These goals were achieved in short order. The District Court appointed Mr. Marwil, who thereafter commenced chapter 11 cases on behalf of several entities and instituted actions against "redeemers" and "partial redeemers" who received inequitable distributions from the debtors prior to their collapse. Within months, a liquidating plan was confirmed and funded with $56.5 million in cash and another $24.7 million in judgments subject to "bonded appeals."

The issue in this case was whether the law firms representing the Unofficial Committee were entitled to recover their fees for work performed pre-petition. The relief was sought under section 503(b)(4), which allows reasonable fees and costs incurred by someone whose expenses are allowable under section 503(b)(3)(D) (allowing compensation for "a committee representing creditors or equity security holders other than a committee appointed under section 1102 of this title, *in making a substantial contribution in a case* under chapter 9 or 11 of this title") (emphasis added).

First, on the issue of whether pre-petition services can be allowed under section 504(b)(3)(D) and (b)(4), the court relied on the Third Circuit decision *Lebron v. Mechem Fin., Inc.,* 27 F.3d 937 (3d Cir. 1994), which, in turn, relied on the law predating the enactment of the Bankruptcy Code to conclude that "substantial contributions" *may* be provided through pre-petition actions, to the extent they are designed to ensure proper administration of the case as a whole.

Second, the court turned to whether the Unofficial Committee's actions in this matter were compensable as "substantial contributions." On this point, however, the court noted the dearth of cases where "substantial contributions" are actually found to exist. Most parties, the court explained, act out of their own self-interest. Further, in most cases, the substantial benefits are ones that should be provided by estate-compensated professionals and their clients who are already estate fiduciaries. This case was one of those rare instances where no fiduciary existed due to the incarcerations of the debtors' principals. The court held that the Unofficial Committee took on the typical fiduciary role by researching potential claims and obtaining the appointment

of Marwil as the new fiduciary. Based on this novel and creative approach, said the court, the Unofficial Committee (through their counsel) provided a substantial benefit to the case and to the estate. Thus, after reviewing the fee applications of the two law firms and reducing the amount slightly for minor amounts of duplication between them, the court allowed the fees as administrative expenses under section 503(b)(4).

VII. The Supreme Court

Ransom v. FIA Card Servs., N.A., --- U.S. ---, --- S.Ct. ---, 178 L. Ed. 2d 603 (Jan. 11, 2011) (Kagan, J.)

No "Ownership Cost" deduction for debtor who has no loan payments due on his car.

In her first bankruptcy-related decision since being sworn in, Justice Elena Kagan wrote for an 8-1 majority, concluding that a chapter 13 debtor who owns his car free and clear, and thus does not make loan or lease payments on the vehicle, may not make an "ownership" deduction in calculating his disposable income payable to creditors under a chapter 13 plan.[14] The issue here arose from the language of 11 U.S.C. § 707(b)(2), which defines "monthly expenses" as "the debtor's *applicable* monthly expense amounts specified under the National Standards and Local Standards, and the debtor's actual monthly expenses for the categories specified as Other Necessary Expenses issued by the [IRS] for the area in which the debtor resides." (emphasis added). At issue here was the meaning of "applicable" and whether the debtor could claim an "Ownership Cost" for a vehicle which he already owned free and clear. On one hand, "applicable" could mean that an expense allowance is only available if the debtor incurs that type of an expense during the life of the plan. Other the other hand, as it applies to the car "Ownership Cost" allowance, "applicable" could mean which column under the allowance chart applies to the debtor (i.e., first car or second car).

According to the debtor's chapter 13 plan, he earned $4,248.56 each month. He calculated his expenses to be $4,038.01, leaving only $210.55 in monthly disposable income to be paid to unsecured creditors under his plan. The debtor's largest unsecured creditor objected to the plan, arguing that the debtor improperly included two expense allowances for his car: an ownership deduction for $471 each month, and an operating deduction for an additional $338 each month.[15] The bankruptcy court sustained the objection and denied confirmation. The Ninth Circuit agreed with the bankruptcy court that the ownership deduction was not applicable to a debtor who already owned his vehicle and, thus, made no loan or lease payments during the life of the plan.

In an 8-1 majority, the Court held that a standard allowance is only applicable for calculating a debtor's monthly expenses if the debtor actually incurs a particular expense of that

[14] In chapter 13 cases, a plan may not be confirmed over an unsecured creditor's objection unless it pays all unsecured claims in full or commits all of the debtor's "disposable income" toward the plan over a three or five year period. "Disposable income" is a defined term under the Bankruptcy Code that is calculated based on the debtor's monthly income and certain standard allowances for living expenses.

[15] According to the Internal Revenue Manual §§ 5.15.1.7-8, "ownership cost" allowance is the average monthly loan and/or lease payment, while the "operating cost" allowance includes other costs such as insurance, fuel, parking, tolls, licensing, registration and similar costs.

type during the term of the plan.[16] To read the word "applicable" otherwise, said the Court, "would sever the connection between the means test and the statutory provision it is meant to implement -- the authorization of an allowance for (but only for) 'reasonably necessary' expenses." To construe ambiguities made by BAPCPA in a manner achieves the "overall purpose of ensuring that debtors repay creditors to the extent they can," the Court concluded that a debtor cannot shield his income by using allowances that are not actually needed—in this case, the debtor would have been able to withhold $28,000 in plan payments over five years for an expense that he did not actually incur.

In his lone dissent, Justice Scalia noted that he would have reversed the Ninth Circuit and allowed the deduction. "The reality is, to describe it in the [majority's] own terms, that occasional overallowance (or, for that matter, underallowance) 'is the inevitable result of a standardized formula like the means test . . . . Congress chose to tolerate the occasional peculiarity that a brighter-line test produces.' **Our job, it seems to me, is not to eliminate or reduce those 'oddit[ies],' but to give the formula Congress adopted its fairest meaning.** In my judgment the 'applicable monthly expense amounts' for operating costs 'specified under the . . . Local Standards,' are the amounts specified in those Standards for either one car or two cars, whichever of those is applicable." (internal citations omitted, emphasis added).

Milavetz, Gallop & Milavetz, P.A. v. United States, --- U.S. ---, 130 S.Ct. 1324, 176 L.Ed.2d 79 (2010) (Sotomayor, J.).

While attorneys are "debt relief agencies," the restrictions imposed by 11 U.S.C. § 526(a)(4) must be narrowly construed.

In this appeal, the Court decided the meaning of "debt relief agency" and the scope of section 526(a)(4). First, the Court held that attorneys do fall within the definition of a debt relief agency, as that term is defined in section 101(12A) of the Bankruptcy Code.[17] Said the Court, "By definition, 'bankruptcy assistance' includes several services commonly performed by attorneys. Indeed, some forms of bankruptcy assistance, including the 'provi[sion of] legal representation with respect to a case or proceeding,' § 101(4A), may be provided only by attorneys. . . . Moreover, in enumerating specific exceptions to the definition of debt relief agency, Congress gave no indication that it intended to exclude attorneys." Thus, the Court concluded that attorneys fall within this definition.

This lead to the next issue: do the restrictions imposed on debt relief agencies in section 526(a)(4)—prohibiting debt relief agencies from advising clients to incur more debt in contemplation of bankruptcy—unconstitutionally infringe on attorneys' First Amendment free speech rights? The Court answer in the negative, but only after adopting a narrow reading of the statute. Reading the revisions added by BAPCPA as a whole, the Court concluded that Congress intended section 526(a)(4) to prohibit debt relief agencies from advising client's to engage in abusive conduct such as "loading up" on debt in contemplation of obtaining a discharge in bankruptcy. "It would make scant sense to prevent attorneys and other debt relief agencies from advising individuals thinking of filing for bankruptcy about options that would be beneficial to

[16] The Court expressly avoided resolving the related issue of what happens when the debtor's *actual* monthly expense is lower than or exceeds the average amount allowable under the national and local standards.

[17] The definition includes "any person who provides any bankruptcy assistance to an assisted person in return for . . . payment . . . , or who is a bankruptcy petition preparer." 11 U.S.C. § 101(12A) (2010).

both those individuals and their creditors. That construction serves none of the purposes of the Bankruptcy Code or the amendments enacted through the BAPCPA." Instead, the Court concluded that attorneys remain free to talk candidly and fully with their clients about filing for bankruptcy protection.

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VII. The Supreme Court

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