

Today's Chapter 7

Hon. David S. Kennedy, Moderator
U.S. Bankruptcy Court (W.D. Tenn.); Memphis

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POST-BAPCPA CASES

1. Amended §330 interpreted to allow Lodestar analysis of Trustee compensation

A Pennsylvania Bankruptcy Court has analyzed the effect of amended §330, and concluded that Trustee compensation remains subject to a reasonableness determination based on the Trustee's efforts in the case, including a Lodestar analysis, prior to consideration of the commission fee structure of §326. *In re Ward*, 366 B.R. 470 (Bkrcty.W.D.Pa. 2007).

In this case the Trustee requested the §326 maximum fee, based on funds disbursed in the case. Initially the Trustee submitted no time records to support his fee request, citing amended §§330(a)(3) and 330(a)(7). He argued that these amended sections, when read together, indicate that the commission structure of §326 now trumps §330(a)(3), which no longer applies to Chapter 7 Trustees. Upon hearing, the Court requested time records, and asked the Trustee to brief the issue. A Memorandum by the United States Trustee and an Amicus Brief by the Chapter 7 Panel Trustees from the district, both in support of the Trustee's position, were also filed.

Judge Bentz cited *In re Clemens*, 349 B.R. 725 (Bkrcty.D.Utah 2006), where the Court found that after the §330 amendments it "must still apply the Lodestar analysis in reviewing Chapter 7 Trustee compensation but now must supplement that analysis with a consideration for the provisions of §326." The Pennsylvania Court further cited Collier on Bankruptcy, which opined: "...It will continue to be necessary for trustees to present detailed fee applications, ..." after the amendments to §330. The Court found that a "typical Lodestar analysis" would render an appropriate fee in the "\$2,000.00 range", and that the maximum compensation under §326 was \$9,188.64; then allowed compensation in the amount of \$5,000.00, plus reimbursement of expenses of \$584.66, recognizing that "trustees often perform services in cases where they end up with an estate of little or no value and receive little or no compensation,"

Editor's Note: There is absolutely no way to read amended §330(a)(3) to do anything other than remove the Lodestar analysis from factors to be evaluated in determining reasonable compensation for Chapter 7 Trustees. While the component of "reasonableness" remains, the Lodestar analysis does not. A Trustee's fee might be unreasonable in the exceptional situation where it amounts to a windfall, but not based on the Lodestar approach. Hopefully, Courts will eventually be able to distinguish the no-longer applicable Lodestar analysis, from the "windfall analysis" that should apply post-BAPCPA. In other words, the §326 commission structure should apply except in the extraordinary circumstance where it would amount to an unconscionable windfall to the Trustee. That is post-BAPCPA "reasonableness".

2. Under BAPCPA, Chapter 7 Trustee compensation is commission based, and lodestar is no longer a method for fee computation

A Texas Bankruptcy Court has analyzed the BAPCPA amendments to §330, and concluded that the omission of "Chapter 7 Trustee" from subsection (a)(3), combined with the addition of the "commission language" of subsection (a)(7) "must mean" that the calculation under §326 "shall be permitted to be regarded as the reasonable compensation

to be paid to him in the Chapter 7 case, and the Court shall not be required to undertake the Johnson-type analysis contemplated in §330(a)(3)." (Emphasis included in text). *In re Coyote Ranch Contractors, LLC*, 400 B.R. 84 (Bkrtcy.N.D.Tex. 2009).

In this case the Trustee requested \$340,913.11 in compensation, computed under §326(a). The largest creditor objected to the fee as unreasonably high. The Trustee had expended 461.7 hours of time, which translated to \$174,420.00 under a "lodestar" computation. Judge Jernigan looked to the plain language of the BAPCPA amendments to make his ruling. He noted that amended subsection (a)(3) specifically omits consideration of lodestar and certain other factors in computing the fee. He further noted that subsection (a)(7) requires "a commission-style approach, based on the parameters set forth in §326." Thus, "courts may start and end with the cap (in other words, there is no obligation to consider the factors described in §330(a)(3))". However, the Court acknowledged that the §326 computation still represents the maximum compensation, subject to a reasonableness component. The Court found that the (a)(3) factors, including lodestar, "may" be used to assess the reasonableness of the fee, after computation under §326. Here, the Trustee's services brought an identifiable, tangible and material benefit to the bankruptcy estate, in a complicated case. Objection denied and maximum fee approved.

Comment: This is the first post-BAPCPA case holding that the §330 amendments require courts to start with the §326 compensation cap as reasonable, and work backwards. It is also the first case to find that lodestar is not to be applied directly to fee computation, though it remains a factor as to reasonableness. This is very close to what NABT has said all along, and it will hopefully advance this interpretation far beyond the great state of Texas.

3. Trustee receives §327(a) compensation based on "substantial time and effort" and "results obtained"

A Florida bankruptcy court has recently awarded a Trustee the maximum §327(a) commission in the amount of \$473,250.00. While this is certainly good news, especially for that Trustee, the Court's rationale and the potential precedential effect of the case are, while somewhat unclear, very important. *In re C & D Dockworks, Inc.*, 437 B.R. 443 (Bkrtcy.N.D.Fla. 2010).

Judge Briskman observed that this case initially appeared to have no assets, and could have been declared a no asset case. Instead, the Trustee engaged special counsel to investigate potential insurance policy claims, and subsequently asserted a bad faith, failure to defend action. This claim was ultimately settled for a lump sum \$15,000,000.00 payment to the bankruptcy estate. In determining Trustee compensation, the Court found that §326(a) and §330 "act in conjunction with each other and a Chapter 7 Trustee's compensation is to be held to a reasonableness standard pursuant to the plain, unambiguous language of the statute." The §326(a) commission calculation constituted "compensation caps and not entitlements"; subject to "substantial discretion" by the Bankruptcy Court in determining reasonableness. The Court agreed with *In re Coyote Ranch Contractors, LLC*, 400 B.R. 84 (Bkrtcy.N.D.Tex. 2009), which found the Fifth Circuit *Johnson* factors "relevant to determining a reasonable compensation award." This Trustee was entitled to the maximum commission "based upon the unique factors of this case, the Trustee's exemplary effort, the extraordinary results obtained, and the *Johnson* factors. The Court further indicated that the Trustee "expended substantial time and effort."

However, there is no mention anywhere in the opinion as to time records kept by the Trustee, or submission of such records to the Bankruptcy Court. There is also no mention or discussion of a lodestar fee calculation based on time expended by the Trustee.

See also *In re McCombs*, 436 B.R. 421 (Bkrcty.S.D.Tex. 2010), where Judge Bohm allowed Trustee compensation, though significantly reduced, in a case where all the funds distributed went to either administrative or secured claims.

4. First Circuit denies §521(i) dismissal sought by debtor in asset case

After the case was converted from Chapter 13, the Chapter 7 Trustee proposed settlement of a discrimination suit which the Debtors had belatedly disclosed in a second amendment to their schedules. The Debtors did not agree with the settlement; and moved to dismiss their case for failure to file payment advices and a statement of monthly net income within the requisite 45 days under §521. The Trustee objected and the Bankruptcy Court "excused" the Debtors' failure to file under these circumstances. The District Court reversed, finding no authority to do anything other than dismiss after the 45-day deadline. Appeal was taken to the First Circuit. *In re Acosta Rivera*, 557 F.3d 8 (1st Cir. 2009).

The Circuit Court noted the two opposing views. On one side, *In re Parker*, 351 B.R. 790 (Bkrcty.N.D.Ga. 2006); *In re Jackson*, 348 B.R. 487 (Bkrcty.S.D.Iowa 2006); *In re Bonner*, 374 B.R. 62 (Bkrcty.W.D.NY 2007), finding that special circumstances can warrant *nunc pro tunc* relief. On the other side, *Warren v. Wirem*, 378 B.R. 640, (Bkrcty.N.D.Cal. 2007) and *In re Hall*, 368 B.R. 640 (Bkrcty.W.D.Tex. 2007), holding that the Court must dismiss the case after expiration of the 45 days. The First Circuit found that neither approach "satisfies both head and heart in equal measure." Acknowledging that the stricter reading might appear to address a congressional effort to reduce the escalation of bankruptcy filings, the Court also found that Congress, through the enactment of BAPCPA, "was not bent on placing additional weapons in the hands of abusive debtors." Thus, the Court held that "where...there is no continuing need for the information or a waiver is needed to prevent automatic dismissal from furthering a debtor's abusive conduct, the Court has discretion to take such action... The great divide in §521 is between information that is required and information that is not. The Act allows courts to do the sifting suggested by that divide without rigid adherence to the 45-day deadline."

Comment: This is the initial circuit court case decided on this issue. Hopefully it will have a precedential impact far beyond the First Circuit.

5. Ninth Circuit reverses District Court allowance of Debtor's §521 case dismissal motion

Following the First Circuit case of *In re Acosta Rivera*, 557 F.3d 8 (1st Cir. 2009), the Ninth Circuit has held that §521 automatic case dismissal for failing to provide information may be waived after the 45-day statutory deadline. The Circuit Court noted that §521(a)(1)(B) provides for dismissal "unless the court orders otherwise." The question of whether this discretion can be applied after the 45 day period has run was found to be ambiguous from the statutory language. The Court then agreed with the First Circuit that BAPCPA was not intended to put "additional weapons in the hands of abusive debtors". Thus, Bankruptcy Courts were found to have discretion to determine that the missing information is not required, "or that denial of dismissal is necessary to prevent a debtor

from abusing and manipulating the bankruptcy system." *In re Warren*, 568 F.3d 1113 (9th Cir. 2009).

6. More cases about which exemption laws apply

When the Debtor filed his bankruptcy case in Texas he had not lived there for 730 days, having moved from Florida during that period. The Debtor claimed the federal Bankruptcy Code exemptions under the hanging paragraph following §522(b)(3)(c) ("Hanging Paragraph"). The Debtor asserted that because the applicable Florida exemptions apply only to Florida residents, he was left without any available exemptions and defaulted to the federal exemptions per the Hanging Paragraph. The Trustee objected, noting that Florida has opted out of the federal exemptions, making them unavailable in any instance. *In re Camp*, 396 B.R. 194 (Bkrtcy.W.D.Tex. 2008).

Judge Gargotta held that the Florida exemptions applied to the Texas Debtor and the Debtor's property in Texas; even though the Florida law specifically provides that it applies only to Florida residents and land in Florida. The Court further found the federal exemptions inapplicable because Florida had opted out of them. The decision was based on the Court's finding that Congress preempted state law residency requirements with the BAPCPA amendments. Therefore, Florida law could apply in Texas regardless of the Florida state law restrictions. The Court further found that Florida's opt out of the bankruptcy exemption scheme made it impossible to use the federal exemptions when Florida exemption law was made applicable under the 730-day rule. As to the Debtor's argument that the federal exemptions apply by default under the Hanging Paragraph, there was no default. The Debtor was not left with no exemptions because, under this Court's analysis, the Florida exemptions did apply to the Texas Debtor.

But see In re Brooks, 393 B.R. 80 (Bkrtcy.M.D.Pa. 2008), *contra*, where Judge France found the federal exemptions to be available, under the Hanging Paragraph, to a Debtor who was unable to use the exemption scheme of his former domicile due to residency restrictions, and unable to use the federal exemptions because the applicable state had opted out of the federal exemption scheme. *In re Brooks*, 393 B.R. 80 (Bkrtcy.M.D.Pa. 2008).

7. State law exemption restriction held preempted

The Debtors filed their Chapter 7 case in Texas, approximately 16 months after they had moved from North Carolina. They had resided in North Carolina for the entire 180-day period immediately preceding the 730 days before their petition filing. The Debtors claimed real and personal property located in Texas as exempt under North Carolina exemption laws; though the subject North Carolina statute limited its application to residents of North Carolina. The Trustee objected, arguing that the Debtors defaulted to the federal exemptions under §522(b)(3)(A). *In re Garrett*, 435 B.R. 434 (Bkrtcy.S.D.Tex. 2010).

The Court found that the North Carolina, state law limitation to its residents was itself preempted by the federal bankruptcy exemption scheme. This finding followed the prior, previously reported Texas Bankruptcy Court holding of *In re Camp*, 396 B.R. 194 (Bkrtcy.W.D.Tex. 2008). Here, Judge Isgur addressed the argument that this finding makes the unnumbered "savings clause" superfluous. That section provides that if the effect of the "domiciliary requirement" renders a Debtor "ineligible for any exemption", the

Debtor may elect to exempt property "under the federal exemptions". The Court gave several examples of situations other than state law restrictions where this clause would apply. A Debtor who was temporarily domiciled overseas during the 180-day period is one such example. The Court reasoned that the 730/180-day requirements of subsection (a)(3)(A) represented federal law preemption of the North Carolina state law limitation. Thus, because the North Carolina limitation did not apply, there was no basis for defaulting to the federal exemptions. The North Carolina exemptions had been properly claimed, and the Trustee's motion was denied.

But see *In re Karavias*, 438 B.R. 86 (Bkrtcy.W.D.Pa. 2010), with almost identical facts, except for the names of the states involved. The Debtor filed a Chapter 7 case in Pennsylvania, with Virginia being the proper state exemptions to apply under the 730/180-day rule of §522(b)(3)(A). However, Virginia exemption law provided that it applied only to Virginia residents. Here, Judge McCullough specifically rejected the preemption argument, citing *In re Stevens*, 402 B.R. 1 (10th Cir. BAP 2009), which held that "acceptance of such preemption argument would operate to 'essentially render the added language at the end of §522(b)(3) [i.e., the §522(b)(3) savings clause] meaningless.'" Thus, this Debtor defaulted to the federal exemptions, which he was allowed to utilize. *In re Erie County Plastics Corp.*, 438 B.R. 89 (Bkrtcy.W.D.Pa. 2010).

Comment: The Pennsylvania case represents the majority position on this issue. While the Texas Courts might be able to cite several situations where the "savings clause" does not implicate state law exemption restrictions these examples fail to face one inescapable fact. State law limitations are almost always the reason the savings clause comes into play. Examples of other applications are exceptions that make the rule.

8. How to count the days in the 730-day exemption residency requirement

Debtors filed their Chapter 7 petition in Missouri on May 30, 2007. They claimed the Nevada exemptions, including the more generous Nevada homestead exemption. The Trustee objected, asserting that the Debtors were "domiciled" in Missouri for the entire 730-day period immediately preceding their bankruptcy filing. The evidence showed that the Debtors had moved from Nevada to Missouri, arriving late in the evening on May 30, 2005. They stayed in a hotel that night. The next day they closed their home purchase and moved into their new residence. The Debtor argued that even if they became "domiciled" in Missouri on their arrival, but before they owned their residence; the filing date was still 729, rather than the required 730 days later. Thus, their prior, Nevada domicile exemption could be claimed. *In re Dufva*, 388 B.R. 911 (Bkrtcy.W.D.Mo. 2008).

Judge Federman found no case explaining how to calculate the §522(b)(3)(A) BAPCPA domiciliary period, but observed that the statute looked to where the Debtor was domiciled "for the 730 days immediately preceding the date of the filing of the petition...." Here, the date "immediately preceding" the filing date was May 29, 2007. Counting backwards from that date, the 730th day was May 30, 2005. Because the Debtors were in Missouri on that date, with the intent to remain, they were domiciled in Missouri. Accordingly, the Trustee's objection was sustained and the Debtors were limited to the Missouri exemptions.

9. Repeat filer stay termination applies to property of the estate

An Illinois Bankruptcy Court has rejected the overwhelming majority opinion that §362(c)(3)(A) applies only to property of the Debtor and not to property of the Debtor's bankruptcy estate. *In re Daniel*, 2009 WL 1133338 (Bkrcty.N.D.Ill.).

Judge Wedoff acknowledged that the statutory language specifically provides that automatic stay relief terminates for creditors of a one-time repeat filing Debtor "with respect to the debtor." However, the Court disagreed that this language necessarily omits property of the Debtor's bankruptcy estate from its application. Rather, this language was found to limit stay relief to the property of the estate of a repeat filer whose subsequent case was filed jointly with a non-repeat filing spouse. Under this reading, the stay termination is limited to the Debtor" who is the repeat filer. Therefore, §362(a)(3) applies "with respect to the debtor" who is the repeat filer, and to that debtor's property, which became estate property upon the petition filing. When read this way, the language makes sense because it differentiates between joint Debtors, and applies only to the one who is a repeat filer. In so holding, the Court further found this statutory interpretation to be more in keeping with the stated policy objectives of BAPCPA generally, and specifically as to repeat bankruptcy filings.

10. Court extends "vaporization" of assets under §362(h) to include abandonment and loss of avoiding powers

Fears and concerns of the authors of this article as to the potential ramifications of amended §521 and §362(h), stated prior to BAPCPA's enactment and repeated frequently since, have unfortunately come true in a recent Ohio Bankruptcy Court case. Here, the Court has ruled that the Debtor's failure to perform the stated intention with regard to a secured claim against a vehicle, less than 30 days after the §341 hearing, not only lifts the stay and removes the vehicle from the bankruptcy estate; it also prevents the Trustee from bringing an action to avoid the creditor's unperfected security interest under §544. *In re Baine*, 393 B.R. 561 (S.D.Ohio 2008).

The issue was joined when the Trustee filed an adversary proceeding based on the secured creditor's violation of the stay when it repossessed the vehicle. The Trustee asserted, and the Court agreed, that the creditor's lien was unperfected under applicable Ohio law. The Trustee cited *In re Houseal*, Adv. No. 306-0429 (Bkrcty.M.D.Tenn. February 15, 2007), where Judge Harrison found that §362(h) does not protect a secured creditor until the secured claim is proved to exist, but Judge Walter rejected this argument. The Court found there was a secured claim, even if it was unperfected; so the vehicle was no longer property of the estate, and the stay was no longer in effect when the Debtor failed to comply with §521(a)(2) within the prescribed time. However, the Court went much further, also finding that when the car left the estate, there was a parallel abandonment of the asset under §554, such that the Trustee lost his right to pursue an action to avoid the unperfected lien under §544. The Court stated it this way: "Because the operation of §362(h) is functionally equivalent to an abandonment, it has the effect of divesting the estate of all its interest in the property." The Court further explained that "all interests" include "the power of the Trustee to avoid an unperfected lien against the vehicle pursuant to 11 U.S.C. §544."

Comment: The Trustee's avoiding powers are statutory. They come into existence upon the filing of the bankruptcy case, and they belong to the Trustee. These statutory

powers are separate and distinct from property owned by the debtor, such as the vehicle in this case. Section 550 allows the Trustee to recover the "value" of an avoided transfer, as well as the "property" transferred. How did the Trustee in this case abandon his statutory power to avoid the lien and recover the value of the vehicle, when the vehicle left the bankruptcy estate. The Trustee's right of action is not the vehicle, and did not leave the estate with the vehicle.

Further Comment: Expanding §521(a)(2)(6) and §362(h), as this Court has done, effectively creates a 30-day statute of limitations for filing avoidance actions, which trumps the two-year limitation of §546.

Final Comment: Given the above, it probably goes without saying, but I'll say it anyway: The authors of this column strongly disagree with this result.

11. Proper venue for preference actions

BAPCPA amended §1409(b) by adjusting the jurisdictional amount and controversy from \$1,000.00 to \$5,000.00. Under the amendment, cases described in §1409(b) must be brought in the jurisdiction of the defendant, rather than the home Bankruptcy Court, where the recovery sought is less than \$5,000.00. It was thought that this would force Trustees to bring avoidance actions in the district where the defendant resides, creating additional expense and difficulty. In a prior article we discussed the unreported case of *In re Sterba*, Adv. Proc. 06-2037 (Bkrtcy.N.D.Ohio, July 10, 2007), Judge Morgenstern-Clarren, which held that preference actions were not included in the proceedings covered by §1409(b). We now have a reported case which finds likewise. *In re Rosenberger*, 400 B.R. 569 (Bkrtcy.W.D.Mich. 2008).

Judge Gregg noted the distinction between §1409(a), concerning venue in proceedings "arising under Title 11"; and §1409(b), dealing with matters "arising in or related to" a bankruptcy proceeding. Because preference actions involve substantive rights created by federal bankruptcy law, they "arise under" the Bankruptcy Code. That is distinguished from cases which merely "arise in" a bankruptcy case, but do not involve a statutory provision of the Bankruptcy Code. The fact that "arising under" is included in §1409(a), but missing from §1409(b) must mean that one type of case is covered by one subsection, and not in the other. In so finding, the Court rejected the defendant's argument that Congress meant otherwise, but obviously made a mistake. Thus, the amount in controversy amendment was found not applicable in preference cases, and the Trustee could maintain his action in the home Bankruptcy Court. Finally, the Court further noted that this defendant "resided" in the district of the home court because it regularly did business there. Therefore, venue may have been appropriate even if §1409(b) applied to this case.

12. §503(b)(9) administrative expenses do not include services provided in conjunction with goods purchased and unpaid

The Debtor operated a chain of retail clothing stores. Claimant provided fulfillment services which included inspecting, ticketing and repackaging apparel purchased by the Debtor from other vendors. Claimant asserted an administrative claim based on unpaid invoices for such services provided during the 20 days immediately preceding the petition filing. The Debtor objected, contending the claim was misclassified as administrative under

BAPCPA §503(b)(9), which expanded administrative expense claims to include the value of goods received by the Debtor during the 20-day period, if they were sold to the Debtor in the ordinary course of its business. *In re Goody's Family Clothing, Inc.*, 501 B.R. 131 (Bkrcty.D.Del. 2009).

Judge Sontchi noted that the word "goods" is not defined in the Bankruptcy Code. The Court then assigned to goods the meaning stated in §21050(1) of the U.C.C.; which is something "moveable". Further, the Court noted that the term "goods" appears throughout the Bankruptcy Code, disjunctively connected to the term "services". This was found to indicate that the terms have separate meanings. Finally, the Court looked to the language of the statute, which provides that "goods", rather than value, must be received by the Debtor to trigger application of §503(b)(9). Therefore, claimant's argument that its contribution of value to the goods based on its services in connection with the goods, was unavailing.

13. Electricity equals goods for §503(b)(9) purposes

Two utilities filed administrative expense applications for the value of electricity supplied to a Chapter 11 debtor within 90 days of the petition filing. The only issue was whether electricity is a "good" entitled to administrative expense priority under §503(b)(9), or a service entitled to only a general unsecured claim. *In re Grede Foundaries, Inc.*, 435 B.R. 593 (Bkrcty.W.D.Wis. 2010).

Judge Martin initially pointed out that neither "goods" nor "services" are defined terms in the Bankruptcy Code. The Court then cited *Dewsnup v. Timm*, 502 U.S. 410 (1992), which held that where statutory terms have "accumulated settled meaning...under the common law" the Court should "infer that Congress meant to refer to that meaning when it provides no alternate definition." Therefore, and consistent with other cited cases, the Court looked to the Uniform Commercial Code definition of goods which is "all things that are moveable at the time of identification to a contract for sale." Section 2-103(1)(k). Here the Court found that electricity was identified pursuant to the contract between the parties "at the moment it was metered." It was also moveable at the time it was metered. The Court conceded that "electrical flow" may be "more difficult to conceptualize.... Nonetheless, there is no principal distinction to be made between natural gas, water or electricity. Regardless of how big the particle or how fast it moves, it is a good if moveable at the time of identification." Thus the value of supply of electricity to the Debtor within 90 days of bankruptcy was subject to §503(b)(9) administrative expense priority.

14. §503(b)(9) priority does not negate new value defense under §547(c)(4)

A Tennessee Bankruptcy Court recently considered an important BAPCPA issue of first impression. Here the Chapter 11 Debtor was a wholesale distributor to restaurants. After deciding to liquidate rather than reorganize, the Debtor sought a declaratory judgment that creditors with unpaid invoices allowing §503(b)(9) administrative expenses could not also claim the unpaid delivered goods as §547(c)(4) subsequent new value in preference actions brought by the Debtor. This was a significant issue, as more than 200 creditors had asserted more than 200 §503(b)(9) claims. *In re Commissary Operations, Inc.*, 2010 WL 99036 (Bkrcty.M.D.Tenn.).

The Debtor argued that including §503(b)(9) claims in the §547(c)(4) defense effectively granted "double value" by giving administrative priority to unsecured creditors while also reducing their preference liability in the amount of the administrative claim. The creditors countered that the plain language of the §503(b)(9) BAPCPA amendment included no indication that it in any way affected or impaired the new value defense of §547(c)(4).

Ruling for the creditors, Judge Harrison found no connection between a §503(b)(9) claim and the right to reclamation under §546(c), which does negate the (c)(4) defense. The Court also found that unlike a reclamation claim, (b)(9) claims arise only post-petition, and apply only in bankruptcy. The Court further cited the Congressional policy favoring allowance of payments to a struggling business, and found that forcing a creditor to elect between an administrative expense claim and a preference defense was contrary to that policy. Finally, as to the statutory language the Court stated: "There is nothing in the plain language of...§503(b)(9) or...§547(c)(4) that indicates any Congressional intent to offset the intended benefit that...§503(b)(9) confers upon sellers for a reduction of available new value in defending a preference action."

15. Supplier/creditor cannot exercise both a §503(b)(9) administrative claim and a §547(c)(4) new value preference defense

A supplier of a Chapter 11 Debtor filed a timely §503(b)(9) administrative claim for the value of goods shipped to the Debtor in the 20 days immediately preceding the bankruptcy filing. The Debtor objected under §502(d), alleging that the supplier had received avoidable preferential transfers. Upon agreement of the parties, the Debtor placed funds in escrow in the amount of the §503(b)(9) claim. This was done pending a determination of whether the supplier could assert the claim, then use the value of the same goods as a (c)(4) new value exception to preferential transfer avoidance. *In re Circuit City Stores, Inc.*, 2010 WL 4956022 (Bkrcty.E.D.Va.).

Judge Huennekens found that payment of the §503(b)(9) claim would be an "otherwise unavoidable transfer" under §547(c)(4)(B), which could not be deducted from preference avoidance as new value. The creditor/supplier was thereby forced to choose between §503(b)(9) or applying the unpaid value to a §547(c)(4) preference defense. It could not have the payment and the defense.

Comment: It seems obvious that suppliers/creditors should not have their cake [§503(b)(9)] and also eat it (§547(c)(4) preference defense). However, at least one Court has allowed this. *In re Commissary Operations, Inc.*, 2010 WL 99036 (Bkrcty.M.D.Tenn). Subsequent cases have gone the other way, creating a majority view consistent with the notion that it's not fair to have it both ways, and benefit twice.

See also *In re Standard Building Systems, Inc.*, 2010 WL 4942104 (Bkrcty.W.D.Va.). There, Judge Krumm held that the release of a garnishment against the Debtor's bank account was not a §547(c)(1) contemporaneous exchange for new value, where the Debtor paid the creditor \$24,000.00 to obtain the release. The creditor's decision to forego one method of collection (execution) created no new value back to the Debtor, which was, one way or the other, out the \$24,000.00 paid to the creditor.

MISCELLANEOUS OTHER NON-BAPCPA CASES OF INTEREST

Exemptions

16. Eighth Circuit BAP finds Social Security benefits are not property of the bankruptcy estate

In a case previously reported in this article, the Bankruptcy Court denied a Debtor's exemption of a pre-petition lump-sum payment of retroactive Social Security benefits. Because the Debtor elected to use the federal bankruptcy exemptions, the Court ruled that federal non-bankruptcy exemptions, including §407 of the Social Security Act, did not apply. The Debtor was therefore left with Code §522(d)(10)(A), which allows exemption only of a "right to receive" Social Security benefits, and does not include funds already received pre-petition. The Debtor appealed to the BAP. *In re Carpenter*, 408 B.R. 244 (8th Cir. BAP 2009).

Writing for the BAP, Judge Federman agreed that funds held by the Debtor did not constitute the "right to receive" a Social Security benefit. Rather, they represented funds which were previously paid as such a benefit. However, that finding was not dispositive of the issue. The Court looked to §407 of the Social Security Act and found that it "rendered Social Security benefits, paid or payable, free from the operation of any bankruptcy laws." Thus, a bankruptcy trustee lacks authority to administer money paid to a debtor as Social Security benefits. "In other words, such proceeds are not property of the bankruptcy estate." Though the Debtor's exemption claim was invalid, the funds sought to be exempted were still not subject to the Trustee's estate administration.

17. What separates permissible pre-bankruptcy exemption planning from fraud? Eighth Circuit answer

When the company partially owned by the Debtor defaulted, the creditor bank looked to the Debtor's personal guarantee to collect its \$1.3 million obligation. Subsequently, and less than 90 days before his bankruptcy filing, the Debtor withdrew \$8,000.00 from a brokerage account which contained approximately \$45,000.00, and established Roth IRA accounts for his wife and him. An additional \$9,000.00 was withdrawn from the brokerage account, along with \$2,500.00 from a bank account, which was used to pay down the principal balance of the Debtor's home mortgage by \$11,500.00. Once this transaction was complete, the bankruptcy petition was filed later that day. The Debtor elected the applicable Minnesota exemptions, claiming his Roth IRA and \$91,250.00 of equity in his homestead as exempt. Upon the Trustee's objection, the Bankruptcy Court denied the exemptions, finding the Debtor's pre-petition transfers were made with intent to hinder, delay, or defraud creditors. On appeal the BAP affirmed, and further appeal was taken to the Eighth Circuit.

Subsequent to the Bankruptcy Court ruling on the exemption issue, the Trustee brought a §727(a)(2) action against the Debtor. The Bankruptcy Court denied the Debtor's discharge, finding that the prior ruling on the exemption issues was preclusive as to the §727(a)(2) issues. Appeal was again taken to the BAP, which immediately transferred and consolidated this appeal with the one already pending on the exemption objection. *In re Addison*, 540 F.3d 805 (8th Cir. 2008).

The Eighth Circuit looked first at the homestead exemption under Minnesota law and BAPCPA amended §522(o), both of which allow for reduction of the exemption where non-exempt funds are used to reduce debt and create exempt equity in a homestead, "with the intent to hinder, delay or defraud a creditor". The Court cited several cases which have addressed §522(o) and followed their analysis that this issue should be construed the same way Courts have previously construed §§548(a)(1) and 727(a)(2), to determine the requisite intent to trigger application of §522(o). The Court then addressed the issue of transfer of non-exempt funds into the Roth IRA, and found the analysis to be essentially the same.

The Court began with the proposition that the mere conversion of non-exempt into exempt property, on the eve of bankruptcy, for the purpose of placing the property beyond the reach of creditors, without more, does not deprive a Debtor of an exemption to which he would otherwise be entitled. Rather, a finding of the fraudulent intent required to trigger state and federal limitations on exemption rights must be based on some evidence of facts or circumstances extrinsic to the transfer itself. Further, these extrinsic facts must indicate a fraudulent purpose. Such evidence relevant to denial of exemption on fraudulent transfer grounds includes: 1) conduct intentionally designed to materially mislead or deceive creditors about the Debtor's position, 2) the Debtor's use of credit to buy exempt property, 3) conversion of a very large amount of property, or 4) the existence of conveyances for less than adequate consideration. Here, none of these specific badges of fraud existed, and the Bankruptcy Court was reversed. The Circuit Court found the Bankruptcy Court's failure to address any conduct "extrinsic" to the transfers themselves was clearly erroneous. Therefore, and likewise, the Debtor's discharge denial was also reversed.

See also, *accord, In re Jones*, 397 B.R. 765 (Bkrcty.D.S.C. 2008) and *In re Wilmouth*, 397 B.R. 915 (8th Cir. BAP 2008), both of which used the §548(a)(1) and/or §727(a)(2) analysis to determine that the transfers in question were not done with sufficient intent to defraud, and §522(o) did not apply.

18. Pre-bankruptcy exemption planning allowed

A Texas bankruptcy court has recently denied relief based on the Debtors' pre-petition manipulation of assets/exemptions. Here, a creditor brought a discharge denial action under §727(a)(2)(A) alleging transfer of property with fraudulent intent during the year immediately preceding the bankruptcy filing. During this time, the Debtors had moved out of their residence, which had no equity, into another house with significant equity. This move enabled them to apply the homestead exemption that would have been otherwise unavailable. The creditor argued that this amounted to eve of bankruptcy conversion of non-exempt assets into exempt assets. The Debtors countered that they were simply "downsizing" to lower their ongoing expenses. Judge Rhoades agreed with the Debtors, finding no fraudulent intent. The Court further found that §727(a)(2)(A) could not apply in any event, as the Debtors had not transferred any property. They just moved. *In re Moseman*, 463 B.R. 398 (Bkrcty.E.D.Tex. 2010).

19. Unscheduled 341 continuance tolls exemption objection deadline

The 341 meeting in this case was adjourned and continued several times from the original date of July 20, 2005. On September 23, 2005, the meeting was continued without

a formal announcement of the continued meeting date, which was subsequently rescheduled for July 19, 2006, but then continued by telephone to August 24, 2006. When the Debtors moved to quash the meeting as untimely, the Bankruptcy Court denied the motion, and the meeting was finally held and concluded on August 24, 2006. The Trustee then filed an objection to the Debtors' claimed exemptions on September 5, 2006, which the Bankruptcy Court sustained. The District Court affirmed on appeal, and further appeal was made to the Fifth Circuit Court. The Debtors asserted that no announcement of a continuation date was made at the September 23, 2005 meeting, which resulted in its conclusion, which thereby triggered the 30-day objection deadline of Bankruptcy Rule 4003(b). Thus, the August, 2006, objection was brought past the deadline, and barred. *In re Peres*, 530 F.3d 375 (5th Cir. 2008).

The Circuit Court cited Bankruptcy Rule 2003(e) which specifically provides: "The meeting may be adjourned from time to time by announcement at the meeting of the adjourned date and time without further written notice." Although recognizing contrary authority, the Court then pointed to the overwhelming majority of cases which have rejected a bright-line approach, and have either held that 1) the question of when the meeting is to be adjourned is to be decided on a case by case basis, or 2) the meeting is not concluded until the Trustee or the Court declares it concluded. Adopting the case by case approach, the Court enumerated the four factors to be considered in determining the reasonableness of a Trustee's delay in adjourning a meeting of creditors: a) the length of the delay, b) complexity of the estate, c) the cooperativeness of the debtor, and d) existence of any ambiguity regarding whether the trustee continued or concluded the meeting. Here, the Bankruptcy Court had made findings on all of these points, and had correctly held that the Trustee acted reasonably. As to the 11-month delay, six months were attributable to continuances requested by the Debtors, who never moved to conclude the meeting. The Bankruptcy Court had further acknowledged an unprecedented increase in bankruptcy filings during the relevant period. Finally, the Circuit Court reiterated the lack of prior written notice as a requirement in Rule 2003(e), and noted that the transcript of the September 23 meeting indicated the parties had agreed to an uncertain continued date.

Comment: While this case is favorable to the Trustee, it would be improvident for Trustees to rely on it. Local practice varies widely on this issue, and local rules should be known and followed. For example, some districts require the Trustee to file a written notice if the meeting is not concluded, while others require the debtor to provide notice of the continued hearing, if it is continued at the debtor's request.

20. Unconcluded 341 meeting held concluded for objection to exemption purposes

At their initial 341 meeting, the Trustee examined the Debtors about their doubtful homestead exemption claim. The meeting ended without an announcement by the Trustee that it had been concluded or adjourned. However, the Trustee did demand the Debtors to provide certain documents and other information, all of which was delivered within ten days of the meeting. This information allowed the Trustee to determine promptly that the residence at issue was subject to an exemption objection. The Trustee then made an offer to settle the issue, which the Debtors rejected. Five months after the initial creditor meeting, the U.S. Trustee concluded its independent §707 and §727 investigation (of which the Trustee was aware) in favor of the Debtors. The Trustee then promptly gave notice of a

continued 341 meeting to occur approximately two months later (seven months after the first meeting). Twenty-nine days after the second meeting, the Trustee filed an objection to the Debtors' homestead exemption claim. The Debtors argued the objection was time barred. The Bankruptcy Court disagreed and sustained the Trustee's objection. Debtors appealed. *In re Newman*, 428 B.R. 257 (1st Cir. BAP 2010).

The BAP stated the three approaches developed in the case law to determine when a §341 meeting was concluded. 1) Under the bright-line approach, a meeting continued without a follow-up date is determined to have been concluded on the date of the initial meeting. 2) Under the case-by-case approach, the facts and circumstances are examined with attention paid to a) length of the delay, b) complexity of the estate, c) cooperation of the Debtor, and d) the existence of any ambiguity regarding whether the Trustee continued or concluded the meeting. 3) The third is the "debtor's burden" approach, where the 341 meeting would not be considered concluded until "the trustee so declares or the court so orders." Here the BAP majority rejected the "debtor's burden approach" and found the other two approaches would yield the same result; relieving the Court from choosing between them. The Court determined that the Trustee had all the information she needed within 30 days of the initial meeting of creditors, and it was not certain that the initial meeting had been continued. Thus the objection was denied as untimely.

Dissenting, Judge Votolato preferred the "case-by-case" approach, and thought the BAP should have deferred to the Bankruptcy Court, which had not abused its discretion.

Comment: Here the Trustee had already noted problems with the homestead exemption claim, and could easily have either continued the meeting on the record to a particular date, or obtained an extension of the deadline to object to exemptions. Leaving the issue open ended was a recipe for trouble.

21. Bankruptcy-specific state exemption statute held constitutional

West Virginia has "opted out" of the Federal Bankruptcy Exemption Scheme, thereby restricting its debtors to exemptions available only under state or local law and federal non-bankruptcy law. The applicable state exemption provisions apply only in bankruptcy proceedings, even though West Virginia has other exemptions that apply to judgment debtors generally. The Trustee objected to the Debtor's claim of exemption, arguing that state exemption laws applicable only in bankruptcy cases are inconsistent with the Bankruptcy Code's objectives regarding distribution of estate assets, rendering them invalid under the Supremacy Clause. The Bankruptcy Court disagreed, allowing the exemptions, and direct appeal was certified to the Fourth Circuit. *Sheehan v. Peveich*, 574 F.3d 248 (4th Cir. 2009).

The Circuit Court found: "This statutory provision [§522(b)(1)] is an express delegation to the states of the power to create state exemptions in lieu of the Federal Bankruptcy Exemption Scheme." The Circuit Court continued: "Congress has not seen fit to restrict the authority delegated to the states by requiring that state exemptions apply equally to bankruptcy and non-bankruptcy cases, and we are without authority to impose such a requirement." Consequently, the Bankruptcy Court decision was affirmed. But see, *contra*, *In re Kanter*, 505 F.2d 228 (9th Cir. 1974).

22. BAP affirms denial of Debtors' exemptions based on bad faith

When the Debtors met with their attorney pre-petition, they were given a worksheet to complete and return. The worksheet stated: "Official Bankruptcy Forms will be completed using the information that you give in these worksheets and you will be required to sign a declaration stating under penalty of perjury that the information is true and correct." Question 16 asked for the approximate average daily balance in the Debtors' bank account, which they found online, and listed as \$300.00 for a checking account and \$25.00 for a savings account. After completion and return of the worksheet, but before they reviewed and signed their bankruptcy schedules, the Debtors borrowed \$17,000.00 from a 401(k) account, and deposited the money in their checking account. Eight days later the Debtors signed bankruptcy papers which listed the current balance in the checking account as \$325.00. They also disclosed no property transferred within two years prior to case commencement. When the petition was filed, the Debtors' checking account had a balance of \$13,918.89 from which they actively drew pre and post-petition, paying their mortgage and other bills. At the meeting of creditors, the Debtors testified that their schedules were true, correct and complete. Upon receipt and review of the bank statements, the Trustee demanded turnover of funds in the bank account in excess of the \$325.00 which the Debtors had exempted. The Debtors then filed amended Schedules B and C listing the value of the bank account at \$13,907.19 and exempting the entire balance. The Trustee objected, and the Bankruptcy Court denied the exemption based on the Debtors bad faith in failing to accurately disclose the bank account, and asserting an exemption only after the Trustee's demand of turnover of the funds in excess of the originally disclosed amount. The Debtors appealed. *In re Barrows*, 408 B.R. 239 (8th Cir. BAP 2009).

Writing for the BAP, Judge Schermer acknowledged that exemption claims are generally subject to liberal amendment. However, that right to freely amend is not absolute. Bad faith by the Debtor or prejudice to creditors "can eliminate a debtor's right to amend exemptions." In this case, prejudice to creditors was not at issue. The Debtors could have exempted the retirement funds if they had remained in the 401(k) account. However, citing *In re Bauer*, 298 B.R. 353 (8th Cir. BAP 2003), the Court found this fact irrelevant. The Bankruptcy Court had determined that the Debtors acted in bad faith, or at least with reckless indifference to the truth when they provided inaccurate information and failed to correct it. Affirming the Bankruptcy Court, the BAP stated: "While there may be no harm to creditors, the debtors acted in bad faith and that bad faith alone is sufficient to disallow the amended exemptions."

See also *In re Akulova*, 407 B.R. 602 (Bkrcty.D.Del. 2009), where Judge Sontchi denied an exemption amendment after the Trustee had settled a pre-petition personal injury action in reliance upon the Debtor's choosing not to exempt it. Upon the Trustee's settlement, the Debtor sought to amend his "wildcard" exemption in a timeshare the Trustee had abandoned, replacing it with a claim against the personal injury settlement funds. The Court found it was inherently inequitable for the Debtor to exempt the "fruits of the trustee's labor" only if and when the Trustee succeeded.

23. State law limitation on garnishment was not applicable as a bankruptcy exemption

On the petition date, the Debtor had earned wages which had not yet been paid. Upon the Trustee's motion for turnover, the Debtor argued that the applicable Illinois garnishment statute set a limitation of 15 percent on the amount of wages subject to garnishment by a judgment creditor, making 85 percent of the unpaid wages exempt in the bankruptcy case. When the Debtor amended Schedule C to include this exemption, the Trustee objected. The Bankruptcy Court held for the Debtor, following the case of *In re Mayer*, 388 B.R. 869 (Bkrcty.N.D.Ill. 2008), which interpreted the garnishment limitation statute to create a general exemption applicable in bankruptcy. The Trustee appealed to District Court. *In re Koeneman*, 410 B.R. 820 (C.D.Ill. 2009).

The District Court compared the *Mayer* case, which held the statute to be effective in bankruptcy although it "does not expressly protect against all forms of collection" to *In re Thum*, 329 B.R. 848 (Bkrcty.C.D.Ill. 2005), which involved nearly identical facts. The *Thum* Court detailed the language employed in several exemption statutes, all of which expressly provided that the covered property was exempt from attachment and/or execution and/or seizure for satisfaction of debt. In contrast, the garnishment statute only provided "express protection for unpaid wages in the context of a deduction order...." Upon close examination the Court found "no language implying that any of the provisions are meant to apply to any proceedings outside the context of a collection judgment, and particularly nothing to suggest it may be applicable to federal bankruptcy proceedings...." There was, therefore, no bankruptcy exemption for any portion of the unpaid wages.

24. Value limitation of personal property exemption applies to insurance proceeds from their loss

Less than a month before their bankruptcy filing, a fire destroyed the Debtor's mobile home. Shortly thereafter, the fire insurer settled the claim by payment of \$39,063.39. That sum included living expense reimbursement, compensation for the mobile home and adjacent structure, and personal property. The Debtor did not initially disclose receipt of the insurance proceeds, but amended and included \$15,000.00 derived from the fire loss of the personal property in the mobile home. She exempted this entire amount in Schedule C, prompting the Chapter 7 Trustee to object. *In re Guenther*, 417 B.R. 685 (Bkrcty.W.D.NY 2009).

The Trustee argued that applicable New York law limited the exemption for household goods to \$5,000.00. The Debtor countered that a different New York exemption statute applied, which concerned causes of action to recover from loss of personal property and had no \$5,000.00 limitation. Judge Bucki looked to the language of the statutory exemption asserted by the Debtor, and found it specifically applicable to actions "to recover damages for taking or injuring personal property...." Here, the subject personal property had not been taken or injured. It had been burned in an accidental fire prompting an insurance claim and subsequent settlement. The Court stated its understanding "that the contents of the Debtor's home would likely have had a fair market value far less than any insurance replacement value"; but that did not matter. The insurance proceeds traceable to the exempt assets maintained their exempt status in bankruptcy, but with the same \$5,000.00 statutory limitation on the exemption that existed before the loss.

25. State law "bankruptcy specific" exemption held unconstitutional

A Michigan Bankruptcy Court has recently addressed an issue fraught with contentious disagreement and varied application. Can a state implement legislation which applies only to debtors in bankruptcy? Is such legislation an unconstitutional violation of the Supremacy Clause because it impermissibly infringes on the exclusive right of Congress to establish "uniform laws on the subject of bankruptcies throughout the United States" U.S. Constitution art. I, section 8, cl. 4 (V) ("Bankruptcy Clause")? In this case the statute provided that "A debtor in bankruptcy under the Bankruptcy Code,..." could exempt up to \$34,500.00 in value from a homestead. Outside of bankruptcy, the general homestead exemption was limited to \$3,500.00 under the Michigan Constitution. The Chapter 7 Trustee triggered the question by objecting to the Debtor's \$34,500.00 exemption claim, asserting the state exemption statute was unconstitutional. *In re Contius*, 421 B.R. 814 (Bkrcty.W.D.Mich. 2009).

Judge Gregg initially noted cases going both ways, including the recent Fourth Circuit case of *Sheehan v. Pevich*, 574 F.3d 248 (4th Cir. 2009). The Court also acknowledged "the admonition that it should not decide a constitutional issue unless it is absolutely compelled to do so." However, there was no way around the issue here. The Court cited *In re Hood*, 541 U.S. 440 (2004), for its holding that the Bankruptcy Clause "was intended to grant exclusive power to the federal government." The Court further cited *In re Wallace*, 347 B.R. 626 (W.D.Mich. 2006), for the proposition that Congress cannot delegate this exclusive legislative authority to states. Under the Bankruptcy Clause, Congress must establish "uniform laws on the subject of bankruptcy throughout the United States." The Court found this to mean, said another way, that Congress is forbidden from adopting laws of states which are not "uniform". While it may be uniform for all states to have the ability to opt out of the federal exemption laws, that is different from Congress adopting state laws which treat bankruptcy debtors different from other debtors. The Court then gave an example of how the Michigan statute created "non-uniformity". A creditor in Michigan might reasonably choose state court action, rather than involuntary bankruptcy against a Debtor with homestead equity above \$3,500.00. Any amount over that would be exempt by the Debtor in bankruptcy, but not otherwise. As such, the Michigan statute would frustrate a particular aspect of federal bankruptcy law, involuntary filings, rendering it unconstitutional under the Supremacy Clause.

26. Supreme Court reverses Circuit Court's in-kind exemption holding

Here are the facts, which we all know. The Debtor valued kitchen equipment at \$10,718.00 and claimed an exemption in that same amount. The Trustee did not object within the 30-day period allowed by Rule 4003(b). When the Trustee sought to sell the equipment for more than the Schedule B and C value, the Debtor objected, asserting the asset was no longer property of the estate. The Bankruptcy Court, District Court and Circuit Court all ruled in favor of the Debtor. The Supreme Court reversed, agreeing with the Trustee (and the United States and National Association of Bankruptcy Trustees as *amici curiae*) that the Bankruptcy Code defines property the Debtor is authorized to exempt as an interest, the value of which may not exceed a certain dollar amount in a particular type of asset. The asset itself is not exempted unless specifically provided as such by the

applicable exemption. Accordingly, the Trustee had no duty to object to an exemption within the limits the Code allowed.

The Supreme Court determined that the Third Circuit erred in holding that its earlier decision in *Taylor v. Freeland & Kronz*, 503 U.S. 638 (1992), dictated a contrary conclusion. While *Taylor* likewise concerned a Trustee's obligation to object to the Debtor's entry of a "value claimed as exempt", there was no colorable basis for claiming the exemption. Here the opposite was true. The amounts listed by the Debtor as the value of the claimed exemption were facially within the limits prescribed, and raised no red flags that warranted an objection. *Taylor* did not rest on an "unstated premise" that a Debtor who exempts the entire reported value of an asset is claiming the "full amount", whatever it turns out to be. Instead, *Taylor* stood for the straightforward proposition that an interested party must object to a claimed exemption if the amount the Debtor lists as the "value claimed exempt" may be beyond statutory limits. The Supreme Court concluded that the Debtor's approach "threatens to convert a fresh start into a free pass."

Comment: Many, many thanks to Bill Shaub, the case Trustee, and Marty Sheehan, author of the NABT amicus brief. Once again, NABT has made a difference for all Panel Trustees, including those who are not members of this Association.

27. Debtor, beneficiary could not exempt life insurance proceeds

Prior to her bankruptcy filing, an 80-year-old debtor received the proceeds from a life insurance policy owned by her recently deceased husband. Of this money, \$46,817.15 was left when her bankruptcy petition was filed. The Debtor claimed these funds as exempt. The Trustee objected and moved for turnover. Cross-motions for summary judgment were filed. *In re Kudela*, 427 B.R. 643 (Bkrcty.N.D.Ohio 2010).

The Debtor cited two Ohio statutes that generally exempted a debtor's interest in life insurance and similar contracts. The statutes essentially provided that all life insurance contracts taken out for the benefit of, or made payable to, the spouse or children or other dependent "shall be held, together with the proceeds...of such contracts...free from all claims of the creditors of such insured person or annuitant." The Trustee argued that the statute only provided an exemption for the person insured, here the late husband. The Debtor argued that she was within the protected class of beneficiaries under the statute. She further asserted that she had acquired a pre-petition ownership interest in the policy as a result of her husband's pre-petition death, thereby giving her the status of an insured under the policy. The Court disagreed. Even if the debtor held a vested interest in the policy prior to filing bankruptcy, she was never the insured party. Recognizing that this was a sympathetic Debtor, the Court was nevertheless "not free to create an exemption where none exists."

28. Trustee's amended objection to exemptions related back to date original objection was filed

Debtor husband was hit by a drunk driver and suffered a cartilage tear to the left wrist and synovitis of the right wrist, among other injuries. The joint Debtors used the federal exemption §522(d)(11)(D) and claimed a joint exemption of \$40,400.00, with one-half attributable to the Debtor husband's injuries, and the other half attributable to loss of consortium by the Debtor wife. The Trustee timely objected, but on the eve of the hearing

filed an amendment more specifically asserting that the statute did not cover pain and suffering or compensation for actual pecuniary loss. The Debtors argued that the amendment was untimely, and the Trustee countered that it related back and would be treated as timely. *In re Shumac*, 425 B.R. 139 (Bkrcty.M.D.Pa. 2010).

Judge Thomas found the Debtors were put under adequate notice by the original objection that the exemption was being attacked under §522(d)(11)(D). Thus they were not prejudiced in any manner and their due process rights were not compromised. The Court then turned to the merits of the objection and noted the ambiguity of the section, conflicting case law, and little legislative history for guidance. The Court disagreed with the Trustee that the "personal bodily injury" must be of a permanent nature, finding the Debtor husband's injuries covered by the statute. The Court further found that the spouse's loss of consortium was derivative of the husband's claim under Pennsylvania law, and her exemption was likewise permitted.

Comment: This case provides a good summary of the split in case law in interpretation of "personal bodily injury". For example, see, contra, *In re Chapman*, 424 B.R. 823 (Bkrcty.E.D.Tenn. 2010), where Judge Stair found loss of consortium was not included in the applicable Tennessee personal injury exemption, with wording very similar to §522(d)(11)(D).

29. Another Circuit applies *Schwab v. Reilly*

The Trustee did not object to the \$36,900.00 homestead exemption claimed by the Debtors, and subsequently brought an action to avoid a mortgage on the property in the amount of \$396,000.00. While this action was pending, the Court approved the Trustee's proposed sale of the property for a little over \$200,000.00. After the sale, the defendant, mortgagee consented to avoidance. The Trustee then moved for an order declaring the Debtors' homestead exemption to have a value of zero, as there was no equity in the property to which the exemption could attach. The Debtors responded by moving for satisfaction of their \$36,900.00 exemption claim from the sale proceeds because the Trustee had failed to timely object under Bankruptcy Rule 4003. The Bankruptcy Court held for the Trustee, but the District Court reversed on appeal. Further appeal was taken to the Third Circuit. *In re Messima*, 2010 WL 2712141 (3rd Cir.).

The Circuit Court suspended the appeal, awaiting determination of the then pending Supreme Court case of *Schwab v. Reilly*, 130 S.Ct. 2652 (2010). Based on the subsequent Supreme Court decision, the Third Circuit noted that the rules had changed such that the 30-day objection period of Rule 4003 "applies to objections based on 'three and only three' elements of a claimed Schedule C exemption": 1) exempted property description; 2) the Bankruptcy Code exemption provisions; and 3) the amount stated as the value of claimed exemption. The Court found that when an exemption objection is based on other elements, such as the Debtor's market value estimation and the right of the estate to retain value beyond the amount exempted, the Rule 4003 30-day deadline does not apply.

30. Continued split in authority over inherited IRA's

Virtually all courts pre-BAPCPA and many post-BAPCPA have ruled that IRA's inherited by anyone other than a spouse are non tax-exempt; not qualified as retirement plans of the debtor; and may not be exempted from the bankruptcy estate. These cases

include *In re Sims*, 241 B.R. 467 (Bkrcty.N.D.Okla. 1999); *In re Navarre*, 332 B.R. 24 (Bkrcty.M.D.Ala. 2004); and *In re Jarboe*, 365 B.R. 717 (Bkrcty.S.D.Tex. 2007). These courts essentially found that an inherited IRA was no longer an IRA at all. There could be no further contributions to it; it could not be rolled over; beneficiaries could take withdrawals at any time without penalty; and withdrawals were required so that the full amount would be entirely disbursed within five years, regardless of the age of the inheriting owner.

For whatever reason, a multitude of cases on this issue have been decided in 2010. Some have found that inherited IRA's remain exempt under two BAPCPA provisions: §§522(d)(12) (under election of federal exemptions) or 522(b)(3)(c) (pre-emption of state law exemptions). *In re Nessa*, 426 B.R. 312 (8th Cir. BAP April 9, 2010); *In re Kuchta*, 434 B.R. 837 (Bkrcty.S.D.Ohio April 16, 2010); and *In re Tabor*, 433 B.R. 469 (Bkrcty.M.D.Pa. June 18, 2010, as amended on July 30, 2010). Contra decisions include *In re Chilton*, 426 B.R. 612 (Bkrcty.E.D.Tex. March 5, 2010); *In re Klipsch*, 435 B.R. 586 (Bkrcty.S.D.Ind. June 7, 2010); and *In re Ard*, 435 B.R. 719 (Bkrcty.M.D.Fla. August 18, 2010).

The latter cases distinguish the *Nessa* line of cases based on the proposition that for funds "to be retirement funds," they must contain contributions made by the debtor for retirement, which these inherited IRA's do not. In *Ard*, Judge May made the further important distinction that funds in the original IRA account do not retain the same tax exempt status after being distributed to the beneficiary. The Court was assisted in this analysis by a Florida state court decision, *Robertson v. Deeb*, 16 So. 3d 936 (Fla. 2d DCA 2009), where the state court held that an inherited IRA is not exempt from the claims of a garnishing creditor of a non-spouse beneficiary.

Comment: Interestingly, neither line of cases cite as authority §408(d)(3)(C)(i) of the Tax Code, which appears to provide that an inherited IRA is *not an IRA*. This is simply omitted from the *Nessa* line of cases, while the contra cases are based on the law of the particular state which has opted out of the federal exemption scheme.

Avoidance Actions

Preferences

31. 11th Circuit rules on ordinary course defense application to first-time transactions between parties

Within the year before its Chapter 11 filing, the Debtor contracted with the defendant for installation of a heat and air control system at Debtor's plant. Payment was to be made in six installments. Within 90 days of the petition date, the Debtor paid two installments totaling \$615,831.00. The Trustee sought avoidance of the payments as preferential transfers, and defendant raised the (c)(2) and (b)(5) defenses of ordinary course payments and no improvement of position by payment. The Bankruptcy Court held for the Trustee, and the District Court affirmed. Further appeal was taken to the 11th Circuit Court. *In re Globe Manufacturing Corp.*, 567 F.3d 1291 (11th Cir. 2009).

As to the ordinary course defense, the Circuit Court found there was no evidence that the parties had ever had dealings prior to the subject contract. The contract called for payment within 30 days from invoice date, and challenged payments were made approximately one month late. While the defendants two other payments, which were made outside the preference period, were also late, the Court found that was not enough to

prove that late payments were ordinary as between the parties. In such a one-time transaction the Court found that the "ordinary business terms" prong of the defense must apply, and the terms between the parties must be consistent and comparable with terms generally used in the industry. As to §547(b)(5), defendant asserted that the payments received did not improve its position because it had rights to perfect a mechanic's lien if not paid, which would have made it a secured creditor. The Court rejected this argument, finding that under applicable Massachusetts law a mechanic's lien exists only after perfection by recording notice of the contract. Further, what the defendant could have done, had the payments not been made, was not relevant to the preference analysis. Finally, the Circuit Court affirmed the Bankruptcy Court's decision to deny pre-judgment interest. Because the defenses failed primarily for evidentiary reasons, the Circuit Court found it was not unreasonable for the Bankruptcy Court to use its equitable powers in disallowing the interest.

32. 11th Circuit also finds credit card balance transfers avoidable

Expressly following the 10th and 6th Circuits cases of *In re Marshall*, 550 F.3d 1251 (10th Cir. 2008) and *In re Wells*, 382 B.R. 355 (6th Cir. BAP 2008), the 11th Circuit likewise held that credit card balance transfers are avoidable preferences, when occurring within 90 days of the bankruptcy filing. *In re Egidi*, 2009 WL 1684601 (11th Cir. June 18, 2009).

The Circuit Court found the transfer was in the control of the Debtor and that it diminished the assets in the estate available to other creditors by directing which creditor received the transfer. It was therefore an avoidable preferential transfer. The Defendant raised the earmarking defense to no avail. The fact that the Debtor, and not the lender, designated the recipient of the transferred funds, was enough for the Court to summarily render the earmarking doctrine inapplicable. Note that *Wells* was affirmed at 561 F.3d 633 (6th Cir. 2009) and also see *accord In re Dilworth*, 560 F.3d 562 (6th Cir. 2009).

33. Lease termination payment avoidable as preferential transfer

In a case that was reported earlier at the lower court level, the Eleventh Circuit Court has affirmed the bankruptcy and district court findings that a payment made pursuant to a lease termination agreement, entered into by the parties during the term of the lease, can be avoided as a preferential transfer. *In re Tanner Family, LLC*, 556 F.3d 1194 (11th Cir. 2009).

In this case the parties entered into a five-year lease with rent due and payable on the first day of each month. In the third year of the lease, the Debtor and the lessor executed a termination agreement which provided that the Debtor would be released from any further obligations upon payment of \$87,172.00. Within 90 days after making the payment, the Debtor filed a Chapter 11 petition. The case subsequently converted to Chapter 7, and the Trustee sought avoidance and recovery of the payment as a preferential transfer. The defendant argued that the debt was not antecedent, because it was not "legally collectible until it was due under the lease", which was on the first day of each month for the balance of the five years left on the lease term. The Eleventh Circuit rejected this argument, finding that the Bankruptcy Code adopts the broadest possible definition of "debt", such that a debtor incurs a debt and the creditor has a claim against the debtor, even if the claim is unliquidated, unmatured, unfixed, or contingent. Here, the debt was

incurred when the lease was signed, and was therefore antecedent to the \$87,172.00 payment.

34. 11th Circuit excepts preference avoidance under state law equitable subrogation

NABT filed an Amicus Curiae Motion for Rehearing in a consolidated appeal of two cases involving a Trustee's actions to avoid mortgages which were untimely perfected in refinancing transactions. The motion deals primarily with the issue of whether the §(c)(1) "contemporaneous exchange for new value" defense to preference avoidance trumps the §(e)(2)(A) grace period for recording non-purchase money security interests. In addition to that issue, the Court in this case also considered whether the applicable Georgia law of equitable subrogation would except a late recording from avoidance. *In re Hedrick*, 524 F.3d 1175 (11th Cir. 2008).

The Circuit Court framed the question as "whether a bona fide purchaser could have acquired an interest superior to [the refinancing creditor] during the period between the time [the refinancing creditor] paid off the earlier creditors, thereby extinguishing their security deeds, and the time [the refinancing creditor's] own security deed was recorded". Based on a Georgia case, the Court found that under Georgia law the refinancing creditor "acquired a first priority interest"....upon paying off the debt, which was "applicable law which controls under §547(b)." Therefore, no purchaser who acquired an interest in the property between the time the earlier debts were paid and the new deed of trust recorded could be a bona fide purchaser under Georgia law, because equitable subrogation would defeat the purchaser's claim.

Comment: This appears to be the only Circuit Court case that allows state law equitable subrogation to essentially preempt the federal law of preferential transfer avoidance under 11 U.S.C. §547. The opinion never mentions the Supreme Court case of *Fidelity Financial Services, Inc. v. Fink*, 522 U.S. 211 (1998), which overruled a similar attempt at state preemption through state statutory law, rather than state case law as applied here. A motion for certiorari will be filed in this case.

35. Court awards monetary judgment in lieu of avoidance of lien under §550

When the Trustee prevailed in his action to avoid a vehicle lien as preferential, he sought judgment in the amount of the value of the car at the time the bankruptcy petition was filed, rather than avoidance of the lien and possession of the car to sell. The value of the car had depreciated by over \$5,000.00 during the 17 months since the Debtor filed the case, even though the Debtor had maintained possession and continued making payments on the vehicle. The creditor contested the Trustee's right to a judgment under §550, arguing that the only remedy was avoidance of the lien and sale of the vehicle. The Bankruptcy Court held for the Trustee, and awarded a judgment based on the petition date value of the vehicle. Appeal was taken to the BAP. *In re Taylor*, 390 B.R. 654 (9th Cir. BAP, 2008).

The Appellate Panel affirmed, holding that avoidance of a lien does not destroy the security interest. Rather, it allows either (1) the transfer of the security interest or (2) the transfer of the value of the security interest to the estate. When appropriate to restore the bankruptcy estate to where it was when the case was filed, the BAP found that a monetary

judgment may well be the correct result. Reversed and remanded at 599 F.3d 880 (9th Cir. 2010).

Comment: This case might be helpful in the situation where an asset has "evaporated" from the estate under §521, prior to the Trustee bringing an action to avoid a lien against the property. If the Trustee can obtain a judgment for the value of the avoided lien under §550, it is immaterial that she cannot avoid the lien and take possession of the non-estate property. *USAA v. Thacker (In re Taylor)*, 599 F.3d 880 (9th Cir.2010).

36. Ninth Circuit rules on application of §550(a) recovery

A case recently reported at the BAP level has been reversed and remanded by the Ninth Circuit Court of Appeals. Here the Trustee successfully avoided the pre-petition security interest in a vehicle as a preferential transfer. However, 17 months had passed since the petition filing, during which time the Debtor had continued to use the car and also continued to make monthly payments. The Bankruptcy Court ordered recovery of the value of the avoided security interest under §550(a), rather than recovery of the lien itself. The Court then determined this value was equal to the full amount of the loan at the time of the pre-petition transfer. Upon appeal, the BAP affirmed, and the lender further appealed to the Ninth Circuit. *In re Taylor*, 599 F.3d 880 (9th Cir. 2010).

The Circuit Court found that the Bankruptcy Court had not abused its discretion by awarding the value of the security interest to the estate, but disagreed with its method of valuation. The Trustee had presented no evidence that the security interest had initially been worth the pre-petition loan amount, nor that the car would have been worth that amount when the security interest was given. The Court then held that where the value of an avoided lien cannot be readily or easily determined, the correct remedy is transfer of the avoided lien to the bankruptcy estate. It was not appropriate to award an estimate of the unclear value of the avoided lien. Nevertheless, the Court remanded the case to the Bankruptcy Court for determination of what to do about the post-transfer interest payments, indicating that they might be recoverable by the Trustee from the creditor, as either pre-petition preferential transfers or unauthorized post-petition transfers.

37. Eighth Circuit applies §550(a) recovery where avoided mortgage was assigned post-petition

Within 90 days of his Chapter 7 filing, the Debtor borrowed \$196,808.71 secured by a mortgage on his residence. Unbeknownst to the Debtor, the mortgage lender had not recorded its mortgage when the bankruptcy case was filed, and Debtor listed the loan as a secured debt on Schedule C. Post-petition, the lender sold the note and assigned the mortgage "as part of a bundle of mortgages." After the case was closed, when the Trustee learned that the initial mortgage was never recorded, he successfully moved to reopen the case. The Trustee then sought avoidance of the unperfected mortgage under §547 and/or §544(a), and further sought recovery of the value of the avoided transfer under §550(a). Bankruptcy Judge Dreher allowed recovery under §550(a) of \$196,808.71, pursuant to preferential transfer avoidance based on §547(e)(2)(C). The District Court affirmed, and appeal was taken to the Eighth Circuit.

The Circuit Court cited and followed subsection (e)(2)(C) of the preference statute, which deems perfection not made pre-petition to have occurred immediately before the

bankruptcy filing. The unrecorded mortgage was therefore deemed to have been perfected within the 90-day preference period. Next the Court looked to §547(b) and found all the other requisite elements of a preferential transfer. The Court then addressed §550(a) recovery, and noted that subsection (a)(1) provides that the Trustee may recover the property transferred or its value from "the initial transferee" or from "any immediate or mediate transferee of such initial transferee." The Court described this as allowing the Trustee "to pick his named defendant." Here that defendant was the initial mortgage lender, and the Trustee could recover the "value of the mortgage." That amount was set at \$196,808.71, which represented the debt at the time of the transfer. The defendant argued that the value was actually less, but could not establish an amount because the mortgage was only one of the "bundle" sold, and not specifically priced in the sale.

38. Tenth Circuit finds application of §550 is permissive and discretionary

In two consolidated cases, vehicle lenders failed to perfect their liens within the requisite 30 days, making them voidable preferences when bankruptcy was filed within 90 days thereafter. The Trustee's actions sought 1) lien avoidance under §547, 2) recovery of the value of the avoided lien as of the petition date under §550(a), and 3) preservation of the lien for the bankruptcy estate under §551. The lenders conceded the issues of lien avoidance and lien preservation, leaving only the question of "the availability of §550(a) relief". The Bankruptcy Court found such relief to be "permissive but only with respect to possessory property interests." On appeal, the BAP affirmed, but on a different basis. The Appellate Panel found the application of §550(a) was "permissive with respect to both possessory and non-possessory interests, but unnecessary [on the facts of this case]." Appeal was taken to the Tenth Circuit. *In re Trout*, 609 F.3d 1106 (10th Cir. 2010).

The Circuit Court cited the Sixth Circuit case of *In re Burns*, 322 F.3d 421 (6th Cir. 2003), for the proposition that under §551 an avoided lien is automatically preserved for the bankruptcy estate; "whereas recovery under §550 is not automatic and requires action by the trustee." The Court then looked to the statutory language and noted that "the trustee may recover under §550." Based on that language, and other circuit cases including *In re Taylor*, 599 F.3d 880 (9th Cir. 2010), the Court concluded that application of §550 is "permissive rather than mandatory."

Again citing *Burns*, the Circuit Court then determined that §550 recovery "is necessary only when the remedy of avoidance is inadequate." In situations with non-possessory creditors, Trustees would "generally" have no need to seek recovery because the estate asset could be sold by the Trustee free and clear of the avoided lien. Again citing *Taylor*, the Court noted that §550 exists for those "circumstances in which §551 would be inadequate to restore the bankruptcy estate to its pre-transfer position." Situations where the asset is no longer estate property or is otherwise unavailable to the Trustee represent such "circumstances". Finally, the Court addressed the Trustee's contention that the vehicle's depreciation since the bankruptcy filing was a basis for awarding the value of the lien under §550. The Court disagreed, holding that the risk of value diminution from delayed recovery is an inevitable creditor risk, which is likewise borne by the Trustee. *In re Haberman*, 516 F.3d 1207 (10th Cir. 2008). In summary, although §550 relief had been requested, its application as to both possessory and non-possessory liens was found to be permissive and discretionary; and it was not applied here because

lien avoidance and lien preservation for the benefit of the estate provided an adequate remedy.

39. Insider status determined at time of transfer

The Debtor married his non-filing spouse on June 29, 2002. On March 31, 2005, they entered into a "Marital Agreement" whereby the Debtor agreed to purchase the wife's interest in two properties they owned as tenants by the entireties. On January 30, 2006, the wife filed for an uncontested divorce. On August 3, 2006, while the divorce case remained pending, the Debtor effected the transfer of his interest in the Marital Agreement property by quitclaim deed, which was recorded on August 25, 2006. Less than a month later, on September 13, 2006, the final decree of divorce was entered. The Debtor filed his Chapter 7 petition on June 3, 2007, and his Trustee sought avoidance and recovery of the property interests conveyed to the former wife as preferential transfers. *In re Paschall*, 403 B.R. 366 (E.D.Va. 2009).

The Trustee asserted that the quitclaim deeds represented transfers of an interest of the Debtor in the property. Because they were made pursuant to the prior Marital Agreement, the transfers were made on account of an antecedent debt. Further, the transfers were made to an insider, the Debtor's wife, within one year of the petition date. This allowed the transferee to receive more than she would have received in the bankruptcy case, had not the transfer been made. The Trustee argued that the elements required for avoidance of the transfer under §547 and recovery under §550 were thereby established. Defendant, former wife, countered that the Marital Agreement transferred the "equitable title" such that only "bare legal title" was transferred through the quitclaim deeds under §541(d), and that the transfers were "judicially recognized" in the subsequent divorce decree. She further argued that she was not an insider, as she was in the process of divorcing the Debtor at the time of the transfer, and was not married to him at the time he filed his bankruptcy petition.

Judge Huennekens rejected these defenses. The Court found that §541(d) applies only to §§541(a)(1) and (2). It does not apply to §541(a)(3) and (4), "which allow trustees to bring into the bankruptcy estate property recovered from avoidable transfers." As to the insider issue, the Court noted that the defendant was married to the Debtor at the time the transfers were made, which is the relevant date under §547(b)(4)(B). The fact that she and the Debtor were divorced soon thereafter, and were divorced at the petition date, were "of no moment."

40. Effect of being a statutory, per se insider

In a case previously reported at the Bankruptcy Court level, an Illinois District Court has affirmed the holding that a managing member of a Debtor, LLC, is a preference insider, regardless of whether he had any actual "control" of the company. *Longview Aluminum, LLC v. Brandt*, 431 B.R. 193 (N.D.Ill. 2010).

The District Court agreed with the Bankruptcy Court's fundamental determination that a managing member of an LLC is the functional equivalent of a director of a corporation. Members are, therefore, included in the §101(31) list of defined "insiders". The Court then addressed the argument that even though the preference defendant was a managing member, he lacked the requisite control over the LLC to be an insider. Again

agreeing with the Bankruptcy Court, the District Court held it was not necessary to prove control as to an insider included in the statutory list; known as a "statutory" or "per se" insider. The Court noted that "person in control" was a separate and different classification from director and officer, citing the statutory language, "director, officer or person in control". Thus, since the managing member was an insider of the LLC by virtue of his having that position at the time of the preferential transfer, no further inquiry was required or allowed.

41. IRS lien not avoidable as preference

The Internal Revenue Service had a lien against the Debtor's accounts receivable which arose from unpaid withholding, social security and unemployment taxes. After assessment of the taxes, and 50 days before the Chapter 7 filing, the IRS perfected its lien by filing a notice of lien in the appropriate offices pursuant to 26 U.S.C. §6323. When the Trustee filed a complaint seeking to avoid the lien perfection as a preferential transfer, the IRS argued that the transfer was excepted from avoidance under §547(c)(6) because it was a "fixing of a statutory lien that is not avoidable under §545." *Spicer v. United States (In re Motion Marketing Solutions, Inc.)*, 43 B.R. 403 (Bkrcty.N.D.Tex. 2009).

The Trustee relied on *Farrey v. Sanderfort*, 500 U.S. 291 (1991), arguing that the term "fixing" was different from "perfecting" and that the fixing of statutory liens did not include their perfection. Judge Lynn rejected that argument and found that §547(c)(6) was specifically intended to protect statutory liens from preferential transfer avoidance. The Court stated, "Congress intended statutory liens to be voidable, if at all, under §545. Section 547(d) was not meant to provide a trustee with an alternate theory for attacking statutory liens."

42. Failure to assert preference claim in defense of stay relief motion no bar to later action

The Trustee filed written opposition to a secured creditor's stay relief motion, alleging equity in the subject real estate. However, the Trustee did not appear at the hearing to oppose the motion, which was granted. When the Trustee subsequently filed a complaint to avoid the mortgage as a preferential transfer, the creditor moved to dismiss based on collateral estoppel, due to the Trustee's failure to raise the preference claim in defense of the stay relief motion. *In re Hurst*, 409 B.R. 79 (Bkrcty.D.Md. 2009).

Judge Schneider noted that stay relief hearings are summary in character and conducted on an expedited basis, while preference claims are required to be asserted through adversary proceedings with more formal procedures. The Court then found that the requisite elements of collateral estoppel were not present in this case. The issue of preferential transfer had never been submitted to the Court; the Court had made no decision relating to any alleged preferential transfer; and the Trustee had no incentive to litigate the transfer at the stay relief hearing, which would have been procedurally improper in any event. The matter had not been "actually resolved" or "actually litigated". Motion to dismiss denied.

43. "New value" need not remain unpaid for viability of §547(c)(4) preference defense

Adversary complaints were filed against two defendants alleging avoidable preferential transfers totalling more than \$326,295.00 and \$1,571,814.00 respectively. The defendants asserted the subsequent new value defense of §547(c)(4), based upon their continued shipment of products to the Debtor during the preference period; and sought partial summary judgment on this issue. *In re Pillowtex Corp.*, 416 B.R. 123 (Bkrcty.D.Del. 2009).

The Bankruptcy Court first recognized a split of authority. Of the seven Circuit Courts that have dealt with §547(c)(4)(B), the Court noted that three (Third, Seventh and Eleventh) have read the section to mean that advanced new value must remain unpaid at the end of the preference period in order to be an offset against preference liability. Three other Circuits (Fourth, Fifth and Ninth) have found no "remains unpaid" requirement, which interpretation has been dubbed the "subsequent advance" approach. The Eighth Circuit was noted as having conflicting opinions. Judge Carney then addressed the applicable Third Circuit law. The Court found that the distinct issue of subsection (c)(4)(B) was not required to be determined in the prior Third Circuit cases, so that stated findings as to this subsection were only *dicta*. The Court then cited Third Circuit lower court opinions which followed the "subsequent advance" approach. Based on the plain language of the statute, and the policies it promotes, the Court concluded that subsequent advances need not "remain unpaid" to be properly excepted from avoidance under §547(c)(4).

44. Purchase by credit bid at non-collusive foreclosure sale avoided as preferential transfer

This is a further examination of a case referenced in the last *NABTalk* article, Winter 2009, Volume 26, Issue 4, regarding application of the Supreme Court case of *BFP v. Resolution Trust Corp.*, 511 U.S. 531 (1994), to state divorce court judgments. The reported case was *In re Bledsoe*, 569 F.3d 1106 (9th Cir. 2009), where the Ninth Circuit found that *BFP* applies to regularly conducted state law divorce cases, as well as to foreclosure proceedings; making property division judgments immune to fraudulent transfer attack absent a specific showing of fraud and/or collusion. The case of *In re Villarreal*, 413 B.R. 633 (Bkrcty.S.D.Tex. 2009), was noted because it did not extend *BFP* to a preference action arising from a non-collusive, properly conducted state law foreclosure sale. This case is worthy of further explanation, as follows.

Within 90 days of their Chapter 13 filing, a third lien creditor on a \$70,000.00 debt bid at the foreclosure sale of commercial property owned by the Debtors. The total debts against the property were less than \$750,000.00, and the creditor was the successful bidder through a credit bid in the full amount of its \$70,000.00 claim. Shortly after the sale, the purchaser had an appraisal done which indicated a value of \$4,020,000.00 for the property. The Debtors sought to avoid the sale as a preferential transfer.

Judge Isgur noted that *BFP* was decided under §548, which requires determination of value at the time of the transfer, which was the foreclosure sale here. The Court recognized that the *BFP* holding had been extended to include §549 in *In re T.F. Stone v. Harper*, 72 F.3d 466 (5th Cir. 1995), but found this decision was based on "present fair equivalent value" in §549 being no different from "reasonably equivalent value" in §548. In

the preference statute, §547(b)(5) requires the Court to compare the value at the time of sale with the amount the creditor would have received in a hypothetical Chapter 7 liquidation. In this analysis the Court determined that a Chapter 7 Trustee would have had time to orchestrate an orderly sale producing a far greater value than was received at the foreclosure sale; and, in this hypothetical Chapter 7 liquidation, the defendant would have received approximately \$100,000.00. Doing the math, the Court then calculated that the creditor/bidder "received at least \$3,250,000.00 to satisfy the remainder of his \$70,000.00 claim"; significantly more than \$100,000.00. The sale was therefore avoided as a preferential transfer. In so finding, the Court acknowledged a contra District Court decision from the same District, but held the District Court ruling lacked *stare decisis* authority.

45. No ordinary course preference defense due to unusual collection activity

Trustee sued to recover an alleged preferential payment of \$79,342.35. The defendant asserted the §547(c) ordinary course of business defense. Judge Hyman stated the four elements to be considered in determining whether that applies as follows: 1) the prior course of dealings between the parties, 2) the amount of the payments, 3) the timing of the payments, and 4) the circumstances surrounding the payments. The Court then determined that the operative date for analyzing the ordinary course defense was the date of delivery, not the date the check was issued in payment. Here the Court agreed with the defendant that the subject payment fell within the range of its consistently late pre-preference payments to the Debtor. However, the Court found that the pivotal question was whether the payment was made in response to unusual collection efforts. The defendant had sent an email to the Debtor placing it on "credit hold" until receipt of a response to its inquiry about outstanding invoices. The Debtor's principal swore the email was the reason for the subject payment, and did not recall any other instances where defendant had placed a "credit hold". This unusual collection activity removed the transfer from the ordinary course of business, making defendant liable for recovery of the full payment. *In re JSL Chemical Corp.*, 424 B.R. 573 (Bkrcty.S.D.Fla. 2010).

46. Perfection occurring 34 days after transfer was "substantially contemporaneous"

Prior to BAPCPA, a secured creditor had ten days to perfect a non-purchase money security interest in order to have the transfer deemed to occur at the time of the transfer. 11 U.S.C. §547(e). If perfection did not occur within ten days, the transfer was deemed to occur on the date of perfection. Thus, if the creditor perfected within the ten-day grace period, the perfection could not be avoided under §547(b) because it occurred at the same time as the transfer. It was therefore not on account of an antecedent debt. BAPCPA extended the ten-day grace period to 30 days.

Section 547(c)(1) excepts from avoidance a transfer for new value that was intended to be, and was "in fact" a substantially contemporaneous exchange. Before BAPCPA, this defense was applied to trump §547(e) by some Courts. These Courts held that perfection later than ten days after a transfer could be substantially contemporaneous with the transfer, and therefore not avoidable. For example, a perfection that occurred 14 days after the transfer was protected by the (c)(1) defense in the case of *In re Dorholt*, 224 F.3d 871 (8th Cir. 2000). When BAPCPA extended the §547(e) grace period from 10 to 30 days, the

question arose as to whether Courts would continue to apply (c)(1) such that perfection more than 30 days after a transfer would be held to be substantially contemporaneous with the transfer. At least one Court has now so held in the case of *In re McCaskill*, 434 B.R. 875 (Bkrtcy.W.D.Mo. 2010), where the perfection occurred 34 days after the transfer. Relying on *Dorholt*, *In re Moreno*, 193 B.R. 907 (9th Cir. 1997) and *In re Pinetop Insurance Company*, 969 F.2d 321 (7th Cir. 1992), Judge Venters extended the "flexible" approach of these Courts, finding that 34 days was not too long to be "substantially contemporaneous"; and denying avoidance of a security interest that was perfected that long after the transfer under the (c)(1), contemporaneous exchange defense.

Comment: It would be fair to say that §547(e) has been effectively read out of the statute in this case. Whether this will be upheld, and whether it will be followed in the other "flexible approach" Circuits (9th, 7th and 11th) remains to be seen. Could it also be extended? If 34 days is substantially contemporaneous, how about 54 days? 74 days? These questions are not relevant in the First and Sixth Circuits, where the "bright line rule" of §547(e) applies. In those Circuits ten days once meant ten days, and 30 days now means 30 days.

47. What effect do state law relation-back priority statutes have upon the perfection requirements of §547?

The Debtor purchased and took possession of a vehicle on February 8, 2005. The assignee of the security agreement sent the titling statement, application for title certificate and required fees by certified mail to the County Clerk, receipt of which occurred on February 22, 2005. However, the Clerk's office failed to take the appropriate steps for recordation of the lien until March 7, 2005. The title certificate was ultimately issued by the state on March 25, 2005, with the notation that March 7, 2005 was the creditor's lien filing date. The Debtor filed a Chapter 7 petition on May 11, 2005, and the Trustee sought avoidance of the vehicle lien as a preferential transfer under §547(b). The lender argued that the enabling loan defense of §547(c)(3) was met because the lien was perfected within 20 days of the Debtor's taking possession of the vehicle. The Bankruptcy Court held for the creditor, but the BAP reversed. *In re Johnson*, 380 B.R. 455 (6th Cir. BAP 2007). Appeal was taken to the Sixth Circuit.

The issue before the Court was what constituted "perfection" of the lien under applicable Kentucky law. Two separate, seemingly contradictory statutes were at play. One provided that "perfection...shall be by notation on the certificate of title." However, another statute provided that a security interest "noted on the certificate of title shall be deemed perfected at the time the security interest attaches...if the secured party tenders the required fees and submits a properly completed title lien statement and application for first title...to the appropriate county clerk within 20 days of attachment." Thus the act of perfection was title notation, with the perfection "deemed" to have occurred when the interest attached, but only if the creditor completed the required procedures for title notation within 20 days of the purchase and security agreement. In a two to one decision, the BAP ruled that the relation-back statute was ineffective, as it would trump the federal law safe harbor provision of §547(b)(3). See *Fidelity Financial Services, Inc. v. Fink*, 522 U.S. 211, 118 S.Ct. 651, 139 L.Ed.2d 571 (1998). Therefore, perfection occurred outside the then 20-day safe harbor of §547(c)(3). The (c)(3) exception did not apply, and the lien was avoidable.

When presented with this issue, the Circuit Court determined it was a matter of state law, and certified the question to the Kentucky Supreme Court. The State Court looked to the plain language of the subject statutes and found perfection to occur only when the lien was noted on the title certificate. The Court pointed out that the perfection statute "unambiguously establishes the 'sole means' of perfecting a security interest in a vehicle in Kentucky...." While the competing statute might establish priority as of an earlier date, it did not perfect the security interest. 313 S.W. 3d 557 (Supreme Court of Kentucky 2010). Based on the state court ruling, the Sixth Circuit held that perfection occurred, longer than 20 days after the Debtor took possession of the vehicle, such that the (c)(3) enabling loan defense did not apply, and the lien was avoidable.

Fraudulent Conveyances

48. Held irrevocable waiver of NOL constitutes a fraudulent transfer

In 2005, the Debtor suffered a net operating loss ("NOL") of \$58,612.00. In his 2005 tax return, filed on July 24, 2006, while he was insolvent, the Debtor elected under 26 U.S.C. §172(b)(3) to carry the entire NOL forward to future years. Six months later he filed a Chapter 7 petition. The Trustee asserted that absent the waiver, the estate would have received a refund of \$11,201.00, and sought to recover the refund or its value as a fraudulent transfer. The government opposed the Trustee. On cross motions for summary judgment the Bankruptcy Court ruled in favor of the Trustee. *In re Taylor*, 386 B.R. 361 (Bkrcty.S.D.Fla. 2008).

Judge Olsen agreed with the government that once a taxpayer elects to waive the carryback, the election is irrevocable under the IRC. Thus, as a matter of tax law, the Trustee cannot undo the Debtor's election, and/or amend the Debtor's 2003 through 2005 returns to claim the refunds that would have been payable to the bankruptcy estate absent the NOL waiver. However, under *Segal v. Rochelle*, 382 U.S. 375 (1966), tax attributes are considered property of the bankruptcy estate. Therefore, notwithstanding the irrevocable nature of the waiver, the Court found as a matter of law that the waiver operated as a transfer of property to the United States. The Court observed that if the waiver were not avoidable, it would constitute "nothing more than money laundering through the kind auspices of the United States."

49. Debtor's pre-petition election of NOL carry forward avoided by Trustee

The question on appeal to District Court was whether an insolvent taxpayer's irrevocable election of waiver of a net operating loss ("NOL"), within two years of a bankruptcy petition filing, was an avoidable fraudulent transfer under §548. The Bankruptcy Court had granted summary judgment in favor of the Trustee, and the United States (sometimes "IRS") appealed. The IRS argued for reversal on three separate theories: (1) a taxpayer's NOL is not a property right; (2) waiver of an NOL carry-back does not constitute a transfer to the United States; and (3) a Trustee cannot avoid a debtor's NOL waiver because the Internal Revenue Code mandates that this tax election is irrevocable. The District Court rejected each argument and affirmed the Bankruptcy Court. *U.S. v. Kapila, (In re Taylor)* 402 B.R. 56 (S.D.Fla. 2008).

The District Court followed *In re Feiler*, 218 F.3d 948 (9th Cir. 2000), and *In re Russell*, 927 F.2d 413 (8th Cir. 1991), in finding the right to waive the NOL carry-back was an interest in property subject to avoidance by the bankruptcy Trustee. The Court then addressed the argument that the United States had received no transfer from the waiver. The Court reasoned that the Debtor's actions had waived the right to a present tax refund, which thereby absolved the IRS from this payment obligation. Thus, the IRS traded this obligation, which would have enhanced the bankruptcy estate, for a future obligation which was out of reach of the Debtor's creditors. As to the irrevocable nature of the tax election, the Court noted that Trustees often avoid transactions that are irrevocable as between the Debtor and a third party, and agreed with the Bankruptcy Court that contrary ruling would allow "money laundering through the kind auspices of the United States."

50. Standard for avoidance of transfers of property in divorce cases

125 days prior to the Debtor's Chapter 7 filing, he transferred his interest in the marital residence to his estranged wife as part of a distribution in their divorce action. The transfer was subsequently approved by the divorce court, and incorporated into the divorce decree. The Trustee sought to avoid the transfer as a constructive fraudulent conveyance. *In re Zerbo*, 397 B.R. 642 (Bkrcty.E.D.N.Y. 2008). Judge Trust first noted no evidence of fraud or collusion between the parties. Without such proof, the Court held the divorce court's subsequent approval of the property division, being part of a regularly conducted marital dissolution proceeding, conclusively established that "reasonably equivalent value" was exchanged between the parties.

Comment: While this represents one prevailing approach to this issue, there are also recent cases, including several reported in prior *NABTalk* articles, where the Bankruptcy Court has looked behind the divorce court settlement and found constructive fraud; especially where the timing of the divorce and bankruptcy raise questions, as here.

51. Ninth Circuit rules on constructive fraudulent conveyance avoidance of transfers made in state court marital dissolution judgments

Following the Fifth Circuit case of *In re Erlewine*, 349 F.3d 205 (5th Cir. 2003), the Ninth Circuit Court has applied the Supreme Court case of *BFP v. Resolution Trust Corp.*, 511 U.S. 531 (1994), to property divisions in state court divorce case judgments: "A state court's dissolution judgment, following a regularly conducted contested proceeding, conclusively establishes 'reasonably equivalent value' for the purpose of §548, in the absence of actual fraud." *In re Bledsoe*, 569 F.3d 1106 (9th Cir. 2009).

In this divorce case, the court entered a default judgment against the wife for failure to comply with discovery orders. Property transfers made pursuant to the default dissolution judgment gave the former husband property valued at \$93,737.00, while she received property valued at \$788.00. Upon her Chapter 7 filing, the Trustee brought a constructive fraudulent conveyance action against the former husband, asserting that fair value was not exchanged in the property transfer. Affirming the Bankruptcy and District Courts, the Circuit Court analogized state court divorce proceedings to state law foreclosure proceedings. As the *BFP* Court found the amount paid in a properly conducted state law foreclosure sale was reasonably equivalent value, the Ninth Circuit found likewise

as to judgments rendered in properly conducted marital dissolution cases, absent a showing of fraud.

Comment: It should be noted that this decision specifically applies to "a dissolution judgment entered at the conclusion of a regularly conducted state-court proceeding, rather than a marital settlement agreement." However, this case includes a default judgment rendered for failure to comply with court orders as a "regularly conducted state-court proceeding." This also begs an important question: Is a final decree approving a settlement agreement a "dissolution judgment"?

Further Comment: This is an important case because it represents the second circuit court to apply the *BFP* analysis and reasoning to divorce actions. It is also contra to many cases around the country which allow fraudulent transfer recovery on a purely constructive fraud theory, i.e. if he got \$93,737.00 and she got \$788.00, that is not a fair value exchange, any way you look at it.

Final Comment: But see *In re Villarreal*, 2009 WL 2432338 (Bkrtcy.S.D.Tex.), where Judge Isgur specifically declined to extend *BFP* to a preferential transfer claim arising from a properly conducted state law foreclosure sale.

52. Installment payments on obligation created outside "look back period" may be avoided as fraudulent transfers

On January 1, 1999, the sole shareholder sold all his stock in a corporation for \$1,555,000.00. \$550,000.00 was paid in cash, with the balance to be paid through a promissory note executed by the purchasers. On the same day, the corporation executed and delivered a guaranty of the purchasers' payment, and a financing statement was executed granting a security interest in the company assets, which was never filed with the applicable Ohio Secretary of State office. All of the subsequent note payments were made by the corporation, rather than the individual purchasers. The corporation filed a Chapter 11 petition on June 10, 2003, and its Trustee subsequently brought actions to recover payments made on the note in the four years preceding the petition date, which amounted to \$493,712.61. The Trustee further sought preferential transfer avoidance and recovery of all payments made within 90 days of the petition filing. The defendant, transferees argued that the obligation to pay the subject funds was incurred longer than four years before the bankruptcy case filing, which was outside the applicable look back period of both §548, and applicable Ohio law under §544(b), making the payments unavoidable. Defendants also asserted their secured status in the Debtor's assets as defense to the preference claim. The Bankruptcy Court held for the Trustee on the preference issue, but denied the fraudulent conveyance recovery. Appeal was taken to the BAP. *In re Omega Door Co., Inc.*, 399 B.R. 295 (6th Cir. BAP Ohio 2009).

The Appellate Panel looked initially to the language of §§544 and 548, noting use of the word "or" between "any transfer of property of the debtor" [or] any obligation incurred by the debtor.... Under §102(5) this language was found to include either a "transfer" or an "obligation incurred". Thus, even though the obligation might be incurred outside the applicable look back period, transfers made within that period, pursuant to the obligation, are not barred from recovery. In so holding, the Court followed the 11th Circuit case of *In re Advance Telecommunication Network, Inc.*, 490 F.3d 1325 (11th Cir. 2007). As to the preference issue, the BAP affirmed the Bankruptcy Court, finding that release of the

unperfected, avoidable security interest could not constitute "new value" for the Debtor's preference payments.

53. Transferee failed to establish that "reasonably equivalent value" was given in the form of an indirect benefit to Debtor

The Trustee filed a complaint to avoid, as both actually and constructively fraudulent, transfers by the Debtor to his non-debtor spouse of \$650,000.00 within two years of the bankruptcy filing. The Trustee filed a summary judgment motion with respect to \$312,626.51 of the transferred money. The only contested statutory element of the Trustee's cause of action was whether the transferee spouse gave reasonably equivalent value in exchange for the transfers. She argued that she was a housewife who did not make a meaningful financial contribution to the marital estate. Their practice, as a couple, was for the Debtor to deposit funds directly into her bank account, which she would use to pay unspecified expenses of the household. That was the only evidence submitted in support of her argument. The Court found it incumbent upon the transferee to come forward with concrete evidence in support of her indirect benefit theory defense. Finding she had failed to do so, Judge Dales granted the summary judgment for the Trustee. *In re Goldstein*, 428 B.R. 733 (Bkrtcy.W.D.Mich. 2010).

See also *In re Citron*, 428 B.R. 562 (Bkrtcy.E.D.NY 2010), a case Yogi Berra would aptly describe as similar in a different way. There, Judge Trust found that absent any evidence of extrinsic fraud or collusion between the sovereign and the accused; payments made pursuant to a plea agreement approved by a court of competent jurisdiction are conclusively presumed to be "reasonably equivalent value." They are, therefore, not avoidable fraudulent transfers.

Other Avoidance Actions

54. Financing statement with trade name held "seriously misleading"

Debtor was in the business of leasing and selling emergency vehicles. Its secured lender filed a 2003 financing statement identifying the Debtor as "EDM Corporation dba EDM Equipment". The creditor subsequently made a timely continuation statement filing. In 2007, another lender entered into a revolving credit arrangement with the Debtor, and made an advance on the line-of-credit loan directly to the manufacturer of an ambulance. The new lender had searched the records of the Nebraska Secretary of State, UCC Division, using the Debtor's correct legal name of "EDM Corporation", and the prior lender's financing statement was not revealed. In the Debtor's subsequent bankruptcy, an adversary proceeding was filed to determine the validity, extent and priority of lien interests claimed in the ambulance. *In re EDM Corp.*, 2009 WL 367773 (Bkrtcy.D.Neb. 2009).

Because the public records indicated no application for approval of the registration of the trade name, the Court found the earlier filed financing statement insufficient to perfect a security interest in the collateral. Noting that the Secretary of State's search engine failed to find the financing statement, Judge Saladino concluded that addition of the trade name to the formal name was not harmless error. Thus, continuing a recent trend, the Court ruled that a financing statement is seriously misleading if a search using the standard search logic would not find it.

55. Lien priority lost by inclusion of Debtor's trade name on financing statement

A timely filed financing statement was challenged over how the Debtor's name was stated in the UCC-1 financing statement. The Debtor's organizational name was correctly listed, but its trade or "d/b/a" name was also included in the name field on the form. The Bankruptcy Court held this was a fatal error, causing the bank to lose its lien priority over another creditor. Appeal was taken to the Eighth Circuit BAP. The Appellate Panel agreed with the Bankruptcy Court that only the Debtor's organizational name should have been in the name field, and its trade or "d/b/a" name constituted superfluous information under applicable Nebraska law, which rendered the financing statement defective for perfection purposes. *In re EDM Corp.*, WL 1929772 8th Cir. BAP (Neb. 2010).

Comment: This is one of many recent cases finding small errors fatal under the "standard search logic" used by the state agency responsible for maintaining personal property lien records. However, previous cases reported in this article have been at the Bankruptcy Court level. Here a BAP affirms this trend. Meanwhile, some states are amending the applicable U.C.C. statute to change this result. This is a tricky proposition that has left some secured creditors sorry the state tried to fix their problem in the first place.

56. Bankruptcy estate diminution is not a required element of §549 post-petition transfer avoidance

Without Court authority, a Chapter 11 Debtor factored accounts receivable with a face value of \$200,600, in exchange for \$186,455 from the account purchaser. The purchaser was able to collect only \$163,007 from these accounts. After conversion to Chapter 7, the Trustee sued to avoid the account sale transactions under §549, as unauthorized post-petition transfers. The Bankruptcy Court held for the Trustee, ordering repayment to the bankruptcy estate of the \$163,007 collected from the accounts and all uncollected accounts still held by the purchaser. The BAP affirmed on appeal, and further appeal was made to the Ninth Circuit Court. *In re Straight Line Investments, Inc.*, 525 F.3d 870 (9th Cir. 2008).

Appellant argued that the Trustee could not recover because there had been no diminution of the estate, as the amount paid to the Debtor was more than the value of the accounts that went out of the estate. The Court first considered whether such estate depletion is required under §549, noting this to be "an open question in this circuit." Though acknowledging that estate diminution "is commonly viewed as a prerequisite for avoidability of pre-petition preferential transfers...and fraudulent transfers..." the Court declined to "expand the diminution of estate doctrine" to §549 avoidance, holding as follows: "Plaintiff's failure to demonstrate a measurable depletion of the estate is not enough to allow a transfer to stand when it is otherwise avoidable under §549 because it satisfies all of the explicit requirements of an avoidable post-petition transfer." The Circuit Court further rejected the ordinary course of business defense, and application of the doctrines of earmarking and recoupment. Finally, the Court held that the measure of recovery applied by the Bankruptcy Court was correct. Section 550 provides for recovery of the property transferred and avoided under §549, or recovery of its value. This was

correctly accomplished by ordering a monetary recovery for the value of the collected accounts, and return of the remaining uncollected accounts.

57. Applicable law allowing recertification of recording mistakes not effective against Trustee as hypothetical BFP

The mortgage deed securing a \$166,500.00 loan from the Debtor was incorrectly filed against the wrong real estate. Under applicable Puerto Rican law a procedure existed to correct such a mistake so that the correction would relate back to the date of the incorrect recording. In this case the error was corrected sixteen months after the Debtor's bankruptcy filing. The Trustee sought avoidance of the mortgage under §544(a)(3) as a hypothetical bona fide purchaser on the date of filing. Under the correction statute, the rectification could not relate back to the initial recording date if there had been an intervening third party, such as a bona fide purchaser. Defendants argued that the Trustee could not be deemed a bona fide purchaser because, as part of any real estate transaction from the Debtor, he would have become aware of the indebtedness and mortgage. They also argued that §542(b) authorizes the error to be rectified, which would lead to unavoidable perfection based on relation back to the date of mistaken recordation. The Bankruptcy Court held for the Trustee and appeal was taken to the District Court. *Doral Mortg. Corp./Doral Fin. v. Segarra-Miranda*, 412 B.R. 72 (D.Puerto Rico 2009).

The District Court agreed with the Bankruptcy Court that under §544 the Trustee is automatically vested with the rights and powers of a bona fide third-party purchaser, upon the filing of the bankruptcy case. The Court acknowledged a "compelling argument as to whether the Trustee should be considered a bona fide purchaser," but found that under §544 the Trustee acquires that status by definition. Therefore, because an intervening bona fide purchaser under applicable law would toll the relation back correction, so would the Trustee.

Comment: This case makes the important distinction between an actual BFP under state law, and the Trustee as a hypothetical state law BFP. An actual BFP might be required to take certain actions to acquire the status of bona fide purchaser; or might somehow obtain knowledge of an unrecorded mortgage and thereby lose BFP status. However, as a hypothetical BFP the Trustee is not subject to those requirements or knowledge. In other words, §544 does not require the Trustee to do anything to acquire and keep hypothetical BFP status.

See also, *In re Huling*, 2009 WL 3460452 (Bkrcty.E.D.Mo.), where Judge Surratt-States found that the recording of a corrected deed of trust within 90 days of the land owner's bankruptcy filing constituted an avoidable preferential transfer.

58. Trustee remains bona fide purchaser despite simultaneous electronic filing of petition and schedules

When the Debtor refinanced her condominium mortgage debt, the refinancing creditor failed to record its deed of trust. Only the prior deed of trust, which had been marked paid in full, remained in the property record. In her subsequent Chapter 7 case, Schedule D listed the unperfected, refinancing mortgage holder as a secured creditor, and the creditor brought an adversary proceeding seeking determination that its lien was valid and unavoidable. The Bankruptcy Court ruled for the mortgage creditor based on *In re*

Professional Investment Properties of America, 955 F.2d 623 (9th Cir. 1992), which had held a scheduled secured claim provided constructive notice to the Trustee. On appeal the BAP reversed. Further appeal was taken to the Ninth Circuit. *Chase Manhattan Bank, USA, N.A. v. Taxel (In re Deuel)*, 594 F.3d 1073 (9th Cir. 2010).

Affirming the BAP, the Circuit Court focused on the phrasing in §544(a)(3), which provides the Trustee with the status of a bona fide purchaser of real property from the debtor "at the time of commencement of the case"; and without regard to any knowledge of the Trustee "as of the commencement of the case." The Court observed that only the petition filing commences the case, regardless of what else happens at the same time. Moreover, because the strong arm power exists without regard to any knowledge of the Trustee, it did not matter if a hypothetical Trustee had immediately read the simultaneously filed Schedule D, thereby giving him constructive notice. Finally, the Circuit Court distinguished "Professional Investment" as limited to involuntary petitions where the Order for Relief always and necessarily occurs after the petition is filed.

59. Cert denied in Ninth Circuit case finding Trustees to be "metaphysical" people

That's correct. No need to re-read. In the previously reported case of *In re Deuel*, 594 F.3d 1073 (9th Cir. 2010), a creditor argued that the Trustee obtained constructive notice of an unperfected mortgage from the schedules filed contemporaneously with the Debtor's bankruptcy petition. The Ninth Circuit found that a Trustee, in the role of hypothetical bona fide purchaser under §544 is a "metaphysical" person; as opposed to a "real" person with the capacity for actual constructive notice, whether from the Debtor's filings or otherwise. And, "metaphysical" we shall remain, at least in the Ninth Circuit, based on the Supreme Court's refusal to hear the creditor's appeal. *Chase Manhattan Bank, USA N.A. v. Txel*, 2010 WL 1751254 (S.Ct. 2010).

Comment: No comment.

60. Trustee avoids unauthorized transfers of cash collateral

Debtor was a distributor of motor fuel and associated products. It had been purchasing petroleum products from a particular supplier since 2003, pursuant to a sales agreement. In 2006, the Debtor entered into a financing agreement whereby it pledged all of its personal property, including collections and cash payments, and its rights thereto, to its primary lender. On October 17, 2006, Debtor filed its Chapter 11 case. On November 6, 2006, the Bankruptcy Court denied Debtor's request to use cash collateral. However, between the petition date and November 6, the case was converted to Chapter 7. The Chapter 7 Trustee subsequently filed an adversary proceeding to avoid the post-petition cash payments to the supplier. The Trustee's motion for summary judgment was granted by the Bankruptcy Court and affirmed by the District Court. Appeal was taken to the Eleventh Circuit. *In re Delco Oil, Inc.*, 599 F.3d 1255 (11th Cir. 2010).

The Circuit Court noted initially that under §363(c)(2) a Debtor can only use cash collateral with the consent of the secured creditor or permission of the Bankruptcy Court, based on a showing that the secured creditor's interest is adequately protected. Neither occurred here. The supplier defended that the funds here did not constitute the secured creditor's cash collateral under Florida's replication of U.C.C. §9-332(b), which provides that

: "[a] transferee of funds from a deposit account takes the funds free of a security interest in the deposit account unless the transferee acts in collusion with the debtor in violating the rights of the secured party." The Circuit Court agreed that the creditor did not have a security interest in the funds after the Debtor transferred them, but found that fact irrelevant. What mattered was the fact that the funds were subject to a perfected security interest before the Debtor transferred them. At the time of the payment to the supplier the funds were subject to a valid security interest. They were therefore cash collateral which the Debtor was forbidden to use.

The Defendant supplier next argued that because the payments were not avoidable as unauthorized post-petition transfers under §549 because equivalent value in inventory was given to the Debtor, through ordinary course transactions, in exchange for the payments. The Court found no "harmless" exception to a Trustee's avoiding powers under §549(a); such that the adequacy of protection of a secured creditor's interest did not matter. The Court concluded that §549(a) and §550(a) contain no reference to, let alone an actual defense based on the transferee's status (vendor, purchase, etc.) or state of mind (innocent, culpable, etc.). Said another way, concepts such as diminution of the estate and adequate protection are not relevant to §549(a) avoidance. Accordingly, judgment in favor of the Trustee was affirmed.

61. Secured creditor's mistaken release of security interest creates unsecured claim

The Debtor initially financed the purchase of a vehicle in 2007, which was properly perfected by the lending bank. In January of 2010, the Debtor refinanced this obligation with the same bank by signing a new note and security agreement. The bank then signed the lien release on the title certificate and returned it to the Debtor, where it remained when she filed her Chapter 7 petition on the following February 11. The claim was listed on Schedule D with an indication that the security interest was disputed. The bank subsequently requested and received a duplicate copy of the title certificate, dated April 20, from the department of transportation. The bank submitted this duplicate copy, which reflected itself as lienholder, with its motion for stay relief to which the Debtor objected. *In re Passa*, 436 B.R. 120 (Bkrcty.D.N.D. 2010).

The bank argued that its claim remained secured because the Debtor had not delivered the title certificate release and fee to the department of transportation as required by statute. Judge Hill rejected this argument, finding that the lien became ineffective when the bank executed its release and delivered it to the Debtor, along with the title certificate. Under applicable North Dakota law, the Court found that a creditor could have a security interest in a vehicle only if it is noted on the title certificate, or the title certificate is in the possession of the secured party. Finally, the Court addressed the bank's submission of the duplicate title certificate with its lien notation as an exhibit to its stay relief motion. The Court stated: "Its [the bank] conduct in requesting a duplicate copy when it had full knowledge that the original title was in the possession of the Debtor is, at a minimum, questionable." Though the lien release was a mistake, the bank "nonetheless released its security interest in a lien when its agent signed the title and returned it to the Debtor." Held stay relief denied based on the bank's pre-petition release of its security interest in the vehicle.

62. Hypothetical BFP status under §544(a)

A creditor's deed of trust was recorded such that it was indexed improperly pursuant to applicable North Carolina law. When the owner of the real estate filed Chapter 7 bankruptcy, the Trustee commenced an adversary proceeding to avoid the deed of trust under 11 U.S.C. §544(a). The Bankruptcy Court held for the Trustee, and appeal was taken to the District Court. *SunTrust Bank v. Northern*, 433 B.R. 532 (M.D.N.C. 2010).

The defendant, creditor argued that the Trustee had constructive notice of the deed of trust because he "occupied" the Debtor's position as owner of the real estate on the bankruptcy petition date. He could not, therefore, be a hypothetical state law bona fide purchaser. The District Court agreed with the Bankruptcy Court that this argument misconstrued the avoidance statute. The Court looked to the statutory language of §544(a) which provides that the Trustee shall have the rights and powers of a bona fide purchaser, as of the commencement of the case, "and without regard to any knowledge of the trustee or of any creditor...." Based on that language, for avoidance purposes the Trustee "stepped into the shoes of a hypothetical bona fide purchaser, not those of the debtor." Because a bona fide purchaser would not have had constructive notice of the mis-indexed deed of trust, the Trustee could avoid this interest in the property for the benefit of the bankruptcy estate.

63. Post-petition perfection of consolidated pre-petition loans is avoidable

Twenty days post-petition, the holder of the first and second pre-petition mortgages effected a consolidation of the two loans; releasing the prior mortgages and perfecting the new one. The Trustee sought to avoid this transaction as a §549 unauthorized post-petition transfer. Because the creditor had knowledge of the bankruptcy filing, the Court concluded it was not a "good-faith purchaser" under §549(c). Based on this finding, Judge Pappas rejected all defenses raised under §549 and §105, including allegations that the estate would receive a windfall based on the bank's release of its valid pre-petition mortgages.

Initial Transferee Issues**64. Law firm holding judgment collected for client is not the "initial transferee"**

After a judgment for \$288,260.00 was obtained, garnishment was issued to collect. Over \$166,000.00 was ultimately turned over pursuant to the garnishment, which was deposited into the trust account of the law firm representing the judgment creditor. \$73,000.00 was subsequently awarded in legal fees, which were transferred to the law firm from the account. The remaining \$109,000.00 was distributed to the client. Shortly thereafter, the judgment debtor filed a Chapter 7 petition. The Trustee sought avoidance of the transfer under §547(b); and recovery from the law firm as the initial transferee under §550(a). Judge McIvor found that a preferential transfer had occurred, but denied recovery against the law firm. Appeal was taken to District Court. *In re Jackson*, 436 B.R. 29 (E.D.Mich. 2010).

The District Court affirmed, finding that because the law firm could not "lawfully spend the money however it wanted," it did not have the requisite "dominion and control" to

be an initial transferee. Rather, it was an immediate transferee for value, in good faith, and without knowledge of avoidability of the transfer. Though the law firm knew of the Debtor's financial distress, and that he was contemplating bankruptcy, the Court found this was not the "degree of knowledge" necessary "to defeat the without knowledge element of the...section 550(b))1) defense."

65. Initial transferee or mere conduit?

In a 2009 case only recently reported, a Georgia bankruptcy court has considered the distinction between an initial transferee of a fraudulent conveyance and a "mere conduit". Pre-petition, the Debtor obtained and delivered a \$35,000.00 cashier's check payable to her older sister. Her sister deposited the funds into a savings account solely in her name, to which the Debtor had no access. The sister agreed to hold these funds for safekeeping, and withdraw them only at the Debtor's request to supplement the Debtor's income and provide for other necessities. This agreement was honored, and all funds from the account were expended on behalf of the Debtor. In the fraudulent conveyance action brought against the sister, she raised the defense that she was not an initial transferee under §550; rather, she was no more than a "conduit through whom the money passed." *In re Kingsley*, 518 F.3d 874 (11th Cir. 2008).

Judge Murphy found the focus of the "conduit" test was whether the sister had sufficient dominion and control to render her a transferee of the funds, and not just a conduit through whom the funds passed. The Court cited two Eleventh Circuit cases: *Nordberg v. Sanchez*, 813 F.2d 1177 (11th Cir. 1987) and *Nordberg v. Arab Banking Corp.*, 904 F.2d 588 (11th Cir. 1990), as controlling precedent. However, it found the Sixth Circuit case of *In re Hurtado*, 342 F.3d 528 (6th Cir. 2003), the most similar and authoritative case on the issue. The *Hurtado* Debtor had transferred funds to his mother, who had paid them for the Debtor's benefit pursuant to his direction. As with the sister in this case, the *Hurtado* mother held the funds in her personal account, and had no legally enforceable duty to use them as requested by the Debtor. The mother had complete dominion and control over the funds, as did the sister here. The fact that they both used the funds only as directed by the Debtor and for the Debtor's benefit was irrelevant. Accordingly, the sister was an initial transferee from whom the Trustee could recover the value of the transferred funds.

See also *In re Harwell*, 2010 WL 5374340 (11th Cir. 2010). In this case the Trustee sued an attorney as the initial transferee of funds placed in his escrow account; and subsequently distributed improperly to the Debtor, his family members, and select creditors. Overruling the Bankruptcy and District Courts on the "mere conduit" issue, the Eleventh Circuit reversed and remanded. The Circuit Court acknowledged that settlement funds transferred in and out of an attorney's trust account typically entitle the attorney to "mere conduit status, rather than that of initial transferee." The Court noted that the first recipient of transferred funds is always the literal initial transferee, with an equitable exception for mere conduits with no control over the funds. However, as to this equitable defense, "good faith is a requirement under this Circuit's mere conduit or control test."

66. Determination of initial transferee

The principal of the corporate Debtor obtained a divorce from his wife pre-petition. Pursuant to the divorce decree, he had a continuing support obligation to his ex-wife and

their children. During the applicable four-year fraudulent conveyance reach-back period, multiple checks totalling \$68,684.25 were written to the ex-wife from the corporate Debtor's bank accounts. The Trustee sought avoidance and recovery of these payments under §544(b), applicable state law, and §550. The ex-wife asserted that her former husband, the Debtor's principal, was the initial transferee. She argued that though the corporate checks were made to her, the "economic reality of the transactions" amounted to her ex-husband withdrawing corporate money to pay the support obligations. She also argued that the Debtor's corporate financial records identified the payments as advances to its stockholder, or as a distribution of capital to him. The Bankruptcy Court ruled for the Trustee, and appeal was taken to the First Circuit BAP. *Antex, Inc.*, 397 B.R. 168 (1st Cir. BAP 2008).

The Appellate Panel acknowledged that lower courts were split on the question of whether the principal of a debtor corporation was the initial transferee of corporate funds paid to satisfy a personal obligation. However, the Court noted that all of the circuit courts addressing the issue (being the Fourth, Ninth, Tenth and Eleventh Circuits) had all concluded that the debtor principal was not the initial transferee. These courts found the principal lacked "legal domination and control" or, stated another way, the "right to put those funds to one's own purpose." The checks were direct transfers from the Debtor's corporate account to the ex-wife and, once issued, the principal had no right to use the money for any other purpose. Furthermore, characterizing the payments as "advances to a stockholder" or as "distributions of capital" did nothing to establish the requisite "legal dominion and control" by the principal.

Property of the Estate

67. How are refunds from joint tax returns divided between a debtor and a non-filing spouse?

The Eighth Circuit BAP has recently addressed the persistent issue of how to divide a tax refund between a Debtor, who is the sole or primary wage earner; and his non-filing spouse, who earned little if any of the income reflected in their joint tax return. *In re Carlson*, 2008 WL 4148318 (8th Cir. BAP 2008).

The Court noted three different methods used to allocate the refunds between the debtor's estate and the spouse: (1) Divide the refund in proportion to the withholdings contributed by each spouse, which is thought to be the majority view. *In re Kleinfeldt*, 287 B.R. 291 (10th Cir. BAP 2002); *In re WDH Howell*, 294 B.R. 613 (Bkrtcy.D.N.J. 2003); *In re Levine*, 50 B.R. 587 (Bkrtcy.S.D.Fla. 1985); (2) Divide the refund in proportion to the income earned by each spouse. *In re Kestner*, 9 B.R. 334 (Bkrtcy.E.D.Va. 1981); or (3) Divide the refund equally between the bankruptcy estate and the non-filing spouse, regardless of earnings or withholdings. *In re Trickett*, 391 B.R. 657 (Bkrtcy.D.Mass. 2008); *In re Marciano*, 372 B.R. 211 (Bkrtcy.S.D.N.Y. 2007); *In re Barrow*, 306 B.R. 28 (Bkrtcy.W.D.N.Y. 2004); *In re Hajmowski*, 296 B.R. 645 (Bkrtcy.W.D.N.Y. 2003); *Loevy v. Aldrich*, 250 B.R. 907 (Bkrtcy.W.D.Tenn. 2000).

The BAP noted that state law should be reviewed to determine the division of property between the parties, but rejected the Debtor's argument that marital dissolution law, with a presumption of equal distribution, is dispositive. The Court stated that the goals of bankruptcy law are different from marital dissolution law, and agreed with the first,

majority view. Because the non-filing wife did not contribute any of the tax withholdings, she was not entitled to any of the refund.

See also, *In re Morine*, 391 B.R. 480 (Bkrcty.N.D.Fla. 2008), where Judge Paskay followed (2) above, and the Debtor's non-filing wife had no interest in the refund from a joint federal tax return because she contributed no taxable income, and the refund check was not deposited into a tenants by the entireties bank account prior to the bankruptcy filing. Therefore, the Debtor could not exempt the refund as entireties property.

68. Real estate commissions earned pre-petition are property of the bankruptcy estate

The Debtor, a self-employed real estate agent, negotiated contracts for buyers of real estate prior to filing a Chapter 7 petition. At the time of filing, the deals had not closed, and there were several remaining contingencies to be satisfied. The Debtor continued work post-petition to facilitate sale consummation, including the assistance of one buyer in obtaining desired zoning. The contracts closed and the Debtor received commissions. The Trustee moved for turnover, which the Bankruptcy Court approved. Appeal was taken to the Bankruptcy Appellate Panel. *In re Smith*, 402 B.R. 887 (8th Cir. BAP 2009).

Relying on *In re Parsons*, 280 F.3d 1185 (8th Cir. 2002), and §541(a)(1), the BAP affirmed the Bankruptcy Court. The BAP found that under applicable Iowa law, the Debtor earned the commissions pre-petition. Pursuant to *Parsons*, such commissions are property of the estate even if the Debtor continued to perform services post-petition. The Court rejected the Debtor's argument that he could not have earned commission payment until all contingencies were satisfied, finding no such provision in the contract or any supporting legal authority for this proposition.

69. Estate property includes assets in deferred compensation plans

Some of the Debtor's key employees entered into deferred compensation plans to provide them supplemental retirement benefits. The deferred compensation was placed in an unfunded trust maintained by an independent trust company. These plans were "top hat" plans under which high-level employees effectively postponed receipt of part of their compensation until a later tax year. While such plans are subject to certain ERISA regulations, they are exempted from nearly all substantive requirements such as minimum funding or investing standards. Moreover, the trusts were "rabbi trusts", which could set aside deferred compensation amounts without jeopardizing the unfunded status of the "top hat" plans. The question before the Court was whether the assets in these plans constituted bankruptcy estate property. *Synovus Trust Co., N.A. v. Bill Heard Enterprises, Inc., et al. (In re Bill Heard Enterprises, Inc.)*, 219 B.R. 858 (Bkrcty.N.D.Ala. 2009).

Under §541(b)(7) estate property does not include any amount withheld by an employer from employees' wages for payment as contributions to an employee benefit plan. However, all plans are not alike, and all plans are not exempt under this statute. The Court noted that funds held in a "rabbi trust" are out of the reach of the settlor/employer, but remain subject to claims of creditors in the event of the employer's insolvency. The Court further noted that the employees did not pay any taxes on the deferred amounts, and pointed out the distinct differences between this plan and other ERISA qualified pension

plans such as 401(k). The Court then held that §541(b)(7) did not exclude from estate property the funds held in trust pursuant to these "top hat" plans.

70. Action under Fair Debt Collection Practices Act (FDCPA) arising from creditor actions pre-petition is bankruptcy estate property

A Chapter 7 Debtor filed a complaint in Bankruptcy Court alleging that a creditor had engaged in pre-petition collection activity which violated the FDCPA. The Debtor asserted that this violation had made him "severely agitated, traumatized, emotionally damaged and inconvenienced." He sought both actual damages of \$1,000.00, punitive damages, legal fees and expenses pursuant to 15 U.S.C. §1629. The Bankruptcy Court *sua sponte* raised the issue of the Debtor's standing to bring this action. *In re Solp*, 425 B.R. 263 (Bkrcty.W.D.Va. 2010).

Judge Klumm cited *Bluemark Inc. v. Geeks On Call Holdings, Inc.*, 2010 WL 28720 (E.D.Va.), as authority for acting on this issue as a threshold matter. Because an action must be brought in the name of the real party in interest, the Court lacks subject matter jurisdiction to hear a case where the plaintiff does not have standing. Therefore, such actions cannot proceed and must be dismissed. *Mirant Potomac River, LLC v. U.S. Env'tl. Agency*, 577 F.3d 223 (4th Cir. 2009). The Court then looked to the Bankruptcy Code and found that under §554(d) "property of the estate that is not abandoned and not administered by a trustee remains property of the estate." Because the pre-petition action came into the estate under §541(a)(1), and had neither been abandoned nor administered, it remained solely under the control of the Trustee for the bankruptcy estate. Therefore, only the Trustee could prosecute this FDCPA claim, which mandated dismissal of the Debtor's lawsuit.

71. State Court claim for equitable distribution of marital assets was part of bankruptcy estate

Two years before filing her Chapter 7 petition, the Debtor initiated a divorce proceeding in Pennsylvania which requested equitable distribution of the marital estate. The Debtor's estranged spouse had a retirement account with an approximate balance of \$130,000.00 which she claimed exempt on her Schedule C. When the Trustee objected to the exemption, the Debtor argued that despite having scheduled the asset, the equitable interest she sought in the divorce case was not part of the bankruptcy estate. *In re Radinick*, 419 B.R. 291 (Bkrcty.W.D.Pa. 2009).

The Debtor relied upon *Kane v. Kane*, 2009 WL 3208653 (D.N.J. 2009), and *In re Frederes*, 141 B.R. 289 (Bkrcty.W.D.N.Y. 1982), for the proposition that her divorce claims had not matured into her property when the bankruptcy case was filed. Judge McCullough rejected those decisions, based on the respective state laws of New Jersey and New York, both of which provided that the right to equitable distribution of marital interests arises only upon the entry of a divorce judgment. Applicable Pennsylvania law was *contra*, providing that interests in marital property vest immediately upon the filing of a divorce action. The Court found the right to the retirement account to be proceeds from or the product of this vested asset under §541(a)(6), regardless of when it was or would be distributed to the Debtor. However, because there had not yet been a distribution ordered by the divorce court, it was premature to rule on the exemption objection.

72. Eighth Circuit finds social security payments are excluded from bankruptcy estate

In a case previously reported at the Bankruptcy Court and BAP levels, the Eighth Circuit has found that 42 U.S.C. §407 keeps social security payments beyond the reach of bankruptcy estates, regardless of whether the payments are received prior to or after the bankruptcy filing. In this case the debtor converted pre-petition Social Security benefits into a cashier's check, which he claimed as exempt. The Bankruptcy Court held that because the debtor had chosen the federal exemption scheme, §522(d) was the only available, applicable exemption. However, §522(d)(10)(A) only exempts the "debtor's right to receive" a "social security benefit." The Bankruptcy Court thus found that the exemption did not apply because the Debtor had already received the benefit. The BAP reversed, finding the payments were not estate property pursuant to 42 U.S.C. §407; and because they were never property of the estate, they did not need not be exempted to be beyond the reach of the Trustee. On appeal, relying on the Sixth Circuit case of *In re Buren*, 725 F.2d 1085 (6th Cir. 1984), the Eighth Circuit affirmed the BAP. *In re Carpenter*, 2010 WL 2977388 (8th Cir. 2010).

73. Self-settled trusts are property of the estate

Pre-petition, the Debtor created a trust to provide for her maintenance and support. The trust contained a spendthrift provision purporting to make the Debtor's interest in the trust assets unavailable to creditors. The Debtor was the grantor, trustee and beneficiary of the trust, and had the right to revoke it at any time. The trust, along with the Debtor, executed a guarantee of a loan to a corporation in which the Debtor was a 75-percent shareholder. The lender subsequently obtained a judgment of over \$3,000,000.00 against the trust and the Debtor, which was entered two days after the Debtor's Chapter 11 petition was filed. The lender filed a stay relief motion asserting that the trust had an independent obligation, and the trust assets were not property of the bankruptcy estate. This motion was brought "in an abundance of caution" as to the issue of whether the trust property might be bankruptcy estate property. *In re Nichols*, 434 B.R. 906 (Bkrcty.M.D.Fla. 2010).

Judge Williamson acknowledged that "a restriction on transfer...under applicable non-bankruptcy law...remains effective even in bankruptcy." However, while acknowledging this "general proposition" he found that a self-settled trust, like this one, is property of the bankruptcy estate. Further, because the trust was revocable, the trust assets were subject to creditor claims under applicable Florida law. Thus, the Debtor's interest in the trust was property of the estate and the trust assets were subject to all creditors' claims, and not just the claim of the bank. Said another way, the bank was only an unsecured creditor as to the guaranty obligations of the Debtor and the trust. Motion for stay relief denied.

74. Is a pre-petition tax refund applied by debtor to a subsequent tax year property of the estate?

The Debtors' 2006 tax return indicated entitlement to a \$3,000.00 refund, but they elected to leave those funds on deposit and apply them to future tax liability. The Chapter 7 Trustee in their subsequent bankruptcy case moved under §542(a) to compel turnover of

\$3,000.00 to the bankruptcy estate, being the value of the pre-petition refund. The Bankruptcy Court denied the motion and the BAP affirmed. The Trustee then appealed to the Eighth Circuit. *In re Graves*, 609 F.3d 1153 (10th Cir. 2010).

The Circuit Court affirmed with the modification that the amount of any future refund of the subsequent year's taxes, which were attributable to pre-petition earnings, would be subject to turnover.¹ The Court first addressed the question of whether the pre-petition refund was property of the estate and found that it was, "as a contingent reversionary interest." However, the Trustee's interest was limited by 26 U.S.C. §6513(d), which made the Debtors' election irrevocable. The Debtors had no further right to the refund after applying it to subsequent tax liability; so neither did the Trustee. The Court then turned to the language of §542(a) which provides for turnover of property or its value from "an entity...in possession, custody, or control, during the case,...." The Debtors did not have such possession, control or custody during the case because the irrevocable election was made pre-petition. Turnover was therefore not an available remedy. However, there remained the potential future refund that could be administered by the Trustee.² The Court conceded that this decision conflicts with the Ninth Circuit case of *Nichols v. Birdsell*, 491 F.3d 987 (9th Cir. 2007); "a case factually indistinguishable from this one" where the Ninth Circuit "held that the entire refund amount was property of the estate and implicitly subject to turnover from the Debtors."

Comment: Would this entire refund amount have been recoverable if the Trustee had sought avoidance of the Debtors' IRC election as a fraudulent conveyance? See *In re Feiler*, 218 F.3d 948 (9th Cir. 2000).

75. Post-petition appreciation belongs to bankruptcy estate and *Schwab v. Reilly* explained and applied

In two consolidated appeals the Ninth Circuit has reiterated its position that the post-petition appreciation of bankruptcy estate assets becomes bankruptcy estate property. Additionally, the Court applied the recent Supreme Court decision in *Schwab v. Reilly*, 130 S.Ct. 2652 (2010), as to the effect of a Debtor's claimed exemptions in such appreciating properties. *In re Gebhart*, 2010 WL 3547641 (9th Cir.).

In each of the consolidated cases, the Debtors filed Chapter 7 petitions when the equity in their residences was less than their eligible homestead exemption. Post-petition, the home values increased so that the equity exceeded the allowed homestead exemption amounts. The issue before the Circuit Court was whether the Trustee could sell the property and recover the excess equity for the bankruptcy estate, or whether the Debtors would retain the post-petition appreciation of the properties. Neither Trustee objected to the homestead exemptions claimed by the Debtors, both of which indicated that the mortgage debt plus allowed exemption amount exceeded the market value. In *Gebhart* the Trustee sought to sell the property almost three years after the petition date. In *Chappell* the Trustee objected to the stay relief motion filed by the mortgage company two years after the petition date, arguing equity in the property.

¹ The practicality and complications of computing and obtaining such turnover, though obvious and meaningful, will not be discussed.

² See Footnote 1.

In both cases the argument was made that the Trustee's failure to object to the homestead exemption released the property from the bankruptcy estate, such that any increase in value belonged to the Debtors. The Circuit Court rejected this argument, stating that *Schwab v. Reilly* "clarified...that exemptions claimed under statutes like these are limited to the dollar value claimed in the exemption." Thus the asset remains in the estate, and "what is removed from the estate is an 'interest' in the property equal to the value of the exemption claimed at filing." "Any additional value" continues as property of the estate, "regardless of whether the extra value was present at the time of filing or whether the property increased in value after filing." The Court then cited its prior holdings that post-petition appreciation belongs to the bankruptcy estate, under both the California exemption statute and §541(a)(6) which includes the product, profit, proceeds, etc. from estate property, as property of the estate. Finally, the Debtors argued that the Trustee should have been estopped, based on dilatory administration of the estate. The Court listed the four required elements for application of estoppel, and found it did not apply. The Court then opined that asset abandonment, which would punish creditors, was not an appropriate remedy for Trustee misconduct. If delayed estate administration amounted to such misconduct, that was a matter for the U.S. Trustee to consider and/or police.

76. Stock appreciation rights held property of the estate

Spirit AeroSystems acquired Boeing Company's Wichita Plant in 2005. During negotiations between Spirit and the labor union, Spirit offered to establish an equity participation program ("EPP") and to contribute stock appreciation rights ("SARs") to the program upon the occurrence of certain "Payment Events". The language in the final collective bargaining agreement ("CBA") provided that "the parties agree to establish an (EPP) for participating employees." Prior to voting on the CBA, slide presentations were presented regarding the EPP. These presentations indicated that participants would be awarded options which allowed a right to share in "Payment Event Profits". The value of the options would be based upon the Payment Event. It was further provided that management did not know when such a Payment Event would take place, but the company "will want a Payment Event as soon as...the conditions are right for an optimal valuation." Several employees filed bankruptcy petitions shortly after ratification of the CBA, but more than a year before Spirit put the EPP agreement into writing, which defined which employees were eligible and the SARs each eligible employee would receive. A month after the EPP was reduced to writing, a Payment Event (IPO) occurred. The SARs became worth \$61,440.00 per employee, with participating employees receiving \$34,556.00 in cash and 1,034 shares of common stock. The Bankruptcy Trustee for the former employees filed motions to compel turnover of distributions received from the SARs as bankruptcy estate property under §541. The Bankruptcy Court denied turnover, and the BAP affirmed. The Trustee then appealed to the Tenth Circuit. *In re Dittmar*, 618 F.3d 1199 (10th Cir. 2010).

The Circuit Court analogized the Debtors SARs to an employee's interest in a stock option plan where the employees own contractual rights to purchase stock in the future subject to "certain limitations of use and to the possibility of defeasance by later events." The Court noted that "such postponed enjoyment" does not make these interests not property. The Court then found the Debtors to have been employees holding similar contingent property rights. While their value prior to any payment event may have been "de

minimis", that did not mean they had no property interest in the SARs. The Court went on to hold that even though their interests were completely dependent upon the economic decisions of their former employers, the Debtors owned cognizable property rights which were included in the broad and generously construed definition of property of the estate under §541(a)(1). The Court rejected the Debtors arguments that at the time of bankruptcy filing the SARs were but a mere expectancy. Rather, the Court found they were contingent interests which were property of the bankruptcy estate even though their rights did not accrue and were uncertain until after the bankruptcy case was commenced.

77. How is post-plan property of Chapter 13 Debtor valued upon conversion to Chapter 7

A Chapter 13 Debtor paid all secured and priority debt over four years of the plan. However, before the unsecured creditors were paid in full the case converted to Chapter 7. The issue before the Court was whether the value of the Debtor's vehicle would be calculated as of the petition date or the conversion date. If the petition date value applied, there was equity for the Chapter 7 estate. The subsequent, depreciated value upon conversion was without equity. *In re Lang*, 437 B.R. 70 (Bkrcty.W.D.N.Y. 2010). Judge Bucki held that though the original equity was an asset of the Chapter 13 estate, it did not belong to the Chapter 7 estate upon conversion.

Claims

78. Debts incurred in Vegas stay in Vegas

Prior to filing bankruptcy in Wisconsin, his state of residence, the Debtor gambled unsuccessfully in Nevada and the Bahamas. His contracts with the casinos provided that Nevada or New Jersey law would apply. However, upon the Trustee's objection to the casino claims against the bankruptcy estate, the Bankruptcy Court applied Wisconsin law and disallowed the claims as violations of public policy. *In re Jafari*, 378 B.R. 575 (Bkrcty.W.D.Wis. 2007). Judge Utschig determined that neither New Jersey nor Nevada law should be applied. There was no connection to New Jersey at all. Although Nevada was where the markers underlying the casino claims were executed and the gambling itself took place, the markers did not specify a place of repayment. Additionally, the casino had reached into Wisconsin to solicit the Debtor and offer him free travel and accommodations as an inducement to gamble in Nevada. Thus, the Court found Wisconsin law to apply and denied the claims as violating Wisconsin's strong public policy against the enforcement of gambling debts.

79. Viva Las Vegas

In the last issue of *NABTalk* I reported the case of *In re Jafari*, where a Wisconsin Bankruptcy Court denied the claims of two Las Vegas casinos based on the unenforceability of gambling debts under Wisconsin law. Not surprisingly, the case was appealed. The District Court reversed the decision, finding the pertinent issue was in no way related to the morality of gambling or the wages of sin. Rather, the only question was which state law must be applied. The Debtor had signed an agreement that Nevada law

would apply in order to obtain credit through markers issued by the casino. Additionally, all of the gambling took place in Nevada, not in Wisconsin. Therefore, the Court found that Nevada law applied, where gambling is indeed legal. Said another way, some things that happen in Vegas, such as debt incurred there, don't stay in Vegas. Instead, they follow you wherever you go. *In re Jafari*, 378 B.R. 575 (Bkrcty.W.D.Wis. 2007). 569 F.3d 644 (7th Cir. 2009).

80. Seventh Circuit upholds Nevada casino's claims in Wisconsin bankruptcy case

A case previously reported in this article at the Bankruptcy and District Court levels has worked its way to the Seventh Circuit Court. Here, a Wisconsin citizen gambled in Nevada, lost approximately \$1.5 million, then went home to file bankruptcy. The Wisconsin Bankruptcy Court denied the casino claims as "unenforceable" under the Wisconsin anti-gaming statute which invalidates gambling debts as a matter of public policy. On appeal the District Court reversed, based on the Debtor's signing an agreement in Nevada that Nevada law (with its very different public policy about gambling) would apply to his gaming transactions in Nevada. The Circuit Court agreed with the District Court's assessment of the issue and looked to Wisconsin choice of law rules. The Court found that the law of the forum state (Wisconsin) presumptively applies unless "it becomes clear that non-forum contacts are of the greater significance." Because the Debtor was in Nevada when he made the agreements; the funds were loaned to him for gambling in Nevada; and, moreover, because the Nevada casinos did business in Nevada the "significant contacts in this case strongly favored Nevada, not Wisconsin." Thus the Nevada casino claims were valid in the Wisconsin bankruptcy case. *In re Jafari*, 569 F.3d 644 (7th Cir. 2009).

But don't mess with Texas. In a case with almost identical facts, substituting Louisiana casinos and a Texas gambler filing bankruptcy in Texas, the result is the reverse of this Seventh Circuit decision. The Texas Bankruptcy Court found that Texas had a more significant relationship to the transactions. It was the state where the Debtor resided and where his repayment obligation would be performed, from his Texas bank account. Further, even though the credit agreement was signed in Louisiana, credit was extended there, and funds were gambled away there; Texas had a greater interest in determining the enforceability of the debt because application of Louisiana law would be contrary to a fundamental policy of the State of Texas against gambling on credit. *In re Guevara*, 2009 WL 2046770 (Bkrcty.S.D.Tex.).

81. Mortgage claim disallowed

A Chapter 13 proof of claim asserted a mortgage obligation of \$234,594.85 and an arrearage of \$30,883.70. The only document attached was a summary sheet dividing the claim into categories of principal balance, interest, late charges, pre-petition attorney fees and costs, pre-petition escrow advances, and "other amounts for inspection fees, appraisal fees and other charges." The Debtors objected to the lack of detail and the computation. At the hearing on the objection, the only document tendered was a copy of the mortgage. The Bankruptcy Court disallowed the claim but granted leave to file a curative amendment within 20 days, including documentation necessary to support the claim and its components. *In re Cramer*, 406 B.R. 267 (Bkrcty.M.D.Pa. 2009).

Judge Thomas found the filing of a claim with attached writings upon which the claim is based, could serve as *prima facie* evidence of the validity and amount of the claim. However, without appropriate documentation, and without any further evidence tendered by either party, the claim is insufficient. At a minimum, both the mortgage and mortgage note would need to be attached for the claimant to obtain the benefits of *prima facie* status. The Court was further troubled by the summary sheet of additional components of the claim because there was no indication of the basis for the computation of each item contained in the summary. Finally, the Court held that if an appropriate amended proof of claim was not timely filed, the claim would be disallowed for insufficient information to be enforceable under §502(b).

82. Second Circuit holds §502(b) does not apply to administrative expense claim

Addressing an issue of first impression, the Second Circuit has ruled that §502(b), which bars allowance of claims filed by alleged recipients of preferential transfers, does not bar allowance of §503(b) administrative expenses. *In re Ames Dept. Stores, Inc.*, 582 F.3d 422 (2d Cir. 2009). In so holding, the Circuit Court disagreed with the Ninth Circuit Appellate Panel that §502(b) was a valid defense to allowance of administrative claims. *In re Microage, Inc.*, 291 B.R.503 (9th Cir. BAP 2002). The Third Circuit rejected the BAP's finding that §502(b) "by its terms applies to 'any claim' of an entity that received an avoidable transfer, and the definition of a 'claim' in §101(5) is sufficiently broad to include requests for payment of administration." Instead, the Circuit Court found that the "structure and context" of §502(b) suggests that Congress intended to differentiate between claims and administrative expenses. Additionally, the Court noted the higher priority of administrative expense requests to pre-petition claims under the Bankruptcy Code, which encourages third parties to supply goods and services on credit to the benefit of all estate creditors. Allowing a Debtor to avoid paying administrative expenses by alleging a vendor had received a preferential transfer would hinder that policy. Thus, based upon its language, as well as a recognized policy advanced by the statute, §502(b) was held inapplicable to administrative expense claims under §503(b).

83. Cert denied on applicability of §502(d) to administrative expense claims

The Supreme Court has denied certiorari in *Ames Department Stores, Inc. v. ASM Capital LP* (Docket No. 09-726) (2010 WL 596884). As previously reported, in *Ames* the Second Circuit ruled that the §502(d) bar of allowance of claims filed by alleged recipients of preferential transfers, does not include administrative expense claims under §503(b). In denying cert, the Supreme Court failed to address an apparent Circuit conflict based on the Eighth Circuit case of *In re Colonial Services Co.*, 480 F.2d 747 (Ca. 8 1973), where the Bankruptcy Act predecessor of §502(d) was held applicable to administrative expense claims.

Comment: It should be remembered that BAPCPA added §503(b)(9), which includes as administrative expenses amounts unpaid by the Debtor to sellers of goods within 20 days of the bankruptcy filing. This amendment has been responsible for much irrational mischief, including the situation in *Ames* and its absurd result. There the Debtors were ordered to pay administrative expense claims of \$393,000.00, while the original

administrative claimant owed \$825,000.00 in preference payments, and was also in bankruptcy. Go figure.

84. The fifth element required for allowable informal proof of claim. Is it equitable to allow the claim???

Based on his pending §544(a) action to avoid a mortgage on real estate, the Trustee moved to sell the property under the "bona fide dispute" provision of §363(f). The mortgage holder objected, and moved for stay relief and abandonment of the property. The Bankruptcy Court authorized the sale, and subsequently avoided the mortgage. The BAP affirmed on appeal, and no further appeal was taken. Throughout this process and beyond, the creditor never filed a proof of claim. Therefore, when the Trustee submitted his final report, he did not recommend distribution on the mortgage creditor's now unsecured claim. The creditor objected, and moved for allowance as an informal proof of claim. The Court denied this relief, finding the various pleadings filed by the creditor lacked the requisite elements to constitute an informal claim. Additionally, the Court found that the equities weighed in favor of disallowing the claim. On appeal, in a split decision, the Sixth Circuit BAP found the pleadings contained the elements required to qualify as an informal proof of claim. However, the majority agreed with the Bankruptcy Court that allowance would be inequitable, and disallowed the claim on that basis. Appeal was then taken to the Sixth Circuit Court. *In re Nowak*, 586 F.3d 450 (6th Cir. 2009).

The Circuit Court stated the four elements required for allowance of an informal proof of claim: (1) It must be in writing, (2) containing a demand by the creditor on the debtor's estate, (3) expressing an intent to hold the debtor liable for the debt, and (4) must be filed with the Bankruptcy Court. If these conditions are met, there is a fifth factor to be examined. This last factor is a determination of whether it is equitable to allow the claim. The Appellate Court found this determination to be within the sound discretion of the Bankruptcy Court, requiring a balancing of the interests of the parties involved. The Court then reviewed the three factors on which the Bankruptcy Court based its decision. The first was the length of the creditor's delay in pursuing an unsecured claim. After the Trustee initiated the adversary proceeding the creditor was on ample notice of a likelihood that its secured creditor status might be lost, necessitating the filing of a claim. Further, regardless of the avoidance action, sale of the Debtor's residence would not have paid the secured claim in full, leaving an unsecured deficiency necessitating a proof of claim filing. Indeed, the creditor had recognized and noted this fact in objecting to the proposed §363(f) sale. As such, the creditor simply failed to protect its own interest. The second factor was the creditor's inability to explain its delay as other than an "oversight". The Circuit Court called that a "self-inflicted wound" that bode against recognizing an informal proof of claim for a sophisticated party represented by counsel. The third consideration was the amount other claims would be reduced by allowance of the informal claim. Here the distribution to other creditors would decrease from 100% to 29%. Finding that reasonable people could differ in this required balancing of equities, the Sixth Circuit held the Bankruptcy Court had not abused its discretion and affirmed its holding.

Section 362 Stay Violation**85. Trustee is not an "individual" under §362(k)**

In a pre-BAPCPA case, which references the new law for purposes of statutory construction, an Illinois Bankruptcy Court has dismissed an action brought by the Chapter 7 Trustee for damages from willful violation of the automatic stay under §362(h), which is now §362(k) of BAPCPA. *In re Glenn*, 379 B.R. 760 (Bkrcty.N.D.Ill. 2007).

Judge Black first noted a split of authority as to whether the Trustee can be an "individual injured" within the meaning of §362(h), with decisions from the Court's District ruling that the Trustee has such standing, and a Ninth Circuit case ruling otherwise. *In re Pace*, 67 F.3d 187 (9th Cir. 1995). The key distinction framed by the Court was between "individual", and the broader terms "entity" or "person". The Court found that "individual" (human being) did not include a bankruptcy estate, and therefore not a Trustee. The Court then considered the provisions of new §362(k) to gain insight into the intent of Congress in this subsection. The amended provision includes the same language ("individual injured") in subsection (a), but also contains a new subsection (b) with certain limitations. Under §362(k)(2), the limitation references the term "entity" and not the word "individual". Judge Black reasoned that the use of these two terms (with different meanings) demonstrates Congressional understanding and intent to retain the more restrictive word "individual" within subsection (a). Thus neither the bankruptcy estate, nor the Trustee, qualify as an "individual injured" with a cause of action under either old §362(h) or new §362(k).

86. Trustee has standing as an "individual" under §362(k) to recover for willful stay violations

Trustee sued to recover damages for defendant's willful stay violation under §362(k), which provides that an "individual" may bring such actions. The defendant argued that the Trustee was not an "individual" under the statute, and thereby lacked standing to bring the lawsuit. *In re Howard*, 428 B.R. 335 (Bkrcty.W.D.Pa. 2010).

Judge Deller first noted that the term "individual" is not "expressly defined" in the Bankruptcy Code. The Court then cited §321, which plainly states that only an "individual" or a "corporation" may serve as a bankruptcy Trustee. Here the Trustee was not a corporation; she was a living, breathing "natural born person" which qualified her as an "individual". Further, as fiduciary of the bankruptcy estate, the Court found the Trustee must have standing to pursue claims for willful violation of the automatic stay, one of the most fundamental bankruptcy protections. The automatic stay not only protects debtors from collection efforts, but also property of the estate and the collective interest of creditors. "Preventing a bankruptcy trustee from having standing to enforce the automatic stay produces an absurd result demonstrably at odds with the purpose of Section 362 of the Bankruptcy Code." The Court concluded it was "unlikely that Congress intended to exclude bankruptcy trustees from the protections afforded by Section 362."

Comment: Though this opinion seems hard to question, it has far from universal acceptance among Courts.

87. Fifth Circuit holds both debtors and non-debtors may bring willful stay violation actions under §362(k)

Section 362(k) allows recovery for both actual and punitive damages where an "individual" has been injured by a willful stay violation. Courts are divided as to whether Trustees are included as an "individual" under the statute. In this case of first impression, the issue was creditor, rather than Trustee standing; and the Fifth Circuit held that owners of a bankrupt company, in their capacity as creditors of the Debtor, have both constitutional and prudential standing to pursue a damages claim for an insurer's alleged stay violation. *St Paul Fire & Marine Ins. Co. v. Lubuzan*, 2009 WL 2501122 (5th Cir. 2009).

The Circuit Court noted that one of the principal purposes of the automatic stay is to "protect creditors from unjust treatment." The term "individual" is not defined in the Code, which led the Court to find, "If Congress intended to abrogate the prudential standing requirement by enacting §362(k), that intent is not expressed clearly." The Court further found, from the legislative history, that the automatic stay was intended to give debtors a breathing spell from creditors while also protecting creditors. If Congress had intended to limit the remedies in the stay provisions to debtors, it could have done so easily by replacing the term "individual" with "debtor". The Circuit Court then ruled that "debtors and creditors are entities whose grievances fall within the 'zone of interest' protected by §362(k)."

Of importance to Trustees, the defendant insurer had argued that the claims being pursued actually belonged to the estate and could only be asserted by the Trustee. The Court disagreed, stating: "if Congress intended to grant the trustee exclusive standing to assert automatic stay violations, it could have done so by replacing 'individual' with 'trustee'". The Court reasoned that possible harm to the debtor did not mean no other harm resulted from the alleged stay violation; such that the claims by the principals and the estate were not mutually exclusive.

Standing

88. Eighth Circuit allows derivative standing to creditors upon Trustee's consent

In a case of first impression, the Eighth Circuit has held that creditors may bring Trustee actions for the benefit of the estate upon consent of the Trustee, subject to Bankruptcy Court approval. *In re P.W. Enterprises, Inc. v. North Dakota Racing Com'n.*, 540 F.3d 892 (8th Cir. 2008). In this case a creditor filed a motion to pursue avoidance actions, and the Trustee formally responded that he did not oppose the motion, but wanted reassurance that the actions would be pursued for the bankruptcy estate. The motion was denied, based on the creditor's failure to show that the Trustee had abused his discretion or acted unjustifiably in not asserting the avoidance claim, which the Court deemed a requirement for derivative standing. The BAP affirmed, and appeal was taken to the Circuit Court.

The Eighth Circuit held that a creditor may proceed derivatively when a Trustee or DIP either consents, or does not formally oppose the creditor's action, thereby adopting the Second Circuit standard of *In re Commodore Int'l Ltd.*, 262 F.3d 96 (Ca. 2 2001). However, the Appellate Panel emphasized that "under no circumstances may a creditor prosecute its

derivative complaint without the Bankruptcy Court's permission." Thus, even if the Trustee consents, the creditor must still obtain leave from the Court for derivative standing, which may be denied under appropriate circumstances, even if the Trustee has consented.

89. Trustee lacks standing to bring conspiracy to commit fraudulent transfer action against non-debtor

In an unreported opinion, the Fifth Circuit has ruled that a Chapter 7 Trustee lacked standing to pursue a civil conspiracy claim against a third party who allegedly conspired with the Debtor to fraudulently transfer assets. Here the issue was not whether such a cause of action existed, but whether it could be asserted by the Trustee. Affirming the District Court dismissal of the Trustee's Texas law conspiracy claim, the Circuit Court held that the subject claims belonged exclusively to creditors of the bankruptcy estate. The Court followed the Supreme Court case of *Caplin v. Marine Midland Grace Trust Co.*, 406 U.S. 416 (1972), and its prior holding in *In re Seven Seas Petroleum, Inc.*, 522 F.3d 575 (5th Cir. 2008), for the proposition that Trustees have no right to bring claims "that belong solely to the estate creditors." The argument that the claims here sought "to remedy an injury to all...creditors and not merely a subset thereof," was unavailing. The action against the alleged third party conspirator belonged to the creditors; and because the Debtor had no interest in these actions, neither did the Trustee. *In re Bradley*, 326 Fed.Appx. 858 (5th Cir. 2009).

See also, *Grede v. Bank of New York, Mellon*, 409 B.R. 467 (N.D.Ill. 2009), where an Illinois Bankruptcy Court ruled that the Trustee of a liquidating trust lacked standing to pursue claims assigned to the trust by individual creditors in a confirmed plan. There, Judge Hibbler found that assertion of these claims would benefit only the assigning, individual creditors, rather than all trust beneficiaries. Because the Trustee represented all beneficiaries, he did not have standing to bring actions on behalf of a group of individual creditors.

90. Surplus estate is only basis for Debtor standing to object to proposed Trustee sale

The Debtors owned a 20-percent interest in an LLC which owned unencumbered commercial property appraised at \$1.47 million. The property also generated a net annual cash flow of \$100,000.00 or more. When their Chapter 7 Trustee proposed sale of their interest for \$36,000.00, the Debtors objected. The Trustee argued that the Debtors lacked standing to object because their debts greatly exceeded the value of their assets; so that this could not be a surplus estate. The Debtors therefore had no pecuniary interest in the sale. The Debtors asserted that they had a pecuniary interest notwithstanding the existence of a surplus. They had non-dischargeable tax claims with distribution priority. To the extent more money came into the bankruptcy estate, payments on these priority claims would increase, which would reduce their ultimate non-dischargeable obligations. This was, they argued, a valid pecuniary interest. *In re Adams*, 424 B.R. 434 (Bkrtcy.N.D.Ill. 2010).

Judge Goldgar acknowledged that "a few Courts do endorse" the Debtor's theory of standing, but rejected it for two reasons. The Court first found that the pecuniary interest of the Debtor must be "directly and adversely" affected, and the effect argued by the Debtor

here was "at best indirect." Second, "granting standing to every Debtor who happens to be subject to some nondischargeable claim would interfere with the administration of Chapter 7 cases." The Court cited *In re Richmond*, 104 F.3d 654 (4th Cir. 1997), for the proposition that the policy of "swift and efficient" case administration is "achieved primarily by narrowly defining who has standing in a bankruptcy proceeding."

91. Can a Chapter 7 Trustee extend the bar date for dischargeability complaints?

At the Debtor's meeting of creditors the Chapter 7 Trustee requested significant additional documentation. Upon its receipt, the Trustee agreed to continue the 341 meeting to allow document review. The Trustee further requested an extension of time for any party to object to discharge, to which the Debtor agreed as to the Trustee and United States Trustee. The Debtor did not agree to any extension as to creditors. The Trustee subsequently filed her motion to extend the deadline for filing complaints objecting to the Debtor's discharge and objecting to the dischargeability of creditor claims. After the initial bar date had passed, a creditor moved to join the Trustee's previously filed motion to extend deadlines. The Debtor objected. *In re Owen-Moore*, 435 B.R. 685 (Bkrcty.S.D.Cal. 2010).

Judge Taylor found that Bankruptcy Rule 4007(c) governs the time for filing dischargeability complaints under §523(c), providing that a creditor must file the complaint "no later than 60 days after the first date set for the meeting of creditors under §341(a)." The Court further found that this rule allows for extension of the deadline upon motion filed "before the time has expired." The Court stated this was an issue of first impression for the Ninth Circuit, and further noted a split in the Circuits which have considered it. In the case of *In re Farmer*, 786 F.2d 618 (4th Cir. 1986), the Fourth Circuit held that the Trustee was not a party in interest for purposes of Rule 4007(c). While the Trustee could bring an objection to discharge for the benefit of all creditors, he lacked standing to bring an action objecting to the discharge of an individual creditor's claim. Therefore, there was no statutory basis for a Chapter 7 Trustee's extension of time for asserting creditor non-dischargeability complaints. In the case of *Brady v. McAllister*, 101 F.3d 1165 (6th Cir. 1996), the Sixth Circuit reached an exactly opposite conclusion. In *Brady*, the order provided that the Trustee's bar date extension was "on behalf of the estate and all secured and unsecured creditors of the estate,...to file nondischargeability complaints...." Based on this order, the Sixth Circuit allowed a creditor to file a complaint that would have been untimely, but for the Trustee's extension of the deadline. In so holding, the Court found the Chapter 7 Trustee's inability to file a dischargeability complaint was not dispositive.

Here the Bankruptcy Court agreed with the Fourth Circuit, finding that the Trustee was not a party in interest under Rule 4007(c) because she could not file a complaint objecting to the dischargeability of the creditor claims at issue. In support, the Court noted that a Chapter 7 Trustee's duties under §704 do not include bringing actions for individual creditors. Further, Chapter 7 Trustees generally lack any economic interest in dischargeability actions, and none existed in this case. Finally, the Court found this interpretation to be consistent with the appropriately strict interpretation of deadlines for objecting to the dischargeability of debts in bankruptcy. Accordingly, the creditor's motion to join the Trustee's extension of discharge deadlines was denied.

Abandonment**92. Bankruptcy estate assets can be abandoned only to the Debtor**

The liquidating supervisor of a Chapter 11 Debtor sought to settle issues with a state environmental protection agency by transferring the Debtor's interest in funds held in a remediation trust to secure performance by the Debtor. In the motion seeking authorization of the settlement, the Debtor proposed to abandon the contingent interest in the trust funds to the state agency. *In re High Voltage Engineering Corp.* 397 B.R. 579 (Bkrtcy.D.Mass. 2008); aff'd by 408 B.R. 163 (D.Mass. 2009).

In a lengthy opinion, Judge Feeney overruled several objections to the settlement, but denied the part of the motion seeking to "abandon" the Debtor's interest in the trust fund to the environmental protection agency. The Court found that §544 only allows abandonment of estate assets to the Debtor, subject to any and all claims against the abandoned asset, which are preserved. Thus, any attempt to "abandon" property to a party other than the Debtor is not consistent with the meaning and intent of §544. Nevertheless, the settlement could be accomplished by a transfer of the asset, reaching the same result without the need for a formal abandonment.

93. Sixth Circuit rules on revocability of technical abandonment

In a case of first impression in the Circuit, the Sixth Circuit Court has found that a Rule 60(b) analysis should be applied to determine if a technical abandonment of the Debtor's assets may be revoked. *LLP Mortg., Ltd. v. Brinley*, 547 F.3d 643 (6th Cir. 2008).

The Court first found "technical abandonment" to occur pursuant to §544(c) as to any property scheduled by the Debtor "not otherwise administered at the time of the closing of a case is abandoned to the Debtor." The Court adopted the approach of the Tenth Circuit in the case of *In re Woods*, 173 F.3d 770 (Ca. 10, 1999), which applied the guidelines of F.R.C.P. 60(b) to Bankruptcy Rule 9024. The Court noted that this requires the parties to act with due diligence, but also allows some flexibility in situations where relief is appropriate. The Court found such application to strike "the appropriate balance between promoting finality and allowing courts to grant relief in limited circumstances." In these consolidated cases, the Trustee's action in not administering the property did not result from mere carelessness, and the equities weighed in favor of preserving unencumbered equity for the bankruptcy estate. Accordingly, the abandonment was revoked.

94. Assets not included on Schedule B are not abandoned upon case closing

Key man life insurance policies owned by the Chapter 7 corporate debtor were not listed on Schedule B. They were, however, scheduled as executory contracts on Schedule G. An NDR was filed and the case was closed, but the Trustee subsequently moved to reopen to administer the insurance policies. The Debtor objected, asserting that the Schedule G listing, and the Trustee's apparent knowledge of the policies prior to case closing were sufficient to cause the assets to be abandoned under §544(c). The Bankruptcy Court disagreed. Judge Ninfo cited the "explicit requirement of §521(a)(1)(B)(I) that the debtor file a schedule of assets." The Court then found that neither the Schedule G

listing nor the fact that the Trustee may have been aware of the policies constituted "the administration of those assets for purposes of §544(c)." Held Trustee allowed to administer the insurance policies in the reopened case. *In re J&S Conveyors, Inc.*, 409 B.R. 635 (Bkrcty.W.D.NY 2009).

95. When can a Trustee revoke a prior abandonment of assets?

A Michigan bankruptcy court has examined the issue of when and how a Trustee can revoke a prior asset abandonment. In this case the Debtors scheduled a secured claim amount in excess of the value they assigned to their residence. The Trustee filed a no asset report, the Debtors received discharges, and the case was subsequently closed. When the residence was later foreclosed, the successful bid price was less than the market value. Upon learning of this, the Trustee moved to reopen the case in order to recover the additional value from the property. The Court granted the case reopening, but denied the Trustee's motion to revoke abandonment. *In re Reiman*, 431 B.R. 901 (Bkrcty.E.D.Mich. 2010).

Judge Shefferly acknowledged that abandonments can be revoked by a Trustee under Bankruptcy Rule 9024, after the case is reopened. However, the Court further noted that such revocation is only proper under "very limited circumstances". *Catalano v. Commissioner of Internal Revenue*, 279 F.3d 682 (9th Cir. 2002). The Court cited the fairly recent Sixth Circuit case of *LLP Mortgage, Limited v. Brinley*, 547 F.3d 643 (6th Cir. 2008), where the Trustee was allowed to revoke abandonment based upon a subsequent Court ruling which created equity in the previously abandoned property. *Brinley* was distinguished because the revocation was sought due to a legal determination which was not foreseeable by the Trustee. It was a mistake of law, as opposed to a mistake of fact. The *Brinley* Trustee acted on an "extraordinary set of circumstances", which were not present here. Revocation motion denied, leaving the asset outside the bankruptcy estate, and not subject to Trustee administration.

Comment: The lesson here is straightforward. Trustees should be diligent in assessing asset values before abandoning assets. The fact that there is definite value for the estate upon revocation is not, alone, a sufficient basis for a revocation motion.

Judicial Estoppel

96. Judicial estoppel upheld by Fifth Circuit

The Debtors neither disclosed their pending personal injury action in the schedules filed in their Chapter 7 case, nor otherwise informed the Trustee, who filed a no asset report. The Debtors subsequently received their discharges. When the personal injury action defendants filed a motion in state court seeking dismissal based on judicial estoppel, for failure of the Debtors to list the action as an asset in their bankruptcy case; the Debtors moved to reopen the bankruptcy proceeding to allow the Trustee to administer the lawsuit for the bankruptcy estate. Over the defendants' opposition, the Bankruptcy Court granted the motion to reopen. The case was then removed by the state court defendants to federal court, where they again moved for dismissal based on judicial estoppel. Shortly thereafter, the Trustee moved to substitute himself for the Debtors in the lawsuit as the real party in interest. The Federal District Court granted the dismissal motion, and summarily denied

the Trustee's motion as moot. Appeal was taken to the Fifth Circuit. *In re Kane v. National Union Fire Ins. Co.*, 535 F.3d 380 (5th Cir. 2008).

The Circuit Court distinguished its earlier case of *In re Superior Crew Boats, Inc.*, 374 F.3d 330, upon which the District Court had relied. The Court noted that the prior case had involved an asset which the Trustee was informed about, and which was formally abandoned under §554. There, the Debtors had the asset back and stood to profit from their prior nondisclosure. Here, the asset had not been abandoned and the Debtor could only benefit from surplus funds available after case administration. The Fifth Circuit cited and followed the Seventh Circuit case of *Biesek v. Soo Line R.R. Co.*, 440 F.3d 410, 413 (7th Cir. 2006), which stated, "Judicial estoppel is an equitable doctrine, and using it to land another blow on the victims of bankruptcy fraud is not an equitable application."

97. Another tale of two Circuits: Judicial estoppel

The Fifth and Sixth Circuit Courts have recently ruled on a constantly recurring issue of great importance to Trustees. Unfortunately, these decisions are not only unfavorable to Trustees and bankruptcy estates; they also represent a distinct direction change in the evolution of Circuit Court precedent in this area.

SIXTH CIRCUIT – *White v. Wyndham Vacation Ownership, Inc. (In re White)* 2010 WL 3155161: Here a Chapter 13 Debtor failed to disclose a sexual harassment claim as either an asset on Schedule B, or an answer to the SOFA inquiry as to "Suits and Administrative Proceedings...." The Debtor did, however, file an "Application to Employ Counsel", requesting representation by an attorney to be paid a 20-percent contingency fee. This application did not contain the underlying facts of the harassment claim or the amount the Debtor sought to recover. It was filed one day before the harassment suit was filed in District Court, and after confirmation of a Chapter 13 plan that did not reflect a value of the harassment action. The Debtor sought \$250,000.00 in compensatory and \$1,000,000.00 in punitive damages.

When the defendants moved to dismiss the District Court action based on judicial estoppel, the Debtor partially amended to disclose the harassment claim. She also filed an affidavit from her bankruptcy attorney which stated that he had been informed of the claim, and that the Debtor had never tried to conceal or keep the information secret. He further stated that he was "unsure" why the papers filed in the bankruptcy case failed to disclose the action. Finally, the affidavit contained the following statement: "When I appeared in Court on Ms. White's bankruptcy, this lawsuit was discussed, as well as, any potential claims thereof." The District Court dismissed the action, and appeal was taken to the Sixth Circuit.

The Circuit Court stated the elements required to be proved for judicial estoppel to apply: 1) the debtor took a position contrary to what she asserted under oath in the bankruptcy case; 2) the Bankruptcy Court adopted the contrary position; and 3) the omission did not result from mistake or inadvertence. The Court then stated the factors to be considered in determining whether mistake or inadvertence was present: A) the debtor lacked knowledge of the factual basis of the undisclosed claims; B) she had a motive for concealment of the claim; and C) the evidence indicates an absence of bad faith. In a split decision, the majority held that judicial estoppel applied, and affirmed the District Court's dismissal. The Court found that the Debtor's attempts to rectify the non-disclosure, all but one of which occurred after the motion to dismiss, were not sufficient to show "an absence

of bad faith or that [the] ...omission resulted from mistake or inadvertence." In so holding, the Court quoted from *Reynolds v. Comm'r*, 861 F.2d 469, 473 (6th Cir. 1988), to the effect that the Bankruptcy Court's "judicial acceptance" of a given position is sufficient "to estop the party from later advancing an inconsistent position." (Emphasis mine)

The first sentence in Judge Clay's dissenting opinion follows: "The majority's approach to this case fails to appreciate the absurdity of the result of its erroneous application of judicial estoppel." The first sentence of the last paragraph: "The majority's approach constitutes a perversion of justice because, under its approach, even if Plaintiff could prevail in her sexual harassment lawsuit, neither she nor her creditors could receive any damages." (Emphasis mine) Suffice it to say that Judge Clay disagreed with his colleagues.

Comment: Now back to the quote cited by the majority as authority for its decision, which stated that judicial estoppel is sufficient to "estop the party" from taking a subsequent inconsistent position. (Emphasis mine) Who is the party estopped? In this case it is the Debtor. However, as the dissent correctly understands, there is another entity participating in the case. That is the bankruptcy estate which includes, among other interests, the claims and rights of creditors. Did the bankruptcy estate assert an inconsistent position? Of course not. The party to be estopped is the Debtor, personally. To the extent she is a representative of the bankruptcy estate, she is not estopped. Finally, regardless of the dishonesty of the Debtor, if the asset was not disclosed on Schedule B, it can never be abandoned from the estate under §554. Thus, in a Chapter 7 case where the Debtor is discharged and the case is closed prior to the undisclosed action being brought, that action remains an asset in the bankruptcy estate, for its benefit. The bad acts of the Debtor should not be relevant to assertion of the action for the benefit of the bankruptcy estate.

FIFTH CIRCUIT - *Reed v. City of Arlington*, No. 08-111098 (5th Cir. September 16, 2010): Here the Debtor obtained a \$1 million plus judgment in Federal District Court, which was on appeal when he filed his Chapter 7 petition. The Debtor did not inform his bankruptcy attorney of the judgment, and it was not disclosed in the statements and schedules filed in his bankruptcy case. The Trustee filed a no asset report and the Debtor received a discharge of approximately \$300,000.00, representing primarily credit card debt. After the bankruptcy case was closed the Circuit Court affirmed the District Court verdict, but remanded for recalculation of damages. When offer of judgment for \$580,000.00 was made, the Debtor called to discuss the offer, and for the first time mentioned his bankruptcy to his attorney, who contacted the Chapter 7 Trustee. The Trustee reopened the bankruptcy case, moved to substitute herself as plaintiff, and attempted to accept the \$580,000.00 settlement offer. The defendant moved for a "take-nothing judgment," asserting the defense of judicial estoppel. The District Court denied the motion, finding it would deprive the Debtor's creditors of their remedies. The Court further held that after all creditors were paid in full, any surplus would be returned to the defendant, instead of being paid to the Debtor. Appeal was taken to the Fifth Circuit.

Writing for the Circuit Court, Chief Judge Jones stated the "principal question" was "whether judicial estoppel should prevent not only Lubke [Debtor] but his bankruptcy trustee from collecting the judgment...." The Court noted that the Debtor had committed acts sufficient for judicial estoppel to apply, which was not challenged by the Trustee on appeal. The Court also acknowledged that the Trustee had not committed such acts, but found it was "not sufficient to distinguish the debtor's conduct from that of the trustee...." Citing no

authority, the Court made the following statement: "Even though Reed herself [Trustee] takes no inconsistent legal positions, she succeeds to the debtor's claim with all its attributes, including the potential for judicial estoppel." The Court then looked to the effect on creditors and found that they would not be "materially advantaged if this case proceeded further." In support of this statement, the Court noted that only 1/6 in amount of the original creditor claims were timely filed; that the untimely filers "have little if any hope of recovery"; and that the timely filers' recovery would "be contingent on the payment of large priority administrative expenses caused by the ongoing litigation." Finally, the Court gratuitously added that the Trustee's claim "has been substantially increased because of this judicial estoppel litigation." From the above, Chief Judge Jones concluded that "equity does not support further continuation of this litigation and that both Lubke [Debtor] and Reed [Trustee] must be judicially estopped from pursuing it."

Comment: Wow!!!! Unlike the Sixth Circuit, which may have confused the bankruptcy estate and the Debtor, the Fifth Circuit straightforwardly applied judicial estoppel to the Chapter 7 Trustee; while conceding that the Trustee neither misrepresented nor concealed anything in the bankruptcy case process. The Court apparently assigned such misdeeds to the Trustee as successor to the Debtor. How does a Trustee, as representative of the bankruptcy estate, become liable for post-petition misdeeds of a Debtor? And what about the creditors? Apparently the fact that the Trustee would be paid a little more than 5 percent of the amount to be distributed to creditors was a problem for the Court, along with the fact that many creditors did not file timely claims. Should those creditors who did file timely be denied payment of their claims? And are not the untimely filed claimants likely to receive distribution as well, as this appears to be a surplus case, though the defendant rather than the Debtor will receive any surplus? Is this decision really based upon a dislike and distrust of the bankruptcy system itself?

98. Debtor estopped from objecting to settlement of undisclosed personal injury action

At the time of bankruptcy filing, the Chapter 7 Debtor was a plaintiff in a motor vehicle accident, personal injury action. The Debtor failed to disclose the pending lawsuit, neither listing it on Schedule B nor telling the Trustee about it when questioned at his meeting of creditors. When the Trustee later discovered the action, and ultimately moved to settle it for \$75,000.00, the Debtor objected. He argued that this amount was woefully inadequate, given the severity of his injuries. The Bankruptcy Court denied the objection and approved the settlement. Judge Bucki held that the Debtor's failure to disclose the pending action was essentially his representation that it had no more than de minimis value. Based on that representation, the Court found the Debtor was judicially estopped from challenging the adequacy of the settlement. *In re Seres*, 473 B.R. 775 (Bkrcty.W.D.N.Y. 2010).

Trustee Immunity/Liability

99. Personal liability of Trustees: A tale of two circuits

The Chapter 7 Trustee sought to obtain \$252,000.00 from the corporate Debtor's former general counsel, claiming the money belonged to the bankruptcy estate. The Debtor's counsel alleged that the Trustee threatened to report him to the U.S. Attorney for criminal investigation if he did not settle by paying \$240,000.00 to the bankruptcy estate. Counsel then sued the Trustee in state court for outrageous conduct and intentional infliction of emotional distress. The Trustee removed the case to the Bankruptcy Court and sought dismissal under the Barton Doctrine. Plaintiff asserted that the Barton Doctrine did not apply because the Trustee was not acting in his official capacity when he threatened referral for criminal investigation. The Bankruptcy Court found the Trustee was acting within the scope of his statutory authority, and that the plaintiff's claim was completely absent of facts to support recovery under state law outrageous conduct (which requires actions to be so intolerable as to reach beyond the bounds of decency or morality). The Bankruptcy Court further imposed sanctions for bringing such an unfounded action against the Trustee. On appeal the District Court affirmed, and further appeal was made to the Circuit Court. *Heavrin v. Schilling (In re SSS Restaurants, Inc.)*, 519 F.3d 575 (6th Cir. 2008).

The Circuit Court initially found that the Bankruptcy Court properly exercised jurisdiction over the case under the Barton Doctrine, which requires leave of Bankruptcy Court before any action can be commenced against a Trustee for acts done within his official capacity. The Court then held the Bankruptcy Court finding that the Trustee was acting within his official capacity was not clearly erroneous, citing 18 U.S.C. §305(a) which puts Trustees under a duty to report criminal activity related to bankruptcy cases. Finally, the Circuit Court found the Bankruptcy Court did not abuse its discretion in imposing sanctions.

Compare this case to *Maxwell v. KPMG LLP*, 520 F.3d 713 (7th Cir. 2008). It is hard to understand how losing a malpractice action after hiring competent counsel, and relying upon advice of counsel, along with an expert retained by counsel, could lead to personal liability for the Trustee; while allegedly extorting a case settlement would not.

100. Barton Doctrine extended beyond Trustees and their professionals

The Eleventh Circuit has extended the protective reach of the *Barton* Doctrine to creditors functioning as the equivalent of court-appointed officers. In this Chapter 7 case, the Debtor was ordered to turn over assets held in a Mauritanian Trust. When he refused, he was held in contempt and eventually incarcerated for his non-compliance. He subsequently brought an action in District Court alleging that the Trustee and others had conspired to enforce the turnover order, along with numerous other claims. The defendants included a judgment creditor and several creditor attorneys. *Lawrence v. Goldberg*, 573 F.3d 1265 (11th Cir. 2009).

The District Court dismissed the complaint for lack of subject matter jurisdiction under *Barton v. Barbour*, 104 U.S. 126 (1881). The Circuit Court affirmed, following *Carter v. Rodgers*, 220 F.3d 1249, 1252 (11th Cir. 2000), which applied the *Barton* Doctrine to actions against officers approved by the Court, when they functioned as the equivalent of

court-appointed officers. Here the Trustee defendants clearly functioned in that capacity, but so did the creditors who had advanced the costs necessary to recover estate property, and would receive payment from any recovered assets. "Thus, to the extent the creditors financed the Trustee's efforts to locate hidden assets on behalf of the estate, they likewise functioned as the equivalent of court-appointed officers, as did their counsel."

101. Sanctions issued for violation of Barton doctrine

When her state court action against the Chapter 7 Trustee and Trustee's professionals was removed to Bankruptcy Court, the Debtor voluntarily dismissed without prejudice. However, the Trustee and his professionals requested that the dismissal be with prejudice, and further sought sanctions against the Debtor and her attorney. *In re Steffen*, 406 B.R. 148 (Bkrcty.M.D.Fla. 2009).

Judge Paskay considered the effect of the Plaintiff's voluntary dismissal upon removal of the case to Bankruptcy Court, and determined that there was no longer a pending case before him. The Court reasoned that without a pending case, there was no basis for continuing the proceeding with regard to the Trustee's motion for dismissal with prejudice and sanctions. Without a case, the Court also found there could be no 9011 sanctions. However, the Court further noted that although the complaint was voluntarily dismissed, the Debtor argued against dismissal with prejudice sought by the Trustee, finding that to be an indication that the Debtor and her attorney felt "justified in filing the Complaint." The Court then considered whether it could, on its own initiative, impose sanctions "pursuant to the inherent power of the Court to do so", and discussed the nature and scope of such "inherent power", ultimately finding that it existed in addition to Rule 11 authority. The Court found the behavior of Debtor's counsel in this case was "outrageous", and further concluded it was "clear that the prime mover of this improper conduct" was Debtor's counsel, such that sanctions were appropriate as to him. Furthermore, the Court held the Debtor "responsible for the actions of her attorney" and sanctioned her as well. The total amount of sanctions was \$5,310.50 "for their continual obstructive, defiant and inappropriate behavior in this Court, their unethical use of the legal system, and for their frivolous pleadings and papers filed against the Trustee and others in this Court and in courts lacking jurisdiction over the Defendants."

102. More Barton Doctrine cases

A proliferation of decisions based on the Barton Doctrine is probably not a good sign for Trustees, but it may be a sign of the times. Several recent rulings, including the following by Florida and Ohio Bankruptcy Courts should provide some solace. In both cases, the Trustee was not found to be liable in very different situations, and for very different reasons.

OHIO: The corporate liquidating trustee in a confirmed Chapter 11 Plan, along with the individual acting on its behalf and its attorneys ("Trust Parties") were sued in state court. The plaintiff alleged a pre-petition conspiracy which led to a "whistle blower action", which led to a settlement agreement which was invalid and/or unenforceable. In addition, there were allegations related specifically to events which occurred post-bankruptcy. Upon request of the Trustee, the action was removed to Federal District Court, which transferred it to Bankruptcy Court. When the dust settled, the Trust Parties sought money damages

and injunctive relief based on violations of the Barton Doctrine in connection with the state court lawsuits. *In re National Century Financial Enterprises, Inc.*, 426 B.R. 282 (Bkrcty.S.D.Ohio 2010).

Judge Hoffman divided the allegations into two categories. One dealt with actions pertaining to the Trust Parties' administration of the Chapter 11 Plan; and the other with events that occurred prior to this case administration. The Court found a presumption that the Trust Parties were acting within the scope of their authority as to actions occurring after appointment; and under the Barton Doctrine any party seeking to sue them regarding those acts had to first obtain leave of Bankruptcy Court. As to the alleged pre-petition activity, the Court found that the state court plaintiff was required, at the time suit was filed, to possess information demonstrating that the Trustee Parties were acting outside the scope of their authority. The fact that discovery was sought to obtain this information post-filing made no difference. Unless actual evidence of actions beyond the scope of case administration was known when the case was filed, the Barton Doctrine would control to disallow continued prosecution of the action. The Court then ruled as follows: (1) the Trust Parties had the opportunity to prove damages incurred in defending the state court actions; and (2) the state court plaintiff was permanently enjoined from further prosecuting the state court lawsuits.

NOW TO FLORIDA where another Bankruptcy Court has recently considered a different aspect of the Barton Doctrine. Here a creditor filed a motion to remove the liquidating Trustee of a confirmed Plan. In response, the Court appointed an examiner who submitted a report indicating various failures of the Trustee to competently administer the Plan. However, this report also found the Trustee lacked "the background experience and foundational qualifications required to serve in a fiduciary role of liquidating trustee...." The report further noted that Trustee counsel "did not provide the requisite level of overseeing advice and guidance...." However, the examiner found "no evidence of misappropriation of funds." Based on that report, the Court found that the Trustee had mismanaged the liquidating trust, but it was in the best interest of the estate not to remove him. Rather, it was ordered that he would not make any further disbursements in the case. The creditor then filed a motion to disgorge fees from the Trustee's counsel, which had already voluntarily disgorged \$324,000.00. An additional amount of \$165,691.00 was ordered disgorged for fees paid without the Court's authorization. An adversary complaint was also filed for disgorgement of all fees paid to the Trustee, which was defended by the surety who issued a bond "for the faithful performance" by the Trustee "of his official duties as the Liquidating Trustee...." *In re TSN USA, Inc.*, 2010 WL 1169752 (Bkrcty.S.D.Fla.).

Judge Cristol stated the "general rule" of the Eleventh Circuit that Trustees are "entitled to qualified judicial immunity for acts taken within their authority as an officer of the Court." Further, in order to be held personally liable, "the actions of the Trustee must rise to the level of willful and deliberate conduct or gross negligence." In order to be "grossly negligent" the Trustee must have "willfully and deliberately attempted to cause harm...." The Court listed the many transgressions of the Trustee, including comingling of funds, failure to put reserve funds into interest-bearing accounts and paying professionals without Court authorization; and conceded that these actions may have diminished the estate. However, there was no deliberate or malicious basis for these actions. They were inadvertent and/or based upon advice of counsel to a Trustee who "admittedly...did not fully understand the requirements of the Plan." Most importantly, these mistaken actions

did not amount to "willful and deliberate conduct or gross negligence." In other words, "Stupidity does not equal malice." Thus, there was no basis for personal liability, and no corresponding liability of the surety on the Trustee's bond.

103. Trustee's alleged slander and libel protected by absolute quasi-judicial immunity

A Chapter 11 Trustee was appointed soon after the case was filed, upon motion of several of the Debtor's investors. The motion alleged that the principal was operating a Ponzi scheme. At the §341 hearing the Trustee stated that the Debtor's principal had "lied" and played a "cruel hoax" on investors. After the principal sent a letter contradicting these statements, the Trustee responded with a letter he posted on the official bankruptcy website of the Debtor's estate. In that letter the Trustee made several allegedly defamatory remarks, including that the principal had knowingly operated a Ponzi scheme and that continuation of the business would mean more investors would "lose their life savings in a hopeless vortex of fraud." A defamation action was subsequently filed in state court, which the Trustee removed to Bankruptcy Court, and which was subsequently dismissed upon the Trustee's motion, but not based on derived judicial immunity as asserted by the Trustee. Appeal was taken to the BAP. *In re Cedar Funding, Inc.*, 419 B.R. 807 (9th Cir. BAP 2009).

The BAP found that the Trustee's communications occurred while he was performing official statutory duties. Further, they were made to the very creditor body represented and served by the Trustee which conferred on him functional judicial immunity. *Antoine v. Byers and Anderson, Inc.*, 508 U.S. 529 (1993). The BAP therefore ruled: "The statutory provisions regarding the trustee's duties give the trustee broad discretion and supervisory powers over the administration of a Chapter 11 estate. As such, we construe them as inextricably intertwined with the Court's functions in the Chapter 11 bankruptcy process, which are aimed at preserving the business as a going concern and maximizing the value of assets for creditors." The BAP then concluded: "A trustee's duties to uncover and report on insider fraud or other fraudulent conduct...should not be compromised by the threat of litigation against a trustee. Granting immunity to bankruptcy trustees for functions which are judicial in nature is based on a policy of protecting the bankruptcy process." Dismissal of the defamation action against Trustee affirmed.

104. Trustee held personally liable

The Chapter 11 Debtor owned several restaurants in Texas, noted as the "home of the legendary 'big sandwich'". During its time in control, the Debtor in Possession neglected to pay state sales taxes for October and November 2005. In March of 2006, a Chapter 11 Trustee was appointed. The appointment order specifically required the Trustee to pay sales taxes as they became due. In order to maximize value, the Trustee sought to maintain and ultimately sell the Debtor's assets as a going concern. However, this was made difficult by continuing, insufficient cash flow; and the Trustee eventually fell behind in remitting the sales taxes. The state moved to convert to Chapter 7. The motion was denied, as the Trustee caught up the delinquent taxes and stayed current for several months. A plan was later confirmed which created a liquidation trust, with the former Chapter 11 Trustee named as Trustee. The plan proposed to sell the restaurants as going

concerns and distribute proceeds to creditors. The plan further required that state sales taxes be held in trust and that payments remain current. When he was unable to consummate a post-confirmation loan, the plan Trustee paid only a small part of the previously unpaid taxes which were due on the effective date of the plan. Based on this default, the state froze bank accounts, and the case converted to Chapter 7. An adversary proceeding was then filed seeking personal liability against the Trustee for the tax payment deficiency. The Bankruptcy Court denied liability, but the District Court reversed and entered judgment which the Trustee appealed to the Fifth Circuit Court. *In re Texas Pig Stands, Inc.*, 610 F.3d 937 (5th Cir. 2010).

Writing for the Court, Chief Judge Jones described the issue as "an unusual, if not wholly unprecedented occurrence." She hardly dismissed the Trustee's argument that his duty to maximize estate value trumped the duty to timely pay the taxes. The Court found these "good intentions" were irrelevant. It made no difference why the Trustee failed to make the payments. The Court then addressed the Bankruptcy Court finding that the "gross negligence standard" applied, and was not met in this case. Judge Jones opined that liability to the estate being based on gross negligence had "nothing to do with the statutory duty to the state to pay taxes held in trust." The Court then found state law applicable when a bankruptcy Trustee manages property. Under the applicable Texas law, Trustees were subject to all applicable taxes "to the same extent as if it were conducted by an individual or corporation." While conceding that a Trustee's personal liability was not expressly addressed by the applicable statutes, the Court found them "fully consistent with holding Trustee's personally responsible for their professional conduct to the same extent as any other actors under the law." Finally, the Court rejected the Trustee's argument that his plan Trust Agreement limited his liability. By failing to remit the tax payments, the Trustee exceeded his authority, violated the plan, and committed willful misconduct. Liability for these acts was not limited by the Trust Agreement.

Miscellaneous

105. Heightened "plausible claim" pleading standard discussed and applied to avoidance actions

Based on recent Supreme Court precedent in the cases of *Bell Atl. Corp. v. Twombly*, 550 U.S. 544 (2007), and *Ashcroft v. Iqbal*, ___ U.S. ___, 129 S.Ct. 1937 (U.S. 2009), a North Carolina Bankruptcy Court has applied the "plausibility standard" to preferential and fraudulent transfer complaints, dismissing them for their failure to properly state a claim for relief. *In re Caremerica, Inc.*, 409 B.R. 737 (Bkrcty.E.D.N.C. 2009).

Judge Leonard initially determined that the new pleading requirements apply to Bankruptcy Code avoidance actions. Therefore, in order to survive a motion to dismiss, an avoidance complaint must contain sufficient facts, accepted as true, to "state a claim to relief that is plausible on its face." "Threadbare recitals of the elements of a cause of action, supported by mere conclusory statements" are not sufficient. In order for a claim to have "facial plausibility", the plaintiff must plead "factual content that allows the court to draw the reasonable inference" that the defendant is liable. If the complaint contains such "well-pleaded factual allegations", the Court "should assume their veracity" and move to the question of "whether they plausibly give rise to an entitlement to relief." This determination

is a "context-specific task which requires the Court both to draw on its judicial experience and common sense."

Applying this standard to preference actions, the Court looked approvingly at the case of *In re Valley Media, Inc.*, 288 B.R. 189 (Bkrtcy.D.Del. 2003), which held that preference complaints must include "(a) an identification of the nature and amount of each antecedent debt and (b) an identification of each alleged preference transfer by (i) date, (ii) name of debtor/transferee, (iii) name of transferee and (iv) the amount of the transfer." The Court acknowledged that the majority of bankruptcy courts have required less than that to survive motions to dismiss, but noted that those cases were decided prior to implementation of the more stringent Supreme Court requirement. The Bankruptcy Court then discussed what would be required to establish "sufficient factual allegations" as to each element of a preferential transfer.

As to fraudulent transfer actions, the Court found the Trustee's allegations of constructive fraud did not meet the "plausibility standard". The elements of constructive fraud under §548, supported by facts as to the dates, amounts, and names of transferees were stated; but the allegations lacked the identification of the consideration received by each transferor, information about why the value of the consideration was less than the amount transferred, and facts supporting the assertion that the Debtor was insolvent at the time of the transfer.

Based on the above, both the preferential transfer and constructive fraudulent conveyance counts of the complaint were dismissed. However, the Court further granted leave to the Trustee to amend the pleadings to adhere to the new requirements. Additionally, the amended complaint would relate back to the date of the original complaint. The amended claim would clarify the original by providing more detail, and the defendants had sufficient notice of the amended claim based on the allegations in the original complaint. The Court further specifically found that the relation back of a proposed amendment is not contingent upon the original complaint having satisfied Rule 8 pleading requirements.

Comment: Though not unexpected, this change will be difficult for Trustees, who never have first-hand knowledge of the facts, and must rely on the Debtor's records. These records are sometimes incomplete and/or impossible to decipher; frequently difficult to organize and understand; and almost always somewhat suspect as to reliability.

106. Plausibility pleading standard applied again in avoidance actions

The Trustee brought an insider preference action based on the following facts: 1) Corporate debtor and its CEO entered into a separation agreement dated October 3, 2006; 2) Per the agreement the CEO's resignation was effective October 5, 2006, and \$2.9 million was to be tendered to him "on or about" this separation date; 3) The Debtor's bankruptcy petition was filed on September 28, 2007. The Trustee's preference complaint alleged that the \$2.9 million payment occurred "on or about" the separation date. The defendant, CEO moved to dismiss the complaint for failure to state a claim; specifically that the complaint failed to allege sufficient facts to support the threshold issue of whether the defendant was an insider. *In re Net Bank, Inc.*, 424 B.R. 568 (Bkrtcy.M.D.Fla. 2010).

Judge Funk initially determined that a transferee must be an insider on the exact date the transfer was made. *Butler v. David Shaw, Inc.*, 72 F.3d 437 (4th Cir. 1996). The Court rejected contra authority that it is enough to be an insider at the time the transfer is

"arranged", as happened here. The Court then looked to the Eleventh Circuit case of *Sinaltrainal v. Coca Cola Co.*, 578 F.3d 1252 (11th Cir. 2009), which interpreted the pleading requirement Supreme Court cases *Twombly* and *Iqbal* to the effect that "well-pled allegations must nudge the claim 'across the line from conceivable to plausible.'" In this case the defendant could not be a "statutory insider" if he had resigned prior to the payment. The complaint also lacked any allegations to support a finding that defendant exercised the requisite control over the Debtor to be a "non-statutory insider". Without these alleged facts, the complaint did not meet the pleading plausibility standard and was dismissed. However, the Court further held that dismissal was "without prejudice to plaintiff filing an amended complaint...."

See also, accord, *In re Gluth Bros. Const., Inc.*, 424 B.R. 379 (Bkrtcy.N.D.Ill. 2009), where Judge Barbosa held the Trustee's complaint failed to adequately plead the insolvency element of a constructively fraudulent transfer, and failed to state a claim for actual fraudulent transfer. The adversary proceedings were dismissed, but the Court granted the plaintiff Trustee leave to file an amended complaint within 30 days.

Comment: As expected, the Supreme Court cases on pleading requirements are having an impact on avoidance actions brought by Trustees. By now we know for sure that it is not sufficient to simply state, without some factual explanation, that the Debtor was insolvent at the time of the transfer. Likewise, it is not sufficient to state that the Debtor made transfers with the intent to hinder, delay or defraud creditors. There must be some factual basis for such conclusory statements.

107. Pre-approved contingency fee upheld

In a Chapter 11 case, special counsel for the Debtors was hired on a percentage contingency basis. After obtaining a favorable result, the firm applied for its fees, and the Unsecured Creditor's Committee objected. The Bankruptcy Court reduced the fees and the case was appealed to District Court. *In re Smart World Technologies, LLC*, 383 B.R. 869 (Bkrtcy.S.D.N.Y. 2008), *aff'd* by 552 F.3d 228 (2nd Cir. 2009).

District Judge Cedarbaum reversed and remanded the decision, finding that the animosity which had developed between counsel and the Committee did not justify a re-visitation of the fee arrangement. A pre-approved fee arrangement can only be modified if the terms prove to be improvident in light of developments not capable of being anticipated when the terms were fixed. In this case, the prolonged nature of the litigation, the animosity with the Committee, and the firm's deference to the Debtor's principals, did not constitute events which were unforeseeable, or incapable of being anticipated, at the time of the appointment.

108. Collateral cannot be surcharged after it leaves the bankruptcy estate

The Fifth Circuit Court of Appeals has held that once assets are sold free and clear, they are no longer "property securing an allowed secured claim", and cannot be surcharged under §506(c). *Borrego Springs Bank, N.A. v. Skuna River Lumber, LLC*, (*In re Skuna River Lumber, LLC*), 564 F.3d 353 (5th Cir. 2009).

In this case, the Bankruptcy Court authorized a sale of substantially all of the Debtor's assets over the objection of the secured creditor. Prior to that, the Court had approved the employment of the auctioneer to conduct the sale, over the same creditor's

objection. At the auction, the secured creditor was the successful bidder by a credit bid; and, over the same creditor's objection, the Bankruptcy Court subsequently authorized payment of the auctioneer under §506(c). The District Court affirmed on appeal. In reversing the lower courts, the Fifth Circuit determined that the Bankruptcy Court had no jurisdiction over the assets at the time of the surcharge, because they had already been conveyed to the lender, free and clear of liens and encumbrances, nearly one month earlier. The Circuit Court cited and agreed with *In re Edwards*, 962 F.2d 641 (7th Cir. 1992), which held that when property is transferred out of a bankruptcy estate free and clear of all liens, the Bankruptcy Court ceases to have jurisdiction over that property.

109. IRS ordered to marshal assets

Debtor had \$225,000.00 of fully exempt equity in his homestead. He also owned a second property which the Trustee sold for a net of \$25,000.00. The IRS had two tax liens totalling \$133,359.88. Because the Debtor's homestead exemption was not enforceable against the IRS, the Trustee petitioned the Bankruptcy Court to require the IRS to marshal its collateral, allowing its tax liens to be paid from the sale proceeds of the homestead property. That would allow the other creditors to share in the sale proceeds of the non-homestead property. The IRS opposed this approach, preferring to take the entire amount from the non-exempt property, leaving it with a deficiency of over \$100,000.00. In order to satisfy that deficiency, the IRS would still need to seek a sale of the residence. Thus, the Bankruptcy Court ordered it to marshal the collateral. Appeal was taken to the District Court. *In re Szwyd*, 408 B.R. 547 (D.Mass. 2009).

After determining that a bankruptcy Trustee may seek marshaling on behalf of unsecured creditors, the Court reviewed the doctrine and found it applicable where there was "(1) a common debtor; (2) two separate funds, one of which is a common fund available to both creditors and one of which is available only to the senior creditor and (3) no detriment or prejudice to the senior creditor if he is required to pursue the fund to which he alone can look." The District Court agreed with Bankruptcy Judge Boroff that each of the elements was met, and concluded with a question: "Why is the government, whose mission is to protect the interests of the citizenry, ignoring those interests in the name of a dubious technicality, and being so petty?...Why is the government playing the proverbial dog in the manger?"

110. Chapter 11 Debtor counsel not entitled to fees for services rendered after Chapter 11 Trustee appointment

A New York Bankruptcy Court has recently applied the Supreme Court case of *In re Lamie*, 540 U.S. 526 (2004), to Chapter 11 debtor counsel fees for services performed after appointment of a Chapter 11 Trustee. Here the Chapter 11 petition was filed on March 30, 2007, with retention of counsel authorized by the Court on May 15. On June 28, 2007, an order was entered appointing a Trustee, and neither the creditor's committee nor the Trustee retained debtor's counsel for any purpose. In March, 2009, a stipulation was negotiated which resolved various claims and provided for case dismissal. The stipulation was signed by the debtor and his Chapter 11 counsel, who had continued to represent him. *In re Bresnick*, 406 B.R. 582 (Bkrcty.E.D.NY 2009).

Judge Craig noted that in *Lamie* the Supreme Court denied fees to Chapter 11 counsel for services rendered after conversion of the case to Chapter 7. Analogizing conversion to appointment of a Trustee, the Court found that both acts terminated the existence of the DIP. Thus, counsel's prior-authorized representation of the DIP under §327 ceased upon the Trustee's appointment. Therefore, following *Lamie*, the Court held that §330(a)(1) "does not authorize compensation awards to debtor's attorneys from estate funds, unless they are employed as authorized by §327." Accordingly, all post-Trustee related fees were denied.

111. Distribution of proceeds from sale of Debtor's interest in entireties property is made under §726 priority scheme

The Debtor and his non-filing wife owned real estate as tenancy by the entireties. There were three unsecured debts to which both the Debtor and his wife were jointly liable. Based on this joint debt, the Debtor did not contest the Trustee's right to sell the property, and the Debtor's wife purchased it for one half of its value. Subsequently, the Trustee proposed distribution of the sale proceeds to priority claims in excess of the remaining proceeds, with no funds left for payment of unsecured claims. The Debtor and his non-filing spouse objected to the proposed distribution. They asserted that the joint unsecured claims must be paid first, based on applicable state law. They contended that only joint creditors could execute against the jointly owned property under Pennsylvania tenancy by the entireties law. Therefore, these joint creditors must be paid first. *In re Owens*, 400 B.R. 447 (Bkrtcy.W.D.Pa. 2009).

Judge Markovitz analyzed Pennsylvania property law of tenancy the entireties, and found that only creditors of both husband and wife can execute against entireties property. He then noted that the Third Circuit case of *Napotnik v. EquiBank*, 679 F.3d 316 (3rd Cir. 1984), which applied to sale of jointly owned property in bankruptcy, disallowing sale when there is no joint unsecured debt. However, in this case there was joint debt which authorized the Trustee to sell the property. The Court then found that this authority to sell, though based on the existence of joint debt, did not alter the Trustee's duty to make distribution pursuant to the priority scheme of §726. To whatever extent state law might be applicable in this regard, the Court determined it was pre-empted by federal bankruptcy law. Finally, the Court further observed that if the joint debts were paid, the wife would receive a windfall. She had paid only half the value of the property to purchase it, and the sale proceeds would also satisfy her obligations on the joint debt; while her husband's debts were discharged in the bankruptcy case.

112. What is the extent of Debtor's duties to cooperate with Trustee?

After the order for relief was entered in an involuntary Chapter 7 case, the Trustee sought information about changes in the Debtor's corporate structure over the preceding three years. Specifically, the Trustee sought documentary explanation of the relationships among a number of companies both prior to and after the corporate restructure. The Debtor representative allowed access to voluminous documents which the Trustee, along with two CPA's, one computer technician and three attorneys spent an entire day examining, without finding significant relevant information. The Trustee then moved to

compel turnover of specific documents relative to the Debtor's financial condition. *In re Royce Homes, LP*, 2009 WL 3052439 (Bkrtcy.S.D.Tex.).

Judge Bohm cited §521(a)(3), which requires Debtors to "cooperate with the Trustee as necessary to enable the Trustee to perform the Trustee's duties." The Court also looked to Bankruptcy Rule 4002(a)(4), which requires that the Debtor cooperate with the Trustee in the preparation of the inventory, examination of proofs of claim, and administration of the estate. Further, under §704 the Trustee was obligated to investigate the financial affairs of the Debtor, and under §105(a) the Court had the power to fashion remedies necessary to preserve these Bankruptcy Code rights and duties. The Court thus had power to order the Debtor's representative to turn over the requested documents. Importantly, the Court ruled that the Bankruptcy Code and Bankruptcy Rules establish an affirmative duty for the Debtor to do more than simply allow the Trustee access to rooms full of paper. Rather, the Debtor has an affirmative obligation to help the Trustee discover relevant information.

113. Trustees are not liable for stub rent

In a case of first impression in the Middle District of Tennessee, Judge Harrison found the Trustee was not responsible for "stub rent" (the rent balance owed for the first month, post-petition) under §365(d)(3). *In re Shippers Transport Company*, Case No. 09-05271-MH3-7 (Bkrtcy.M.D.Tenn., Decided July 22, 2009, order entered July 24, 2009).

Under §365(d)(3), "the trustee shall timely perform all the obligations of the debtor...arising from and after the order for relief under any unexpired lease of nonresidential real property, until such lease is assumed or rejected..." Trustees (and DIP's) are therefore responsible for making the lease payments on the date due under the lease. However, the question of whether that requirement extends to all or a portion of the unpaid lease payment for the month the case was filed has been subject to contradictory rulings in other jurisdictions. In this unreported decision, Judge Harrison adopted the approach that if the payment became due prior to the filing of the petition, it was not subject to §365(d)(3). The Court further held that the filing of a motion to reject the lease is not sufficient to terminate this responsibility. Unless a rejection order has been entered before the next "due date", that payment must be made.

114. Consumer debtor counsel sanctions under §707(b)(4)(C) and Rule 9011

Less than two weeks after filing a skeleton Chapter 13 petition, the Debtor converted to Chapter 7. Statements and schedules, Official Form B 22A, and Rebuttal of Presumption of Abuse were subsequently filed. The Chapter 7 Trustee objected to the Rebuttal based on, among other discrepancies, recent pay stubs indicating the Debtor continued to receive overtime pay, while alleging loss of such income in his Rebuttal. When Debtor's counsel filed his fee application, the Trustee objected, noting undisclosed bank accounts, failure to claim and later amend proper exemptions, along with the issues related to Form B 22A. Debtor's counsel sought and obtained an evidentiary hearing at which he explained that the mistakes made in the documents were based on his personal health issues and the Debtor's faulty memory. These excuses were not deemed sufficient by the Bankruptcy Court, and sanctions of \$3,585.00 were imposed. Appeal was taken to the First Circuit BAP. *In re Withrow*, 405 B.R. 505 (1st Cir. BAP 2009).

The Appellate Panel noted that under BAPCPA §707(b)(4)(C) and (D) Debtor's attorneys have a duty to perform a reasonable investigation into the circumstances surrounding documents before they are filed in a Chapter 7 case. The Court found this duty to be equivalent to that under Bankruptcy Rule 9011. Accordingly, an attorney who files statements and schedules makes a certification that based on "an inquiry reasonable under the circumstances" the information in the document is not incorrect. In this case, the BAP found that even if counsel's excuse that the Debtor had provided him with inaccurate information were correct, that would not explain the "numerous inconsistent statements in the various documents regarding the Debtor's income, entitlement to overpay in a support obligation to his mother." The fact that these factual discrepancies were in the documents, for whatever reason, indicated that Debtor's counsel failed to conduct a reasonable investigation. Finally, the Court held that sanctions are intended to deter and compensate, both of which policies were properly met by the Bankruptcy Court sanctions.

115. §108(a) applies to statutes of repose

The Trustee commenced a state law malpractice suit against the Debtor's pre-petition attorneys under §108(a), which allows such actions to be brought in the period allowed by state law or within two years after the order for relief, whichever is later. Defendants argued, and the District Court agreed that the applicable Louisiana law was a statute of repose, rather than a statute of limitations. Therefore, all rights were extinguished upon expiration of the one-year statutory deadline, pre-empting commencement of any action thereafter. This ruling was based on the District Court's finding that §108(a) could not alter such substantive state law property rights. Appeal was taken to the Fifth Circuit. *Stanley ex rel Estate of Hale v. Trincharid*, 579 F.3d 515 (5th Cir. 2009).

The Circuit Court first found that bankruptcy falls within the constitutional powers of Congress, and that bankruptcy law could therefore take precedence over state laws under the Supremacy Clause. The Court further determined that the clear purpose of §108(a) was to afford Trustees extra time to assess and pursue potential assets of Debtors' estates. These findings compelled the Court's conclusion that Congress expressly extended the time for pursuing any action that would otherwise be time-barred under state law. It made no difference that the state law deadline was one of "limitation or prescription, repose or pre-emption." The District Court reversed, and Trustee was permitted to prosecute the malpractice action.

116. Bankruptcy Court lacks jurisdiction over administration of ERISA-qualified plan

The Chapter 7 Trustee and the Debtor's employee benefit plan administrator sought Bankruptcy Court approval of their agreement that the administrator would wind up the plan in exchange for a right to payment from the plan assets. The Department of Labor objected, asserting that the proposed order required the Bankruptcy Court to determine the reasonableness of the requested fees and whether they were compliant with ERISA. The DOL argued that determination of these issues exceeded the subject matter jurisdiction of the Bankruptcy Court. *In re AB&C Group, Inc.*, 411 B.R. 287 (Bkrcty.N.D.W.Va. 2009).

Judge Flatley acknowledged that the plan was excluded from the bankruptcy estate under §541(b)(7), though BAPCPA mandated that the Trustee succeed the Debtor as plan administrator under §704(a)(11). The Court further recognized that the Bankruptcy Code provides no guidance on how to pay the cost of administration generated by the performance of plan administrator duties, and that the proposed agreed order was an effort to address this issue. Because bankruptcy Trustees enjoy complete immunity from suit when acting pursuant to a Bankruptcy Court order, the Trustee would naturally want to obtain the Court's imprimatur on decisions made regarding plan administration. Nevertheless, these concerns were insufficient to establish Bankruptcy Court jurisdiction. The Court found that ERISA, not Title 11, supplied the law governing whether the administrator could be paid from the plan, which affects only non-estate assets that have no relation to the bankruptcy estate. The Court also found no authority to review compensation from funds which were not part of the bankruptcy estate. The issue neither "arose under" Title 11 nor "arose in a case under Title 11". There was also no "related to" jurisdiction because the proposed order governed the Trustee's ERISA fiduciary obligation to a non-estate trust, which did not impact the administration of the bankruptcy estate. There was, therefore, no basis for Bankruptcy Court jurisdiction.

117. Bankruptcy Court does not lack jurisdiction over administration of ERISA-qualified plan

A Michigan Bankruptcy Court has addressed the same issue presented in the above case of *In re AB&C Group, Inc.*, 411 B.R. 287 (Bkrtcy.N.D.W.Va. 2009), and reached a contra conclusion. In the Michigan case, the Court agreed that §704(a)(11) added the new Trustee duty to perform the obligation required of an ERISA plan administrator, where the Debtor was serving as administrator on the petition date. The Court further acknowledged that there were no related BAPCPA statutory changes allowing the Bankruptcy Court subject matter jurisdiction over these matters. However, the Court found "related to" subject matter jurisdiction to decide actions filed by Trustees in performance of this §704(a)(11) duty. *In re Trans-Industries, Inc.*, 419 B.R. 21 (Bkrtcy.E.D.Mich. 2009).

Here, the Trustee filed a complaint against pre-petition ERISA fiduciaries seeking damage for breach of contract and fiduciary duty. Though the Trustee had standing to continue performance as a plan administrator, the defendants argued that any recovery based on these Trustee claims would belong to the pension plan, not the bankruptcy estate. As such, subject matter jurisdiction did not exist as to the adversary proceeding which could not benefit or otherwise affect the estate. Judge Tucker rejected this argument. He agreed that the adversary action was not a "core proceeding", and did not arise "under the Code", nor "in a case under the Code". However, the Court found non-core "related to" jurisdiction because the outcome of the adversary proceeding would impact the bankruptcy estate. The Trustee had advanced estate funds to pay professional fees in performance of the §704(a)(11) duties, as well as costs and fees relating to the pending action. To the extent the Trustee was successful, the plan would reimburse the estate for these fees and expenses. Thus the ultimate distribution to creditors of the bankruptcy estate would be affected, and "related to" subject matter jurisdiction did exist. Finally, and most importantly, the Court found the Trustee was allowed to apply estate funds to the fees and expenses related to the ERISA plan.

118. Bankruptcy Trustee responsibilities as to ERISA plans

The Debtor had been the administrator of a 401(k) plan which had a zero balance on the bankruptcy petition date. All of the plan participants had previously withdrawn their funds from the plan. The Trustee moved for authority to terminate the plan pursuant to his responsibilities under §704(a)(11), and the Department of Labor ("DOL") objected to two of the Trustee's requests in the motion: 1) That any and all claims related to the 401(k) plan and the termination thereof, other than termination expenses, would be forever barred; and 2) that the Trustee had satisfied his obligations under §704(a)(11) and would have no remaining liability and/or obligations related thereto. The DOL argued that the Bankruptcy Code goal of speedy and efficient administration must yield to ERISA's need to hold plan fiduciaries responsible for breaches of their fiduciary duties for the full six-year statute of limitations. *In re NSCO, Inc.*, 427 B.R. 165 (Bkrtcy.D.Mass. 2010).

Judge Rosenthal found that under §350(a), when the bankruptcy case is closed, the Trustee is discharged from his fiduciary duties. If the DOL later believed the Trustee had breached his fiduciary duties, it would be required to return to the Bankruptcy Court to proceed against the Trustee. In so holding the Court disagreed with the statement in *In re AB & C Group, Inc.*, 411 B.R. 284 (Bkrtcy.N.D.W.Va. 2009), that the bankruptcy Trustee's duties were created by ERISA. Instead, the Court found these duties originated in §704(a) and only connected to ERISA under §704(a)(11) By placing the Trustee's obligations solely in the Bankruptcy Code, rather than in ERISA, or in both statutes; Congress clearly intended these ERISA responsibilities to fit within the framework of the Bankruptcy Code. Not the other way around. Therefore, the Court found contra to the ABC holding that it did not have jurisdiction to determine whether the Trustee had fulfilled his fiduciary duties under ERISA; or to release the Trustee from any ERISA liabilities. The Court also distinguished *In re Trans-Industries, Inc.*, 419 B.R. 21 (Bkrtcy.E.D.Mich. 2009), where the Court had found related-to jurisdiction. That finding was based on the anticipated use of bankruptcy estate funds in connection with the administration of the employee benefit plan; while here there was nothing left in the plan to administer.

119. Trustee may not sell estate's avoidance claims

The Trustee filed a motion for authority to sell all the Trustee's avoidance claims to a creditor for \$5,000.00. The Debtor objected, expressing concern that the purchasing creditor was a predatory lender who would use the purchased assets unscrupulously. The Trustee asserted that his investigation had led him to conclude that there were no actionable avoidance claims. Thus the \$5,000.00 payment was more than fair value. *In re McGuirk*, 414 B.R. 878 (Bkrtcy.N.D.Ga. 2009).

Judge Bihary stated that a Trustee's avoidance powers were "intended to benefit the estate, not a single creditor." Here, the creditor was not seeking derivative standing. Rather, it sought to purchase the Trustee's rights to bring avoidance claims in its own name. The Court held that absent "extraordinary circumstances", a Trustee cannot sell, transfer or assign the right to assert and maintain an estate's avoidance action to an individual creditor. The Court observed that unlike the Trustee, who is the "appointed representative of creditors"; a buyer is "just another self-interested party". Sale motion denied.

120. Effect of bad-faith conversion from Chapter 13 to Chapter 7

In a case with multiple issues important to Trustees, a Texas Bankruptcy Court has held a Chapter 13 to 7 conversion was made by the Debtors in bad faith; such that assets acquired by the Debtors post-Chapter 13 filing became property of their converted Chapter 7 estate. The Court further found the Chapter 7 Trustee had standing to seek damages for the Debtors' willful stay violation in transferring the post-petition assets, in addition to the right to recover those transfers, or their value, under §549 and §550. *In re Mullican*, 417 B.R. 389 (Bkrtcy.E.D.Tex. 2008).

The Debtors confirmed a Chapter 13 plan that was to pay unsecured creditors \$18,525.00 over 57 months. This amounted to a 1.04-percent distribution. Eight months after plan confirmation the Debtor/husband's mother died leaving him 1) an IRA account worth \$162,000.00, 2) a bank account containing \$14,000.00, 3) \$20,000.00 equity in real estate, and 4) a late-model vehicle. After spending much of this inheritance, the Debtors sought conversion of their case to Chapter 7, alleging an impending layoff of the Debtor/husband from his job. The case was converted, but the conversion schedules lacked sufficient disclosure of the inheritance. The Chapter 7 Trustee brought actions seeking 1) injunction against further dissipation of the inherited assets, 2) damages for the Debtors' willful violation of the stay under §362(k), and 3) recovery of the value of the assets transferred under §549 and §550.

Judge Rhoades held the inheritance to be post-confirmation property of the Chapter 13 estate. Upon conversion to Chapter 7, such property remains with the Debtor with one exception. If the conversion was made in "bad faith", this property becomes part of the Chapter 7 bankruptcy estate under §348(f)(2). Based on the totality of the circumstances, the Court found this to be a "bad faith" conversion. The inherited assets were therefore property to be administered by the Chapter 7 Trustee. The next question was what to do about inherited assets already spent by the Debtors. The Court found the Chapter 7 Trustee was a §362(k) "individual" who could recover from willful stay violations, including the dissipation of the inheritance by the Debtors. The Court found this remedy was in addition to the Trustee's avoidance and recovery powers under §549 and §550. Affirmed at 417 B.R. 408 (E.D.Tex. Aug. 04, 2009).

121. Basis for approval of settlement proposed by Trustee

Almost eight years after her appointment, a Chapter 7 Trustee held approximately \$3.2 million, which she estimated would pay \$0.90 on the dollar to unsecured creditors; or more, depending on the disposition of the last remaining asset in the estate. This calculation was based on a settlement the Trustee had negotiated with several former employees of the Debtor. The claims of these employee creditors were based on unpaid overtime compensation and failure of the Debtor to convey promised equity interests in consideration of their continued employment. The Trustee's settlement was properly noticed, and timely objections were raised by other creditors. *In re Final Analysis, Inc.*, 417 B.R. 332 (Bkrtcy.D.Md. 2009).

Judge Capliota stated the factors to be considered in approving settlements: 1) the probability of success in litigation; 2) the likely difficulties in collection; 3) the complexity of the litigation involved, and the expense, inconvenience and delay necessarily attending it; and 4) the paramount interest of the creditors. The Court noted that this case involved

claims against the bankruptcy estate, which somewhat changed the normal dynamics. Because the claimants had timely filed their proofs of claim, the burden to establish disallowance was shifted to the objecting parties. However, this was an overlay to the Trustee's burden of proving that the settlement was "fair and equitable". The Court then determined these four factors in this unusual setting.

As to probability of success in litigation, the Court analyzed the strengths and weaknesses of the claims and objections; and made a mathematical calculation of the "Low-High Range" of potential recovery, setting a percentage to be applied to some aspects of the claims such as 60 percent to 80 percent probability of recovery. The Court assigned only nominal value to other parts of the claims, based on what a "rational litigant" would accept in settlement. The Trustee argued that even though there was little risk, the amount in dispute was so high that a small potential of loss merited the proposed settlement, especially since all unsecured creditors would be paid 90 percent of their claims. The Court rejected this argument, and likewise found factors 2, 3 and 4 above to be either neutral or negative toward the settlements, leaving only one claim within the acceptable settlement range. All the rest were denied.

122. Trustee's action against state court receiver not barred by state statute of limitations

In 1993, a state court Receiver was appointed. Two years later an involuntary Chapter 7 bankruptcy petition was filed against the company in Receivership, which the Receiver resisted. An order for relief was subsequently entered by the Bankruptcy Court. In early 2000, the bankruptcy Trustee filed an adversary proceeding against the Receiver, personally. She alleged negligence and breach of fiduciary duty. The Receiver argued these claims were barred under the applicable Massachusetts three-year statute of limitations. Bankruptcy Judge Feeney rejected this argument and held for the Trustee. The Court found that the limitation on actions against the Receiver did not start to run until he had accounted for and been discharged from his estate administration. Judgment was entered, which the receiver appealed to District Court which reversed, finding the Massachusetts statute of limitations ran from discovery of the Receiver's actions by the bankruptcy Trustee. Appeal was taken to the First Circuit. *In re American Bridge Products, Inc.*, 599 F.3d 1 (1st Cir. 2010).

The Receiver asserted protection under the Barton Doctrine, such that actions against him required approval of state court. The Circuit Court rejected this argument, finding that authority over the subject estate had passed to the Bankruptcy Court upon the order for relief. That was before the Trustee's claim was filed, and the Receiver was responsible to account to the Bankruptcy Court pursuant to the Trustee's adversary proceeding. The Receiver's further argument that the Rooker Feldman Doctrine barred the Trustee's action was also rejected; as no prior judgment had been entered by the state court on the claims now being pursued by the bankruptcy Trustee. Finally, based on the case of *In re San Juan Hotel Corp.*, 847 F.2d 931 (1st Cir. 1988), the Court held that a fiduciary of an estate cannot be "released from liability prior to presentation of a final accounting and discharge from the fiduciary duty." Such fiduciaries include state court Receivers as well as bankruptcy Trustees.

123. Debtors ordered to vacate homestead to allow sale by Trustee

The Chapter 7 Trustee avoided an unrecorded \$20,000.00 line of credit mortgage on the Debtors' homestead. When the Trustee subsequently attempted to market the property, the Debtors refused to cooperate. That led to the Trustee's motion to remove the Debtors from the property. The Debtors responded with a motion to compel abandonment by the Trustee. They alleged that the \$25,000.00 value of the property was less than their \$30,000.00 homestead exemption. Thus the avoided lien held by the Trustee had no value. They further argued that the Trustee was limited to foreclosing on the mortgage, and could not sell the property. *In re Neal*, 424 B.R. 235 (Bkrcty.E.D.Mich. 2010).

Judge Rhodes rejected all of the Debtors' arguments. He found that upon avoidance of the unrecorded mortgage, the lien existed for the benefit of the bankruptcy estate. It therefore came ahead of the Debtors' homestead exemption rights which are limited to equity above the debt amount. The Court further held the Trustee could sell the property, as it became property of the estate after avoidance under §551 and §541(a)(4). Further, §704(a) and §363(b) specifically authorize such sales by Trustees. Finally, the Court ordered the Debtors to vacate the premises so the Trustee could properly market the sale and administer the asset.

124. *In pari delicto* defense explained and denied

Pre-petition, the Debtor owned several companies in the home construction business. In 2004, he met an attorney who subsequently began representing him. The Debtor and his attorney later became partners in several business ventures. When it became obvious that the Debtor could not sustain his continuing operations, his lawyer/partner drafted documents whereby the Debtor transferred to him all of his interest in certain properties they owned jointly. The Chapter 7 Trustee brought actions against the attorney for malpractice, aiding and abetting breach of fiduciary duty; and avoidance and recovery claims based on these pre-petition transfers. The attorney/former partner/present defendant asserted the equitable defense of *in pari delicto*. *In re Leli*, 425 B.R. 673 (Bkrcty.M.D.Fla. 2010).

Judge Paskay first explained the history and theory of the *in pari delicto* defense, which he summarized as the "principle that a plaintiff who has participated in wrongdoing may not recover damages resulting from the wrongdoing." The Court then acknowledged the extension of this doctrine to the Trustee of a Debtor who had perpetrated such wrongful conduct. As simply stated by the Court, when a Trustee asserts a claim under §541, he "stands in the shoes of the debtor" with no greater rights and all the infirmities the Debtor had himself.

After explaining *in pari delicto*, the Court found it was evident that the doctrine did not apply to this case. There was nothing in the record indicating that the Debtor was guilty of wrongdoing, such as transferring his interest in the properties for the purpose of hiding them from creditors. In fact, the record supported "the inference that because of a dire and almost hapless financial situation...[the debtor] was convinced" by his attorney to turn over property. Because the Debtor's interest in these transferred properties was not now available to the bankruptcy estate, and because the defendant's "intimate involvement in the dealings with the debtor were so pervasive"; the defense of *in pari delicto* did not apply.

125. Section 363 sale was not subject to creditor's objection that it was bad faith attempt to avert successor liability

A creditor moved to dismiss a Chapter 7 case, and objected to the Trustee's proposed free and clear sale of assets to the Debtor's sole shareholder. Both the filing of the case and the proposed sale were alleged to be bad-faith attempts by the shareholder to avoid the successor liability that would accompany a non-bankruptcy sale. *In re Remember Enterprises, Inc.*, 425 B.R. 757 (Bkrtcy.M.D.N.C. 2010).

Judge Waldrep found no basis for either case dismissal or sale objection. The Court noted that there were "relatively substantial assets available for distribution to creditors." These included over \$4,000.00 in cash, \$10,000.00 from the proposed sale to the Debtor's shareholder, and potentially another \$22,000.00 to be recovered from the shareholder as a preference. Based on this potential "meaningful dividend" and the "totality of the circumstances" the Court found no cause for case dismissal. As to the sale objection, the Court found no authority for denying the sale because it allowed the Debtor shareholder to escape successor liability that would attach to the same sale outside of bankruptcy. The Court cited numerous cases holding that §363 free and clear sales, barring successor liability claims, are not only permitted but stand "as one of the bedrocks of enhancing recovery to creditors in distressed business environments." The Court further rejected the creditor's argument that the sale price was insufficient, noting that neither the creditor nor anyone else had chosen to offer more.

126. Trustee of liquidating trust can pursue claims assigned to the trust for the sole benefit of the assignors

When the plan of reorganization was confirmed, the Chapter 11 Trustee became Trustee of the liquidation trust created in the plan. The plan further provided that certain third party claims were assigned to the liquidation trust, which the Trustee would pursue for the sole benefit of the claim assignors. When these claims were subsequently asserted, the defendant Bank argued that the Trustee lacked standing to bring these actions on behalf of the Trust; which would bear the expenses and not share in any recovery. The Bankruptcy Court agreed, and dismissed the claims. On appeal the District Court affirmed. Further appeal was taken to the Seventh Circuit. *Grede v. Bank of New York Mellon*, 598 F.3d 899 (7th Cir. 2010).

Writing for the Circuit Court, Judge Easterbrook distinguished a Chapter 11 Trustee from a Trustee of a liquidation trust in a confirmed plan. The Court found that the issue was not the Trustee's "standing" to bring the assigned actions. Rather, it was whether the Trustee had "authority" to act on behalf of the claim assignors. Explaining and distinguishing the Supreme Court case of *Kaplan v. Marine Midland Grace Trust Co.*, 406 U.S. 416 (1972), the Court found that the Bankruptcy Code governs "the permissible duties of a trustee in bankruptcy." However, the terms of a confirmed plan "govern the permissible duties of a trustee after bankruptcy." The Court noted that the beneficiaries of the trust created in the plan could have objected to the plan provision allowing assignment and prosecution of third party claims by the Trustee, but did not. The party defendant to these claims could not now assert the rights of trust beneficiaries who had allowed the claim assignments to become part of a plan of reorganization confirmed by the Bankruptcy Court.

127. Results of retention and final fee hearings precluded Trustee's later claims

The liquidating Trustee in a confirmed Chapter 11 plan brought an adversary proceeding against the Debtors' pre and post-petition financial adviser, seeking recovery of \$330,000.00 fees paid; based on breach of contract, fraudulent transfer, and unjust enrichment theories. Defendants asserted that the Trustee was precluded from bringing these actions, pursuant to prior Court orders. *In re All American Semiconductor, Inc.*, 427 B.R. 559 (Bkrcty.S.D.Fla. 2010).

During the course of the Chapter 11 case, evidentiary hearings had been conducted with respect to the retention and employment of the financial adviser, as well as its final fee application. The Committee and U.S. Trustee had objected, and the issue of reasonableness of the fees was addressed. Ultimately, with some modifications, the financial adviser was employed and retained, and subsequently received a final fee award. The Court found the same nucleus of operative facts was considered in those hearings, as was now being raised in the Trustee's complaint. Further, because the confirmation order provided that the liquidating Trustee was to prosecute all estate litigation claims, the liquidating Trustee stood in the shoes of the Committee for purposes of issue and claim preclusion. Accordingly, the Court found the Liquidating Trustee's claims barred by *res judicata*.

Comment: This case highlights the problem faced by Chapter 7 Trustees who are new to the case at the time Chapter 11 professionals seek final fee awards for their services. Trustees should seek to have such awards designated as and limited to interim fees. That should prevent a claim preclusion argument, if the Trustee later discovers actionable claims against those professionals.

128. What happens when a putative involuntary petition Debtor files a voluntary petition??

After an involuntary Chapter 7 petition was filed against the corporate Debtor, but before an order for relief was entered, the Debtor filed a voluntary petition. It then moved to dismiss the involuntary case, which would have pushed forward the look-back period for avoidable transfers from the date of the involuntary petition to the later voluntary petition date. Judge Clark considered the effect of the subsequent filing upon creditors, and found that the later filed voluntary petition was the functional equivalent of a motion to convert the involuntary case to a voluntary case under whatever chapter the Debtor chose. Therefore, the two cases would be consolidated under the first filed case with the initial filing date, thereby preserving avoidance actions based on the earlier date. *In re Premiere General Holdings, LTD*, 2010 WL 1489911 (Bkrcty.W.D.Tex.).

129. Section 363(m) moots appeals of orders allowing property sales under §363(h)

In this case the Debtor owned real estate jointly with investors who held interests as tenants in common. When the Debtor moved to sell the property, the committee of tenant in common investors (TIC) objected. The Bankruptcy Court ultimately denied the objection and further found that the proposed sale "satisfied the requirements of Bankruptcy Code

section 363(h)...." The TIC committee then sought a stay of the sale, which was denied by the Bankruptcy Court. After waiting one week, the TIC sought a stay at the BAP; but before the matter could be heard, the sale was closed. The BAP subsequently dismissed the appeal as moot under §363(m). The TIC argued that §363(m), by its own terms, only applies to sales under §363(b) and (c). The BAP held that the Bankruptcy Court had approved the sale under both §363(b) and (h). Citing *Parker v. Goodman (In re Parker)*, 499 F.3d 616, 626 (6th Cir. 2007), the BAP further found that the provision for an exception to statutory mootness, where a portion of a sale required §363(h) authorization, would undermine the role of §363 in protecting the finality of bankruptcy sales. Appeal was taken to the Sixth Circuit. *Official Committee of Unsecured Creditors v. Anderson Senior Living Property, LLC; et al (In re Nashville Senior Living, LLC)*, 2010 WL 3447746 (6th Cir. 2010).

Affirming, the Circuit Court noted that property of a bankruptcy estate can be sold by a Trustee or Debtor in Possession only through either subsection (b) or (c) of §363. If other parties have an interest in the property to be sold, subsection (h) specifically provides that a "trustee may sell both the estate's interest, under subsection (b) or (c), and the interest of any co-owner in the property..." in which the debtor had, at the time of the commencement of the case, an undivided interest. Thus a sale that implicates subsection (h) must, by definition, be a sale under subsection (b) or (c). The Court therefore found that §363(m) applies to §363(h) sales.

130. When is a conversion from Chapter 13 to Chapter 7 prohibited under *Marrama*?

The Debtors moved to convert their case initially filed in Chapter 7 to Chapter 13. A creditor objected based upon the good-faith standard as stated in the Supreme Court case of *In re Marrama*, 549 U.S. 365, 127 S.Ct. 1105 (2007). The objecting creditor was an attorney who had represented the Debtors' son in a domestic relations case. The Debtors had guaranteed payment of her fees, and approximately \$3,700.00 remained owing. This creditor had also brought a pre-petition action for judgment of more than \$75,000.00 based on allegations that the Debtors had attacked her by engaging in intentional, willful and malicious conduct "designed to defame her and ruin her professional reputation." This allegation was predicated upon letters written by the Debtor which were typewritten in English, though the Debtor could neither read nor write in the English language. In addition to the subject creditor, \$28,000.00 of other debt, including credit card and medical expenses were listed on the schedules, and the Debtors' income was below the applicable median family income. When the creditor filed a timely nondischargeability complaint, the Debtors moved to convert the case to Chapter 13. The creditor objected. *In re Ortega*, 434 B.R. 889 (Bkrcty.D.Kansas 2010).

At the Bankruptcy Court hearing, the Debtor testified that the conversion motion was filed to avoid the dischargeability complaint litigation. He stated that he had already incurred attorney fees for state court representation and knew defense of the adversary proceeding would be expensive. He further testified that the creditor would be paid through the Chapter 13 plan. The creditor countered that the conversion motion was based on "bad faith and abuse of the bankruptcy process" which made the Debtors ineligible for Chapter 13 conversion. Judge Somers cited §706(a) and noted that prior to the *Marrama* decision the Tenth Circuit BAP had held that a Chapter 7 debtor whose case had not previously been converted, had an absolute right to convert to a case under another chapter for which

he was eligible. The Court acknowledged that the *Marrama* case had held otherwise, finding that a Chapter 7 Debtor could forfeit his right to proceed under Chapter 13. One basis for this forfeiture "is bad faith, as evidenced by all of the facts and circumstances of the case." Here the Court found no such bad faith. Though the conversion motion was prompted by the creditor's dischargeability complaint, there was no evidence that the Debtors' "actions toward creditors in general was wrongful"; such that their actions "both before and after the filing for relief" did not evidence bad faith. There was no evidence of concealed assets, misstated income, or erroneous statements of liabilities. There were also no allegations of pre-petition transfers and/or fraudulent dealings. Therefore the Debtors, who were eligible for Chapter 13 when they initially filed their Chapter 7 petition were allowed to convert their case to Chapter 13.

131. Receiver may serve as Trustee for related entities

The assets of a billion dollar Ponzi scheme perpetrator were frozen and placed into receivership. The receivership order authorized the Receiver to initiate bankruptcy cases for any related entities, in order to protect and preserve assets. Chapter 11 petitions for affiliated companies were subsequently filed. Upon motion of the U.S. Trustee and a creditor group asserting \$220,000,000.00 in claims, the Bankruptcy Court approved appointment of Chapter 11 Trustees in all of the cases. The U.S. Trustee then selected the Receiver as the sole Trustee in each and all the cases, to be jointly administered. The creditor group objected, asserting that the Receiver was not disinterested, and that separate Trustees should be appointed in each case. The Bankruptcy Court overruled the objections, the District Court affirmed on appeal, and further appeal was taken to the Eighth Circuit Court. *Ritchie Special Credit Investments, Limited v. U.S. Trustee*, 620 F.3d 847 (8th Cir. 2010).

The Circuit Court first found no material adverse interest in being both the Receiver and the bankruptcy Trustee. As to the question of separate Trustees in the various cases, the Court noted that Bankruptcy Rule 2009(c)(2) contemplates a common Trustee for estates that are being jointly administered; with the potential for a conflict of interest among the estates being insufficiently serious or infrequent to warrant separate Trustees. The Court observed that a single Trustee is often able to maximize the return from jointly administered estates through increased economy and efficiency. Concluding that the Bankruptcy Court had properly considered the factors under Rule 2009(d), including the size and complexity of the case, and the need to concentrate the attention and effort into one fiduciary, the Circuit Court affirmed its ruling.

132. Prospective v. retroactive adequate protection

Six months after the Debtor's Chapter 11 filing, a secured lender moved for stay relief or, in the alternative, adequate protection. The parties agreed and the Court authorized adequate protection payments of \$3,500.00 per month. However, the lender further asserted its right to "retroactive" adequate protection to compensate for the decline in the value of its collateral from the petition date to the date the adequate protection motion was filed. The Bankruptcy Court denied this request, finding that the lender had not been harmed, prior to the hearing, as a result of the automatic stay. While the equipment had depreciated in value, that was due to adverse economic conditions; and not to wear

and tear caused by the Debtor's continuing use. The Court further expressed concern that the lender had not filed its motion within a reasonable time. Appeal was taken to the Ninth Circuit BAP. *In re Big 3D, Inc.*, 438 B.R. 214 (9th Cir. BAP 2010).

The BAP, sitting en banc, affirmed. The Appellate Court opined that bankruptcy courts have the appropriate "flexibility to make appropriate adequate protection determinations as provided for in the Code based upon the evidence presented by the parties." The BAP agreed with *In re Deico Electronics, Inc.*, 139 B.R. 945 (9th Cir. BAP 1992), which held: 1) Adequate protection payments are intended to compensate a secured creditor only for those losses occasioned by the bankruptcy; 2) adequate protection is payable for only that period of time after the creditor would have exercised its state court remedy; and 3) courts have broad discretion in fixing the beginning date, the amount, and the frequency of adequate protection payments.

133. Pre-judgment interest

After the Trustee obtained a partial summary judgment avoiding three fraudulent transfers in the respective amounts of \$22.7 million, \$1.5 million and \$3.3 million; the issue of the correct rate of pre-judgment interest was addressed. The defendant argued that the federal judgment rate applied, pursuant to 28 U.S.C. §1961; from commencement of the adversary proceeding until the judgment was entered. That rate was 0.64 percent. The Trustee countered that the applicable rate should be the federal judgment rate in effect on the date of the three subject transfers: 3.76 percent on September 7, 2005; 5.24 percent on June 26, 2006; and 4.9 percent on September 29, 2006. *In re V1031 Tax Group, LLC, et al*, 2010 WL 4312906 (Bkrtcy.S.D.N.Y. 2010).

Judge Glenn disagreed with both parties, and initially noted that bankruptcy courts have discretion in deciding whether, and at what rate to apply pre-judgment interest. The Court determined that both proposed rates were insufficient to fully compensate the bankruptcy estate for its loss; and held that the Trustee was entitled to a market rate of interest determined by the bank prime loan rate on the date of each of the transfers: 6.5 percent on the \$22.7 million; 8 percent on the \$1.5 million and \$8.25 percent on the \$3.3 million.

134. Debtors ordered to turn over checking account balance at time of bankruptcy filing, notwithstanding that funds had been paid through post-petition negotiation of pre-petition checks written by the Debtors

Pro se Debtors indicated \$513.00 in a joint checking account on their Schedule B, but claimed no exemptions on Schedule C. Schedule C was subsequently amended to include the \$513.00. The Chapter 7 Trustee objected to all of the Debtors' claimed exemptions with the exception of their Jaguar and IRA's. This objection specifically included the sum of \$5,862.38 which remained in the joint checking account on the date of filing. In their response, the Debtors argued that the \$513.00 was exempt, and that the balance in the account stated by the Trustee represented the total of checks written pre-petition, but honored post-petition. The Debtors cited the case of *In re Pyatt*, 486 F.3d 423 (8th Cir. 2007), in support of their position. The Trustee argued that the funds were property of the estate because they were in the account on the petition date. Thus, under

§542 the Debtors were required to turnover "such property or the value of such property...to the Trustee." *In re Brubaker*, 2010 WL 1260131 (Bkrtcy.M.D.Fla.).

Judge Paskay first found that the funds did not leave the checking account until the previously written checks were honored post-petition. The Court reasoned that "until the checks were honored by the Debtors' bank, the Debtors still had the opportunity to close the account or to stop payment on the checks." The Court cited §2-104 of the U.C.C and the case of *Barnhill v. Johnson*, 503 U.S. 393, 112 S.Ct. 1386 (1992), as support for this finding. However, this did not completely answer the question. While the funds were property of the estate when the case was filed, they no longer belonged to the Debtors after the checks were negotiated post-petition. Should the funds be recovered from the Debtors under §542, or from the post-petition recipients under §549 as the Eighth Circuit found in *Pyatt*? While the Court noted no bad faith or fraudulent intent by these Debtors, the fact remained that (1) their interest in the bank account became estate property upon their petition filing, and, (2) though they may have lacked "technical custody" they maintained control of them until the checks were honored. They were therefore ordered to turn over the non-exempt portion of their bank account as of the date of their bankruptcy filing.

Comment: Though it is not specifically mentioned in this holding, there is one inescapable fact in all these cases. The Debtors chose to write the checks. They also chose which creditors were paid by these checks. They had total control of the situation, and made a conscious decision. Why should they not be responsible for the consequences?