*Consumer Track*

# Case Law Update

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# AMERICAN BANKRUPTCY INSTITUTE ANNUAL SPRING MEETING

APRIL 26, 2014

## CASE LAW UPDATE

# Exemption Issues

**P. 4 #6**
**(SURCHARGES)**

*Stephen Law v. Alfred H. Siegel, Chapter 7 Trustee*
*(Unanimous Supreme Court rules against trustee* 3/4/14)

401 B.R. 47 (Bankr. C.D. Cal. 2009),
*aff'd* 2009 WL 7751415 (9th Cir. BAP 2009),
*aff'd* 435 Fed. Appx. 697 (9th Cir. 2011),
*Pet. for Cert. granted, 2013 WL 2922137* (June 17, 2013), *rev'd*, 2014 U.S. LEXIS 1784 (U.S. Mar. 4, 2014)

(BAP and Circuit Court opinions were unpublished)

**P. 4 #6**
**(SURCHARGES)**

A. YES
*Law v. Siegel* (9th Cir. 2011)
*Latman v. Burdette*, 366 F.3d 774 (9th Cir. 2004)
*Malley v. Agin (In re Malley)*, 693 F.3d 28 (1st Cir. 2012)

B. NO
*In re Scrivner*, 535 F.3d 1258 (10th Cir. 2008)
***Law v. Siegel***, 2014 U.S. Lexis 1784 (U.S. Mar. 4, 2014)
(Unanimous)

**P. 4 #6**
**(SURCHARGES)**

1. Did it matter that there was no timely objection?

2. Did it matter that all unsecured creditors had been fully paid and the surcharge would have been applied only to unpaid administrative fees and expenses?

3. What is the impact on concealed assets?

**P 4 #6**
**(SURCHARGES)**

So what is left for the trustee (and Court) as a remedy?

What does this mean for the holding in
*Marrama v. Citizens Bank of Mass.*,
549 U.S. 365 (2007)?

What about Bankruptcy Rule 4003(b)(2):

"The trustee may file an objection to a claim of exemption at any time prior to one year after the closing of the case if the debtor fraudulently asserted the claim of exemption."

# Lien Stripping

Pp. 86-87 # 137-138
(Lien Stripping in Chapter 7 and 13 Cases)

A. Yes
*Bank of America v. David L. Sinkfield (In re Sinkfield)*, 2014 U.S. LEXIS 2251; *cert. denied* (U.S. March 31, 2014)
*In re McNeal*, 2012 WL 8964264 (11th Cir. 2012)
*In re Malone*, 489 B.R. 275 (Bankr. N.D. Ga. 2013)
*In re Alonso*, 495 B.R. 53 (Bankr. M.D. Fla. 2013)
*In re Bertan*, 2013 WL 216231 (Bankr. S.D. Fla. 2013)

B. No
*Branigan v. Davis (In re Davis), 716 F.3d 331 (4th Cir. 2013)*
*In re Williams*, 488 B.R. 492 (Bankr. M.D. Ga. 2013) (tax lien)
*Ryan v. United States (In re Ryan)*, 2013 WL 3380131
(7th Cir. 2013 (tax lien)
*Wachovia Mtge. V. Smoot*, 478 B.R. 553 (E.D.N.Y. 2012)
*In re Palomar*, 2012 WL 4739407 (N.D. Ill. 2012)
*In re Woolsey*, 696 F.3d 1266 (10th Cir. 2012)

# Chapter 13 Property of the Estate/ Judicial Estoppel

P. 96 #2
Judicial Estoppel Applied to Chapter 13 Debtor for Undisclosed Post-Petition PI Claim

P. 96 #1
Property of the Estate Includes Chapter 13 Debtor's Inheritance Received Three Years into Repayment Term

# TURNOVER


CLAIM ISSUES

P. 99 #7
Secured Claim Cannot Be Disallowed Due to Untimeliness

*Shelton v. Citimortgage, Inc.*, 735 F.3d 747 (*8th Cir. 2013*)

# Can (Should) the Trustee File Claims for Creditors?

11 U.S.C. § 501(c) and Rule 3004

P. 52 #79

*In re Van Cleef*, 479 B.R. 809 (Bankr. N.D. Ind. 2012) (Klingenberger, J.) (although not facially ambiguous, court looks to legislative history and rules that trustee can only do so if it benefits the debtor),

*rev'd Yoon v. Van Cleef*, 498 B.R. 864 (N.D. Ind. 2013) (the statute is not ambiguous and permits it expressly)

- Compare *In re Schmidt*, 333 B.R. 868, 870 (Bankr. N.D. Fla. 2005)(Killian, J.)
- "While the Trustee may not have an affirmative duty to file such proofs of claims, he likewise has no duty to refrain from doing so in order that the Debtor receive a windfall while receiving a discharge in bankruptcy." (Debtor had objected and asserted that the trustee had an improper motive. The court held that motive is irrelevant.)

- What if the claims are filed by the trustee more than 30 days after the bar date?
- Are they then treated as late claims and still paid ahead of the Debtor?

- In re Rothman, 373 B.R. 785 (Bankr. S.D. Ga. 2006)(Davis, J.)(even though no claims were filed by creditors, trustee's late claims were disallowed ---funds became surplus payable to the debtor who had objected).

- Section 726(a)(3) refers to claims tardily filed under section 501(a), whereas trustee's authority to file late claims falls under section 501(c).

## Status of the Absolute Priority Rule In Individual Chapter 11 Cases

# Good Faith Inquiry in Chapter 13

P. 96 #3

*Drummond v. Welsh*, 711 F.3d 1120
(9th Cir. 2013)

## Statute of Limitations

The humorist Douglas Adams was fond of saying, "I love deadlines. I love the whooshing sound they make as they fly by." But the law more often follows Benjamin Franklin's stern admonition:" You may delay, but time will not." To paraphrase Emile Zola, deadlines are

often the terrible anvil on which a legal result is forged.

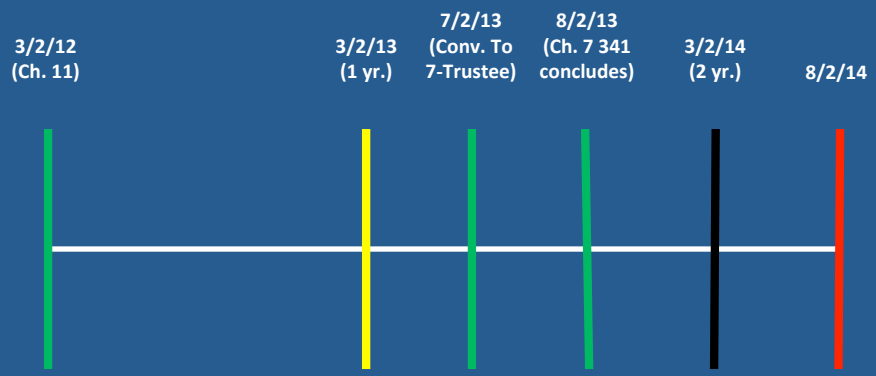
**Pp. 41-42 # 63**

*Fogel v. Shabat (In re Draiman),*
483 B.R. 338 (Bankr. N.D. Ill. 2012),
*rev'd* 714 F.3d 462 (7th Cir. April 8, 2013)

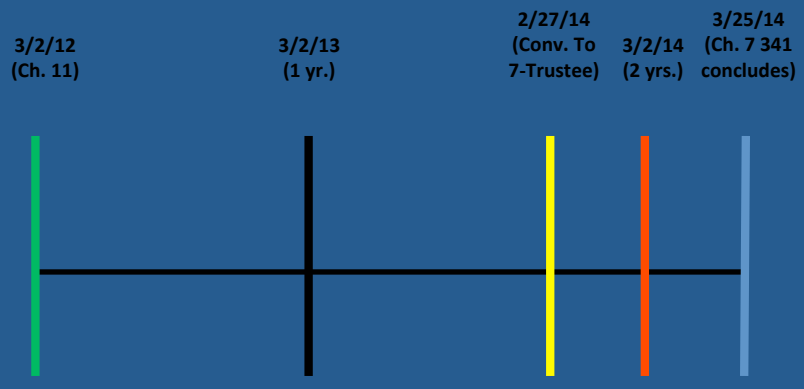
Compare to:

*In re American Pad & Paper Co.,*
*478 F.3d 546 (3rd Cir. 2007)*

## Pp. 41-42 # 63




## Pp. 41-42 #63



**P. 44 #66**

**(When Does the 341 Meeting Actually Conclude?)**

*PMC Marketing Corp.,*
482 B.R. 74 ( Bankr. D. Puerto Rico 2012)

P. 41 #62

If the statute of limitations has run on avoidance actions (as often happens in converted cases), can the trustee still use his avoidance powers defensively?

*Grant , Konvalinka & Harrison, P.C. v. Still (In re McKenzie*), 737 F.3d 1034 (6th Cir. Dec. 17, 2013)

Pp. 42-44 # 64-65

The shrinking statute of limitations

*Hope v. Acorn Financial, Inc*. 731 F.3d 1189 (11th Cir. 2013)

*In re McDonald*, 500 B.R. 208 (Bankr. N.D. Ga. 2013)(Brizendine, J.)

CAN THE TRUSTEE RECOVER AGAINST A JUNIOR MORTGAGE THE AMOUNT OF PAYMENTS MADE TO THE SENIOR MORTGAGEE DURING THE PREFERENCE PERIOD?

P. 16 #25

*In re Vassau*, 499 B.R. 864 (Bankr. S. D. Cal. 2013) (Bowie, J.)

FACTS

1. Senior is oversecured and junior is undersecured.

2. $41,716.45 is paid to senior during the preference period.

Against whom can the Trustee recover?

- Trustee cannot recover against the Senior (the actual transferee) because it is oversecured.
- Trustee gets a preference judgment against the junior whose position was improved—even though BOA holds both the senior and junior position—OUCH!
- (Similarly, payments to a senior lender can be adequate protection to a junior lender.)

Forced Conversion of Chapter 7 to Chapter 11 Despite Eligibility as a Chapter 7 Debtor

P. 102

*In re Schlehuber*, 489 B.R. 570 (8th Cir. BAP 2011)

P. 102
Consecutive Chapter 11 Filings by Individuals

Compare *In re Lee*, 467 B.R. 906 (6th Cir. BAP 2012)
to
*In re Colon Martinez*, 472 B.R. 137 (1st Cir. BAP 2012)

P. 103
Impact of Confirmed Individual
Chapter 11 Plan on Automatic Stay

*In re Houlik*, 481 B.R. 661 (10th Cir. BAP 2012

# CASE LAW UPDATE

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WASHINGTON, D.C.
APRIL 24-27, 2014

# CASE LAW UPDATE

## ABI – APRIL 24-27, 2014

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# CASE LAW UPDATE

## A. DISMISSAL

### 1. Assets of non-filing spouse can be considered in determining whether to dismiss Chapter 7 case

Debtor filed a chapter 7 bankruptcy petition. Her husband did not. Debtor and husband had been married for over twenty years and "operated as a financial unit, maintaining joint checking account, filing joint tax returns, and pooling their income and expenses." Non-debtor's husband income was substantial. US Trustee moved to dismiss debtor's case under §707(b)(3)(B) arguing that the "totality of the circumstances" require the dismissal of the debtor's case given the significant resources of the household. The bankruptcy court agreed.

On appeal, the Eleventh Circuit affirmed. *In re Kulakowski*, 735 F.3d 1296 (11th Cir. 2013). The court rejected debtor's argument that husband's income was relevant only to the extent it was used to pay household expenses. Next, the court held that equity demanded that the husband's income be considered. The court noted that almost all of the debtor's debts were incurred for the benefit of herself and her husband. The court held that the bankruptcy court did not err when it determined that the debtor's attempts to discharge the household debts without taking advantage of her household's substantial income warranted the dismissal of her case.

### 2. Bad faith constitutes "cause" for dismissal

Debtor filed Chapter 7 with primarily business-related debts. A single judgment creditor was owed more than half of the unsecured debt as the result of a state-court judgment which it had unsuccessfully attempted to collect for more than two years. That creditor moved to dismiss the case, arguing that the case was an "abuse" of the provisions of Chapter 7 within the meaning of § 707(b) and that under the "totality" of the circumstances, the petition should be dismissed on bad faith grounds under § 707(a). Debtor disputed that he had acted in bad faith or that bad faith was a ground for dismissal under § 707(a). The bankruptcy court, however, granted the motion to dismiss finding that "cause" existed to dismiss under § 707(a) based on debtor's bad faith. 451 B.R. 608. Debtor appealed, but the district court affirmed. 469 B.R. 388. Debtor appealed to the Eleventh Circuit Court of Appeals, which likewise affirmed. *In re Piazza*, 719 F.3d 1253 (11th Cir. 2013).

The circuit court noted a split at the circuit court level with the Third and Sixth Circuits holding that cause under § 707(a) included bad faith compared to decisions from the Eighth and Ninth Circuits which held to the contrary. The Eleventh Circuit agreed with the Third and Sixth Circuits. It followed the ordinary meaning of "cause," being when adequate or sufficient reason existed for such an action. It also noted that over 840,000 Chapter 7 filings had occurred in 2012 with respect to which it stated: "Although these numbers do not tell us how many cases were filed in bad faith, they do indicate that we should not artificially limit the tools Congress has given bankruptcy

courts to protect their jurisdictional integrity." The court further reasoned: "Considering bankruptcy courts may sanction litigants for filing documents with 'any improper purpose,' see Fed. R. Bankr. P. 9011(b)(1) as well as 'tak[e] any action … necessary or appropriate to prevent an abuse of process,' see 11 U.S.C. § 105(a), we see no reason why pre-petition bad faith should not constitute an adequate or sufficient reason for dismissal." The court rejected the debtor's arguments that §§ 523 and 727 precluded alternative remedies to prevent an abuse of process. Finally, the court concluded: "Because Congress amended § 707(b) in 2005 to include the phrase "bad faith," while failing to amend § 707(a) in a similar manner, Congress "did not, by implication, transform § 707(a) into a safe harbor for bad faith debtors." As the bankruptcy court had applied the proper "totality" of the circumstances standard in its "bad faith" findings supported by the record, the circuit court affirmed.

### 3. *Marrama* extended to block debtor's unqualified right to dismiss a Chapter 13 case

Debtor filed a Chapter 13 case. At his confirmation hearing, the bankruptcy court heard testimony from the debtor and denied confirmation, citing numerous misrepresentations in the forms contained in his bankruptcy petition. The bankruptcy court entered an order to appear and show cause why the case should not be dismissed or converted to Chapter 7 under § 1307. Twelve days later, debtor filed a motion to dismiss his case under § 1307(b), which provides that on request of the debtor at any time, if the case has not previously been converted, "the court shall dismiss a case under this chapter." The bankruptcy court denied the debtor's motion the day after it was filed. At the show-cause hearing, the court found that the debtor had filed his petition in bad faith and converted the case. The debtor appealed to the district court, which affirmed. Debtor then appealed to the Fifth Circuit of Appeals which likewise affirmed. *In re Elliott*, 506 Fed. Appx. 291 (5th Cir. 2013). Debtor argued that under § 1307(b), he had an unqualified right to dismiss his bankruptcy case at any time. However, the circuit court declined to read § 1307(b) as an "escape hatch" from which a debtor could escape a conversion motion filed under § 1307(c). It also determined that the Supreme Court's decision in *Marrama v. Citizens Bank of Massachusetts*, 549 U.S. 365 (2007), which identified a bad faith exception in a provision that seemingly created an unqualified right to convert a case from Chapter 7, should be extended to the automatic right to dismiss a bad faith case under Chapter 13 that would constitute an abuse of process. Based on the debtor's own testimony, the bankruptcy court had determined that the debtor's schedules, statement of financial affairs, and statement of current monthly income contained a large number of misrepresentations. Given the breadth of those misrepresentations, the court held that the bankruptcy court did not abuse its discretion in denying the motion to dismiss and converting the case to a case under Chapter 7. While debtor argued that *Marrama* and an earlier Fifth Circuit precedent, *Jacobsen v. Moser (In re Jacobsen)*, 609 F.3d 647 (5th Cir. 2010), suggested that bankruptcy courts could invoke the bad faith exceptions only if the debtor's conduct was somehow "atypical" or "extraordinary," the circuit court found that his conduct met the standard as the bankruptcy court found his level of deceit was "just virtually unprecedented." Accordingly, the lower courts were affirmed.

### 4. Ability to pay is a proper consideration of the totality of circumstances of debtor's financial situation

The bankruptcy administrator filed a motion to dismiss or convert to Chapter 13 on the ground that debtors' petition constituted an abuse of the Chapter 7 process. The court found there was no presumption of abuse under § 707(b)(2)'s so-called means test but held that the petition demonstrated abuse under the totality-of-the-circumstances-test of § 707(b)(3)(B). The primary basis for this determination was that debtors had retained certain luxury items – including a camper, a boat, a trailer, and a tractor – and had continued making payments on these items to the relevant secured creditors. The court determined that their ability to pay coupled with their reluctance to modify their lifestyle to enable a distribution to unsecured creditors indicated the case would be an abuse of Chapter 7. The court gave debtors two weeks to convert the case to Chapter 13. Upon their failure to do so, the court dismissed the case. Debtors appealed to the district court, arguing that an ability to pay may not be considered as part of the totality-of-the-circumstances analysis. Debtors argued that there would be no reason for the complex formula created by Congress if a court could take the factors that are incorporated in the means test and utilize those same factors in the totality-of-the-circumstances-test. The district court rejected this contention and affirmed. Debtors then appealed to the Eleventh Circuit, which also affirmed. *In re Witcher*, 702 F.3d 619 (11th Cir. 2012). The Circuit Court concluded that the ability to pay his or her debts was a proper consideration which Congress had not intended to preclude from consideration. The court made clear that it was not deciding whether a debtor's ability to pay a loan could be dispositive under the totality-of-the-circumstances test or the proper weight a bankruptcy court should give to that factor as compared to other factors making up the totality of the circumstances, since debtors did not raise these issues on appeal.

### 5. Dismissal provision did not apply in case converted to Chapter 7

Debtor originally filed a Chapter 13 petition but it was converted to Chapter 7 after she was unable to fund her Chapter 13 plan. Section 707(b)(1) provides for the dismissal or voluntary conversion of a case filed by an individual debtor "under this chapter" whose debts are primarily consumer debts if the court finds that the granting of relief would be an abuse of the provisions of Chapter 7. A presumption of abuse arises when a Chapter 7 debtor fails the Means Test. Judge Williamson noted a split in authority with the majority position being the so-called "common sense" view that congress intended for the Means Test to be applied in all Chapter 7 cases, whereas a significant minority of courts follow the "plain language" view that the section applied only to cases "filed under" Chapter 7 and not those converted to it. Here, the court determined to follow the "plain language" view and, therefore, denied the motion to dismiss. *In re Layton*, 480 B.R. 392 (Bankr. M.D. Fla. 2012). In adopting the plain language approach, Judge Williamson provides a detailed analysis of the various views and their supporting and detracting arguments. In particular, he noted that to apply the Means Test, there had to be a mechanical computation of the debtor's current monthly income. Because current monthly income is a defined term requiring the court to consider the debtor's taxable income during the six-month period ending on "the last

day of the calendar month immediately preceding the date of the commencement of the case," he noted that a court would have to consider financials that are either months or even years old and not reflective of the debtor's current financial condition. This faulty application would be avoided by applying the plain language approach. In the event that the court determined that the debtor was converting in bad faith and committing an abuse of process, the court retained the powers under § 105(a) as enunciated *Marrama v. Citizens Bank of Mass.*, 549 U.S. 365 (2007), to dismiss the case. *See contra, In re Chapman*, 447 B.R. 250 (8th Cir. BAP 2011)l *In re Reece*, 498 B.R. 72 (Bankr. W.D. Va. 2013)(Connelly, J.); and *In re Davis*, 489 B.R. 478 (Bankr. S.D. Ga. 2013)(Barrett, J.)("The view that this statute does not apply to cases converted to Chapter 7 from another chapter – removes a whole category of chapter 7 cases from review for possible abuse, contradicts the manifest intent of Congress, and frustrates the purpose of the statute." [*Author's Comment:* These cases are important to trustees attempting to administer asset cases that have been converted from Chapter 13 and whose dismissal is sought by the United States Trustee.]

### B. SECTION 522 EXEMPTIONS

#### 6. Surcharge of exemptions issue before the U.S. Supreme Court

In 2006, the trustee obtained from the bankruptcy court a surcharge of debtor's homestead exemption because of alleged fraudulent conduct. The Bankruptcy Appellate Panel for the Ninth Circuit reversed after determining that the trustee's intent was to punish the debtor for his litigation tactics. In 2008, trustee filed another surcharge motion alleging that the second mortgage on the residence was fictitious and fraudulent and intended to falsely show that the property had no equity beyond the legitimate exemption and mortgage encumbrances so the trustee would not proceed with any sale of that property. Debtor had scheduled the second mortgage for $156,929 in favor of Lily Lin of China. Debtor forged Lily Lin's name to the deed of trust and had recorded it. The bankruptcy court had ordered the debtor's entire $75,000 homestead exemption surcharged finding that the loan was fictitious and meant to preserve the debtor's equity in the residence beyond what he was entitled to exempt. *In re* Law, 401 B.R. 447. The debtor refused to cooperate and appealed so many decisions that over a dozen ended up at the appellate level running up the estate's costs to over $450,000 in legal fees as a direct result of debtor's misrepresentations. This time, the BAP affirmed in an unpublished opinion. *See* 2009 WL 7751415 (9th Cir. BAP 2009). The BAP not only affirmed the surcharge but also certain discovery sanctions that had been issued by the bankruptcy court. There was a concurrent opinion by Judge Markell in which he questioned the continuing viability of *Latman v. Burdette*, 366 F.3d 774 (9th Cir. 2004), wherein the circuit court first enunciated the legitimacy of surcharging exemptions. His view was in part colored by a contrary view from the 10th Circuit in *In re Scrivner*, 535 F.3d 1258 (10th Cir. 2008), and also the adoption of Bankruptcy Rule 4003(b)(2) which addressed fraudulently asserted exemptions.

However, after this BAP opinion, the First Circuit Court of Appeals in an opinion authored by Justice Souter also found the appropriateness of surcharging exemptions: "There could not be a clearer example of foiling abusive process than a surcharge order mitigating the effect of fraud in retaining non-exempt assets." *Malley v. Agin*, 693 F.3d

28 (1st Cir. 2012). The Ninth Circuit affirmed the BAP opinion (in an unpublished opinion) "because the surcharge was calculated to compensate the estate for the actual monetary cost imposed by the debtor's misconduct, and was warranted to protect the integrity of the bankruptcy process." Thus, the Ninth and First Circuits support the concept of surcharging exemptions and the Tenth Circuit does not, thereby creating a division in the Circuit Courts that the Supreme Court has agreed to resolve. *Stephen Law v. Alfred H. Siege*l, Chapter 7 Trustee, 435 Fed. Appx. 697 (9th Cir. 2011), cert granted June 17, 2013. [*Author's Comment:* The BAP concurring opinion is misplaced in referring to Rule 4003(b)(2). That Rule addresses fraudulently claimed exemptions whereas a surcharge is against a properly claimed exemption. NABT has filed an amicus brief in support of the trustee.]

### 7. Trustee may surcharge exemptions

The First Circuit Court of Appeals has ruled that bankruptcy courts are empowered to surcharge exempt assets when a debtor fraudulently conceals non-exempt assets. Justice David H. Souter, sitting by designation, authored the unanimous opinion in the case, *Malley v. Agin (In re Malley)* 693 Fed. 28 (1st Cir. 2012).

In *Malley*, the debtor fraudulently concealed his right to a portion of the proceeds from the sale of his former marital house. When the trustee discovered the deception, he sought an order surcharging the debtor's exemption in his truck to remedy the fraud. The bankruptcy court granted the trustee's request and surcharged the debtor's exemption in the truck.

On appeal, the Court framed the question: "Should Malley's interest in the truck be recognized as 'exempted under this section' when its exemption would consummate a fraud on creditors by giving the debtor a greater exemption in fact than the code entitles him to claim in law?" The Court answered the question in the negative, resting its holding on 11 U.S.C. § 105(a), and determining that surcharge orders are "necessary and appropriate to carry out the provisions" of the Bankruptcy Code. Surcharge is grounded in the other provisions of the Bankruptcy Code, as it enforces the disclosure requirements of § 521 and prevents the debtor from retaining more property than permitted by § 522. Although the Bankruptcy Code provides specific penalties for fraud, such as denial of discharge or dismissal, the Court determined that surcharge is a necessary remedy to alleviate the effect of the debtor's misconduct on creditors, who would otherwise "bear the brunt of the fraud."

The Court also discussed § 105(a)'s authorization for the bankruptcy court sua sponte to take "any action necessary or appropriate… to prevent an abuse of process." The Court found no reason to limit this grant to sua sponte actions; instead, courts may enter surcharge orders upon request of the trustee where necessary to prevent an abuse of process. The Court stated, "There could not be a clearer example of foiling abuse of process than a surcharge order mitigating the effect of fraud in retaining non-exempt assets."

The Court found support in *Marrama v. Citizens Bank of Mass.*, 549 U.S. 365 (2007), where the Supreme Court articulated a broad understanding of § 105 in the context of an abuse of process, and in *In re Hannigan*, 409 F.3d 480, where the First Circuit denied a debtor's amendment of exemptions based on bad faith conduct. *Malley* is in accord with the Ninth Circuit's conclusion in *Latman v. Burdette*, 366 F.3d 774 (9th

Cir. 2004), the first circuit level decision to approve surcharge orders. There is, however, an ongoing circuit split over the surcharge issue: the Tenth Circuit denied surcharge of exempt assets in *In re Scrivner*, 535 F.3d 1258 (10th Cir. 2008).

**8. Inherited IRA issue before the U.S. Supreme Court**

Debtor Heidi Clark was the designated beneficiary of her mother's IRA worth approximately $300,000. Upon her mother's death, Heidi inherited the IRA and claimed it fully exempt in her Chapter 7 bankruptcy case. The trustee timely objected. The bankruptcy court had agreed with the trustee that the inherited IRA was not exempt, concluding that an inherited IRA does not represent "retirement funds" in the hands of the current owner. Judge Martin had noted that while the funds remained sheltered from taxation until the money was withdrawn, many of the other attributes of the IRA had changed. For example, no new contributions could be made and the balance could not be rolled over or merged with any other account, 26 U.S.C. § 408(d)(3)C). Additionally, instead of being dedicated to Heidi's retirement years, the inherited IRA must begin distributing its assets within a year of the original owner's death and payout must be completed in as little as five years. 26 U.S.C. § 402(c)(11)(A) incorporating 26 U.S.C. § 401(a)(9)(B). The debtor appealed. Judge Martin's decision was reversed by the District Court Judge who followed recent appellate decisions such as *In re Nessa*, 426 B.R. 312 (8th Cir. BAP 2010) and *In re Chilton*, 674 F.3d 486 (5th Cir. 2012). Those courts had observed that any "retirement funds" in the decedent's hands had to be treated the same way in the successor's hands because §§ 522(b)(3)(C) and (d)(12) referred to "retirement funds" without providing that they must be the debtor's. It would be enough if they had ever been anyone's retirement funds. The trustee appealed and was joined by NABT in an amicus brief and was opposed by NACBA in an amicus brief before the Seventh Circuit Court of Appeals. The Seventh Circuit reversed and reinstated the holding of the bankruptcy court. *Rameker v. Clark (In re Clark)*, 2013 WL 1729600, 2013 LEXIS U.S. App. 8112 (7th Cir. April 23, 2013) *cert. granted* ____ U.S. ____, 134 S. Ct. 678 (Nov. 26, 2013).

In an outstanding opinion authored by Judge Easterbrook, the Circuit Court makes it seem very simple and obvious that "an inherited IRA does not have the economic attributes of a retirement vehicle, because the money cannot be held in the account until the current owner's retirement." It finds that the attributes of any inherited IRA do not in any way resemble "retirement funds." Further, the court concludes: "The district judge thought the question close and believed that close questions should be decided in debtor's favor. We do not think the question close; inherited IRAs represent an opportunity for current consumption, not a fund of retirement savings." The court further concludes that the bankruptcy judge "got this right" and disagreed with the 5th Circuit in *Chilton*. The court recognized that it was creating a conflict among the circuits and noted that it had circulated the opinion before release to all judges in active service. "None of the judges requested a hearing *en banc*." [*Author's Comments:* Trustees have been making these arguments and losing cases all over the country or winning in the bankruptcy court and being reversed on appeal, which is what happened here when Judge Martin was reversed by the district court. With the contrary appellate opinions from the 5th Circuit and the 8th Circuit BAP, this looked like the last good chance to turn

the tide and bring a measure of common sense to statutory interpretation. Congratulations to the NABT's Amicus Committee for an outstanding victory. Petition for Certiorari has been granted to the U.S. Supreme Court. NABT and NACBA will be filing amicus briefs in that proceeding as well.]

### 9. Debtor did not impermissibly use IRA to extend himself credit by granting a lien therein against potential future debts

Debtor opened an IRA with Merrill Lynch by rolling over $64,646 from another financial institution. In connection therewith, he signed a Client Relationship Agreement that included a provision whereby all of the securities and other property in the account "shall be subject to a lien for the discharge of any and all indebtedness or any other obligations you may have to Merrill Lynch." The bankruptcy court relied on an advisory opinion by the Department of Labor that the grant of a security interest in an IRA to cover debt in a non-IRA account "would amount to an extension of credit by the IRA to the IRA owner." Therefore, the bankruptcy court found that the IRA was disqualified and lost its tax exempt status and the bankruptcy exemption claimed in it. The district court affirmed. Debtor appealed to the Circuit Court of Appeals, which reversed. *In re Daley*, 2013 U.S. App. LEXIS 12138 (6th Cir. June 17, 2013). The circuit court noted that debtor never opened a margin-trading account or any other account and, thus, never became indebted to Merrill Lynch nor did he withdraw money from his IRA, borrow from it, or use it as collateral for a loan of any sort. Additionally, Merrill Lynch's IRAs had received a favorable determination letter from the IRS creating a presumption that the funds were exempt. Accordingly, even though the Tax Code provided that any direct or indirect lending of money or other extension of credit between the IRA and its owner was a disqualifying event, the circuit court found that debtor's "naked lien, stripped of any connection to a credit transaction, was not an extension of credit." The lien provision was contingent on an event that never occurred and thus could be exempted in his bankruptcy case.

### 10. Debtor denied exemption in unscheduled rent pre-payment

Debtors filed their Chapter 7 Petition and Schedules on May 14, 2013. Neither Schedule B nor C reflected or claimed as exempt any pre-paid rent. At the meeting of creditors, the trustee reviewed the debtor's checkbook and bank statements and inquired about a payment to their landlord in the amount of $2,707 that had been made on March 11, 2013. Debtors testified it was a pre-payment of rent for the months of April, May, and June 2013. Trustee then demanded turnover, following which debtors amended their Schedules to reflect and claim as exempt the pre-paid rent. Trustee objected the next day claiming that the failure to disclose the asset at the outset of the case was grounds to deny the exemption. Debtors responded that an amended claim of exemption should not be denied solely because of delay or late filing absent "a showing of debtors' bad faith or prejudice to creditors." Trustee responded that trustees should not be expected to ferret out undisclosed assets, by careful examination of checkbooks and bank statements only to have the asset so discovered belatedly claimed as exempt "especially when trustees are paid only $60 for no asset cases." The court sustained the objection. *In re Gray*, 498 B.R. 238 (Bankr. D. Ariz. 2013). Judge Haines first

determined that a credit for pre-payment was an asset and constituted property of the estate, citing *In re Nichols*, 491 F.3d 987, 990 (9th Cir. 2007). Next, the court rejected debtors' reliance on tax refund cases because those were assets that did not exist at the time of filing and often did not require any investigation by the trustee to discover, since refunds were often sent by the IRS directly to the trustee. Here, there was not only a late-filed exemption claim but also failure to disclose the asset. The court noted that intentional concealment can be inferred from the non-disclosure and that bad faith can be found on the basis of that inference, absent an innocent explanation. Here, the only explanation was that the Schedules had been prepared two months prior to the actual filing, which meant that they were prepared in the same month that the asset was intentionally created. The court held that no "fact-finder could find innocent oversight in the failure to identify an asset that was intentionally created in the same month as the Schedules were prepared," in actual contemplation of filing bankruptcy. Finally, the court recognized that some exemption planning was permissible but only where it was done without concealment.

### 11. Home with no equity can be sold by trustee on carve-out with the IRS despite debtor's claimed exemptions

Debtors owned a residence with a value of $325,000. A first mortgage encumbered it in the approximate amount of $195,500 followed by a federal tax lien in the approximate amount of $382,300. Although there was no equity in the property, debtors claimed under North Carolina law a homestead exemption of $60,000 indicating "debtors exempt their entire interest in this property despite the lack of equity." The trustee objected on the ground that debtors had no equity in the residence to exempt. The bankruptcy court overruled the objection but noted that title to the home remained with the bankruptcy estate under § 541. The trustee negotiated a carve-out with the IRS whereby 30% of the sale proceeds that would otherwise be paid to the IRS toward satisfaction of its tax lien would instead be retained by the bankruptcy estate for payment of allowed administrative claims, with any balance to be paid on a pro-rata basis to unsecured creditors. Trustee then filed a motion to sell the property pursuant to that carve-out. Debtors objected on the ground that their exemption claim had removed the residence from the bankruptcy estate such that the trustee lacked statutory authority to sell it. The bankruptcy court denied the objection and granted the motion. Debtors appealed. The district court affirmed. On further appeal to the circuit court, the lower court was affirmed. *Reeves v. Callaway (In re Reeves)*, 2013 U.S. App. LEXIS 23358 (4th Cir. Nov. 20, 2013). The Fourth Circuit noted that the fully encumbered property remained the property of the bankruptcy estate until it was either abandoned or sold by the secured creditor after obtaining stay relief. The fact that the IRS had agreed to the carve-out had no adverse consequences for debtors because the trustee confirmed that debtors would receive full credit with respect to their indebtedness to the IRS for any amount paid under the carve-out to the bankruptcy estate. This arrangement justified the trustee's action in selling the residence as opposed to abandoning it. Further, the court held that the debtors' exemption of $60,000 was subordinate to the first mortgage lien and the federal tax lien. Therefore, effectively, there was no value to which the exemption could attach. [*Author's Comment*: NABT and NACBA filed competing amicus briefs with NABT prevailing. Congratulations to Marty Sheehan who prepared the brief

and appeared on behalf of NABT, as well the entire Amicus Committee. This is an important case because some courts do not understand that the lien position from which the carve-out proceeds are obtained is not subject to the subordinate exemption rights of the debtors. This case makes clear that not only does the trustee have the right to sell the property notwithstanding the exemption claim but that the estate's interest in the carve-out comes ahead of those same exemption claims.]

### 12. Short sale incentive belongs to estate

On her petition date, debtor's mortgage was far greater than the value of her home. She nevertheless claimed as exempt "any and all proceeds, revenues, or concessions conceded to or granted by the secured mortgage lender on the property" up to $11,764. Trustee objected, and the court sustained the trustee's objection. *In re BonnieJean Bunn-Rodemann*, 491 B.R. 132 (Bankr. E.D. Cal. 2013). Judge Sargis stated: "Attempting to claim an exemption in this type of asset is a relatively new phenomenon arising from creditors realizing that a short sale of the property securing the debt (by which the creditor agrees to take less than the full amount owed) is better than the creditor completing a non-judicial foreclosure sale and the creditor becoming the owner of the property." The court explained that some "savvy" borrowers were negotiating incentive payments from the lenders that would be less than the cost of foreclosing, owning the property, and selling the property itself. Further, Chapter 7 trustees had determined that they could obtain incentive payments by conducting short sales of homes rather than abandoning them. When they did so, the incentive payment would not be the liquidation of the asset that the debtor owned on the petition date but, rather, compensation paid by the secured creditor to the trustee for services rendered. However, once the Chapter 7 petition was filed, the debtor no longer had the right or power to conduct a short sale or to "sell her own real estate services." "It is the Chapter 7 Trustee's labor and the estate's expense in working to sell property of the estate which is the subject of the incentive payment." The court observed that when the trustee chose to retain and attempt a sale of the underwater home, the debtor had the option of moving out, asking the trustee to abandon the property, or attempting to stay and negotiating with the trustee the terms of continued possession, such as paying the current insurance and maintenance costs to allow the debtor to avoid paying rent for housing and moving expenses during the first months of a Chapter 7 fresh start. The court observed: "In reality, these debtor-trustee issues concerning a short sale are steeped in the highest tradition of bankruptcy – what deal can be made that is in everyone's best interest." [*Author's Comment*: This court's analysis seems to state the obvious, particularly with its last comment concerning the deal being made "in everyone's best interest." Nevertheless, in certain regions, the U.S. Trustee objects to efforts to do short-sales or carve-outs, despite the win-win-win scenario, if it feels the trustee and his or her professionals receive a disproportionate amount of benefit when compared to the general unsecured creditors. No assessment of the risk borne by the trustee is part of the calculation nor does it seem to matter that every unsecured creditor would prefer a meaningful distribution rather than no distribution.]

### 13. Holding permits debtor to exempt carve-out proceeds (creating a conflict with other cases)

The trustee believed that she could obtain carve-outs from the mortgage holders on two separate properties. After debtor had received a discharge, trustee filed an application to employ a bankruptcy short sale specialist. In response, the debtor filed an amended Schedule C asserting wild-card exemptions in the properties in the total amount of $26,328. Trustee asserted that the debtor could not do so as those exemptions would not have existed on the petition date and exceeded the maximum amount permitted under California law. The court sustained the objection only as to the amount claimed as it was beyond the wild-card limit of $23,350, but otherwise overruled the objection. *In re Wilson*, 494 B.R. 502 (Bankr. C.D. Cal. 2013)(Clarkson, J.) The court stated that it did not matter how the funds were generated by the estate through a § 363 sale, including if derived from a "gift" from the mortgage lender so that they would not have to undertake a foreclosure proceeding under California law. Those funds were subject to the valid exemption asserted in this case. *Contra, In re Bunn-Rodemann*, 491 B.R. 132 (Bankr. E.D. Cal. 2013); *In re Baldridge*, 2013 WL 1759365, 2013 U.S. Dist. LEXIS 58512 (E.D. Mich. 2013); *In re Reeves*, 2013 U.S. App. LEXIS 23358 (4th Cir. Nov. 20, 2013), and *In re Goben*, 2013 WL 5302798, 2013 BANKR. LEXIS 3952 (8th Cir. BAP 2013).[*Author's Comment*: The court misunderstands the exemption in part because the trustee did not properly assert the objection. There is no equity in the properties to exempt as this is a gift from the lenders to the estate that bypasses debtor's exemption rights. Many cases so hold but none were discussed by the court or apparently asserted by the trustee here. It is also possible that the trustee did not properly document the nature of the carve-out which led to this result. The amount carved-out should be deducted dollar for dollar from the mortgage holder's lien to reflect that the trustee is standing in the shoes of the mortgage holder for purposes of the carve-out amount which would not be subject to exemption for that reason.]

### 14. 100% FMV exemption claims potentially sanctionable

A court in North Carolina consolidated seven Chapter 7 cases where debtors' counsel inserted the following prefatory paragraph in Schedule C-1, "Undersigned debtors are claiming and intend to claim 100% of Debtors' interest in 100% fair market value of each and every item listed, irrespective of the actual value claimed as exempt." The trustee timely objected to the exemptions. Debtors then amended to remove the 100% language and substituted a longer notice that included the language: "If the 'internal net value' of an asset listed below is equal to or less than the amount of the exemption claimed and if that value is less than the maximum amount of the exemption allowance under applicable law, the debtor exempts the asset from the estate and his entire interest in the asset from the estate." Thus, by inserting this provision, debtors were attempting to exempt their entire interest in every item listed in Schedule C-1 whenever the "net-value" was less than the allowable exemption, irrespective of the item's actual fair market value. Debtors maintained that under *Schwab v. Reilly*, 130 S. Ct. 2652 (2010), they were authorized to claim the full value of an item as exempt, which the notice provision was intended to indicate. The court disagreed and sustained the trustee's objections. *In re Gregory, et al.*, 487 B.R. 444 (Bankr. E.D.N.C. 2013).

Judge Leonard analyzed *Schwab* and its progeny and found the extensive body of case law that had developed as almost entirely uniform in rejecting designations such as "100% of the FMV," "100% equity," or comparable language. It found such language also violated the language of the General Statutes of North Carolina and concluded that if counsel persisted in "further use of this language, the court will not hesitate to utilize its *sua sponte* powers under Federal Rule of Bankruptcy Procedure 9011 to require counsel to demonstrate a colorable basis for its inclusion to avoid sanctions."

### 15. Objection to amended exemptions not limited to the amended items

Debtor's Chapter 11 case was converted to Chapter 7. After filing his original schedules, debtor amended them five times. The omission of several items of value that appeared on subsequent amended schedules was, in part, the basis for conversion to Chapter 7. After the final amendments were filed, a creditor objected on the 30th day thereafter, asserting that the objection was timely under Rule 4003(b). The debtor, however, asserted that the deadline had long passed on items not previously objected to that had not been amended. The court ruled that the creditor's objection was timely. *1*, 2012 Bankr. LEXIS 4435, 2012 WL 4484890 (Bankr. W.D. Tex. 2012). Judge Gargotta noted a split of authority between the "restrictive rule," wherein a party in interest has 30 days to object only to changes made by the amendment and not to claims that are unaffected by an amendment, and the "non-restrictive rule" under which a party in interest may object to any claimed exemption within 30 days of an amendment to the schedules. The court observed that the 7th and 9th Circuit Courts of Appeals and 8th Circuit BAP had all followed the "restrictive rule," but with very limited analysis, grounding their respective holdings on the need for prompt action and finality. These arguments were found by Judge Gargotta to be "not convincing." He determined that the plain reading of Rule 4003, which does not limit the scope of the objection, and the interdependence of exemption schemes supported adoption of the "non-restrictive rule". The court concluded that a trustee or other party-in-interest should be allowed to reassess a debtor's use of an exemption scheme upon the filing of any amendment that changes that use, particularly since it would not be prejudicial to the debtor whose prerogative it is to file accurate schedules or amendments thereto. [*Author's Comment*: The "non-restrictive rule" could also be referred to as the "common sense approach." Every time a piece of a case is changed the trustee reassesses the whole.]

### 16. Debtor's bad faith and reckless disregard for the truth precludes him from amending his exemption schedules

Flag Star Bank had obtained a judgment against debtor and others for $1.1 million on October 2, 2009, and had begun collection proceedings, including garnishment of bank accounts. Over a year later, debtor received over $107,000 of retroactive retirement benefits from the State of Michigan by direct deposit into his checking account. The following day, debtor withdrew $100,000 from the account and purchased a cashier's check made payable to himself which he placed into a safe deposit box. Debtor filed his Chapter 7 petition four months later. Neither the cashier's check nor garnished funds were disclosed in the schedules. Trustee discovered the existence of them upon questioning the debtor at the meeting of creditors. Debtor then

flied amended schedules, pursuant to which he disclosed and sought to exempt these funds, pursuant to § 522(d)(12). The trustee objected. Following an evidentiary hearing, the bankruptcy court determined that the debtor's failure to list the cashier's check and the garnished funds in his Schedules was intentional or in reckless disregard of his duty of full disclosure and, as a result, sustained the trustee's objection. The bankruptcy court further ruled that even if the debtor had not acted in bad faith, the claims of exemption pursuant to § 522(d)(12) would be denied as the funds were not in an account exempt from taxation. *See In re Rice*, 452 B.R. 623 (Bankr. E.D. Mich. 2011)(Rhodes, J.). Debtor appealed to the district court. After a thorough review and analysis of the bankruptcy court's holding, the district court affirmed, finding the bankruptcy court's factual findings that Rice was either reckless or intentional in omitting the check to not be clearly erroneous. *In re Rice*, 478 B.R. 275 (E.D. Mich. 2012).

### 17. Exemption barred in unscheduled IRAs

Debtor had failed to schedule his IRAs or disclose them at three meetings of creditors, a Rule 2004 examination, and various pleadings and motions, or in response to a discovery request by the trustee in a separate proceeding regarding the debtor's profit-sharing plan. When the trustee finally discovered the existence of the IRAs, debtor amended his schedules to claim them as fully exempt. The trustee filed an objection thereto. The bankruptcy court found that, even if the IRAs were otherwise exemptible and not subject to administration by the trustee, the debtor had acted with at least reckless indifference to the truth. The bankruptcy court also rejected the debtor's "advice of counsel" defense. After the bankruptcy court disallowed the exemptions, debtor appealed to the district court, which has affirmed. *Daniels v. Agin*, 482 B.R. 1 (D. Mass. 2012). The district court held that the findings of the bankruptcy court were not clearly erroneous, and further observed: "A debtor cannot, merely by playing ostrich and burying his head deeply in the sand, disclaim all responsibility for statements which he has made under oath."

### 18. "100% of FMV" exemption claim rejected by 1st Circuit BAP

The Chapter 13 debtors claimed exemptions in both their residence and car as "100% of FMV," pursuant to § 522(d). The Chapter 13 trustee objected on the grounds that it exceeded statutory limits and was an improper attempt to capture post-petition appreciation in both the residence and the car. The debtors countered that the phrase "100% of FMV" was merely a "phrase of art" authorized by the Supreme Court in *Schwab v. Reilly*, 130 S.Ct. 2652 (2010), where the court stated near the end of the opinion that listing the exempt value as "full fair market value (FMV)" or "100% of FMV" would encourage the trustee to promptly object to the exemption if he wished to challenge it and preserve for the estate any value of the asset beyond relevant statutory limits. The bankruptcy court ultimately sustained the objection and ordered the debtors' exemptions limited to specific dollar amounts. It further held that to the extent any appreciation in the exempted assets exceeded the maximum exemption amounts allowed, that appreciation would be property of the estate potentially available for creditors. Debtors also pointed to proposed changes to Official Form C, which would

allow a debtor to state the value of the claimed exemption as "the full fair market value of the exempted property." On appeal, the trustee maintained that the claimed exemptions were facially defective and ambiguous and would hinder the administration of the estate. The Bankruptcy Appellate Panel agreed. *In re Massey*, 465 B.R. 720 (1st Cir. BAP 2012).

The BAP observed that the Supreme Court questioned the effectiveness of a "100% FMV" type of exemption, noting that (a) such an exemption would not likely pass title to the asset itself, (b) the majority of lower courts to have construed *Schwab* found such exemptions impermissible, and (c) no court had interpreted the Supreme Court's holding as "either unfettered authorization for debtors to exempt assets in-kind or as a mandate for courts to allow such exemptions." It cited with approval the opinion one month earlier from a Massachusetts bankruptcy court, *In re Luckham*, 464 B.R. 67 (Bankr. D. Mass. 2012), that was in line with the majority of courts in finding that the Supreme Court had not outlined a procedure by which an exemption claim could be legitimately converted into an exemption in-kind and that an evidentiary hearing on valuation was unnecessary because the basis of the objection was the manner in which the debtor had claimed it. The BAP further rejected "the argument that proposed changes to Official Form C support in-kind exemptions which exceed the statutory limits," noting that *Schwab* itself precluded such a form-based argument. Finally, the BAP rejected the debtor's policy argument that such a ruling would impair a debtor's "fresh start" referring to the statement in *Schwab* that the approach advocated by the debtors would "convert a fresh start into a free pass." [*Author's Comment*: On behalf of NABT, the author provided extensive testimony on February 10, 2012, making the same points in opposition to the proposed amendment to Official Form C that this Court makes just three weeks later. The testimony is available on the NABT website.]

### 19. Joint debtors can stack § 522(p) homestead exemptions

Debtor Charles Gentile conveyed his martial home to his spouse for $1.00 on August 9, 2011. The following month, she conveyed the property to herself and Mr. Gentile as joint tenants by the entirety. A few months later, they filed a joint bankruptcy petition, in which they claimed the homestead exempt to the extent of $195,667. Creditors objected to the exemption claim on several grounds. The objections were overruled and the exemption allowed. *In re Gentile*, 483 B.R. 50 (Bankr. D. Mass. 2012). Judge Hoffman first noted that Massachusetts homestead exemption laws are available to individuals who own and occupy or intend to occupy real property as their residence up to a maximum of $500,000. The only potentially valid argument made by the creditors was under § 522(p), which capped the homestead exemption at $146,450 in cases where the debtor had acquired an interest in the property within 1,215 days of the petition date. Here, the conveyances occurred within a few months of the petition date triggering application of § 522(p), which code section the court found was equally applicable to transfers between spouses. However, the court also found that under § 522(m), § 522(p) applied separately with respect to each debtor in a joint case, thereby allowing the capped exemption amounts to be "stacked" by the debtors. Here, that would have entitled the debtors to a capped exemption of $292,900, which exceeded the amount claimed. Therefore, the objection was overruled.

### 20. Debtor entitled to a single personal injury exemption no matter how many accidents

Debtor had more than one personal injury claim pre-petition and sought to exempt for each injury claim the maximum federal statutory cap set forth in § 522(d)(11)(D) of $21,625. The trustee timely objected. The court sustained the court's objection. *In re Phillips*, 485 B.R. 53 (Bankr. E.D. N.Y. December 27, 2012). Judge Trust noted a split of authority on the issue of stacking the personal injury exemptions for multiple incidents and turned to the legislative history. He found that the legislative history created more confusion than clarity about congressional intent and failed to illuminate an answer to the problem. The court returned to a plain meaning analysis and read the exemption statute in light of § 102(7)(the singular includes the plural) and determined that the debtor could not exceed in the aggregate $21,625 no matter how many accidents and injuries debtor has suffered.

### 21. Unliquidated personal injury claim not exempt in Missouri

Debtors had a personal injury claim arising from an automobile accident. Under the law of their state, there was no statute specifically exempting an unliquidated tort claim. After filing Chapter 13, debtors amended their schedules to exempt the PI clam under state and common law. The trustee objected. The bankruptcy court disallowed the exemption, following circuit court precedent in *In re Benn*, 491 F.3d 811 (8th Cir. 2007). The Eighth Circuit Bankruptcy Appellate Panel affirmed, also following *Benn*. Debtor appealed to the Circuit Court supported by an amicus brief from NACBA that sought to have *Benn* limited to tax refunds, but the Eighth Circuit affirmed, ruling that as debtor's state had opted out of the federal bankruptcy exemptions, debtors were limited to their non-§ 522(d) exemptions. *In re Abdul-Rahim*, 720 F. 3d 710 (8th Cir. 2013). The court acknowledged that the trustee would have the ability in Missouri to seek more assets for creditors than a creditor outside of bankruptcy but held that until *Benn* was overruled by the *en banc* circuit court or by the Supreme Court, the decision remained binding. Moreover, it noted that the state had not amended the law in Missouri despite several years of opinions consistent with this case. The circuit court also rejected the debtors' reliance on *Butner v. United States*, 440. U.S. 48 (1979) which held that security interests were determined under state law. The circuit court observed that in *Butner*, the Supreme Court qualified its holding by stating that state law applied "[u]nless some federal interest requires a different result." Here, the circuit court noted that "the federal interest in balancing and promoting the multiple purposes of the Bankruptcy Code provides sufficient justification for why a bankruptcy trustee might have more remedies available to it than another Missouri creditor."

### 22. Debtors could not claim "tool of trade" exemption in company's truck

Debtor truck drivers had set up a corporation for the truck that they used at their business. Debtors were the sole owner of the corporation. When they filed their Chapter 7 petition, they sought to claim a "tool of trade" exemption in the truck that was owned by the corporation. The bankruptcy court sustained the trustee's objection to the

exemption claim. Judge Williamson held that the debtors could not "reverse veil pierce" in the absence of evidence that the corporate forum was used for a fraudulent or improper purpose. There was no evidence in the record of an improper purpose, since the ostensible purpose was for the debtors to own the truck that was used in the business. Moreover, the court concluded that the use of veil piercing in the manner sought by the debtors would injure their innocent creditors, who would receive $13,140.47 less in the case if veil piercing were allowed. *In re Checiek*, 492 B.R. 918 (Bankr. M.D. Fla. 2013)(Williamson, J.).

### 23. Property of the estate includes health savings account funds

The bankruptcy court held that the funds in debtor's health savings account were not excluded from the bankruptcy estate under § 541(b)(7)(A)(ii) and were not exempt. Debtor appealed to the Bankruptcy Appellate Panel, which affirmed. *Leitch v. Christians*, 494 B.R. 918 (8th Cir. BAP 2013). The Appellate Panel held that an HAS was not a health insurance plan regulated by state law and, therefore, was not excluded from the bankruptcy estate nor did the exemptions as set forth in § 522(d)(10)(C)and (11)(D) apply where the funds in the HAS could have been used for purposes other than "disability, illness, or unemployment" and also could have been used for purposes other than "personal bodily injury." The Appellate Panel also noted that these exemptions applied only to a debtor's "right to receive" the stated benefits, but in this instance, debtor had already received the money from his employer and there was no longer a "right to receive" the funds that were already in the account. Accordingly, the judgment of the bankruptcy court was affirmed.

### 24. Debtor's exemption planning unwound from § 522(o)

Judge Markell begins his opinion with the following: "All siblings fight. Rich siblings fight interminably." He then sets forth that debtor's sister obtained a state court judgment for $525,000 for, among other things, fraud and breach of fiduciary duty plus another judgment for approximately $518,000 representing attorney fees and costs incurred in obtaining the first judgment. The Colorado trial court had found that the debtor "lives in a different reality and has little capacity to perceive the actual reality." Debtor had liquidated over $400,000 in real estate and other investments within months of the entry of her sister's judgment, and then distributed the proceeds to family creditors and immediate family (other than her sister). This was done in a hurried fashion to put assets beyond the reach of creditors. The court determined to reduce the value of her allowed homestead exemption pursuant to § 522(o). *In re Stanton*, 457 B.R. 80 (Bankr. D. Nev. 2011). Judge Markell traced the history of the code section noting that it utilized the historic language of fraudulent conveyances – first drafted over 400 years ago under the Statute of 13 Elizabeth and that badges of fraud were relied upon to show the intent to hinder, delay, or defraud. He explained that a "badge of fraud" was a fact which made a transaction suspicious, thus calling for an explanation, and then outlined the 11 most commonly relied upon badges of fraud set forth in § 4(a) of the Uniform Fraudulent Transfer Act. He described debtor's actions as “hoary badges of fraud,” engaged in by debtors from time immemorial. The court rejected debtor's

uncorroborated testimony that she relied on the advice of others in making the transfers or that she was just taking reasonable actions in light of the economic climate of late-2008. Accordingly, her sister's motion was granted and the exemption limited.

## C. SECTION 544-551 AVOIDANCE ACTION

### (i) Preferences

#### 25. Mortgage payments to senior lienholders deemed preferential to undersecured junior lienholder

Within 90 days of their Chapter 7 petition, debtors made ten payments totaling $41,716.45 to the senior lienholder on their residence. These were catch-up payments as they had fallen behind. The residence itself was worth approximately $1.1 million which exceeded the claim of the senior mortgage but not the combined claims of the senior and junior liens, both held by Bank of America (BOA), rendering the BOA junior position as only partially secured. These payment transfers were applied to interest charges, late charges, a negative escrow balance, and miscellaneous charges, all of which would be secured under the senior note of BOA. Absent these payments, BOA's fully secured senior mortgage would have been greater by $41,716.45. The trustee filed a complaint to recover the transfers as preferences from BOA in its capacity as holder of the junior mortgage. The parties filed cross-motions for summary judgment. The court granted the trustee's motion with respect to the preference liability but continued the matter for an evidentiary hearing on the ordinary course defense. *In re Vassau*, 499 B.R. 864 (Bankr. S.D. Cal. 2013). Judge Bowie noted that the effect of the transfers was to reduce the amount of BOA's senior secured claim and correspondingly increase the value of its junior position on the Property. BOA defended by asserting that the trustee could not satisfy § 547(b)(1) or (5) because the transfers were not "to or for the benefit of a creditor" and did not enable it to receive "more than it would have had the transfer not been made." The court disagreed, finding that it was well established that the intent of the parties was irrelevant to the preference analysis. It merely required that the transfer actually benefit the creditor, following *In the matter of Prescott*, 805 F.2d 719, 723 (7th Cir. 1986). The court also found that the transfers satisfied the hypothetical test of § 547(b)(5), because they resulted in BOA's junior lienholder position receiving more in the Chapter 7 case than it would have received had the transfers not been made. The court finally rejected BOA's argument that the payments could only be preferential if made directly on the unsecured portion of the claim. The court found no support for such a distinction. [*Author's Comment*: This is an unusual but useful case. These were very large mortgages with high monthly payments. Most debtors in Chapter 7 would not be able to make such payments or afford such an expensive home. It is also unusual because the bank having to repay the trustee held both mortgages. In the chapter 11 context, there are numerous cases that hold payments to the senior lien to constitute adequate protection to the junior lien. This is seemingly the same general concept.]

### 26. Conduct does not become "ordinary" just by virtue of its repetition

At all relevant times, the debtors owned and operated four skilled nursing facilities in Connecticut. Affinity was the management company that exclusively managed, operated, oversaw, and did the billing for the other debtors. The debtors used a unified cash management system under the control of Affinity. When debtors began experiencing cash flow problems in 2005, they sought financing from third parties including the defendant, a medical doctor who had been the medical director for one of the debtors for several years. His employment had ended many years prior to the petition date. Beginning in May 2005, the defendant made unsecured loans to Affinity in a manner similar to a revolving line of credit out of several checking accounts over which the defendant had control. The loans were made because Affinity often faced a shortfall in its accounts during the course of a month, continuing until such time as it received Medicaid reimbursement payments from the State of Connecticut. The amount of the loans ranged from $100,000 to as much as $500,000 and were "informal" with no real terms. Defendant maintained a crude and incomplete handwritten log that was generally unintelligible to anyone but himself. The loans would be repaid by Affinity in full or in part by one or more checks a week or two later, after receipt of its payment from the State. Affinity would also pay an additional sum by separate check characterized as interest on the loans. No specific interest rate was agreed upon by the parties. Often at the same time repayments were received, additional loans were made. Following this practice, several hundred checks were exchanged between Affinity and the defendant. Notwithstanding the payments of interest, Affinity never prepared or sent to the defendant and/or IRS any 1099 tax reporting documents. Two checks totaling $200,000 and $10,000 were sought to be repaid as preferences. There was no indication that either check was intended to repay all or part of any particular outstanding loan.

Defendant primarily defended on the basis of the ordinary course of business exception. The court rejected that defense and granted summary judgment for the plaintiff, observing that conduct does not become "ordinary" for purpose of the exception just by virtue of its repetition. Here, the parties had failed to document the loans or the terms of their repayment, advances were not noted on debtors' books or records, and the rate of interest was determined, in what appeared to be, an arbitrary fashion at the time of repayment. This prevented the court from finding that the debts were ordinary, arms-length transactions notwithstanding the parties' history of engaging in more than a hundred such transactions. The court concluded that loans giving rise to this debt must meet a basic test of legitimacy and objective fairness; otherwise, loans that were patently illegal could be, if made in a consistent manner, regarded as being in the ordinary course of business. Additionally, the court determined that pre-judgment interest was necessary to compensate the estate for loss of the use of the funds. Here, the court awarded that interest at the federal, pre-judgment rate. *In re Affinity Healthcare Management, Inc.*, 499 B.R. 246 (Bankr. D. Conn. 2013)(Dabrowski, J.).

### 27. "New Value" does not have to remain unpaid

On Christmas Eve, the Third Circuit delivered a gift to preference defendants in *In re Friedman's Inc.*, 2013 WL 6797958 (3d Cir. Dec. 24, 2013). Here, the creditor

received payments during the preference period and provided "new value" after those payments were received. After the debtor filed for bankruptcy, the debtor received permission to pay the defendant for pre-petition unpaid services. A liquidating trust was established and the trustee sued the creditor for the payments received during the preference period. The liquidating trustee argued that the post-petition payments the creditor received offset creditor's new value thereby increasing the creditor's exposure.

The Third Circuit held that a post-petition transfer cannot be used to diminish a creditor's new value defense. The court based its conclusion on §547 as a whole noting that the petition date serves as the critical date for all other aspects of preference liability. The court held that the new value defense should be no different and the petition date serves as a hard stop for a new value analysis. While the court's holding is a boon for creditors, the court also noted that application of its holding also means that a court may not take into consideration "new value" a creditor gives a debtor after the bankruptcy petition. In short, preference liability and defenses are determined as of the petition date.

### 28. Pre-petition wire transfers related to returned checks not avoidable preferences

Stinson Petroleum Co. engaged in a check-kiting scheme using checking accounts they held with Community Bank and Bank of Evergreen. Stinson perpetrated the kite by depositing worthless checks into its account with Community that were drawn on its account with Evergreen while simultaneously depositing worthless checks into the latter that were drawn on the former. By circulating worthless checks between the two accounts, and by taking advantage of provisional credits that both banks extended to deposits not yet collected, Stinson created the impression of a positive account balance while substantial debt accrued. The scheme eventually collapsed. Evergreen was the first to uncover the kite, so it did not incur any losses. Community, unfortunately, ultimately determined that the kite created an overdraft of between $6 million and $7 million. Community agreed to receive two wire transfers worth $3.5 million from Stinson's Evergreen account to reimburse Community for the 18 checks Evergreen had returned to Community after the kite collapsed. After Stinson filed a Chapter 11 petition, the committee of unsecured creditors brought an adversary proceeding against Community to avoid the two wire transfers as preferences under § 547(b). The bankruptcy case was later converted to Chapter 7, and the trustee was substituted as the plaintiff in the lawsuit. Ultimately, both the bankruptcy court and district courts concluded that the wire transfers were not avoidable preferences. The trustee appealed, but the circuit court affirmed. *In re Stinson Petroleum Co., Inc.*, 506 Fed. Appx. 305 (5th Cir. 2013).

Community only disputed the trustee's claims under § 547(b)(5) relating to whether the creditor received more than it would have received upon liquidation under Chapter 7. The bankruptcy court had found (a) that because Community granted provisional credit to Stinson, Community held a perfected, first priority security interest in the 18 returned checks and their proceeds under Mississippi law, and (b) the trustee had failed to prove that the transfers were not intended to satisfy Community's security interest. Hence, the bankruptcy court had concluded that the wire transfers did not

deplete Stinson's bankruptcy estate nor improve Community's position relative to how the bank would have fared via Chapter 7. The district court observed that the trustee had the burden of proving that Community would have received less than $3.5 million via Chapter 7 liquidation, but concluded that the record contained "scant" evidence to that effect. The trustee argued that Community could not guarantee when and whether it would have received a new payment and thus the lower courts had erred for improperly assuming that Community would have received $3.5 million from Stinson via Chapter 7. However, the circuit court concluded that the lower courts were correct because it was the trustee who had failed to prove that Community would have received less than $3.5 million under Chapter 7.

### 29. Insolvency presumption not rebutted by book value nor repayments in the ordinary course

At issue in this case were three payments totaling $1,899,970.73 that were made by debtor Ames Dept. Stores to its supplier Cellmark Paper, Inc. for previously received paper shipments. Ames made the first payment on August 8, 2001, to pay off $700,000 of a $1,390,690.52 Cellmark invoice that was due on August 2, 2001, a second payment on August 10, 2001, to pay off the rest of that invoice, and a third payment on August 13, 2001, to pay off three separate Cellmark invoices that together were worth a total of $764,918.81. Two of those three invoices were scheduled to become due on August 15 and 16, 2001, including one that was not due until two days after payment was made. Ames filed for bankruptcy on August 20, 2001. The bankruptcy court held that Cellmark failed to rebut the presumption of insolvency and the payments were not in the ordinary course of the company's dealings. 450 B.R. 24. The district court affirmed. 470 B.R. 280. Cellmark further appealed to the circuit court which likewise affirmed stating: "The bankruptcy court has broad discretion when considering evidence to support a finding of insolvency." It found that the bankruptcy court did not clearly err by concluding that Cellmark failed to submit evidence sufficient to rebut the presumption of Ames' insolvency as evidence of the book value of Ames's assets, without more, would ordinarily be insufficient to establish solvency under the bankruptcy code, which is a concept based on the fair market value of the debtor's assets. The court noted that book value may be relevant in determining fair market value but would not compel the fact finder to draw an inference of solvency. Thus, it was not clearly erroneous for the bankruptcy court to have concluded that book value along with the other evidence cited by Cellmark was insufficient to support a reasonable finding of Ames's solvency. The court also determined that the bankruptcy court findings were not clearly erroneous with respect to the transfers not being in the ordinary course of the company's dealings. Ames had not previously made partial payments on an invoice, issued a lump sum check for several invoices, or paid an invoice early. Moreover, the invoice due August 2, unlike invoices for Cellmark, was manually prepared and out of numerical order. Cellmark's explanations for these differences were found by the bankruptcy court to be either unpersuasive or not credible, which findings the circuit court determined were not clearly erroneous. Accordingly, the judgment of the lower courts was affirmed. *In re Ames Dept. Stores, Inc.*, 506 Fed. Appx. 70 (2nd Cir. December 26, 2012).

### 30. Payment to materials supplier not a preference

The debtor subcontractor's pre-petition joint check agreement with the general contractor and materials supplier required the general contractor to make payments for materials payable jointly to the debtor and supplier. The agreement made the general contractor directly liable for the payments if the debtor failed to timely endorse the checks over to the supplier. During the preference period, the general contractor delivered to the debtor two checks that were made jointly payable to the debtor and the supplier. The debtor endorsed both checks and paid them over to the supplier which deposited them into its checking account. The Chapter 7 trustee commenced a preference action against the supplier to avoid and recover the two transfers. The supplier argued that the debtor had no interest in the funds and was a mere conduit for payment. The bankruptcy court agreed and granted summary judgment to the supplier because the trustee failed to establish that the payments were transfers of an interest of the debtor in property. *Novak v. CMC Joist and Deck (In re Steel Fab, Inc.)*, 2013 WL 65548, 2013 Bankr. LEXIS 700 (Bankr. D. Conn. 2013). Judge Dabrowski found that the transfer of an interest of the debtor in property occurred outside the preference period when the parties entered into the joint check agreement. It was at that time that the debtor gave up dominion and control over the receivables and the right to decide when and how to pay the supplier. The debtor no longer had an interest in the two transfers when it turned them over to the supplier. Explaining further, the court determined that under Connecticut's version of the UCC, a "holder" or someone who has the rights of a holder may properly present an instrument for payment. A "holder" is defined as a person in possession of a negotiable instrument that is payable either to bearer or to an identified person that is the person in possession. Possession required an "intent to control" so Debtor could not be a "holder" and had no property interest in the checks when they were delivered to the debtor by the general contractor.

## (ii) Fraudulent Conveyances

### 31. Ten-year reachback for debtor's pre-petition transfer of substantially all of his assets into self-settled trusts for his benefit

The debtor had been involved in real estate development and management in the Puget Sound area for over 40 years. However, he was required on many projects to sign as a guarantor in favor of third-party lenders, many of them local banks. To protect his assets in light of an increasingly bleak financial situation, debtor set up an asset protection trust, called the Donald Huber Family Trust ("Trust") which was established on September 23, 2008. One of its principal goals was to "protect a portion of [the debtor's] debts from [his] creditors." Debtor had also expressed urgency in setting up the Trust. Among the assets transferred into the Trust was $10,000 in cash, his ownership or membership interests in over 20 entities, including his residence, his daughter's residence, interests in several shopping centers, 13 development projects, and a few corporations. Debtor acknowledged receiving no consideration for the transfers. All of the assets in the Trust were located in Washington State except for a $10,000 certificate of deposit held in Alaska where the Trust had been established. The Trust generated for debtor $345,248 in discretionary beneficial income in 2010 and

$360,000 in 2009. Debtor filed a Chapter 11 petition on February 10, 2011. The court appointed an examiner to investigate the case which was later converted to Chapter 7. The Chapter 7 trustee brought an action to avoid the transfers into the Trust and he was granted summary judgment. *Waldron v. Huber (In re Huber)*, 493 B.R. 798 (Bank W.D. Wash. 2013)(Snyder, J.).

Although Alaska recognizes self-settled asset protection trusts, Washington State does not. The court noted that under the Restatement Second of Conflict of Laws 1971 (Restatement), debtor's choice of Alaska law designating the Trust should be upheld if Alaska had a substantial relation to the Trust as indicated by (1) whether the trustee or settlor was domiciled in the state, (2) whether the assets were located in the state, and (3) whether the beneficiaries were domiciled in the state. Here, none of those criteria existed for Alaska law to be applicable. Instead, the assets, the creditors, and the debtor and other beneficiaries were all in Washington State which has a strong public policy against self-settled asset protection trusts and provides that they are void against existing or future creditors. Therefore, the court declared those transfers of assets into the Trust as void.

Section 548(e)(1) allows the trustee a 10-year reachback for avoiding transfers of interest of the debtor in property if (a) such transfer was made to a self-settled trust or similar device, (b) such transfer was by the debtor, (c) the debtor is a beneficiary of such trust or similar device, and (d) the debtor made such transfer with the actual intent to hinder, delay, or defraud…. The court determined that five badges of fraud were present supported by evidence submitted by the trustee. First, at the time the debtor transferred his assets into the Trust there was threatened litigation against the debtor. Next, debtor transferred all or substantially all of his property into the Trust. Next, debtor had significant indebtedness at the time he transferred the assets into the Trust. Next, debtor acknowledged that he was both the trustee and beneficiary of the Trust. Finally, debtor had effectively retained the property transferred into the trust, continuing to reside in a Trust asset and receive some $14,500 per month in trust income, which went toward his personal expenses, loan payments, cash, education expenses for his family, and payments to his former spouse, all at the expense of his creditors. The court found that the only reasonable conclusion was that the debtor continued to use and enjoy the Trust assets just as he did before the transfers. Debtor had argued that the Trust was created merely for estate planning purposes. However, the court found that the facts surrounding its creation and the timing of the asset transferred supported a finding of a motive other than estate planning: asset protection at the expense of his creditors. The court also found that they were not mutually exclusive. The goal of estate planning can exist independent of the actual intent to hinder, delay, or defraud creditors. Therefore, summary judgment was granted to the trustee.

### 32. Trustee cannot stand in shoes of IRS and assert its ten-year reachback for avoidance of fraudulent transfers

The trustee sought to avoid a number of transfers that had occurred more than four years before commencement of the bankruptcy case. The trustee asserted that § 544(b) permitted her to invoke the statute of limitations available to any unsecured creditor of the estate, including the IRS. Since Internal Revenue Code § 6502 provided a ten-year statute of limitations for collection of taxes by the IRS, trustee contended that

she should be entitled to recover those fraudulent transfers made within ten years of the petition date. The court recognized substantial support for the trustee's position (see, e.g., *In Porras*, 312 B.R. 81, 97 (Bankr. W.D. Tex. 2004)(ten-year look back period available to trustee so long as IRS is an unsecured creditor of the estate); *In re Republic Windows & Doors, LLC*, 2011 WL 5975256 (Bankr. N.D. Ill. 2011)(same); *In re Polichuk*, 2010 WL 4878789 (Bankr. E.D. Pa. 2010)(same); *In re Greater Southeast Community Hosp. Corp. I*, 365 B.R. 293, 304 (Bankr. D. Dist. Col. 2006)(same); *In re Emergency Monitoring Technologies, Inc.*, 347 B.R. 17, 19 (Bankr. W.D. Pa. 2006)(same); and *In re G-I Holdings, Inc.*, 313 B.R. 612, 635 (Bankr. D. N.J. 2004)(trustee allowed to use the ten-year look back period available to a federal environmental agency). The ten-year period is a reflection, as noted by the court, of the ancient principle that "no time runs against the king." Here, the court believed that the distinguishing circumstance was that no public rights or interests were involved. "The Court does not believe that Congress, by enacting Section 544(b) intended to vest sovereign powers in a bankruptcy trustee and thereby immunize her from the strictures of state law in the pursuit of her private interests." Further, the court held that § 544(b) was meant to incorporate state law and not to subordinate it. On the basis of the foregoing, the court would not allow the ten-year reachback period to be utilized by the trustee. *In re Vaughan Co.*, 498 B.R. 297 (Bankr. D. N.M. 2013)(Jacobitz, J.).

### 33. LLC owned by individuals who participated in fraudulent transfer could not "wash" transaction through judgment lienholders

The Radabaughs were the owners of the debtor LLC and also the LLC that was the plaintiff in the subject lawsuit. Prior to the filing of an involuntary petition against the debtor LLC, the debtor had fraudulently transferred two parcels of real estate to Ms. Radabaugh. The trustee successfully avoided those transfers pursuant to § 548 and subsequently sold the transferred property for $142,000. An adversary proceeding was filed to determine the entitlement to the sale proceeds. At the time of the fraudulent transfer, there were a number of unsatisfied judgments against Ms. Radabaugh, and those judgments immediately became liens upon the fraudulently conveyed real estate. Just two days after the trustee filed a motion to sell the recovered properties, the judgments were assigned to the plaintiff LLC owned by the Radabaughs, which then claimed a lien upon and entitlement to the net sale proceeds. Because the plaintiff LLC was a subsequent transferee, it asserted entitlement to the "good faith transferee" defense in §550(b), arguing that as assignee of the judgment lienholders, it succeeded to their protected status as good faith transferees. The court disagreed because (a) they gave nothing of value in return for their liens, which simply sprang into existence by operation of law when Ms. Radabaugh acquired the property, (b) the plaintiff LLC was not a good faith transferee under the oft cited holding of *Bonded Financial Services, Inc. v. European American Bank*, 838 F.2d 890 (7th Cir. 1988), and (c) the legislative history to the section specifically stated that "washing" a transaction through an innocent third party could not qualify the transferee as one in good faith. "In order for the transferee to be excepted from liability under this paragraph, he himself must be a good faith transferee." A transferee lacks good faith if he possessed enough knowledge of the events to induce a reasonable person to investigate the avoidability of the transaction. Here, the court found that plaintiff LLC failed to prove it qualified as a good faith

transferee. Rather, the opposite had been demonstrated that it was little more than an attempt at "washing" a fraudulent transfer through third parties so that the fraudulent transferee could try to keep its ill-gotten gains. *In re J.T. Real Estate Investments, LLC*, 498 B.R. 869 (Bankr. N.D. Ind. 2013)(Grant, J.).

### 34. Notice of debtor's precarious financial conditions insufficient to support "collapsing" of fraudulent transfers

Trustee sought to collapse multi-step transaction into one and hold all recipients liable for the transfers. The Second Circuit held that the initial transferee can be held liable in a collapsing transfer only if: "(1) the consideration received from the first transferee is re-conveyed by the debtor for less than fair value or with the actual intent to defraud creditors, and (2) the transferee in the leg of the transfer sought to be avoided had actual or constructive knowledge of the entire scheme. . . . " The trustee alleged that the defendants had knowledge of the debtor's precarious financial condition at the time the transfers were made. The Second Circuit held this knowledge to be insufficient to hold the defendants liable. *In re Fabrikant & Sons, Co.*, 2013 WL 5614238 (2d Cir. Oct. 15, 2013).

### 35. Trustee may avoid transfers made pursuant to a separation agreement

Prior to bankruptcy debtor and husband divorced and entered into a separation agreement, which divided their assets. Debtor retained her pension (approximately $18,000) and assumed $28,000 of a loan from her parents, and $60,000 in credit card debt mostly incurred during the marriage and for the household. Husband retained the home which was encumbered by a $50,000 mortgage and worth $77,500.

The trustee sought to avoid the transfers in the separation agreement. Trustee argued that debtor received less than reasonably equivalent value for the transfers to the husband and the assumption of the marital debt. The bankruptcy court ruled in the trustee favor's and ordered the husband to pay half of (i) the value of the credit card debt; (ii) the loan from the debtor's parents; and (iii) the surplus the husband received in the exchange for the pension for the home. On appeal the BAP reversed holding that the debtor did not confer a benefit on husband when she assumed the debt because there was no evidence that the husband ever was contractually obligated on the debt. The BAP affirmed the award for the surplus that the husband received from the exchange of debtor's interest in the pension for the interest in the home. The 6th Circuit reversed. *In re Neal*, 2013 WL 5734120 (6th Cir. Oct. 23, 2013).

The court of appeals held the assumption of an ex-spouse's interest in marital debt that is joint debt only by virtue of marital law may constitute a fraudulent transfer. The court rejected the BAP's holding that a non-marital contractual relationship must be present in order to confer a benefit on the husband. In other words, "it simply does not matter that Defendant was not liable for the debt under non-marital law."

### 36. Spinoff as fraudulent transfer

The decision in *In re Tronox Inc.*, 2013 WL 6596696 (Bankr. S.D.N.Y. Dec. 12, 2013) is a very long opinion and worthy of a careful read. In brief, Kerr-McGee had an otherwise viable oil and gas business except for the fact that it was faced with very large environmental liabilities that had accumulated over decades. Tired of seeing earnings swallowed by these liabilities, Kerr-McGee entered into a transformative revamp of its corporate structure. Specifically, it created a new company where it put the good oil and gas subsidiaries. The new company was called, Kerr-McGee and was sold for $16 billion. The old Kerr-McGee became the ill-fated Tronox, which had a fairly small chemical business and the absolutely staggering environmental liabilities. Tronox got *nothing* for giving up its subsidiaries. Further, despite a detailed analysis, it still is not clear exactly how these transactions occurred. On some level, it is as if Kerr-McGee simply spoke the transaction into existence. As expected, little Tronox could not survive and entered into bankruptcy. Unsurprisingly, these transactions were challenged and the bankruptcy court had no problem finding these transactions to be fraudulent as both actual and constructive fraudulent transfers. The proffered defense was that Tronox could not be insolvent because it was spun off in a public offering that resulted in a payment to Kerr-McGee. The bankruptcy court, however, suggests that the prospectus filed with the public offering was suspect at best and could not be trusted.

### 37. The Seventh Circuit reverses itself on the standard for actual fraud

In previous editions, we took you down the strange road of *In re Sentinel Mgmt. Group*, an investment advisor that collapsed in 2007. The trustee alleged that the collapse occurred due to a massive fraudulent scheme, which included the Bank of New York Mellon – specifically, the removal of customer money out of segregated accounts and the pledging of those funds to the Bank. The district court ruled against the trustee on his actual fraud claims and the Seventh Circuit affirmed.

In the new opinion, the court rejected the district court's conclusion that because Sentinel "robbed Peter (Sentinel's … clients to pay Paul (the Bank of New York)" in "a desperate attempt to stay in business" that the transfers were not made with actual intent to delay, hinder, or defraud. Instead, the Seventh Circuit held that when Sentinel pledged the funds that were supposed to remain segregated for its customers, it should have seen that the natural consequences of this action would be to expose its customers to a substantial risk of loss of which they were unaware, in violation of its obligation pursuant to the Commodity Exchange Act. *In re Sentinel Mgmt. Group, Inc.*, 2013 WL 4505152 (7th Cir. Aug. 26, 2013).

### 38. Trustee obtains equitable lien on property fraudulently transferred

The bankruptcy court found that the undisputed facts in the case fit a classic pattern of fraudulent transfer activity. The debtor was engaged in litigation with his former business partner for nearly a decade, and just when that lawsuit appeared to be heading toward a judgment against him, the debtor transferred nearly all of his properties to a close friend/girlfriend with whom he had been living for several years. His

girlfriend then sold some of the property the debtor had transferred to her and invested in an unencumbered homestead property in Sarasota, Florida purchased for $650,000.00. The debtor's girlfriend was the functional equivalent of an insider, and he did not receive reasonably equivalent value for the transfers. Additionally, he continued to reside with his girlfriend after the transfer retaining at least some control thereof. Judge Williamson noted that since actual fraud was seldom proven by direct evidence, it often had to be proven through circumstantial evidence established by certain "badges of fraud" adopted by the Eleventh Circuit. Here, multiple badges of fraud were found to exist to justify a finding of actual intent to hinder, delay, or defraud and thus, summary judgment was granted to the trustee. In Florida, where property, including homestead property, was obtained through ill-gotten proceeds, equitable liens could be imposed by the courts. The court found that debtor was reaping the benefits of the fraudulent transfers by living in the Sarasota, Florida property that his girlfriend had purchased with the proceeds from the Debtor's fraudulent transfers. Therefore, the court also imposed an equitable lien against the property in favor of the Trustee. *In re Bifani*, 493 B.R. 866 (Bankr. M.D. Fla. 2013)(Williamson, J.)

### 39. "Flexibility and Time" sufficient benefits to satisfy reasonably equivalent value

The debtor was an S corporation and therefore its shareholders were responsible for paying the taxes on the debtor's income. The debtor's shareholder agreement also provided that if the debtor's income becomes taxable to the shareholders then the corporation must pay an annual dividend sufficient to allow each shareholder to cover their portion of the corporation's income tax. Pursuant to the terms of the shareholder agreement, the corporation made a dividend to defendant for approximately $94,000.

The trustee brought a fraudulent transfer action claiming that the debtor received no reasonably equivalent value for the dividend. The Eleventh Circuit disagreed. *In re Northlake Foods, Inc.*, 2013 WL 1603442 (11th Cir. Apr. 16, 2013). The court held that in return for reimbursing defendant for his payment of the taxes, the debtor was able "to shift to S-corporation status whenever it determined it was advantageous to do so" and "enjoyed the added benefit of freeing up cash that otherwise would have been dedicated to paying its tax liability." In other words, the arrangement "provided [the debtor] with two valuable benefits: flexibility and time."

### 40. Non-compensatory tax penalties and fines not avoidable as fraudulent transfers

The Chapter 11 debtor sought to recover pre-petition tax penalty payments in the amount of $637,652.07, arguing that the imposition of the penalty payments provided no value to the debtor, the debtor did not receive reasonably equivalent value in exchange for the penalty payments, and debtor was insolvent when the payments were made. The bankruptcy court disagreed and was affirmed by the 6th Circuit Bankruptcy Appellate Panel. Thereafter, the debtor appealed to the Sixth Circuit Court of Appeals, which also affirmed. *In re Southeast Waffles, LLC*, 702 F.3d 850 (6th Cir. 2012). The Circuit Court noted that a dollar-for-dollar reduction in debt typically constituted, as a matter of law, reasonably equivalent value in the application of fraudulent transfer

statutes. Indeed, the Circuit Court was unable to find a single case in which legitimate pre-petition tax penalties (or pre-petition payments made in relation thereto) had ever been avoided as fraudulent transfers. The Circuit Court observed that when Congress enacted the Bankruptcy Code, it specifically addressed non-compensatory penalties and carefully differentiated treatment of such penalties in other contexts within the Code, but they were not addressed in § 548, which the Circuit Court found significant. The Court supported its decision with this quote from a prior Supreme Court opinion:"

### 41. Pre-petition tax sale may constitute a fraudulent transfer

After the debtor failed to pay his real estate taxes, the township conducted a public tax sale. The successful bidder then assigned its lien and tax sale certificate to a third party, who eventually filed a foreclosure action in state court. The debtor failed to redeem the property and the holder of the certificate obtained a judgment which enabled him to obtain title to the property.

After filing bankruptcy, the debtor sought to void the judgment conveying title as either a preference or fraudulent conveyance. The defendant filed for summary judgment, which was denied. *In re Berley Associates, Ltd.*, 492 B.R. 433 (Bankr. D.N.J. 2013). In doing so, the court held that the price received at a public tax sale does not automatically qualify as reasonably equivalent value for the underlying real property, distinguishing between a tax sale and mortgage foreclosure. The court noted that the public bidding component of the sale occurred only with the sale of the tax certificate and not with the transfer of the property's title. The court also noted that the value of the tax certificate was fixed and consequently the only bidding that actually occurred is in connection with the underlying interest rate, where the lowest bid wins. Consequently, the court found that this type of public sale does not necessarily reflect the true value of the underlying property. *Accord, In re Varquez*, 502 B.R. 186 (Bankr. D. N.J. 2013), *In re Smith*, 501 B.R. 843 (Bankr. N.D. Ill. 2013), *City of Milwaukee v. Gillespie*, 487 B.R. 916, 920 (E.D. Wis. 2013), and *In re Murphy*, 331 B.R. 107, 120 (Bankr. S.D. N.Y. 2005).

### 42. TOUSA – Eleventh Circuit reverses district court and holds lenders liable as transferees of fraudulent transfers

Debtors operated a homebuilding enterprise (TOUSA) with subsidiaries which owned most of the assets of the enterprise and generated nearly all its revenue. TOUSA borrowed unsecured debt that was guaranteed by the subsidiaries and also borrowed funds under a revolving line of credit secured by liens on the assets of the companies. After the downturn in the housing market, TOUSA paid a settlement of $421 million to a new lender who was funding a joint venture in Florida. To fund this settlement, TOUSA and some subsidiaries incurred additional loans, secured by first and second priority liens on the assets of the subsidiaries and TOUSA. Six months later, TOUSA and the subsidiaries filed for bankruptcy. The official committee of unsecured creditors claimed that the subsidiaries' transfer of the liens to these new lenders to fund the settlement was a fraudulent transfer under section 548(a)(1)(B). The committee argued that the subsidiaries were insolvent or made insolvent by the transfer, had unreasonably small capital, or were unable to pay their debts when due,

and they did not receive reasonably equivalent value in exchange for their transfer. The committee sought to recover the payment of the $421 settlement to the Florida lender as the entity for whose benefit the transfer was made. The bankruptcy court avoided the transfer as fraudulent and the district court quashed the ruling. The Eleventh Circuit reversed and remanded the district court order. *Senior Transeastern Lenders v. Official Comm. of Unsecured Creditors (In re TOUSA, Inc.)*, 680 F.3d 1298 (11th Cir. 2012).

The Eleventh Circuit held that the bankruptcy court did not err when it found that the subsidiaries did not receive reasonably equivalent value in exchange for the liens. The court declined to decide whether the possible avoidance of bankruptcy can confer value, because the bankruptcy court found that the benefits of the transaction were not reasonably equivalent in value to what the subsidiaries surrendered, noting this was a question of fact. Further the court found evidence of avoidance or delay of bankruptcy irrelevant because the transaction was still the more harmful option and at most delayed the inevitable. The Eleventh Circuit also held that the bankruptcy court did not err when it ruled that the transferee lender was an entity for whose benefit the liens were transferred. The court noted cases holding that a creditor similarly situated to the transferee lender could be liable as an entity for whose benefit a transfer was made under section 550(a)(1). The court also dismissed concerns that such a reading of section 550(a) would drastically expand which entities could be liable for a transaction, noting that "every creditor must exercise some diligence when receiving payment from a struggling debtor. It is far from a drastic obligation to expect some diligence from a creditor when it is being repaid hundreds of millions of dollars by someone other than its debtor." The Eleventh Circuit, therefore, reversed and remanded to the district court.

### 43. Trust fund liable for fraudulent transfers because it received property as debtor's nominee

The U.S. government brought both actual and fraudulent transfer claims to collect taxes owed by defendant. On remand from the Second Circuit, the district court was directed to reconsider its findings regarding whether certain conveyances by defendant to a trust created by him for the benefit of his sons were actually fraudulent and whether the trust was defendant's alter ego or held property as his nominee. Around the time of learning that he owed approximately $700,000 in tax liability due to a series of tax shelters, defendant set up a trust with his sons as the named beneficiaries and transferred $220,000 and his primary residence to the trust.

While the district court had originally held that the transfers were not actually fraudulent because (1) defendant remained solvent and (2) his primary motives for creation of the trust were to prevent his estranged wife from reaching the assets and to engage in estate planning (and avoid the estate tax), the Second Circuit held that (1) a finding that the transfers did not leave defendant insolvent did not preclude a finding that the transfers constituted actually fraudulent transfers, and (2) for nominee and alter ego findings, the critical issue is not motive, but control. The district court on remand held that defendants transfers to the trust were actually fraudulent, finding the following badges of fraud: (1) the transfers made collection efforts much more difficult; (2) his debts likely exceeded his available assets; (3) he was well aware of his mounting liabilities; (4) he engaged in a pattern or series of transactions or course of conduct after

incurring the debt that establish his intent to impair the IRS's collection; and (5) he maintained the benefits of ownership of his primary residence after he transferred it to the trust for no consideration.

The district court on remand also found the real property transferred to the trust to be nominee for defendant based on the following factors: (1) the trust paid no consideration for the property; (2) the trust was created and property transferred in anticipation of defendant's liabilities; (3) defendant remained in possession and control of the property; (4) defendant had a close relationship with the trustees, having selected close friends and associates to manage the trust; and (5) defendant retained and enjoyed possession and control over the property. *United States v. Evseroff*, No. 00-06029, 2012 WL 1514860 (E.D.N.Y. 2012)

### 44. Debtor de facto owner of accounts titled in subsidiaries' name – transfers were fraudulent

The trustee brought fraudulent transfer claims against defendant insiders of the debtor. The bank accounts from which the transfers were made were not titled in the debtor's name and, instead in the name of related subsidiaries. The debtor, however, had the ultimate power to transfer the funds. The bankruptcy court found that the transfers were fraudulent and the district court affirmed. The district court determined that the debtor was the de facto owner of the accounts through which the transfers passed. The Fifth Circuit affirmed. *De la Pena Stettner v. Smith (In re IFS Fin. Corp.)*, 669 F.3d 255 (5th Cir. 2012).

The court found that although the debtor did not legally own the accounts, the debtor had an intent to defraud by attempting to avoid a paper trail. Any money in the account was effectively the debtor's. Further, the court looked to Texas law to determine that the legal title holder is not always the owner of an account and that control is a predominate factor, including in the context of the avoidability of preferential transfers. Regardless of legal title, the debtor had the ultimate power to transfer funds and obscured that power in an intentionally complicated corporate structure. The court found that these facts suggested that control was decisive and that legal title was irrelevant. The court did note that this was a fact-based inquiry and control may not always be decisive. Although the subsidiary that owed the account was distinct from the debtor, the debtor dominated the subsidiary to such an extent that the subsidiary acted at the debtor's direction and the directors and stockholders used the corporate entity to perpetrate a fraud.

### 45. Trustee could recover entire annual charitable contribution

Debtors had made 32 charitable contributions to the defendant in 2008 and 2009 which exceeded in the aggregate 15% of gross annual income. Defendant's defense was that the payments should not be considered in the aggregate, and if they were considered in the aggregate, only the amount that exceeded the 15% safe harbor amount in § 548(a)(2) could be recovered. The bankruptcy court held that the payments were considered in the aggregate but the trustee could recover only the amount in excess of the 15% of GAI. *In re McGough*, 456 B.R. 682 (Bankr. D. Colo. 2011). That

ruling was affirmed by the Bankruptcy Appellate Panel at 467 B.R. 220 (10th Cir. BAP 2012). The trustee further appealed. The circuit court reversed. *Wadsworth v. The Word of Life Christian Center (In re McGough)*, 2013 WL 6570853 (10th Cir. Dec. 16, 2013). It agreed with the only other decision on the issue, *In re Zohdi*, 234 B.R. 371 (Bankr. M.D. La. 1999), which held that when a transfer exceeded 15% of the debtors' GAI, the plain language of § 548(a)(2) subjected the entire transfer to avoidance. Accordingly, it reversed the lower courts. [*Author's Comment:* We highlighted the lower court opinions (and disagreed with them) when they were issued. We contrasted the lower court rulings to § 547(c)(8) and (9) where the trustee is limited on consumer debts to transfers in excess of $600 and in non-consumer debts of $5,850. The case law on those provisions has held for many years that the entire amount in the aggregate is recoverable once those thresholds are exceeded. *See, e.g. Western States Glass Corp. of Northern California v. Barris (In re Bay Area Glass, Inc.)*, 454 B.R. 86 (9th Cir. BAP 2011)("When Congress intends to limit avoidance to only a portion of a particular transfer, it knows how to do so.") The lower court ruling here was inconsistent with that analysis, but upon this reversal these cases are now in harmony.

### 46. No cap on avoidance up to the amount of "unpaid creditor claims"

A Chapter 11 debtor filed a fraudulent conveyance complaint, alleging that a transfer of assets in a spin-off was an intentional or constructive fraudulent conveyance under sections 548 or 544(b). The defendant transferee argued that section 550(a) capped the debtor's recovery at the amount of "unpaid creditor claims" in the case. The transferee argued that the phrase "for the benefit of the estate" imposes a cap on its liability as a transferee at the aggregate claims of the creditors who would be benefited by the litigation. The bankruptcy court held that the plain words of the statute created no such cap on recovery and the estate is not limited to the interests of creditors. In addition, benefit to the estate is given a very broad construction and includes both indirect and direct benefits. According to the court, once an avoidance action created some benefit for creditors, section 550 was satisfied – section 550 does not say "to the extent of benefit to the estate." Any other limits on recovery had to be found elsewhere in the law. The court therefore denied the transferee's motion for summary judgment. But the court also determined that the debtor was not correct that there were no limits on recovery other than the value of the property. The court could reduce recovery by the value of consideration paid, the value of any improvement to the property, etc. Therefore, the amount of damages would be determined after trial of all issues. *Tronox Inc. v. Anadarko Petroleum Corp. (In re Tronox Inc.)*, 2012 Bankr. LEXIS 120 (Bankr. S.D.N.Y. 2012). [*Author's Comment*: Compare to *Rahmi v. Trumble*, 464 B.R. 710 (N.D. W. Va. 2012) where creditor unsuccessfully argued it was a breach of fiduciary duty to sell more "property than was necessary to satisfy the creditors."]

### (iii) Other Avoidance Actions

#### 47. Salary paid by company to debtor's wife for work performed by debtor held fraudulent

The Chapter 7 trustee commenced an adversary proceeding against debtor and his non-debtor spouse, among others, to recover avoidable transfers as fraudulent. Debtor had been hired by Airpack in 2002 after an extensive career in the freight forwarding industry. He executed a non-compete agreement but quickly violated it by beginning his own business as a sole proprietorship using the name MacPack. When Airpack discovered this violation, it terminated his employment. Thereafter, an LLC was formed under the name MacPack, L.L.C. listing debtor's wife as the principal member, although she had little prior experience in the industry and the court found no credible evidence of any actual investment by her to support her listed ownership. In fact, debtor acted as the principal person in the business although his title was held out to be at various times General Manager or consultant. The court found the arrangement was purposely constructed so it would appear that debtor was not the person participating in competition with Airpack through the LLC. The arrangement was also made so that debtor would receive no income from the LLC that Airpack as a judgment creditor could attach. Instead, all income or salary due to the debtor was paid to his spouse for the work that he had performed. The court found that the misdirection of income was a transfer of valuable rights from the debtor to his spouse without receipt of fair consideration or reasonably equivalent value and was part of an intentional act to defraud creditor Airpack by transfer of the debtor's assets into MacPack LLC. The trustee had also tried to extend the period that he could recover these transfers beyond the statutory state law period in Maryland under the Maryland and common law "discovery rule" by which a cause of action is deemed to accrue only when a plaintiff in fact knows or reasonably should have known of the wrong. However, the court found that the trustee derived his standing under § 544(b) through Airpack who should have known about these transfers. Therefore, the discovery rule was not applied. *In re McLean*, 498 B.R. 525 (Bankr. D. Md. 2013(Keir, J.). [*Author's Comment*: Compare *In re Coady*, 588 F.3d 1312 (11th Cir. 2009) where the individual debtor's discharge was denied for failure to disclose his equitable ownership interest in his "wife's business," that he effectively operated for no compensation while she maintained his luxurious lifestyle.]

#### 48. Trustee avoids mortgages under his strong-arm powers

The security deeds at issue were on single-family homes in Georgia. Under Georgia's recording statutes, a deed could be admitted to record only if it contained the attestation of two witnesses to the grantor/borrower's signature, one of whom was an official witness. Two cases by the same trustee before the same judge have resulted in clarification of the law in Georgia. In both cases, the trustee sought to avoid the security deeds using his strong-arm powers as a bona fide purchaser under § 544(a)(3). In one case, the security deed lacked any witnesses attesting to the validity of the debtor's signature. In the other case, the security deed had one official witness but no unofficial witness. In both cases, the security deed holders argued that because the security

deeds were actually recorded, there could be no bona fide purchaser as constructive notice was provided. The trustee argued that the security deeds could not be "duly" recorded, filed, and indexed as required by state statute if they were not in the proper, legal form. An additional defense in the second case was that a waiver of borrower's rights and other riders to the security deed contained all the proper attestations and were incorporated into the security deed itself. The bankruptcy court ruled in favor of the trustee in both cases and ordered the security deeds avoided. *Gordon v. U.S. Bank, Nat'l Ass'n* (*In re Hagler),* 429 B.R. 42 (Bankr. N.D. Ga. 2009) and *Gordon v. Wells Fargo Bank, N.A.* (*In re Codrington),* 430 B.R. 287 (Bankr. N.D. Ga. 2009). Each lender appealed to the district court. The district court certified to the Georgia Supreme Court in *Hagler* the question of whether there was constructive notice where the deed was recorded even though it had no attesting witnesses. The Georgia Supreme Court answered unanimously that there was no constructive notice, so the District Court ruled in favor of the trustee. *U.S. Bank Nat'l Ass'n v. Gordon*, 289 Ga. 12 (2011). The district court then ruled in favor of the trustee in *Codrington*. The lender further appealed that case to the Eleventh Circuit Court of Appeals. The Circuit Court then certified to the Georgia Supreme Court two questions: whether the properly executed and attested riders were sufficient to cure the defects and provide constructive notice and, if not, whether inquiry notice was separately provided by the recording of those documents. The Georgia Supreme Court answered unanimously that neither constructive notice nor inquiry notice was provided. *Wells Fargo Bank, N.A. v. Gordon*, No. S12Q2067, 2013 Ga. LEXIS 158 (2013). *[Author's Note*: Efforts by trustees to avoid mortgages with alleged defects receive mixed results. This is in part because the cases turn on applicable state law which varies widely in terms of what constitutes a fatal defect and other issues of state law. Even where there is a potentially fatal defect, state law may provide other defenses that can rescue the lender from its own mistakes.]

### 49. Georgia choice of law rules determine what law is applied to trustee's strong-arm fraudulent transfer avoidance claims

The plan trustee of a confirmed Chapter 11 plan sought to recover, as fraudulent transfers under state law, the "fictitious profits" that the defendants received on their "investments" in a Ponzi scheme in which debtor and its affiliates had been engaged. It was undisputed that under Georgia law, defendants would have received $68,600.88 in fraudulent transfers. However, defendants contended that Louisiana law governed this proceeding and that the applicable period of limitations under that law had expired before the filing of the Chapter 11 petitions. Defendants had made their initial investment in Louisiana, but the headquarters office of the debtors was in Atlanta, Georgia, and checks were drawn on the debtors' Georgia bank, although they were deposited in their Louisiana bank. Defendants argued that most of the activity surrounding their investments and contacts between the parties occurred in Louisiana. The trustee contended that under Georgia's choice of law rules, Georgia law applied and, alternatively, that the most significant contacts between the parties occurred in Georgia. The court agreed with the trustee and applied Georgia law and entered judgment against the defendants. *In re International Management Associates, LLC*, 495 B.R. 96 (Bankr. N.D. Ga. 2013) (Bonapfel, J.). The court performs an extensive analysis of case law on this issue, including cases with the United States Supreme Court, Fifth

Circuit Court of Appeals prior to the formation of the controlling Eleventh Circuit, and Eleventh Circuit cases as well. The court concluded that the forum states' choice of law rules should be applied in bankruptcy proceedings when bankruptcy jurisdiction existed under § 1334 and the underlying rights and obligations of the parties were defined by state law. Although § 544(b) is a federal bankruptcy law, it depends wholly on state law. Further, the court determined that the rights and obligations of the parties in a fraudulent transfer action depended on the operation of non-contractual rules and may result in consequences quite different from those that the parties contracted for. Therefore, the court found that the claim more closely resembled a tort matter than a contractual one. In tort cases, Georgia's choice of law rule is the rule of *lex loci delicti*, which requires application of the substantive law of the place where a tort or wrong occurred. Georgia follows the general rule that the location of a tort is the place in which the last event necessary to make an act liable for an alleged tort occurs. Here, the transfer of funds to the defendants occurred in Georgia when the drawee bank honored the checks in favor of the defendants. Therefore, Georgia law was applied and judgment entered against the defendants.

### 50. Trustee loses strong-arm avoidance action against mortgage lenders

The trustee argued that the two mortgages in question violated Section 11 of the Illinois Conveyances Act by failing to state the interest rate and maturity date on the face of the mortgage, thus arguing that the mortgages did not give constructive notice to subsequent bona fide purchasers. The bankruptcy court entered judgment for the trustee, but on appeal, the U.S. District Court reversed and remanded. *The Gifford State Bank v. Jeffrey D. Richardson (In re Crane)*, 487 B.R. 906 (C.D. Ill. 2013). The district court found that Section 11 used the word "may" and did not actually require mortgage documents to include an interest rate or maturity date. Rather, it was providing a safe harbor clause, whereby a mortgagee who deviated from Section 11 risked losing automatic protection from a challenge, but if a mortgage did not include all of the factors set out in Section 11, it did not necessarily fail to provide constructive notice. The court further noted that even if Section 11 did require an interest rate and a maturity date to be stated on the face of the mortgages, these mortgages were sufficient because they incorporated the promissory notes by reference which provided those terms. By having constructive notice, the trustee was not a bona fide purchaser and could not prevail under § 544(a)(3).

### 51. Mortgage valid despite trustee's "split-note" challenge

The trustee argued that there had been a split between the Note and Mortgage thereby nullifying the Mortgage and rendering the Note unsecured because on the petition date, Fannie Mae held the Note and MERS held the Mortgage. Like most states, the law in Wyoming provides that a transfer of a note carries with it the mortgage security and operates as an equitable assignment of the mortgage, unless it is agreed otherwise. When the note and mortgage are split, as a practical matter, the note becomes unsecured. The trustee further argued that the Mortgage was ineffective because of the failure to record the assignment to Fannie Mae. The bankruptcy court ruled against the trustee. On appeal, the Bankruptcy Appellate Panel affirmed. *(In re*

*Trierweiler*, 484 B.R. 783 (10th Cir. BAP December 28, 2012). The BAP concluded that the Mortgage naming MERS as Mortgagee on behalf of the lender was valid when granted and properly recorded prior to the petition date. Thus, the trustee had constructive knowledge of the Mortgage and could not avoid it. Moreover, the Court held that at all times the Note and Mortgage were united with no invalidating split when the loan transaction closed or when the Note was later assigned to Fannie Mae. As to the unrecorded assignment, the court relied on an earlier decision from the Eleventh Circuit Court of Appeals, *Kapila v. Atl. Mortgage & Inv. Corp. (In re Halabi)*, 184 F.3d 1335 (11th Cir. 1999). In *Halabi*, the mortgage had been assigned three times pre-petition and once post-petition with the latter two transfers not being recorded. The Eleventh Circuit held that the trustee could not prevail under § 544 because the mortgage had been properly perfected and its assignment did not involve a "transfer of property of the debtor" that would activate the trustee's strong-arm powers under § 544. This was merely an assignment from one creditor to another. As there was no transfer of an interest in the debtor's property here, the BAP concluded that the trustee could not avoid the mortgage.

### 52. Mortgages rendered invalid as to omitted parcels despite corrective documents

Judge Utschig begins his opinion: "Whether one is baking a cake, building a house, or recording a mortgage, sometimes even the slightest deviation from the directions can lead to catastrophe." How true! Here, the trustee brought an adversary proceeding to avoid a refinance mortgage pursuant to § 544(a). The mortgage was secured by two principal properties, a "homestead" parcel and "vacant land." However, the mortgage did not contain legal descriptions for either. Subsequently, an "Affidavit of Correction" was executed and recorded setting forth the correct properties and legal descriptions but was not signed by the debtors/grantors or acknowledged by them in any way. The trustee's argued that the bank did not originally have a properly recorded mortgage on the omitted properties, and the affidavit was invalid because it was not signed by the debtors/grantors. The bank argued that the trustee had either constructive or inquiry notice arising from the recorded affidavit or, alternatively, it had an equitable lien superior to the position of the trustee. The court ruled in favor of the trustee. *In re Couillard*, 486 B.R. 466 (Bankr. W.D. Wis. Nov. 9, 2012).

Analyzing Wisconsin law, the Court noted that it specifies that certain information must be included in recordable documents, including the full legal description of the property to which it relates. Even absent such, a document may still be deemed to be "duly recorded" if the instrument is properly indexed in a public index maintained in the office of such register of deeds and records. The court found that the bank had conflated what rendered an interest in property enforceable between the parties with what made it enforceable against third parties, such as the trustee. The court found that the original mortgage was outside the chain of title with respect to the omitted properties. Moreover, because entire parcels were being added by the affidavit, the affidavit had to be signed by the grantor/debtor. Thus, the improperly recorded affidavit which referenced another improperly recorded document could not constitute constructive notice to a bona fide purchaser such as the trustee or create inquiry notice. Moreover, the rights of the bona fide purchaser were superior under Wisconsin law to

any equitable lien to which the bank might otherwise be entitled. *See also In re Couillard*, (Bankr. W.D. Wis. Dec. 6, 2012)(denying motion for reconsideration) and *In re Borges*, 485 B.R. 743 (Bankr. D.N.M. Dec. 31, 2012)(mortgage that inadvertently omitted 220 acres of land not corrected by a unilateral modification of the property description through a corrected mortgage recorded by the lender without the knowledge or consent of the debtor/grantor; the unacknowledged corrected mortgage was therefore ineligible for recording and could not serve as constructive notice to any prospective purchaser). [*Author's Comment*: Trustees must be familiar with the recordation laws of the states in which they administer cases. To know whether a mortgage is (a) valid, (b) in recordable form (e.g. properly attested), and (c) encumbering all the property intended, and how to correct such deficiencies can be different depending on the different laws of each state even on identical facts.]

### 53. Trustee stands in the shoes of homeowner as to avoided mortgage

At the time of her bankruptcy filing, debtor's first mortgage with JPMorgan Chase Bank was unrecorded. In her bankruptcy schedules, debtor valued her home at $223,500 and listed her second mortgage claim of $29,431.04 and the unperfected Chase mortgage claim of $185,770.30. Without challenge, she also claimed a Massachusetts homestead exemption of $500,000. Invoking his strong-arm powers under § 544, the Chapter 7 trustee filed an adversary complaint seeking to avoid the unrecorded Chase mortgage and to preserve the mortgage lien for the benefit of the bankruptcy estate pursuant to § 551. Debtor filed a counterclaim seeking a declaration that, even should the trustee successfully avoid and preserve the Chase mortgage lien, he could not sell her home without first foreclosing the mortgage in accordance with state law, which she contended he could not successfully do because the mortgage was not in default. The trustee was granted summary judgment. On further appeal, the Bankruptcy Appellate Panel affirmed. *In re Traverse*, 485 B.R. 815 (1st Cir. BAP 2013). The Appellate Panel agreed with the trustee's position that he could in proper order sell the property, satisfy the liens encumbering it, and, if the proceeds reached that far, fund the debtor's exemption. The court noted that with a valid homestead exemption, the debtor extricated from the estate such value as might remain after the mortgages are satisfied. Avoiding the Chase mortgage did not render the trustee to be an assignee, subject to mortgage covenants and state foreclosure law. Rather, it left him in the homeowner's shoes, with the added benefits that funds that would otherwise be allocated to pay the Chase mortgage would instead enrich the estate. The court concluded that such was the "meaning of avoidance and preservation."

### 54. Trustee not entitled to recover post-petition payments after avoiding mortgage

Debtors owned real estate that appeared of record to be unencumbered. However, over two years before their bankruptcy filing, a mortgage had been given on a loan to certain family members. It was not recorded until less than 90 days before the bankruptcy filing. Once the trustee sought to avoid the mortgage, the defendant's strongly opposed it mostly due to a lack of understanding of why the lien was avoidable as a preferential transfer. Ultimately, the defendants argued that at the very least they

retained an equitable lien on the property. Trustee, in addition to seeking to avoid the mortgage, also sought to recover all post-petition payments made to the defendants. The court avoided the mortgage but would not allow the trustee to recover the post-petition payments. *In re Moorhouse*, 487 B.R. 151 (Bankr. W.D. N.Y. 2013). Judge Kaplan explained that "equitable" claims of ownership or lien could not be honored against other creditors when a "legal" claim of ownership or lien was fully available to the claimants but was not sought. The court analogized to a child or spouse of a debtor who was making all the payments on a car loan that was titled in the name of the debtor for convenience (or because of cheaper insurance rates or better credit worthiness of the debtor). When the bankruptcy is filed, the child or spouse claims to be the "equitable" owner of the non-exempt equity in the car rather than the trustee. Judge Kaplan set forth why such assertions of equitable interests are not to be permitted. The court held the mortgage avoided but the post-petition payments made from post-petition income of Chapter 7 debtors were not recoverable by a trustee. Only if there was evidence that the post-petition payments and the mortgage were made with pre-petition assets could the trustee seek recovery of those payments. [*Author's Comment*: For a contrary case holding that the trustee can also recover the post-petition payments made from post-petition income, *see In re Wyatt,* 440 B.R. 204 (Bankr. D. Dist. Col.. 2010)(Teel, J)].

### 55. Extrinsic evidence not admissible against trustee to vary terms of deed

The debtors' parents purchased the subject properties for $680,000 with title vested in themselves and debtors as joint tenants. Approximately 2.5 years later, debtors transferred their interest in the subject properties back to the parents as joint tenants via quitclaim deed. The transfer was for no present consideration as no conveyance tax was paid. Less than two years later, debtors filed a Chapter 7 petition, and the trustee sought to avoid the transfer and bring the debtors' former interest in the subject properties back into the bankruptcy estate. The trustee filed an adversary proceeding seeking to avoid the transfer under §§ 544(b) and 548(a)(1). The parents opposed the complaint, essentially arguing that they were at all times the 100% equitable owners of the subject properties having essentially paid the entire purchase price and they originally took title with the debtor "solely for estate planning purposes." The bankruptcy court granted summary judgment to the trustee and the parents appealed. The district court affirmed. *In re Henshaw*, 485 B.R. 412 (D. Hawaii 2013). The district court agreed with the bankruptcy court that third parties such as creditors and the bankruptcy trustee should be allowed to rely on the plain terms of a deed. "Indeed, . . . allowing extrinsic evidence would open the door to collusion given that joint tenants' interests will often be aligned to shield assets from the bankruptcy trustee and/or creditors. The parol evidence rule is designed to prevent this type of possible fraud – the rule discourages interested witnesses to a contract from committing fraud, perjury, or unintentional invention by making statements that the contract did not actually represent the agreement of the parties." The court rejected further those cases where the equitable ownership of a joint bank account could be determined by extrinsic evidence distinguishing such an asset from real property ownership created through a recorded deed. Accordingly, the bankruptcy court's summary judgment ruling was

affirmed. *See also In re Corse*, 486 B.R. 241 (Bankr. D. R.I. 2013)(ownership of real estate, unlike bank account, cannot be challenged when the recorded deed is unambiguous, so sale of debtor's remainder interest approved over objection that debtor had only bare legal title).

### 56. Transfers of property to a trust instead of a trustee held invalid

Gloster owned real property that his attorney-in-fact conveyed by warranty deeds to "Morison Outreach, a Trust." Gloster then sued the attorney-in-fact to set aside the transfers as invalid. The Georgia Trial Court held that the deeds were invalid because they attempted to convey property to the Trust instead of to a trustee. On appeal, the Georgia Court of Appeals affirmed. *Ford v. Reddic*k, 2012 WL 6621686 (Ga. App. Dec. 2012). The Georgia Appellate Court held that under a state statute, O.C.G.A. § 53-12-25(a), the "[t]ransfer of property to a trust shall require a transfer of legal title to the trustee." In other words, to convey property to a trust by deed, the trustee must be designated as the grantee of legal title. Here, the transfer was directly to the trust which was held to be invalid. [*Author's Comment*: Although this is a simple principle, it is an important one for trustees nationally. Trustees must be aware of their respective state laws. This particular holding is not unique. The transfer would be invalid under the laws of many states and should be a prime target for trustees.]

### 57. § 362(h) held not to deprive a trustee of standing to avoid a lien

Debtors scheduled Source One Financial with a lien on a 2003 Cadillac. A statement of intent only indicated that the Cadillac would be "retained." It did not state there would be a redemption or reaffirmation. After several months of requests by the trustee, debtor finally produced the contract between debtor and Source One. Trustee investigated and determined that Source One was not listed as a lienholder on the title. Trustee engaged in settlement discussions with counsel to Source One. Unbeknownst to the trustee, during those discussions, Source One was proceeding to perfect its lien on the Cadillac. Trustee eventually sought turnover and avoidance of the lien while also seeking sanctions for willful stay violation. Source One moved to dismiss the complaint on the basis that debtor's failure to comply with § 362(h)(1) both terminated the automatic stay with respect to the Cadillac and also removed it from property of the estate. Therefore, it concluded that the trustee had no authority to seek lien avoidance in reliance on *In re Baine*, 393 B.R. 561 (Bankr. S.D. Ohio 2008). The bankruptcy court agreed with Source One that it could not be held liable for a stay violation, but agreed with the trustee that he could avoid the lien. *In re Mollison*, 463 B.R. 169 (Bankr. D. Mass. 2012). The court clarified that because the stay had been dissolved by operation of law under § 362(h), Source One could not have violated the stay in perfecting its lien post-petition. However, the court disagreed with *Baine* that removal from the estate of such property also deprived the trustee of the ability to avoid the lien. [*Author's Comment*: The *Baine* case has been a bane for trustees since its issuance in 2008. National car lenders have regularly used *Baine* to dissuade trustees from seeking lien avoidance where no statement of intent was filed or there was a failure to comply with the stated intent. The author wrote an article entitled "*Section 362(h) Does Not Deprive*

*a Trustee of Standing to Avoid a Lien*," 29-10 Am. Bankr. Inst. J. 50 (January 2011), which is cited by the *Mollison* court in its opinion.]

### 58. Mortgagee not entitled to good faith defense

Shortly before the bankruptcy filing, property was transferred to debtor's brother for no consideration. Post-petition, the brother transferred the property to an LLC owned by a family friend. These two transfers were avoided by the trustee. The LLC was not validly formed at the time of the transfer but was able to obtain a mortgage for $155,000. The mortgagee had met with the LLC for less than an hour, did not seek to obtain any financial information about the LLC, did not investigate the discrepancies in the name of the LLC in various documents, and did not update the LLC's certificate of good standing or perform a title or records search. The mortgagee never even saw the actual deed of ownership for the property. The mortgagee was not the initial transferee, so it was able to assert the good faith for value defense under§ 550(b)(1). The bankruptcy court found that the mortgagee was not entitled to the defense. The district court affirmed. The circuit court likewise affirmed. *In re Nieves*, 648 F.3d 232 (4th Cir. 2011). The Fourth Circuit joined three other circuit courts in adopting the objective standard for the good faith prong of the defense. Thus, the knowledge prong is satisfied if the transferee knew facts that would lead a reasonable person to believe that the property transferred was recoverable. Here, the mortgagee did not have actual knowledge of facts because it had done no investigation whatsoever. But, it cannot have taken the transfer in good faith because it was willfully ignorant of facts which demanded an investigation. The court held that this requirement was consistent with interpretation of two U.C.C. provisions: § 3-302 for determining a holder in due course and § 1-304 relating to the implied duty of good faith in contracts. Thus, good faith was held to contain both the subjective (honesty in fact) and an objective (observance of reasonable commercial standards) component which the mortgagee did not meet. Accordingly, the trustee's avoidance of the transfer of the property from the LLC to the mortgagee was upheld.

## D. SECTION 542 TURNOVER

### 59. *Shapiro v. Henson (In re Henson)*, 2014 WL 68998 (9th Cir. 2014)

The trustee filed a turnover motion under § 542(a) against the debtor to recover a petition-date bank account balance. His prior demand letter had been ignored. The bankruptcy court denied the motion because debtor did not have possession or control of the funds at the time the turnover motion was filed. The district court affirmed. On further appeal to the Ninth Circuit Court of Appeals, the lower courts were reversed in an opinion of first impression for the circuit. The court observed that the statute required turnover of property or its value from an entity "in possession, custody, or control during the case…." It did not require that possession be maintained at the time of the demand or the motion for turnover. Additionally, because the statute includes the phrase "or the value of such property," it was clear that the entity need not be in possession of the property itself when the turnover motion was filed. Thus agreeing with *In re Ruiz*, 455 B.R. 745 (10th Cir. BAP 2011) and *In re USA Diversified Prods., Inc.*, 100 F.3d 53 (7th

Cir. 1996). The court specifically rejected the reasoning and holding in the troublesome opinion of *In re Pyatt*, 486 F.3d 423 (8th Cir. 2007). The court quoted from *USA Diversified Prods., Inc.*, that to rule otherwise would allow an entity to avoid liability under § 542(a) simply by transferring the property.

### 60. Value of refunds spent post-petition still subject to turnover

Debtor did not list his 2011 tax return as an asset nor claim any portion of it as exempt. After debtor received a discharge, the trustee sent debtor a letter requesting a copy of his 2011 tax return, which showed a refund of $5,135. The trustee sent a second letter requesting turnover of the pre-petition portion of the refund. When debtor did not turn over the refund portion demanded, the trustee moved for an order compelling turnover and for sanctions. Debtors objected arguing that the refund was not property of the estate to the extent of the non-debtor spouse's interests and that the motion to compel was untimely because the money had already been spent. The bankruptcy court granted the motion. Thereafter, debtors amended Schedule C to claim most of the demanded portion as exempt and also filed a notice of appeal. The Bankruptcy Appellate Panel affirmed. *In re Newman*, 487 B.R. 193 (9th Cir. BAP 2013). The Appellate Court noted that under Nevada law, the refund was community property allowing for joint control by each spouse. Consequently § 541(a)(2) "dictates that the entire prorated tax refund is property of [d]ebtors' bankruptcy estate." Next, the court rejected the Eighth Circuit's opinion in *Brown v. Pyatt (In re Pyatt*), 486 F.3d 423 (8th Cir. 2007), as representing a minority view in conflict with appellate decisions from four circuits which did not require present possession, custody or control when a demand for turnover was made. *In re Shearin*, 2224 F.3d 353 (4th Cir. 2000); *In re USA Diversified Products, Inc.*, 100 F.3d 53, 56 (7th Cir. 1996)(otherwise, upon receiving a demand from a trustee, the possessor of property of the debtor could thwart the demand simply by transferring the property to someone else); *In re Bailey*, 380 B.R. 486, 491-93 (6th Cir. BAP 2008)(already transferred tax refund subject to turnover); *In re Ruiz*, 455 B.R. 745 (10th Cir. BAP 2011)(petition date checking account balance). The Court concluded that §542(a) had no "present possession" requirement and would apply to any property in the possession, custody or control of a debtor during the case. *See also In re Pilate*, 2013 WL 827730 (Bankr. D. Dist. Col. 2013)(Teel, J)(holding a Chapter 7 trustee is entitled to a monetary judgment against the debtor for that portion of an inheritance that was no longer in her possession when turnover was sought having been used by the debtor without authorization to make payment to taxing authorities. [*Author's Comment*: The *Pyatt* case has been a thorn in the side of trustees ever since the opinion was issued. The NABT had filed an amicus brief in that case that did not prevail. It is encouraging to see so many other circuits reject the reasoning of *Pyatt*.]

### 61. Lien in account funds relinquished upon turnover to the trustee

Debtor was in the business of check clearing and payment processing services. Debtor and North American Banking Co. ("NABC") had entered into a "Remote Deposit Capture Service Agreement" pursuant to which the debtor submitted to NABC electronic deposits of funds captured from checks the debtor received. NABC would process the check transactions on the debtor's behalf and credit the debtor's account. The U.S.

Treasury would charge back claims for fraudulent, counterfeit, or forged Treasury checks. When an item was rejected, NABC was entitled to recover the funds from the debtor's accounts at NABC. Under the agreement, the debtor had assigned all of its deposit accounts to secure its obligations to NABC, and NABC was granted rights of setoff and a security interest in the debtor's deposited funds. At the time of its Chapter 11 petition, debtor had over $933,000 on deposit in its account with NABC. NABC froze the debtor's account. Soon thereafter, the case was converted to Chapter 7, and the trustee demanded turnover of the funds in the account, agreeing to a $50,000 holdback to cover future reclamation requests. NABC turned over $883,120 to the trustee without requesting from the court adequate protection of its lien such as by having its lien impressed upon the turned over funds. After Treasury reclamations that greatly exceeded the $50,000 holdback, NABC demanded that the trustee return the full $883,120. The trustee refused. NABC filed a complaint seeking a determination that it held a first-priority lien in the funds. The bankruptcy court ruled that NABC lost its possessory lien because it failed to first obtain a court order granting adequate protection. NABC appealed to the Eighth Circuit Bankruptcy Appellate Panel, which affirmed. *North American Banking Co. v. Leonard (In re WEB2B Payment Solutions, Inc.)*, 488 B.R. 387 (8th Cir. BAP 2013). It is undisputed that NABC's possessory lien had survived the bankruptcy filing. NABC argued that by virtue of § 542 and § 362's automatic stay, it was required to turn over the funds to the trustee, but that its lien was preserved pursuant to *U.S. v. Whiting Pools, Inc.*, 462 U.S. 197 (1983). However, the Appellate Panel noted that *Whiting Pools* involved a statutory tax lien, not a possessory lien, so that the creditor's lien in that case remained with the property after it was turned over. Whereas, the situation here was governed by *Citizens Bank of Maryland v. Strumpf*, 516 U.S. 16 (1995), which recognized that a bank's right to setoff is lost when possession of an account is relinquished. The BAP saw no distinction between a setoff right and a possessory security interest. NABC was entitled to withhold turnover until the bankruptcy court made a determination as to whether, and what extent, it was entitled to adequate protection. It failed to seek or obtain this determination and, therefore, lost its perfected security interest in the account funds turned over.

### 62. Bank loses its security interest in deposit accounts after voluntary turnover to trustee

The bank loaned $412,000 to the debtor secured by collateral listed in a security agreement. Debtor later filed Chapter 7 with $19,601 still on deposit with the bank in two accounts. The bank wrote to the trustee seeking direction about whether the funds should be turned over or released from the estate. The letter contained a box for the trustee to check indicating his election regarding the funds, and the trustee elected turnover. The bank then transferred the funds to the trustee without asserting any interest therein. Some months later, the bank moved for stay relief, seeking permission to pursue its state law remedies as to the collateral listed in the security agreement and made no mention of the account funds previously turned over to the trustee. The court granted the stay relief motion. The bank filed a proof of claim for $271,147. Trustee informed the bank that $10,000 of the funds from the accounts turned over to him were the proceeds from the sale of a vehicle that was not part of the bank's collateral. The bank responded that it held a perfected security interest as well as a statutory banker's

lien in all of the funds it had turned over to the trustee. The bank filed a motion to compel abandonment of those funds, which the trustee opposed. The court denied the motion. *In re Willis Enterprises, Inc.*, 2012 WL 3988062 (Bankr. D. Idaho 2012). Trustee argued that his strong-arm powers as a judgment lien creditor were superior to the bank's asserted liens. Judge Pappas noted that under Idaho law, the banker's lien was dependent on possession, which the bank had voluntarily relinquished, thereby constituting a waiver of its right to assert a banker's lien because of the unconditional nature of the turnover. Moreover, even if the turnover was involuntary, the bank was required to take prompt action to preserve its possessory-lien rights. Here, there was a five-month delay which the Court determined was not prompt, particularly in view of the unconditional, voluntary nature of the turnover. Further, while the collateral description of the security agreement included "general intangibles," it did not include "deposit accounts" as required under Idaho's version of the UCC. As to the bank's argument that the account funds could have been the proceeds of its accounts receivable collateral, the bank was unable to trace the funds on deposit to accounts receivable and, therefore, could not show that the funds were of inconsequential value to the estate.

### E. SECTION 546 LIMITATIONS/DEFENSES

#### 63. Trustee can use his avoidance powers defensively even after the limitations period has expired

Within the 90-day preference period, debtor executed a promissory note and pledge agreement in favor of GKH for the purpose of securing legal fees owed to the law firm. The pledge agreement listed almost two dozen entities in which the debtor held an ownership interest and later listed several additional entities in an amended pledge agreement. The entities ranged from a so-called "auto mall" to a farm. GKH initially filed a proof of claim for $406,829 for "services performed" and described the collateral as "real estate." The debtor objected because certain documents were not attached to the claim. GKH amended the claim, increasing it to $750,000 and describing the collateral as "Real Estate" and "Other." It subsequently filed a stay relief motion that was opposed by the trustee. Among the many issues presented was which party had the burden of proof respecting the asserted security interest and whether the preference could be asserted after the statute of limitations had expired in a defensive manner to defeat the claim. These questions were answered by the bankruptcy court in favor of the trustee and affirmed by the district court. On further appeal, the circuit court likewise affirmed. *Grant, Konvalinka & Harrison, P.C. v. Still (In re McKenzie)*, 2013 WL 6607062 (6th Cir. Dec. 17, 2013). It noted that virtually all courts outside of the Eleventh Circuit had determined that it was the creditor's burden to establish the validity of its security interest when stay relief is sought under § 362(d)(2). (The Eleventh Circuit holds that the debtor bears the burden of establishing that a creditor has failed to perfect its security interest.) The Circuit Court agreed with the overwhelming majority of bankruptcy courts that a trustee could exercise his avoidance powers defensively even after the expiration of the statute of limitations as set forth in § 546(a)(1)(A). "At bottom, nothing in the text of § 502(d) prevents a trustee from using his avoidance powers defensively after the expiration of the statute of limitations set forth in § 546(a)(1)(A)."

The Circuit Court then observes that two circuit-court decisions had construed the predecessor to § 502(d) and permitted trustees to object to claims after the limitations period had run. *In re Meredosia Harbor & Fleeting Serv., Inc.*, 545 F.2d 583, 590 (7th Cir. 1976) and *in re Cushman Bakery*, 526 F.2d 23, 36 (1st Cir. 1975). Finally, the court observed that the majority view furthered one of the central purposes of the Bankruptcy Code: to ensure the "inequality of distribution among creditors of the debtor," citing *Union Bank v. Wolas*, 502 U.S. 151, 161 (1991). [*Author's Comment*: This is a valuable tool for trustees in cases converted from Chapter 13 to Chapter 7 because some Chapter 13 trustees do not police avoidance actions.]

**64. Statute of limitations extensions for interim trustee analyzed**

Debtor filed Chapter 11 on May 14, 2009. The case was converted to Chapter 7 on May 13, 2011. The interim Chapter 7 trustee was appointed that same day. The Chapter 7 meeting of creditors was conducted and concluded on June 30, 2011. The trustee brought an adversary proceeding on May 11, 2012. The defendant moved to dismiss on the basis that the statute of limitations for avoidance actions had expired on May 14, 2011, and that the trustee's lawsuit was filed almost one year later. The trustee asserted that an additional year was afforded to him when he was appointed interim trustee one day shy of the two-year anniversary of the petition date. Pursuant to § 546, the statute of limitations for avoidance actions is "the later of 2 years after the entry of the order for relief or 1 year after the appointment or election of the first trustee under section 702…." (Emphasis added.) The problem arises because interim trustees are appointed under § 701, not § 702 as set forth in the statute. For this reason, many courts, led by the 3rd Circuit in *In re American Pad & Paper Co.*, 478 F.3d 546 (3d Cir. 2007), have employed a plain language analysis and determined that the additional one year is not triggered by the appointment of an interim trustee. The interim trustee must become the permanent trustee before the expiration of the two-year anniversary of the petition date for an extra year to be added. Here, the court disagreed with those cases and extended the statute of limitations by a full year and denied the motion to dismiss the lawsuit. *In re Draiman*, 483 B.R. 338 (Bankr. N.D. Ill. 2012). Judge Barnes found the statute to be ambiguous by using the term "appointment" when § 702 made reference only to elections and not appointments. He then reviewed the history of § 546 and observed that it had always contained the concept of appointment but not election. In his view, an interim trustee would never be afforded the benefit of the statute under the 3rd Circuit's approach, which the Court considered an absurd result. The court acknowledged that its ruling could lead to inconsistent results for elected versus appointed trustees and cause creditors to act differently at a meeting of creditors occurring more than two years after the initial order for relief. In such instances, the additional year would be lost if creditors elected a permanent trustee but not if there was no election of a new trustee, and the interim trustee had been appointed within two years of the order for relief. [*Author's Comment*: While trustees appreciate this interpretation of the statute, it is recognized that the analysis is somewhat tortured and the holding might not survive an appeal. Neither view seems to make a great deal of sense and congressional action is desperately needed.]

[*Author's Further Comment*: The Seventh Circuit Court of Appeals has indeed agreed with the Third Circuit and reversed the lower court here. 2013 WL 1397159,

2013 U.S. App. LEXIS 7045 (7th Cir. 2013). The Seventh Circuit rejected the trustee's argument that when §546(a)(1)(B) refers to the *appointment* or election of a trustee under §702, it must be referring to the appointment under §701. The Seventh Circuit held that such a "reading reads the reference to section 702 right out of section 546(a)(1)(B)." In sum, the court found the statute to be clear—the extension of the statute of limitations period under §546(a)(1)(B) is contingent upon a permanent case trustee being appointed within two years of the petition date.]

### 65. Conversion and reconversion of case did not equitably toll statute of limitations on fraudulent transfer claim

During trustee's examination of the debtor at the § 341(a) meeting on October 14, 2008, he discovered that three months prior to the petition date, debtor had transferred real property that was unencumbered to certain individuals, allegedly for no consideration. This was not disclosed in the Statement of Financial Affairs. Just 64 days after the meeting, debtor filed a motion to convert her case to one under Chapter 13, proposing a 100% repayment plan. The motion was granted and the plan funded for several years until October 2011, when payments ceased. The case was converted back to one under Chapter 7 on April 2, 2012, whereupon the Chapter 7 trustee made demand upon the defendants to turn over the subject property that had been transferred. When that did not occur, the trustee filed his avoidance action on March 26, 2013. Predictably, defendants asserted the statute of limitations defense arguing that it had run in 2010. The court granted the dismissal motion over the trustee's asserted equitable tolling argument. *In re McDonald*, 500 B.R. 208 (Bankr. N.D. Ga. 2013)(Brizendine, J.).

Judge Brizendine observed that the statute of limitations can be equitably tolled where despite a trustee's exercise of due diligence, the alleged fraud at issue is actively concealed, thus preventing the trustee from asserting a claim regarding same on a timely basis. In that situation, the limitations period is considered to be tolled until the point of discovery. It can also be equitably tolled where "extraordinary circumstances" beyond a trustee's control are shown that make it impossible to otherwise file a timely claim. Here, the Court found there were no such "extraordinary circumstances," rejecting the trustee's position that (a) 64 days was insufficient time and (b) the conversion of the case itself was for the purpose of preventing him from bringing the lawsuit on the fraudulent conveyance. As to the latter point, the Court noted that the trustee had not put forth sufficient evidence demonstrating even a triable question of fact as to debtor's motive in seeking to convert her case. [*Author's Comment*: This is a harsh result for the trustee but one that could have been prevented. The trustee could have obtained a tolling agreement or actually filed the complaint prior to conversion of the case. Even after the case was converted, the trustee could have requested that the Chapter 13 trustee at least obtain a tolling agreement even if the Chapter 13 trustee was not disposed toward filing a lawsuit given that it was a 100% repayment plan. Equitable tolling, however, is not a particularly strong argument several years after the trustee had become aware of the transfer.]

### 66. Chapter 13 trustee barred from bringing post-confirmation avoidance action

Acorn Financial filed a proof of claim secured by a vehicle. Debtor proposed in his Chapter 13 plan to treat the creditor's claim as secured. The Chapter 13 trustee's office had determined that the lien on the vehicle was likely avoidable as having been perfected beyond the safe-harbor period after the filing of the Chapter 13 case. Nevertheless, the Chapter 13 trustee did not challenge the claim or object to confirmation and, in fact, affirmatively recommended to the bankruptcy court that the proposed plan be confirmed. Thereafter, the Chapter 13 trustee brought an avoidance action under § 547, and designated its claim as an unsecured debt. Acorn moved for summary judgment on the grounds that the trustee was bound by the terms of the confirmed plan which was *res judicata* with respect to its claim. The bankruptcy court agreed and granted summary judgment. This was affirmed by the district court. On further appeal to the circuit court, it was again affirmed. *Hope v. Acorn Financial, Inc.*, 731 F.3d 1189 (11th Cir. 2013). The circuit court described the trustee's argument as "simple and straightforward." The argument was that § 1327(a) did not specifically say that trustees were bound by a confirmed Chapter 13 plan, whereas several other provisions of Chapter 13 specifically mentioned trustees. She argued that the exclusion of trustees from § 1327(a) was not a mere legislatively oversight. While respectful of this argument, the court disagreed for purposes of this case based on the fact that the trustee recommended the plan for confirmation which had proposed to treat the claim of Acorn as secured. The court concluded:

> We have tried . . . to make the best of bankruptcy provisions which do not mesh very well together, but we know that our ruling is not ideal. We recognize, as did the bankruptcy court, that in certain routine Chapter 13 cases, the confirmation of proposed plans will take place before the bar dates for proofs of claims and avoidance actions. We also acknowledge that not all scheduled creditors file proofs of claims, thereby creating administrative nightmares for busy trustees. Our holding, therefore, is a narrow one, necessarily limited by the facts before us: A Chapter 13 trustee who is aware prior to confirmation about the defects in a creditor's security interest and who, despite that knowledge, does not object to the creditor's claim and affirmatively recommends confirmation of a proposed plan in which the creditor is given a secured position. We may not, and do not, address this scenario where the trustee is unaware of the defects in the creditor's security interest until after confirmation." 731 F.3d 1190 at 1195.

[*Query*: Had this case later converted to one under Chapter 7 before the statute of limitations under § 546 had expired, would the Chapter 7 trustee, as the successor trustee, be bound by the failure to bring this action prior to confirmation of the plan or could the trustee still bring it unimpeded by the actions taken or not taken in the Chapter 13 case?]

### 67. Trustee entitled to additional one-year period to commence transfer avoidance proceeding

Debtor filed its Chapter 11 petition on March 18, 2009. The case was converted to Chapter 7 on May 19, 2010, and the interim trustee was appointed on May 20, 2010. The trustee commenced the meeting of creditors on June 30, 2010, and continued it several times. The final meeting was conducted on September 23, 2010. The last meeting had a notation in the minutes reflecting a continuance "*Sine die*." The court in the meantime granted four requests by the trustee to extend the deadline to file an avoidance action with the last extension expiring on March 20, 2012. On March 2, 2012, trustee filed an adversary proceeding against the Puerto Rico Electric Power Authority ("PREPA"). PREPA filed a motion to dismiss on the basis that the complaint was time barred because the two-year avoidance action period had expired without the appointment or election of a permanent trustee. PREPA argued that the two-year period expired on March 18, 2011, and the trustee's first requested extension of the avoidance action deadline was on May 3, 2011. Therefore, the deadline had already expired and could not be extended. In rebuttal, the trustee argued that she became the permanent trustee on September 23, 2010, which fell within the two-year time frame and therefore added an additional year to the statute of limitations from that date, which was well after the extensions had been granted by the court. The Bankruptcy Court ruled in favor of the trustee. *In re PMC Marketing Corp.*, 482 B.R. 74 (Bankr. D. Puerto Rico 2012). Judge Tester noted that the version of Rule 2003(e) in effect at all pertinent times in this case permitted a simple announcement at the meeting of creditors of the adjourned date and time. The court discussed two approaches to determination of whether the meeting had been continued. Under the "bright-line" approach, a meeting continued *"Sine die*" without a follow-up date would be deemed to have been concluded automatically but for reasons of promptness and finality. The "case-by-case" approach permitted circumstantial evidence to be examined including consideration of the length of the delay, complexity of the estate, cooperativeness of the debtor, and existence of any ambiguity regarding whether the trustee continued the meeting. Here, the court found that under either test, the meeting should be determined to have been concluded and denied the motion to dismiss, finding the complaint to have been timely filed. [*Author's Comment*: Effective December 1, 2011, Rule 2003 was amended to add the requirement that the trustee promptly file a written notice specifying the date and time to which the meeting is adjourned. Additionally, our Trustee Handbook in the October 1, 2012 edition complements that rule change by requiring that meetings be closed or continued with a specific date and time. This is designed to provide certainty of the meeting's conclusion point for purposes of the 30-day deadline for objecting to exemptions under Rule 4003(b) as well as determining in cases such as this when the statute of limitations for avoidance actions expires.]

### 68. Second Circuit expands on Enron decision

Unsecured creditors committee sought to avoid pre-petition payments totaling approximately $375 million debtor made to note holders in connection with repurchase and cancellation of privately-paced notes. The Second Circuit held that these transactions fall within the safe harbor provision of §546(e) as transfers made in

connection with a securities contract. *In re Quebecor World (USA) Inc.*, 2013 WL 2460726 (2d Cir. June 10, 2013). In doing so, the Second Circuit rejected that argument that the only financial institutions involved in the transaction were conduits and should be disregarded in determining whether §546(e) applies. The Court held that this argument was foreclosed by the plain language of the statute which states that transfers made by, to or for the benefit of a financial institution may be protected. The Second Circuit also believed that its ruling was in line with the relevant statutory intent because "[a] clear safe harbor for transactions made through these financial intermediaries promotes stability in their respective markets and ensures that otherwise avoidable transfers are made out in the open, reducing the risk that they were made to defraud creditors. Interestingly, the Second Circuit did hedge its bets and in *dicta* noted that while §546(e) is broad it is not limitless and that a "mere structuring of a transfer as a 'securities transaction' may not be sufficient to preclude avoidance."

## F. SECTION 541 PROPERTY OF THE ESTATE

### 69. Question on "Unfinished Business Doctrine" certified to New York Court of Appeals

The partners of Thelen LLP voted to dissolve the law firm. The partners adopted their Fourth Amended Limited Liability Partnership Agreement, affirmed by California law, and a Plan of Dissolution. This agreement, unlike previous agreements, contained an "Unfinished Business Waiver," which provided that neither the partners nor the partnership would have any claim or entitlement to clients or matters ongoing at the time of dissolution other than entitlement to collection of amounts due for work performed prior to the partners' departure. The waiver included an express intent to waive any rights partners or the partnership might have to "unfinished business" as that term was defined in *Jewel v. Boxer*, 156 Cal. App. 3d 171 (Cal. App. I Dist. 1984), or as might otherwise be provided through interpretation of the California Uniform Partnership Act. Following the law firm's dissolution, eleven of its partners joined Seyfarth Shaw LLP, with ten going to its New York office and one to its California office. Thelen then filed Chapter 7 in the Southern District of New York.

The trustee commenced an adversary proceeding against Seyfarth, seeking to avoid the Unfinished Business Waiver as a constructive fraudulent transfer under § 548(a)(1)(B) and § 544 as well as under California law. The trustee sought to recover the value of Thelen's unfinished business for the benefit of the bankruptcy estate, proceeding on the assumption that pending hourly matters were among the firm's assets and were, thus, transferred to the individual partners without consideration when those partners adopted the Unfinished Business Waiver on the eve of dissolution. Seyfarth moved for judgment on the pleadings which the District Court granted after withdrawing the reference. This created a split in the case law at the District Court level on whether pending hourly matters were law firm assets. The trustee appealed to the Second Circuit Court of Appeals. The Circuit Court recognized the strength of arguments on both sides of the issue and determined, given the significance of the issues to the members of the New York Bar, to certify to the New York Court of Appeals the following questions:

> "Under New York law, is a client matter that is billed on an hourly basis the property of the law firm, such that, upon dissolution and in related bankruptcy proceedings, the law firm is entitled to the profit earned on such matters as the "unfinished business" of the firm? If so, how does New York law define a 'client matter' for purposes of the unfinished business doctrine and what proportion of the profit derived from an ongoing hourly matter may the new law retain?"

*Geron v. Seyfarth Shaw LLP (In re Thelen LLP)*, 736 F.3d 213 (2d Cir. Nov. 15, 2013).

**70. Debtor's right to appeal was estate property**

Debtor lost two state-court lawsuits, resulting in sanctions against him and attorney's fees in favor of the opposing litigants. Debtor appealed both sanction orders to a Texas appeal Court and thereafter filed for Chapter 7 relief. The appeals were abated by the Texas court. Debtor moved the bankruptcy court for limited relief from the automatic stay in order to proceed with the appeals. The opposing litigants argued that the appellant rights had become property of the bankruptcy estate and could be sold by the Chapter 7 trustee. The bankruptcy court granted the debtor's motion, finding that his appellate rights were not estate property because they were purely defensive. The district court reversed finding that the defensive appellate rights were property of the estate subject to sale by the Chapter 7 trustee. On further appeal, the circuit court affirmed, agreeing with the district court that under § 541 and Texas's definition of property, the estate would not be restricted to only those appellate rights that constituted choses in action. Instead, the right to appeal was held to be valuable in nature, irrespective of whether the underlying judgment had any value to the debtor. *Croft v. Lowry, et al. (In re Croft)*, 2013 WL 6503393 (5th Cir. 2013). Even though the judgment against the debtor was an obligation with no value to the estate, the right to appeal that judgment had a quantifiable value to the debtor and therefore was held to constitute property under Texas law. "And while the debtor may not have a legal interest in the cause of action underlying the judgment against him, he certainly retains a legal interest in the assets that will be used to satisfy that judgment and in insuring that the damage to those interests is minimized." [*Author's Comment*: Trustees frequently settle pending litigation, so this decision really is consistent in allowing a sale or settlement of that litigation before final orders have been entered.]

**71. Tenth Circuit rules that fraudulently transferred property does not become part of the bankruptcy estate until it is recovered**

The court stated the issue as "whether a bankruptcy estate includes fraudulently transferred property that the trustee has not yet recovered." The 10th Circuit Court of Appeals noted a split on the issue at the circuit level. The Fifth Circuit in *In re MortgageAmerica Corp.*, 714 F.2d 1266 (5th Cir. 1983) held that fraudulently transferred property is property of the estate under § 541(a)(1) and subject to the automatic stay of § 362 even before it is recovered as a legal or equitable interest of the debtor in property. This rationale had been rejected by the Second Circuit in *In re Colonial Realty Co.*, 980 F.2d 125 (2d Cir. 1992). The Second Circuit thought the language was clear that property could only become part of the estate after it was recovered pursuant to §

541(a)(3). The Tenth Circuit agreed here with the Second Circuit and ruled against the trustee. *Rajala v. Gardner*, 709 F.3d 1031 (10th Cir. 2013). The Tenth Circuit noted that there could be no equitable title to property based on a mere allegation. Further, if § 541(a)(1) included fraudulently transferred property, the Tenth Circuit felt it would render § 541(a)(3) meaningless and lead to an absurd result. [*Author's Comment*: Because of the circuit split, petition for cert. to the United States Supreme has been filed and NABT will be adding its voice through an amicus brief.]

### 72. Trustee of sole member's individual bankruptcy controls LLC

On October 22, 2010, Marsha Raj filed a personal Chapter 7 bankruptcy scheduling her LLC with a value of zero and claiming no exemption therein. She was at all pertinent times the sole member of the LLC. On March 26, 2013, she caused to be filed a Chapter 11 petition for the LLC even though her Chapter 7 trustee had never abandoned the estate's interest therein. This triggered a flurry of motions including one by the U.S. Trustee to dismiss the LLC's case as having been filed without proper authorization. That motion was granted. *In re B&M Land and Livestock, LLC*, 498 B.R. 262 (Bankr. D. Nev. 2013)(Beesley, J.). The court first determined that state law classified the pre-petition membership interest in the LLC as personal property. Next, the court determined that the trustee controlled all rights associated with an LLC previously owned by the debtor, including the right to control and make decisions on the LLC's behalf without the necessity of the trustee taking further specific actions to comply with state law before exercising management functions. Reaching this conclusion, the court relied on *In re Blixseth*, 484 B.R. 360, 368-369 (9th Cir. BAP 2012), and *In re First Protection, Inc.*, 440 B.R. 821, 830 (9th Cir. BAP 2010). The court specifically rejected the argument that the trustee had no greater rights than a judgment creditor which would not be entitled to participate in the management of the business. Instead, the court determined that § 541 gave the trustee much broader rights. Therefore, the motion to dismiss was granted.

### 73. Debtor's misrepresented value of her sole membership interest in an LLC leads to reopening of the case

Debtor filed her Chapter 7 petition in January 2010, listing her 100% sole membership interest in a number of businesses including the subject LLC, which she stated to have no value. The bank was owed money by that LLC and also by debtor for her personal guaranty. In April 2010, the trustee filed a report of no distribution, the discharge was entered the next month, and the case closed the following month. Four months later, the LLC filed a lawsuit in state court against several entities for tortious interference. The case settled in February 2012, for $80,000, of which $44,985 was distributed to the debtor individually with the balance paid to her attorneys. None of the settlement was paid to or deposited in the bank account of the LLC. After learning of the settlement, the bank sought to reopen the bankruptcy case, which the court granted over debtor's objection. The bankruptcy court had determined that the events relating or giving rise to the lawsuit had occurred as early as nine months prior to the bankruptcy filing and continued well after. The bankruptcy court rejected debtor's arguments that the recovery was not property of the bankruptcy estate because it was received after

debtor received the discharge or that it had been abandoned by the trustee upon the closing of the case. Debtor appealed the reopening of the case, but the decision of the bankruptcy court was affirmed. *In re Underhill*, 498 B.R. 170 (6th Cir. BAP 2013).

The Appellate Panel determined that the claim was sufficiently rooted in the pre-bankruptcy past to constitute property of the bankruptcy estate, and it had not been abandoned because it had not been scheduled or otherwise disclosed. The Appellate Panel noted: "Placing a value of zero on the LLC membership interest with knowledge of the tort claim and the failure to list such claim constituted a failure to disclose the asset and warrants reopening and a determination by the bankruptcy court of the value of the debtor's interest in the LLC." Creditors of the LLC were clearly entitled to be paid before debtor distributed funds to herself on account of her membership interest. On remand, the bankruptcy court was to determine what was necessary to pay the creditors of the LLC and what balance should be distributed to the bankruptcy estate on account of the membership interest of the individual debtor.

### 74. Debtor retained interest in asset ordered by state court to be turned over

EEI possessed against debtor a judgment in the amount of over $884,000. Pursuant to a non-wage garnishment issued to Merrill Lynch, EEI learned that Merrill Lynch was holding funds belonging to debtor consisting of two IRAs with a value of approximately $199,000. EEI filed a motion in the state court for turnover of those funds which was granted. Debtor filed an emergency motion to stay enforcement of the state court orders. That was denied, and he filed a Chapter 7 petition shortly thereafter. The bankruptcy filing occurred before Merrill Lynch had turned over the funds to EEI. Debtor then filed a motion to avoid the judicial lien of EEI under § 522(f). EEI maintained that the IRAs had been removed as debtor's property once the turnover orders became final and were not part of his bankruptcy estate. The bankruptcy court granted debtor's motion, and EEI appealed. The district court affirmed. *In re Quade*, 498 B.R. 852 (N.D. Ill. 2013). The district court agreed with the bankruptcy court that the state court's turnover order did not divest the debtor of her property interest in the IRAs so they were part of the bankruptcy estate and could be claimed as exempt. The bankruptcy court had equated that turnover order to a check that had not cleared. As the IRA funds had not been remitted to EEI pre-petition, they remained property of the bankruptcy estate. [*Author's Comment*: This is good news for trustees who might be confronted with a similar claim by a creditor that property that the trustee seeks to administer is not property of the estate for a similar reason. However, the analysis here seems deficient for an obvious reason. Had the funds in fact been transferred out of the account to EEI, it would have constituted a preference and would have been recoverable in any event by the bankruptcy estate. So under no theory could EEI have retained these funds.]

### 75. Contingency fee owed to debtor-attorney constituted property of the estate

The debtor was a practicing attorney. Three months after the commencement of his bankruptcy case, he became entitled to a fee of $690,000, representing his share of a contingency fee for referring a case pre-petition to a law firm ten years earlier that

concluded its settlement negotiations shortly after the petition date. The bankruptcy court ruled that the trustee was entitled to recover the entire fee as property of the bankruptcy estate. *In re Scotchel*, 2013 Bankr. LEXIS 1736, 2013 WL 1788484 (Bankr. N.D. W.Va. 2013). Judge Flatley found that the claim was completely rooted in the pre-bankruptcy past for which reason it was included in its entirety as property of the bankruptcy estate, in reliance on *Segal v. Rochele*, 382 U.S. 375 (1966). The debtor-attorney was obligated to assist the law firm to which the case was referred with the historical facts of the case and to review depositions and other documents and be prepared to testify as a witness, but he provided no such services after the petition was filed. Moreover, settlement negotiations were handled exclusively by the law firm to which the case had been referred.

### 76. Debtor's relinquishment to proceeds of assets does not divest estate of interest in those assets

The debtor and his wife entered into a marital settlement to govern the terms of their divorce. The marital settlement awarded the wife all annuity income to the wife while the debtor continued to hold the annuity itself. After the debtor filed bankruptcy, the now ex-wife filed a claim for the remaining annuity payments and the trustee and the ex-wife received court permission to allow the trustee to transfer annuity payments the trustee had received to the ex-wife and a court order directing the insurance company to forward future annuity payments to the ex-wife. The trustee's position was that the annuity payments were not the property of the debtor's estate under the marital agreement.

The Seventh Circuit reversed. *In re Peel*, 2013 WL 3957581 (7th Cir. Aug. 2, 2013). The court noted that the marital settlement did not transfer the annuity to the ex-wife but had promised the ex-wife payments "in lieu of" her interest in the annuity. In other words, the ex-wife's right to the payments was contractual in nature and the failure to honor those contractual commitments merely created a claim against the estate. It did not divest the estate of its interest in the annuity payments.

### 77. Post-petition appreciation belongs to the estate

Debtor scheduled a one-eighth interest in vacant land that is subject to an oil and gas lease, along with a one-fourth interest in royalties from the lease. No wells had ever been drilled on the land and no royalties were due. Debtor claimed an exemption of $4,250 in the land interest and $1.00 in the royalty interest, which were equal to the scheduled values of these assets, utilizing his federal wild card exemption. After no party timely objected to the exemptions, trustee moved to close the case but to except debtor's royalty interest from abandonment in order to preserve the trustee's ability to recover for the benefit of the estate any potential future royalties resulting from a productive well. Debtor agreed to close the case but objected to the trustee's motion to except the royalty interest from abandonment. The bankruptcy court ruled in favor of the trustee, allowing the royalty interest to be excepted from abandonment and holding the trustee was entitled to pursue any future increase in value of the royalty above the amount of the interest listed as exempt. Debtor appealed, and the district court affirmed. Debtor then appealed to the Third Circuit Court of Appeals, which likewise affirmed. *In*

*re Orton*, 687 F.3d 612 (3d Cir. 2012). The Circuit Court agreed with the trustee and lower courts that the wild card exemption preserved only a debtor's interest in an asset rather than the asset itself in that debtor had not unambiguously claimed as exempt a "full" or "100%" fair market value interest in the royalty interest, nor had debtor done anything else to put the trustee on notice of debtor's intent to exempt the entire royalty interest. The Third Circuit further noted that, even if debtor had claimed that the asset was wholly exempt, the Supreme Court in *Schwab v. Reilly*, 130 S.Ct. 2652 (2010) had suggested that "it is far from obvious that the Code would 'entitle' [a debtor] to clear title in [an asset]." The Third Circuit also agreed that any potential appreciation in value above the exempted dollar amount would accrue to the bankruptcy estate, not the debtor. This was also the holding of the Ninth Circuit in *In re Gebhart*, 621 F.3d 1206 (9th Cir. 2010).

### 78. Commingled money in law firm bank account not subject to forfeiture

Rothstein perpetuated a Ponzi scheme through his law firm of Rothstein, Rosenfeldt & Adler, P.A. ("RRA"). Rothstein pled guilty and forfeited to the United States "all of his right, title and interest to all assets listed in the Information." Thereafter, the Government attempted to seize the funds RRA held in some of the listed bank accounts. TD Bank rejected the attempt because of the dispute between the Government and the Trustee, as the Trustee was contending that those funds were a part of the RRA bankruptcy estate. The Trustee petitioned the district court to order the Government to return the RRA accounts and properties which the Trustee contended were purchased with funds from those accounts, as constituting assets of the bankruptcy estate. After the district court denied in large part the petition, the Trustee appealed. The Eleventh Circuit vacated and remanded the judgment of the district court. *In re Rothstein, Rosenfeldt & Adler, P.A.*, 2013 U.S. App. Lexis 11793 (11th Cir. June 12, 2013). Writing for the court, Judge Tjoflat explained that property can only be forfeited as proceeds if the Government "establishes the requisite nexus between the property and the offense." Where no such showing can be made, the Government must resort to the substitute asset forfeiture provisions relating to forfeitable property, such as proceeds that have been "comingled with other property which cannot be divided without difficulty." The Government may seek forfeiture under this provision of property "up to the value of" comingled property.

The court noted that this was not a case involving few individual deposits and easily traceable proceeds. Instead, "Rothstein's investors' funds were deposited in RRA bank accounts and comingled with legitimate income RRA received from the billings of its 70 lawyers, $12 million in the first ten months of 2009 alone." Therefore, the court found that the district court erred in ordering the forfeiture of the funds as proceeds. Consequently, all proceedings the court held subsequent to the imposition of Rothstein's sentence were vacated. On remand, the Government would be required to identify and establish the value of the proceeds that were comingled. The circuit court also found that the district court erred in refusing to consider the Trustee's claim that other properties listed in the Information in the preliminary order of forfeiture should not have been forfeited because they were neither proceeds nor properties derived from proceeds. While agreeing with the Trustee's theory, the court concluded that it was a

question of fact as to whether the account funds were used to acquire the other properties. Therefore, the case was remanded so the district court could resolve that fact issue. Although there is a presumption in the Government's favor, the court concluded: "If the Trustee introduces credible evidence that the properties were acquired with funds from RRA's bank accounts, that presumption will vanish and, in order to establish its right to forfeiture, the Government will have to produce credible evidence that the properties were acquired with proceeds of Rothstein's criminal activity."

### 79. Uniform Fraudulent Transfer Act does not displace common law rule that self-settled spendthrift trusts are void

Prior to his death, Promissor established a spendthrift trust; he was both the settlor and a lifetime beneficiary of the trust, and he retained the right to remove trustees and veto any discretionary trustee actions. Also prior to his death, Promissor pledged $1.5 million to plaintiff, a university hospital, for the construction of a new president's house on plaintiff's campus. In reliance on this promise, plaintiff constructed the new house. When Promissor died, however, he had made no payments to plaintiff and his will also did not provide for the pledge.

Plaintiff filed a complaint in the probate court seeking to enforce Promissor's $1.5 million pledge. The trustee of the spendthrift trust objected, arguing that trust funds were beyond the reach of Promissor's creditors. In response, plaintiff argued that under Illinois' long-standing common law, spendthrift trusts are void as to creditors when the settlor and beneficiary are the same person. The probate court agreed with plaintiff and entered summary judgment in its favor. The appellate court, however, held that Illinois' Fraudulent Transfer Act (FTA), enacted in 1990, displaced the common law rule against self-settled spendthrift trusts.

The Illinois Supreme Court reversed, holding that the common law can co-exist with statutory remedies concerning fraudulent transfers. The court began by stating that "[c]ommon law rights and remedies remain in full force in [Illinois] unless expressly repealed by the legislature or modified by court decision," and that "[t]he implied repeal of the common law is not and has never been favored." The court held that the FTA was not intended to repeal the common law in this instance for four reasons. First, the FTA expressly stated that "the principles of law and equity, including . . . the law relating to . . . fraud . . . supplement [the FTA's] provisions." Second, the FTA's "general purpose" is to protect creditors, while the common law rule addresses a specific instance of self-settled trusts, such that they have complementary goals. Third, the common law focuses on interests "retained" by the settlor, while the FTA concerns a fraudulent transfer of an asset or incurrence of an obligation. Finally, Illinois statutes had provided for the avoidance of fraudulent transfers in some manner for at least 100 years before Illinois enacted the FTA, and this "longstanding coexistence of the common law trust rule and the statutory provisions against fraudulent conveyances" led the court to believe that the Illinois legislature did not intend to abrogate the common law rule against self-settled trusts. *Rush Univ. Med. Ctr. v. Sessions*, Nos. 112906, 112993, 2012 WL 4127261 (Ill. Supr. Ct. 2012).

## G. CLAIMS

### 80. Court ruling that trustee could not file claims for creditors reversed

Several years after the trustee had closed the case, the debtor joined a class-action law suit for a claim that arose pre-petition but of which he had not been aware during the pendency of his bankruptcy case. Trustee then caused the case to be reopened. A few days after the claims bar date expired, the trustee filed claims on behalf of all of the creditors originally listed in the debtor's schedules who had not filed claims themselves. The debtor objected to the claims and to the trustee's authority to have filed them. The bankruptcy court ruled in favor of the debtor and disallowed the claims, holding that the trustee did not have authority to file them. The bankruptcy court based its holding solely on its conclusion that the Bankruptcy Code did not permit a trustee to file a proof of claim on behalf of a creditor unless it was for the benefit of the debtor. Although the bankruptcy court had acknowledged that § 501(c) was not facially ambiguous, it nevertheless looked to the legislative history and to the context of the Bankruptcy Code itself to reach its conclusion. *See, In re Van* Cleef, 479 B.R. 809 (Bankr. N.D. Ind. 2012)(Klingeberger, J.). The district court reversed, *In re Yoon v. Van Cleef*, 498 B.R. 864 (N.D. Ind. 2013), based on the statute being unambiguous, in plainly providing that when a creditor did not file a timely proof of claim "the trustee may file a proof of such claim." Hence, the trustee was especially permitted to file these claims. The court also relied on *In re Schmidt*, 333 B.R. 868, 870 (Bank. N.D. Fla. 2005) which held: "While the Trustee may not have an affirmative duty to file such proofs of claims, he likewise has no duty to refrain from doing so in order that the Debtor receive a windfall while receiving a discharge in bankruptcy." Finally, the court remanded the matter to the bankruptcy court to allow for the merits of the claim objections to be heard. [*Author's Comment*: It is not uncommon in cases reopened after several years to have few if any claims filed by creditors. That was the situation here.]

### 81. Chapter 11 "super-priority" claim primes Chapter 7 administrative expenses

Debtor filed its Chapter 11 petition on July 22, 2012. On October 19, 2012, debtor filed its emergency motion for DIP financing, seeking to borrow up to $200,000, with $120,000 of it carved out for professionals and the U.S. Trustee's fees. Debtor requested that the DIP lender receive a § 364(c)(1) super-priority administrative claim. Interim orders were entered by the court and a final order entered on December 4, 2012. Two days later, the court converted the case to Chapter 7 at the debtor's request. On February 6, 2013, the DIP lender filed its motion for allowance and payment of priority claim seeking to be treated ahead of Chapter 7 administrative expenses. The trustee and a creditor objected, but the court overruled the objections and granted the motion. *In re National Litho LLC*, 2013 WL 2303786, 2013 Bankr. LEXIS 2112 (Bankr. S.D. Fla. 2013). Judge Isicoff held that while Chapter 7 administrative expenses generally come ahead of even Chapter 11 super-priority administrative claims, pursuant to § 726(b), that is not true when the super-priority administrative expense claim is derived from § 364(c)(1). That code section expressly states that a claimant under that section would have priority over any or all administrative expenses derived from §

503(b) or § 507(b). In reaching this conclusion, the court distinguished or disagreed with prior case law and found it to be an unambiguous statute that must be interpreted according to its plain meeting notwithstanding policy arguments to the contrary. [*Author's Comment*: When a Chapter 11 case is converted to Chapter 7, it is imperative that the trustee review and understand all orders entered in the Chapter 11 case as they often contain unwelcome surprises. If the trustee does confront an order granting a super-priority claim, the trustee might consider at the outset of the case reaching a carve-out with that lender to enable the trustee's administration of the estate.]

**82. Bank denied super priority administrative claim**

JPMorgan Chase Bank and the debtor corporation had entered into a pre-petition loan agreement and guaranty for $50,000, secured by a blanket lien on all of the debtor's assets. After debtor filed for Chapter 11 relief, the court entered interim and final cash collateral orders authorizing the debtor's use of cash collateral pursuant to § 363(c). The orders provided the bank with replacement liens on the debtor's post-petition receipts. The bank filed a secured proof of claim. After the case was converted to Chapter 7, the trustee advised the bank that she had received post-conversion payments of $7,423, including post-petition commissions and certain refunds. The bank filed a motion to establish a super priority administrative expense claim pursuant to § 507(b). The court denied the motion. *In re Mary Holder Agency, Inc.*, 2012 WL 4434362 (Bankr. D. N.J. 2012). Judge Kaplan noted that a § 507(b) super priority claim is intended to compensate the secured claimant for the difference between the adequate protection provided by the debtor and any actual decrease in value of the collateral occurring during the pendency of the bankruptcy case. That section establishes three requirements for allowance of such a claim in the event that adequate protection proves inadequate: (1) the court must have directed the debtor to provide adequate protection, (2) such adequate protection must have failed to preserve the creditor's interest in the collateral, and (3) the claim must be allowable under § 507(a)(2), and by reference, § 503(b). The court noted that the final cash collateral order was totally devoid of language suggesting that the replacement liens provided adequate protection or were intended to adequately protect the bank's interest in the collateral. At no time did the court direct the debtor to provide adequate protection nor did the court ever make a ruling as to the value of the underlying collateral or extent of the bank's lien against the debtor's assets, or the adequacy of the proffered replacement liens. Further, the court was not persuaded that the debtor's use of the bank's collateral even caused a decline in collateral value, there being a "myriad of potential reasons for the diminution of the collateral's value." Finally, the bank was not entitled to assert a § 503(b) administrative claim because the bank's claim did not arise from a post-petition transaction with the debtor. Instead, the bank was seeking to recover its entire secured claim which was grounded upon its pre-petition loan agreement with the debtor. The court rejected the proposition that the negotiation for continued possession of collateral in return for adequate protection was a post-petition transaction providing additional value to the estate. [*Author's Comment*: Although not addressed here, there is a split of authority over whether a super priority claim arising from the Chapter 11 estate has priority over its Chapter 7 administrative claims despite § 726(b). The better reasoned line of cases

holds that its super priority status is only with respect to other Chapter 11 claims; otherwise, how is the Chapter 7 trustee to administer the estate of the converted case.]

### 83. Quarterly fees in Chapter 11 cases due UST or BA include amounts credit bid

Under 28 U.S.C. § 1930(a)(6) and (7), certain quarterly fees must be paid to the U.S. Trustee or bankruptcy administrator calculated on a graduated scale based on "disbursements" made during a given quarter. During the course of a particular quarter the Chapter 11 debtor sold a building with residential apartments and retail space. The secured lender was the successful purchaser through a credit bid of $37.1 million. Thereafter, the debtor filed its quarterly fee statement and its post-confirmation report for the quarter, listing total disbursements in the amount of $111,821, resulting in a quarterly fee of $975. The bankruptcy administrator challenged the payment, contending that the debtor owed the maximum quarterly fee of $30,000 based on the credit bid. The bankruptcy court noted that § 326(a), which sets limits placed on the compensation of Chapter 7 and Chapter 11 trustees, was based on "monies disbursed." Therefore, use of the term "disbursement" alone must mean more than "monies." Further, the court noted that the fees were designed by Congress as a revenue generating mechanism to fund the U.S. Trustee program by imposing costs on users of the bankruptcy system rather than tax payers. Accordingly, the court agreed with the bankruptcy administrator and imposed a quarterly fee at the $30,000 maximum amount. *In re WM Six Forks, LLC*, 502 B.R. 88 (Bankr. E.D. N.C. 2013)(Small, J.). [*Author's Comment*: Chapter 7 trustees are responsible for paying the amounts owed to the U.S. Trustee upon conversion to Chapter 7. This case indicates the difficulty and challenge that might exist in such a case and the caution with which the trustee may need to proceed given that these quarterly fees are considered super priority claims.]

### 84. Mortgagee's administrative expense claim denied

The USDA filed a proof of claim asserting a claim of $714,475.86, secured by several mortgages on the debtor's real property in New Hampshire. Trustee and the USDA discussed a process by which the trustee might attempt to market and sell the property. The trustee had no money to pay for the property's upkeep, so the USDA paid for it. There was no written agreement concerning this obligation, but it was clearly the expectation of the trustee that it be paid by the USDA. After the trustee was unable to sell the property, the USDA was not willing to work with the trustee at a reduced listing price below its payoff. The USDA obtained relief from the automatic stay and foreclosed on the property, leaving a deficiency claim of $393,062.43. It also asserted an administrative priority for $28,344.49, which it later reduced to $16,962.18. Although it failed to comply with the requirement that it file a motion for allowance and payment of administrative expense, it was included in its proof of claim and the trustee objected thereto. The bankruptcy court sustained the objection and disallowed the administrative expense claim, finding that the expenses did not benefit the bankruptcy estate as the trustee did not end up selling the property. Moreover, the USDA received whatever benefit came from the in currence of those expenses as it ended up foreclosing and selling the property itself. Additionally, the court noted that if the trustee had paid for all

of those costs, it would have been entitled to surcharge the USDA under § 506(c). Thus, the court concluded that the USDA would receive a windfall if it was reimbursed as an administrative claim. *In re Hopkinton Independent School, Inc.*, 499 B.R. 158 (Bankr. D. N.H. 2013)(Harwood, J.).

**85. Sheriff's agents allowed administrative claims for pre-petition storage charges)**

A judgment creditor had obtained a writ of possession for the debtor's equipment. Sheriffs in two counties levied on the property. At the direction of the judgment creditor, the equipment was stored with LaRoche Towing ("LaRoche") and Earth Waste & Metal ("ERM"). After the debtor filed a Chapter 11 petition, it entered into a stipulation with the judgment creditor for turnover of the equipment to the debtor with certain conditions, as the equipment was needed for the continued operation of the business. With respect to both pre-petition and post-petition storage claims, a motion for determination of allowance of an administrative expense was filed. The court found that as agents of the sheriffs, LaRoche and EWM were "custodians" as defined by § 101(11). LaRoche and EWM filed accountings seeking payment of charges totaling $25,300 and $43,000, respectively, as administrative expenses. The court determined that although the judgment creditor, and not the sheriffs, had made the arrangements for storage, that did not change the court's conclusion that they acted as agents of the sheriffs with respect to possession and storage of the equipment and were therefore entitled to payment under § 543(c)(2) allowing for reasonable compensation for services rendered and costs and expenses incurred by a "custodian." The court determined that the post-petition storage charges were eligible for treatment as administrative expenses under § 503(b)(1)(A), and that the pre-petition storage charges were allowable under § 503(b)(3)(E) as actual, necessary expenses incurred by a "custodian superseded under Section 543 … and compensation for the services of such custodian." The court finally determined that the charges were actually and necessarily incurred and were reasonable and that LaRoche and EWM had met their burden of proof by a preponderance of the evidence. *In re R. Brown and Sons, Inc.*, 498 B.R. 425 (Bankr. Vt. 2013)(Brown, J.).

**86. No administrative claim for unsecured creditors despite substantial contribution**

Certain creditors filed an application for allowance of administrative expenses in the amount of $164,336.28 for the attorney fees and costs incurred in removing the Chapter 7 trustee and assisting the successor trustee in a resolution of the bankruptcy estate's claims against the removed trustee and his law firm. The bankruptcy court denied the application saying that § 503(b) did not authorize such treatment. On appeal, the district court affirmed. *In re Connolly North America Connolly LLC*, 498 B.R. 772 (E.D. Mich. 2013). The district court agreed with the bankruptcy court that § 503(b)(3)(D) which allows for an administrative claim where a "substantial contribution" was made in a bankruptcy proceeding was limited by its terms to only cases "under Chapter 9 or 11." In response, the creditors pointed to the preamble language of § 503(b) which says that "there shall be allowed administrative expenses . . . including . .

." followed by nine categories of administrative expense. They argued that by use of the term "including" it was not an exhaustive list. While a minority of courts have agreed with that interpretation, the overwhelming majority have not. The district court also relied on *RadLax Gateway Hotel, LLC v. Amalgamated Bank*, ___ U.S. ___, 132 S.Ct. 2065, 2070-71 (2012), where the Supreme Court reiterated that when engaged in statutory interpretation, the specific governs the general, especially where Congress has enacted a comprehension scheme and deliberately targeted specific problems with specific solutions. The Supreme Court had found that the Bankruptcy Code qualified as a "comprehensive" enactment as did § 503(b) itself, which featured a thoroughly comprehensive listing of nine specific categories of allowable administrative expenses, leaving little room for a court to supplement the list. Indeed, the court determined that if anything, congressional intent was demonstrated not to extend administrative expense treatment to such a creditor in a Chapter 7 case where the code section specifically limited its application to Chapters 9 and 11. The creditors were essentially asking that the court rewrite the code section, which the court would not do.

### 87. Purchased claims disallowed under § 502(d)

ASM Capital purchased nine claims via assignment agreements that had originally been held by various trade creditors to whom the Chapter 11 debtors owed money. Despite generic indemnification restitution clauses in the event of disallowance of the claims, the original claimants were out of business and uncollectible. The trustee had commenced preference actions against the original claimants and obtained judgments in each case. ASM had purchased eight of these claims before the preference actions were commenced and one after the trustee had obtained a judgment. The trustee objected to all nine claims seeking disallowance pursuant to § 502(d) which provides that the court shall disallow "any claim of any entity" unless such entity or transferee had paid the amount, or turned over any such property, for which such entity or transferee is liable. The bankruptcy court disallowed the claims, concluding that a claims purchaser holding a trade claim is subject to the same § 502(d) challenge as the original claimant. The district court affirmed. On further appeal, the Third U.S. Circuit Court of Appeals likewise affirmed. *In re KB Toys, Inc., et al.*, 736 F.3d 247 (3d Cir. 2013). The Third Circuit held: "Because the Statute focuses on claims – and not claimants – claims that are disallowable under Section 502(b) must be disallowed no matter who holds them." Otherwise, the court observed, it would contravene the aims of § 502(d), the purpose of which was to ensure equality of distribution of estate assets. "If a transferred claim is protected from disallowance, an original claimant who received an avoidable transfer would have an incentive to sell its claim and 'wash' the claim of any disability." That would also erase the further goal of coercing compliance with judicial orders. Finally, the Circuit Court rejected ASM's argument that its claims should be allowed pursuant to the protections afforded a good-faith purchaser under § 550(b). The Circuit Court concluded that § 550(b) was not even applicable here because that section protected a good-faith transferee of property of the estate, whereas ASM purchased claims against the estate.

### 88. § 503(b)(9) administrative expense may not be disallowed based on § 502(d)

Ameri-Source delivered steel to the debtor 14 days before its Chapter 11 bankruptcy petition. It filed an administrative claim for an administrative expense in the amount of $185,348.95 based on § 503(b)(9). It then filed a motion for allowance and immediate payment of the claim as an administrative expense. The trustee objected, arguing that under § 502(d), Ameri-Source should be required to pay preferential payments received during the 90-day period preceding the petition date that totaled $84,166.65 or its claims would have to be disallowed. Ameri-Source countered that § 502(d) was inapplicable to § 503(b)(9) administrative expense claims. The trustee further argued that even if it didn't apply, the court should use its discretion to delay any required payment until after the trustee's preference claim had been adjudicated. The court ruled against the trustee. *In re Energy Conversion Devices, Inc.*, 486 B.R. 872 (Bankr. E.D. Mich. 2013). Judge Tucker recognized a split of authority in both pre- and post-BAPCPA cases. Several pre-BAPCPA cases held that all administrative expense requests under § 503(b) were subject to disallowance under § 502(d) which would require "the court [to] disallow any claim of any entity" that is a transferee of an avoidable transfer. Those cases believe that the word "claim" was broad enough to include even post-petition administrative expense requests. The leading case asserting the contrary view was from the Second Circuit Court of Appeals, *ASM Capital LP v. Ames Dep't Stores, Inc.*, 582 F.3d 422 (2nd Cir. 2009), holding as that (a) the Bankruptcy Code distinguished between "claims" and requests for administrative expenses under § 503(d) and (b), § 502(d) was an exception to the automatic allowance of claims under §§ 502(a) and (b) and its scope should be limited accordingly.

While *In re Circuit City Stores, Inc.*, 426 B.R. 560 (Bankr. E.D. Va. 2010) supported the trustee's argument, almost all other cases disagreed with the trustee's position. *Circuit City Stores* held that § 503(b)(9) administrative expenses were different because they were claims that arose pre-petition and were subject to the provisions of both § 502 and § 503 and therefore § 502(d). That court stated that such administrative expense claimants were required to file a proof of claim under § 501 in order to have such claim allowed as an administrative expense under § 503(b)(9). Cases to the contrary note that § 503 states an entity must "request" an administrative expense claim, not file a proof of claim. The court here held that those were the better reasoned cases and that § 502(d) did not apply to Ameri-Sources' § 503(b)(9) administrative expense request. The court further determined that it had no discretion to delay ordering the payment of that administrative expense claim because of the terms of the already confirmed Chapter 11 plan.

### 89. No preference recovery against administrative claimant

Debtor filed Chapter 11 intending a quick sale of the company. On the petition date, Almond Investment was owed $518,786. Debtor proposed a sale of the business to a stalking horse bidder that included the assumption and assignment of executory contracts. The debtor and Almond established the amount of Almond's secured claim at $367,385. The sale was approved by the court, and Almond received payment in the amount of $367,385, which satisfied its secured claim. After closing the sale, Almond

and the purchaser began performing under the supply agreement. After the case was converted to Chapter 7, the trustee commenced a preference action against Almond for recovery of $1,445,659. The bankruptcy court granted summary judgment to Almond. *Guiliano v. Almond Investment Co. (In re Carolina Fluid Handling Intermediate Holding Corp.)*, 467 B.R. 743 (Bankr. D. Del. 2012). Judge Sontchi rejected the trustee's arguments that the supply agreement was not executory and had not been assumed and assigned. The court found the trustee failed to satisfy § 547(b)(5) because Almond held an administrative claim that would have been fully funded and it, therefore, did not receive less than it would have had the payments not been made. The court relied upon the holding in *In re Kiwi International Airlines, Inc.*, 344 F.3d 311 (3d Cir. 2003) that § 547(b)(5) cannot be satisfied if during the case an executory contract was assumed or assumed and assigned pursuant to a court order. The judge noted that it was irrelevant whether a critical trade vendor is a vendor, supplier, licensor, subcontractor, or counter party to an executory contract. "The basis and point of a critical trade order is to give a debtor authorization to pay pre-petition services and goods when necessary to preserve the debtor's estate. Indeed, one of the primary bases for issuing the relief is to avoid having to inquire or to litigate the details of the relationship of the parties, e.g. executory contract or supply agreement, because there is *no time* to do so." *[Author's Comment:* In a converted case, trustee must be mindful not just of all first day orders and their terms, but particularly other orders such as sale orders and related proceedings that have taken place prior to conversion in order to determine the feasibility of avoidance actions as well as super priority claims.]

### 90. Secured creditors must comply with Rule 3002(c) bar date

A Chapter 13 debtor objected to a secured claim filed by a creditor on the basis that it was not filed prior to the claims bar date set forth in Rule 3002(c) and thus should be disallowed as untimely under § 502(b)(9). The creditor opposed the objection contending that it was not required to file a proof of claim as Rule 3002(a) expressly applied only to unsecured creditors and equity security holders. The court held that the secured creditor was required to comply with the claims filing deadline set forth in Rule 3002(c) and disallowed its claim as untimely. *In re Dumain*, 2013 Bankr. Lexis 1906, 2013 WL 1890256 (Bankr. S.D. N.Y. 2013). Judge Morris acknowledged that on its face, Rule 3002(a) seemed to suggest that secured creditors need not file proofs of claim. However, the court found this reading inconsistent with other sections of the Bankruptcy Code and Rules. The court reviewed the three "camps" on this issue. The first found that secured creditors need not comply with any bar dates, reasoning that the omission of such creditors from Rule 3002(a) meant that they should also be entirely exempt from Rule 3002(c). The second held that secured creditors must comply with the bar date, but not necessarily the bar date set forth in Rule 3002(c). The third required that secured creditors comply with the bar date imposed by Rule 3002(c). After reviewing the three approaches, the court determined that Rule 3002(c) applied to secured creditors in Chapter 13, concluding that § 502(b)(9) imposed a time limit requirement on every claim with no qualification as to whether the claim was secured or unsecured. The court determined that the omission of secured creditors from Rule 3002(a) was simply recognition of the longstanding principle that secured creditors need not file a claim for its lien to pass through bankruptcy. Finally, considering the policy

considerations, the court determined: "Without a claims bar date, secured creditors could file a proof of claim at any time, which would disrupt distribution and lead to uncertainty of administration." [*Author's Comment*: Would this holding be equally applicable to Chapter 7 cases? It has become a challenge to get mortgagees to file claims in bankruptcy cases and difficult to determine who even owns the mortgage due to the frequency of unrecorded assignments.]

### 91. DSO status given to claim for overpaid child support

Debtor's ex-husband received a judgment for the amount of overpayments made to debtor for child support. He then filed a claim characterized as a DSO claim entitled to the highest priority in the amount of $41,581.79. The trustee objected and sought to reclassify the claim as a general unsecured claim. The Bankruptcy Court analyzed various cases that reached different results and ultimately determined to overrule the objection and allow the claim as filed. *In re Knott*, 482 B.R. 852 (Bankr. N.D. Ga. 2012). In dealing with prior decisions, the court determined that the relative economic and other circumstances must be considered. Here, the repayment obligation to the ex-spouse could properly be characterized as intended for and in the nature of support for the child who was then living with the ex-spouse and had been living with him during the period of overpayments. Therefore, the court decided that the claim was entitled to priority under § 507(a)(1)(A). [*Author's Comment*: This case provides an excellent analysis of all other cases involving this issue. Ultimately, the *Knott* case is really about how you untie the knot.]

### 92. Litigation finance company had no enforceable claim against the Chapter 7 trustee

After an automobile accident, the debtor commenced litigation in the state court to recover compensation for her resulting injuries. While this action was pending, she entered into several agreements with litigation finance company PSF, which advanced a total of $18,600. The debtor agreed that from the proceeds of her outstanding litigation, PSF would receive the total of its advances, together with processing fees of $875 and interest calculated at an annual rate of 42.5%. There was no personal obligation of the debtor other than from what she might recover from her personal injury action. Hence, the obligation could be described as non-recourse. Further, in order to avoid a claim of usury, PSF structured the agreements not as loans, but as investments providing a contingent right of repayment that would arise only in the event of a recovery on account of the personal injury. While the action was pending, debtor filed her Chapter 7 petition. Trustee eventually moved for authority to settle the action for $55,000 and sought authority to pay the fees and expenses of his special counsel and $23,808 to PSF in full satisfaction of any secured claim. The court approved the settlement of the PI action and payment of special counsel but disallowed any settlement with or payment to PSF. *In re Minor*, 482 B.R. 80 (Bankr. W.D.N.Y. 2012). Judge Bucki held that PSF possessed at most an equitable lien which was unenforceable against the trustee. Therefore, it could have no secured claim. PSF then asked to be allowed a general unsecured claim which the court likewise denied. The debtor had no personal liability owing to PSF under the agreement so the "loans" established no liability for which PSF

could receive a distribution from property of the Chapter 7 estate. The court found that even an unsecured claim cannot be allowed under § 502(b)(1) and disallowed the claim.

### 93. Service of claim objection held sufficient

The Chapter 7 trustee had objected to EMC's claim, noting that the claim did not indicate how EMC came to become the rightful owner and holder of the note. The objection provided a negative notice and was served on EMC at the address listed on its proof of claim and also at the address of its counsel that had requested service of notices in the case. No response was filed and an order was entered disallowing the claim. EMC sought reconsideration of the disallowance of its claim for, among other reasons, improper service, claiming that the objection was required to be served in accordance with Rule 7004(b)(3) by serving the objection "to the attention of an officer, a managing or general agent, or an agent authorized by law." The bankruptcy court denied the motion. *In re Wilkinson*, 457 B.R. 530 (Bankr. W.D. Tex. 2011). Judge Leif Clark first noted that Rule 3007 provided that a "copy of the objection with notice of the hearing thereon shall be mailed or otherwise delivered to the claimant, the debtor or debtor-in-possession, and the trustee, at least thirty (30) days prior to the hearing." He recognized that some courts had read Rule 3007 in conjunction with Bankruptcy Rule 9014 which provided that: "The motion shall be served in the manner provided for service of a summons and complaint by Rule 7004." However, he also recognized case authority that held to the contrary, with which he agreed. Judge Clark concluded that (1) the specific Rule 3007 would govern over the more general Rule 9014; (2) the express language of Rule 9014 provided that it only applied to contest a matter "not otherwise governed by these rules," which were in effect governed by Rule 3007; (3) by filing the claim, the claimant had already submitted to the jurisdiction of the court' (4) even if the court were to conclude that Rule 7004(b)(3) applied, service upon EMC generally as well as a claimant's attorney satisfied the requirements of that rule which allowed for service to "any other agent authorized by appointment or by law to receive service of process." Accordingly, service was held to be valid and the motion for relief in consideration denied.

## H. CONVERSION

## I. SECTION 362 STAY VIOLATION

## J. STANDING

### 94. In non-excess cases, debtor lacks standing to sue trustee or to object to trustee's compensation

Individual debtor filed for relief under Chapter 11 but then converted the case to one under Chapter 7. Trustee administered the case and filed a final report and a compensation motion. The trustee's final report showed that creditors would be paid less than 100% of their claims. Debtor objected to the compensation motion. The bankruptcy court dismissed debtor's objection to the trustee's claims on standing grounds and the district court affirmed. On appeal, the Tenth Circuit affirmed in *In re*

*Perez*, 535 Fed. Appx. (10th Cir. 2013). The court held that appellate review is "available only to a person aggrieved." The court held that a debtor only is aggrieved "when the estate is solvent and the excess will eventually go to the debtor."

### 95. Debtor's competitor lacked standing to reopen Chapter 7 case

The debtor Alexandria Surveys International, LLC filed a Chapter 11 petition in March of 2010, but the case was converted to Chapter 7 in January 2012. Later that year, the trustee filed a report of no distribution, and in May 2012, the case was closed. It so happened that in October of 2010, right after the debtor ceased doing business, the spouse of the debtor's principal formed Alexandria Surveys LLC ("Newco") and began doing business out of the debtor's old location. After the Chapter 7 case was closed, Newco acquired the former debtor's telephone number, web address, and property formerly owned by the debtor, including computer equipment. On the motion of a competitor company, the bankruptcy court reopened the Chapter 7 case. The competitor had asserted that it wanted to buy personal property that had been unscheduled by the debtor, including customer lists, files, web pages, phone and fax numbers. The trustee served notice of an upcoming asset sale to which Newco objected. The auction was held with the competitor outbidding Newco. The competitor paid the trustee for the assets, after which the trustee moved for an order requiring Newco to turn them over. The court granted the motion with respect to all unscheduled assets but not those scheduled because they were deemed abandoned. Newco appealed and the District Court reversed and remanded. *In re Alexandria Surveys International, LLC*, 500 B.R. 817 (E.D. Va. 2013).

The District Court held that (a) the competitor lacked standing to move to reopen the bankruptcy case, (b) even if it had not lacked standing, the web address and phone numbers were not property in which the debtor could claim an ownership interest, and (c) the scheduling of "computers" by the debtor had included the server for the business. The District Court noted that there was a split at the Circuit Court level as to whether the address and telephone number constituted property in which the bankruptcy estate could claim an interest, but held that there was no division as to the standing issue. The competitor lacked a direct pecuniary interest and could not establish standing as a result. [*Author's Comment*: The competitor should have contacted the Office of the U.S. Trustee and had it file the motion to reopen the case on the basis of unscheduled assets. That single mistake cost the competitor dearly in this case. It should also be noted that the facts described in the Opinion demonstrate that there had been a "bleed-out" of the assets of the debtor to a parallel company operating at the same location, with a similar name, and ultimately with the same contact information. This constitutes not just a fraudulent transfer but a criminal offense that should have been referred to the U.S. Trustee separately for criminal prosecution.]

### 96. Bankruptcy courts are not required to consider non-cash bids

In bankruptcy, debtor sold most of its assets through an auction to a joint venture. A party (not a creditor and not a proposed buyer) objected to the sale, arguing that the establishment of the joint venture was collusion. The bankruptcy court held that the party did not have standing to challenge the sale.

On appeal, the Seventh Circuit affirmed. *In re New Energy Corp.*, 2014 WL 145274 (7th Cir. Jan. 15, 2014). The court held that only aggrieved parties may be injured by a §363 sale and the only parties that can be injured are unsuccessful bidders or creditors. Being neither, the party had no standing to object to the sale. The party argued that it could have been a bidder given that it had offered to lease the debtor's plant (the primary asset being sold) with an option to buy. This bid was not considered as it did not comport with the bankruptcy court's requirement of a cash-upfront bid. The court held that the party's own decision not to follow the bidding guidelines established by the court did not justify giving the party standing. In doing so, the Seventh Circuit held that "bankruptcy courts are entitled to require cash bids, rather than complex and hard-to-value bids including leases and options."

**97. Trustee's settlement approved over debtor's objection**

Pre-petition, the corporation entered into a sales-commission agreement with the debtor and two of debtor's companies, whereby the corporation acquired vehicle fleet-leasing assets in exchange for a $20 million payment, as well as a series of deferred, formula-based incentive payments. After approximately two years, debtor filed its Chapter 7 petition and scheduled the sales-commission agreement with an estimated value of $6 million. Debtor did not claim the payments owed under the agreement as exempt property in the original schedules or in two subsequent amendments. The trustee and two secured creditors asserted claims against the corporation for monies allegedly owed under the sales-commission agreement. After extensive negotiations, the parties agreed to a settlement under which the corporation would pay $2.07 million to the bankruptcy estate, $500,000 to one of the secured creditors, and $1.53 million to the other secured creditor, receiving in exchange a complete release of liability for all claims related to the agreement. Trustee filed a motion to approve the settlement under Rule 9019 to which the debtor objected on the basis that the sale-commission agreement was an employment agreement so some of the funds owing would constitute exempt earnings under state law. At the hearing, debtor requested a continuance in order to assert the exemption claim, but the request was denied. The bankruptcy court found that at the time of the hearing the debtor had no standing since no exemption had been claimed. When debtor's appeal reached the circuit court, the bankruptcy court's decision was affirmed. *In re Hecker*, 703 F.3d 1112 (8th Cir. 2013). The circuit court held the bankruptcy court had correctly overruled the objection because debtor had no legitimate basis to object to the settlement at the time of the settlement hearing. In addition to having never claimed an exemption, debtor had repeatedly represented to creditors that debtor was self-employed or unemployed and had no prospective "wages, salary or commissions." In reliance on such representations, the trustee and the secured creditors as well as the corporation had negotiated the multi-million dollar settlement. On this record, the circuit court held that debtor's "lack of diligence (if not outright deception)" was apparent, as was the prejudice to the parties to the settlement if a continuance had been granted. Accordingly, the lower court was affirmed.

### 98. Insolvent debtor lacked standing to object to claim

The Chapter 7 individual debtor was insolvent based on his schedules which reflected total assets of $136,925 against total liabilities of $478,220. The debtor objected to proofs of claim filed by an alleged assignee of mortgage debts on the theory that the individual executing the assignments on behalf of the original mortgage lender did not have authority to do so. *In re Riley*, 478 B.R. 736 (Bankr. D. S.C. 2012). Judge Duncan overruled the objection because debtor had no standing to assert it and further noted that even without regard to the debtor's insolvency, in his capacity as a mortgage borrower who was a third party to an assignment between the original mortgage lender and the lender's assignee, debtor did not have standing to attack the validity of the assignment in objecting to proofs of claim filed by the assignee.

### 99. Discharged trustee had standing to appear and be heard in debtor's motion to reopen chapter 7 case – motion to convert to chapter 11 denied

Debtors moved to reopen their chapter 7 case and convert it to chapter 11. The debtors had failed to disclose a motor vehicle accident claim on their schedules and at their 341. The trustee joined in the debtor's motion to reopen the case, but opposed the motion to convert based on their failure to disclose the claim. The debtors claimed they failed to disclose based on advice from their attorney. The bankruptcy court granted the motion to reopen the case, but denied the motion to convert the case. The debtors appealed, arguing that the trustee had no standing to be heard because he had filed his final report and had been discharged. The Bankruptcy Appellate Panel (BAP) affirmed. *Levesque v. Shapiro (In re Levesque)*, No. 10-21796-BAM, 2012 Bankr. LEXIS 2970 (B.A.P. 9th Cir. 2012)

The BAP addressed the issue of first impression of whether the trustee had standing, looking to Rule 5010 to determine whether the trustee was a party in interest. The BAP followed the majority approach, which recognizes that a discharged chapter 7 trustee has standing to appear and is a party in interest in cases involving reopening a closed case for administration of undisclosed assets. While the discharge of the trustee with the original closing of the case raised "a technical question as to his authority to administer or otherwise deal with the claim", the BAP noted that the trustee is the representative of the estate and the debtors had no authority to administer the claim on behalf of the estate. It was also the debtors, rather than the trustee, who filed the motion to reopen. Therefore, the trustee had standing to appear and be heard with respect to the motions. Further, the BAP held that the bankruptcy court did not abuse its discretion in denying the motion to convert to a chapter 11 under section 706(a). While the bankruptcy court did not find that the debtors committed fraud, it did find they did not tell the truth and signed untrue schedules under oath and penalty of perjury.

## K. SECTION 363 SALES

### 100. Court approves sale of debtor's remainder interest in property over objection of relatives

Trustee sought to sell the debtor's one-half quarter remainder interest in certain residential real property for $30,000. Debtor's mother who held a life estate in the residence objected as did her daughters who had the other remainder interests. The mother had obtained quitclaim deeds executed by each of her daughters. They were never recorded, and no consideration had been paid. The family members argued that debtor held bare legal title and had no equitable interest in the property. Debtor had never scheduled a remainder interest. After the trustee discovered the interest, debtor claimed a wild-card exemption therein. The court denied the objections and approved the sale, finding that debtor held both a legal and equitable interest in the residence. *In re Corse*, 486 B.R. 241 (Bankr. D.R.I. 2013). Judge Finkle held that ownership of real estate, unlike a bank account, cannot be challenged when the recorded deed is unambiguous. The relatives had also sought to have debtor disclaim her rights in the remainder interest, but the court held that only the trustee had the right to disclaim the interest post-petition as it was a property right of the estate. Finally, the relatives had argued that the debtor's homestead exemption, if asserted, would exceed the purchase price of the interest. However, the court held that the relatives had no standing to assert the homestead exemption on behalf of the debtor and that under the circumstances of the case, it was inapplicable anyway.

### 101. Scope of "interest" covered by a § 363 sale

The Chapter 11 debtor's assets were purchased at a court-authorized sale free and clear of all interests. The purchaser moved for enforcement of the court's sale order against the Massachusetts Department of Workforce Development, Division of Unemployment Assistance (DUA) to prevent the DUA from imputing debtor's experience rating to purchaser as "successor employer" and determining the contributions that purchaser would have to make to the DUA. The bankruptcy court entered an order barring the DUA from taxing the purchaser at debtor's unemployment contribution rate. The DUA appealed to the Bankruptcy Appellate Panel, which affirmed. *In re PBBPC, Inc.*, 484 B.R. 860 (1st Cir. BAP 2013). The Appellate Panel held that the term "any interest" as set forth in § 363(f) authorizing a sale of debtor's assets free and clear of any interests, is not limited to *in rem* interests in property, but should be interpreted expansively to include other obligations that may flow from ownership of the property. The Appellate Panel also held that the DUA's right to tax the purchaser based on the debtor's experience rating was in the nature of an "interest" of which debtor's assets could be sold free and clear. [*Author's Comment*: The court provides an excellent discussion of the wide divergence of views of the term "any interest" and what it covers, but determined to follow the more expansive reading that had been advanced by the 7th, 4th, 3rd, and 2nd Circuits in cases discussed in the opinion.]

### 102. Credit bid equivalent to cash bid

The bank loaned SDG several million dollars to finance construction of a golf course. The loans were secured by liens on SDG's assets and limited guaranties executed by SDG's principals containing forum selection clauses. As additional collateral, a $1.2 million certificate of deposit was pledged by the guarantors on the condition that it be returned upon payment in full of the senior indebtedness. After SDG filed Chapter 11. Fire Eagle purchased the senior indebtedness from the bank stipulating to an outstanding balance of $9.1 million. After the bankruptcy court refused to confirm a plan, it ordered a sale of SDG's assets. There was active bidding with a final cash bid of $9.2 million that was topped by Fire Eagle's credit bid of $9.3 million. The bankruptcy court accepted the credit bid and ordered that the senior indebtedness had been paid in full. Fire Eagle asserted that it could still recover from the guarantors. The guarantors then filed an adversary action for declaratory judgment that the guaranties had been satisfied and for release of the CD. Fire Eagle moved to dismiss and sued the guarantors in the Eastern District of Louisiana contending that its credit bid had not paid it in full and that it could therefore still collect against the guarantors. The bankruptcy court granted summary judgment to the guarantors and the Louisiana court transferred venue to the bankruptcy court. Fire Eagle appealed. The district court affirmed. It then appealed to the Fifth Circuit Court of Appeals which also affirmed. *In re Spillman Development Group, Ltd.*, 710 F.3d 299 (5th Cir. 2013).

The circuit court first rejected Fire Eagle's argument under *Stern v. Marshall*, 131 S.Ct. 2594 (2011), that the bankruptcy court lacked constitutional authority to issue the judgment, holding that the issues were inextricably intertwined with the interpretation of a right created by federal bankruptcy law, *viz.* the effect of Fire Eagle's credit bid. It also rejected Fire Eagle's assertion that venue was improper due to the forum selection clause in the guaranty. Finally, the court rejected Fire Eagle's contention that the credit bid did not result in the senior indebtedness being satisfied. Fire Eagle argued that the lower courts should have assessed the fair market value of the assets purchased at the 363(b) sale and that only this value should be credited against the senior indebtedness. The circuit court noted that if Fire Eagle had simply declined to credit bid, the cash proceeds from the auction would have been applied against the senior indebtedness. If such cash bid had paid in full the senior indebtedness, it would be absurd to suggest that Fire Eagle could separately proceed against the guarantors. The court saw no difference between such a cash bid and Fire Eagle's credit bid. The court further held that § 363(k) contemplated explicitly mixed bids of cash and claims, implicitly presupposing an equivalence with cash of the value of the credit bid. Finally, the circuit court rejected Fire Eagle's argument that modification or elimination of a debt in bankruptcy should not affect payment rights under guaranties of such debts, because it held that the debt had in fact been paid in full. Indeed, the guaranty agreements provided for their own termination on payment of the guaranteed debt. The circuit court found no reason for the bankruptcy court to have determined the fair market value of the assets sold and affirmed the lower courts.

### 103. Trustee seeks to recover amount of alleged overbid by credit bidding lender at foreclosure sale

The lender had obtained stay relief and proceeded with a non-judicial foreclosure sale as permitted by Georgia law. The lender credit bid in the amount of $2,025,281. Its proof of claim had been filed in the amount of $1,522,825.13 and purported to include principal, interest, late charges, and actual attorney fees. It further asserted the property value to be $1,500,000. After the case was converted to Chapter 7, the trustee made demand for what he considered to be a bid in excess of the lawful amount owing to the lender, treating the credit bid as equivalent to a cash bid. The lender had followed Georgia law and included in its debt and credit bid statutory attorney fees which amounted to $262,386.87, which was estimated to be ten times its actual attorney fees. Under controlling precedent from the 11th Circuit in *Welzel v. The Advocate Realty Invs. (In re Welzel)*, 275 F.3d 1308 (11th Cir. 2001), the statutory attorney fees are part of the lender's secured claim only to the extent of actual and reasonable fees, pursuant to § 506(b), and unsecured for the balance of the statutory amount. The trustee argued that this resulted in a credit bid in excess of the lender's secured claim and demanded that difference. The court, however, held that the outcome could only be determined by a valuation of the property. If the property value was less than the credit bid after deducting the statutory attorney fees, then the court held that the lender would not actually have received any surplus or a windfall. It would have merely satisfied its claim. Accordingly, the court ordered a further evidentiary hearing to determine the value of the property at the time of the foreclosure sale. *In re Solid Rock Development Corp., Inc.*, 481 B.R. 221 (Bankr. N.D. Ga. 2012)(Hagenau, J.).

## L. SECTION 554 ABANDONMENT

## M. JUDICIAL ESTOPPEL

### 104. Seventh Circuit expands use of judicial estoppel against trustee

In *Spehar v. Mayer Brown Rowe & Maw, LLP*, (7th Cir. June 21, 2013), a trustee attempted to collect on a malpractice suit. The suit failed and instead of just taking its victory, the defendant sought sanctions against the trustee and his counsel. The law firm failed in its attempts and both parties appealed.

The facts of *Spehar* are convoluted but quickly summarized involve the successful attempt of a creditor to obtain a default judgment and then convince the trustee to sue the law firm (based on a malpractice theory that the firm was negligent in allowing the default judgment to be entered) as such a suit was the only way the creditor could collect on its judgment. The district court granted the law firm summary judgment on a judicial estoppel theory because the only way the trustee (whose litigation was funded by the creditor) could prevail was to convince the court that the creditor's claim (the same claim that the creditor obtained a substantial judgment on) was actually meritless.

The Seventh Circuit affirmed the use of judicial estoppel against the trustee. The Seventh Circuit held that judicial estoppel is a "flexible" doctrine concerned with "protecting the integrity of the courts from the appearance and reality of manipulative litigation conduct" and can be applied against a litigant based on the litigation position of

another party. Here, the court found that the true ringleader of the litigation was not the trustee, but the creditor and that to allow the trustee to prevail would be to allow the creditor to successfully engage in exactly the type of conduct judicial estoppel is designed to prevent.

Finally, the Seventh Circuit turned to the question of sanctions and affirmed the district court's decision not to award them. Of particular interest is the Court's discussion of whether the "willful and deliberate" standard for a trustee's personal liability for a breach of fiduciary duty also should be the standard for sanctions concerning a trustee's litigation conduct. The Seventh Circuit noted that a distinction between the two types of conduct makes "intuitive sense" but declined to go further than general ruminations.

### 105. Debtors judicially estopped from bringing civil claims for failure to disclose claims in bankruptcy proceeding

Joint debtors filed their chapter 11 petitions in September 2008. In May 2009, while the chapter 11 case was still pending, police conducted an investigation of debtors, which included a search of debtors' homes. In June 2009, debtors converted their case to one under chapter 7 and, shortly thereafter, they each filed separate pro se civil lawsuits in district court against government officials and the police, alleging violation of their constitutional rights and other claims arising from the search of their homes. Debtors did not amend their schedules to disclose the lawsuits, and they filed affidavits with the bankruptcy court stating that their original schedules were still true and accurate.

Debtors received their discharge in October 2009. Three months later, in January 2010, they filed with the bankruptcy court a Rule 1019 Report of Unpaid Chapter 11 Obligations in which they disclosed their civil lawsuits for the first time. The chapter 7 trustee then abandoned the lawsuits because he believed that they had no value to the estate.

Defendants in the civil suit sought dismissal of the action on the grounds of judicial estoppel due to debtors' prior failure to disclose the suit in their bankruptcy schedules. The district court granted summary judgment in defendants' favor, and the First Circuit affirmed. The court noted well-established precedent that failure to identify a claim as an asset in a bankruptcy proceeding is a prior inconsistent position that can serve as the basis for dismissal of a later civil claim on the grounds of judicial estoppel. In this case, the debtors satisfied the prerequisites for judicial estoppel because (a) their prior statements in bankruptcy court that they did not possess any potential lawsuits was clearly inconsistent with their position in the district court suit, and (b) the bankruptcy court accepted defendants' prior statements when it granted them a discharge. Finally, although debtors may not have benefitted from their failure to disclose the lawsuits, the court of appeals concluded that the debtors' abuse of the judicial process justified applying judicial estoppel in this case. The court of appeals therefore held that the district court did not abuse its discretion in applying the doctrine of judicial estoppel and affirmed the dismissal of debtors' civil claims. *Guay v. Burack*, 677 F.3d 10 (1st Cir. 2012),

## N. TRUSTEE IMMUNITY/LIABILITY

### 106. Sixth Circuit rejects attempts to expand trustee's personal liability

Plaintiff law firm brought a complaint against chapter 11 trustee alleging malicious prosecution and abuse of process. The trustee had brought three adversary proceedings against the law firm and all three had been dismissed. *In re McKenzie*, 716 F.3d 404 (6th Cir. 2013).

The Sixth Circuit began its discussion by noting that in the Sixth Circuit "a bankruptcy trustee is liable personally only for acts willfully and deliberately in violation of his fiduciary duties." Further, this quasi-judicial immunity protects the trustee "for actions taken in his official capacity." The plaintiff argued the typical protections of a trustee did not apply because the trustee's action was *ultra vires* and because the trustee acted without prior court approval. The court acknowledged that while pre-approval of a court may help shield a trustee, such pre-approval is not required for a trustee to invoke his personal immunity. The Sixth Circuit also rejected the *ultra vires* argument. The court noted that the only situations where this exception has been applied are cases where the trustee seized property that was not estate property. The Sixth Circuit refused to take the doctrine one step further and hold that it can apply to a trustee's *attempt* at seizing property that is not an asset of the estate such as through a failed adversary proceeding campaign.

### 107. Sanctions imposed for expenses charged to estate

The trustee in *In re Financial Corporation* (Bankr. S.D. Tex. May 13, 2013) secured a favorable judgment which his opponent appealed to the Fifth Circuit. The trustee represented himself in the appeal and traveled to New Orleans for the arguments. The bankruptcy court questioned the amount of the expenses incurred and the trustee explained that the trip was designed primarily to help the trustee prepare for argument. Upon further investigation, the court discovered that the trustee had traveled along with his family. The court found that several expenses did not appear to be related to the appeal and were more personal in nature and removed the trustee from the case.

The court's decision highlights that the trustee's tenure in the case had been a turbulent one concerning the trustee's actions regarding compensation and allegations of retaliatory conduct. In other words, the Court found a pattern of the trustee placing his own pecuniary interests ahead of the interests of the estate.

### 108. Trustee not personally liable for negligently performing his duties

The debtor's landlord sued the chapter 7 trustee in his personal capacity for negligently failing to winterize the landlord's building after the building's water pipes had frozen and burst, resulting in water damage. The trustee moved to dismiss on the ground that he cannot be held liable in his personal capacity for negligent acts. The Sixth Circuit dismissed the claim, holding that a bankruptcy trustee is not personally liable for negligently performing his duties. *Warren Inv., Inc. v. Dery (In re J&J Video)*, No. 11-2013 (6th Cir. 2012).

### 109. Bankruptcy Court had jurisdiction over removed state court claims against trustee; trustee had immunity

Debtor contested the trustee's sale of his residence and other decisions of the bankruptcy court. Debtor sought relief from the trustee's actions in California state court, alleging fraud, interference with contractual relations, and abuse of process. Trustee removed the California action to the bankruptcy court, which dismissed the claims and the debtor appealed. The Ninth Circuit Bankruptcy Appellate Panel (BAP) held that the bankruptcy court had jurisdiction over the alleged wrongs committed by the trustee while he was acting in the scope of his duties. The actions the debtor attacked were all related to his actions under the Bankruptcy Code and some were, in fact, approved by the court in its approval of a settlement. Debtor did not obtain advance permission to sue the trustee in state court or bankruptcy court, which the BAP explained justified dismissal because a person seeking to sue a court officer such as a bankruptcy trustee must first obtain permission of the court. The BAP also held that the trustee had an absolute defense of immunity where the complaint only referred to him in his capacity as case trustee. The Ninth Circuit affirmed in an unpublished decision. *Law v. Siegel (In re Law)*, 435 Fed. Appx. 702 (9th Cir. 2011)( Judges Pregerson, Thomas, and Paez).

## O. SETTLEMENT

### 110. Trustee entitled to deference in settlement decisions

Court of Appeals for the First Circuit affirmed District Court and Bankruptcy Court approval of Trustee's settlement of debtor's pre-petition legal malpractice claims. The Debtor objected to the settlement of the malpractice claims for $25,000 against his former attorney as being "too low."

The First Circuit cited precedent holds that the trustee is to be given deference for decisions and that settlements are favored in bankruptcy. The bankruptcy judge must determine whether the settlement falls within the lowest point in the range of reasonableness. The court held that the settlement fell within the range of reasonableness and the Bankruptcy Court did not abuse its discretion in approving it. On the other hand, the First Circuit hinted that Bankruptcy Court should have drafted a decision with more than "only four sentences" to explain its decision to approve the settlement. However, the First Circuit noted that this did not preclude affirming the bankruptcy Court's decision, because the trustee had conducted an investigation of the claim and offered an explanation for the settlement decision, the record supported the trustee's decision, and the Bankruptcy Court had been fully briefed and held a hearing before approving the settlement. *Yacovi (In re Yacovi) v. Rubin and Rudman LLP*, 411 Fed. Appx. 342 (1st Cir. 2011).

### 111. Settlement did not violate priority scheme – creditor financial services firm not entitled to proceeds

Debtor was a Chicago towing company that owned and operated a tug boat service on Lake Michigan. Debtor filed a chapter 11 bankruptcy, which was converted

to a chapter 7 the following year. A dispute arose over the sale of property where the debtor operated its business. There were competing claims to the property, including among the debtor's principals, who were in the middle of a bitter divorce. The debtor had brought claims against these principals for breach of fiduciary duty and usurping corporate opportunities, seeking to have the property at issue declared an asset of the bankruptcy estate. The parties reached a settlement that divided up the proceeds from the sale of the property. The principals each received 25% and the bankruptcy estate received the other 50%. The principals paid the debtor's bankruptcy attorneys from their personal share as part of the agreement. Creditor financial services firm that had provided financial consulting services to the creditors' committee during the chapter 11 bankruptcy proceedings objected to the payout in the settlement agreement, arguing that a portion of those funds should have been distributed to it and the other chapter 11 creditors. The creditor challenged the bankruptcy court order approving the settlement. The district court upheld the settlement agreement and the Seventh Circuit affirmed. *In re Holly Marine Towing, Inc.*, No. 11-1787, 2012 U.S. App. LEXIS 239 (7th Cir. 2012).

The creditor had standing to challenge the order approving the settlement, because it had a pecuniary interest in the outcome of the proceeding – there was no dispute that the creditor provided services to the estate during the chapter 11 proceedings. But the creditor's argument that the settlement violated the Bankruptcy Code's priority scheme failed because the amounts paid to the attorneys were never property of the estate. Therefore, the priority scheme simply did not apply. Finally, the bankruptcy court did not abuse its discretion in approving the settlement because 50 percent of the value of the property was within the reasonable range of possible litigation outcomes and was in the best interests of the estate.

## P. SECTION 523 AND 727 DISCHARGE

### 112. Notices sent only to creditor's former lawyer insufficient

Creditor Lampe had obtained a $25,000 judgment against the debtor approximately eight years prior to the bankruptcy petition date, at which time the judgment had not been satisfied. In the list of creditors, Lampe was only scheduled c/o the law firm that had represented him eight years earlier. She never received any of the notices. Debtor received a discharge. When Lampe went to revive her judgment, the court held that the debt had been discharged. On appeal to the Sixth Circuit Court of Appeals, that judgment was reversed. *Stephanie Lampe v. Kirk Cash*, 735 F.3d 942 (6th Cir. 2013). The Circuit Court noted that the Due Process Clause entitled Lampe to receive service of notice reasonably calculated to reach her before she could be deprived of her property. The Circuit Court observed that, under agency law, notice to the attorney would count as notice to the client, but notice to a former attorney did not. Further, nothing in the record even suggested that a search had been made for Lampe's address or that any other effort had been made to ascertain where she resided. Moreover, the Circuit Court concluded that it was unreasonable for the debtor to have reasonably believed that the law firm would still be representing Lampe at the time of the bankruptcy case. [*Author's Comment*: As trustees, we rely on the accuracy of debtor's list of creditors and schedules. Whenever a creditor is scheduled c/o another person or entity, it is always prudent to try to locate and serve that creditor at its own

address as well.]

### 113. "Defalcation" construed by U.S. Supreme Court

Section 523(a)(4) provides that an individual debtor cannot obtain a discharge from a debt for "fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny." The circuit courts are widely divided over the meaning of defalcation in that context. In this case, the Supreme Court reversed the 11th Circuit applying a scienter requirement. Writing for the court, Justice Breyer stated that where the debtor's conduct does not involve bad faith, moral turpitude, or other immoral conduct, "defalcation" requires an intentional wrong. "We include as intentional not only conduct that the fiduciary knows is improper but also reckless conduct of the kind that the criminal law often treats as the equivalent. Thus, we include reckless conduct of the kind set forth in the Model Penal Code." Hence, if the fiduciary lacked actual knowledge of wrongdoing, the conduct would be equivalent if the fiduciary consciously disregarded or was willfully blind to a substantial and unjustifiable risk that his conduct would turn out to violate a fiduciary duty. *Randy Curtis Bullock v. Bankchampaign, N.A.*, 133 S.Ct. 1754 (May 13, 2013).

### 114. Non-dischargeability complaint filed two minutes and 44 seconds late not permitted

Plaintiff and debtor had entered into two consent orders extending the deadline for plaintiff to file a complaint relating to discharge objection. As the deadline approached, debtor refused to extend the deadline a third time. The plaintiff had already deposed the debtor and his wife and had pursued settlement negotiations. Those agreements terminated 25 days before the deadline. No further motion was filed. At 11:45 p.m. on the night of the deadline, plaintiff attempted to file its complaint electronically but had computer difficulties, delaying the filing. Only after three attempts did the complaint get filed. Unfortunately for the plaintiff, the time stamp for the filing was 12:02:44, just two minutes and 44 seconds beyond the extended deadline. The debtor promptly filed a motion to dismiss. The plaintiff sought allowance of the complaint under principles of equitable tolling. The court denied that request finding it "hard to accommodate a creditor's request for equitable tolling of a hard and fast deadline when that creditor sat on its hands and waited until the last moment to meet said deadline." Further, equitable tolling usually is based on misconduct of some kind by the debtor which did not exist here. There was very little discussion of Rule 9006(b) and the grounds for excusable neglect. Instead, the court held that it had no discretion to consider the merits of the complaint under the prior 11th Circuit precedent of *Byrd v. Alton (In re Alton)*, 837 F.2d 457 (11th Cir. 1988). Accordingly, the motion to dismiss the complaint was granted. *In re Harper*, 489 B.R. 251 (Bankr. N.D. Ga. 2013)(Drake, J.). (Accord, *Anwar v. Johnson*, 510 Fed. Appx. 499 (9th Cir. 2013)(18 minutes late was still too late).

### 115. Trustee's discharge objection complaint filed one day late allowed nunc pro tunc

Trustee and debtor had two agreed orders entered extending the original deadline to object to discharge as set forth in Rule 4004(a). The motions seeking such extended deadlines were timely filed. The final deadline was August 8, 2012. The trustee filed her adversary proceeding objecting to debtor's discharge under several subsections of § 727, but she filed it one day after the court's deadline established by agreement of the parties and court order. The court nevertheless allowed the complaint by extending the deadline *nunc pro tunc* by one day on an excusable neglect basis under Rule 9006(b)(1). *In re Soler*, 490 B.R. 629 (Bankr. S.D. Fla. 2013). Judge Isicoff recognized that under 11th Circuit precedent, *Byrd v. Alton (In re Alton)*, 837 F.2d 457, 459 (11th Cir. 1988), the bankruptcy court would have no authority to extend the deadline if the motion seeking such extension was filed after the expiration of the deadline in Rule 4004(a). However, where, as here, the established deadline was extended by court orders "the court for cause may at any time in its discretion . . . on [a] motion made after the expiration of the specified period permit the act to be done where the failure to act was the result of excusable neglect." Rule 9006(b)(1). Thus, the court agreed with an earlier decision *In re Chira*, 343 B.R. 361, 369-371 (Bankr. S.D. Fla. 2006), *aff'd*, 378 B.R. 698 (S.D. Fla. 2007), *aff'd, 567 F.3d 1307 (11th Cir. 2009)*, where the court had concluded that once it extended a deadline in accordance with Rule 9006(b)(1), a court may further extend that deadline due to a party's excusable neglect. In determining excusable neglect, the court would consider (1) the danger of prejudice to the debtor, (2) the length of the delay and its potential impact on judicial proceedings, (3) the reason for the delay, including (4) whether it was within the reasonable control of the movant, and (5) whether the movant acted in good faith. Here, the delay of several hours was not prejudicial to the debtor and was not done in bad faith. Accordingly, the deadline was extended *nunc pro tunc*. [*Author's Comment*: The same analysis should be applicable to the deadline for objecting to exemptions if previously extended by court order.]

### 116. Sunday deadline not "automatically" extended

The deadline to extend the dischargeability deadline had been extended by consent to March 31, 2013, as set forth in the order granting that motion. As it turned out, that day was a Sunday. X Open Company filed its dischargeability action the following day – a Monday. The debtor moved to dismiss the complaint as untimely. The issue before the court was whether the March 31 deadline was extended to the following day under Rule 9006(a), since the deadline for filing the complaint had fallen on a Sunday. The court concluded that the dischargeability deadline was not extended as Rule 9006(a) only applied when the original time period had to be computed – not when a fixed date to act is set. If the order had simply said that it was extended for 30 days or 60 days, then it would have been tolled over to the next business day; whereas , here, a court order fixed a date certain to act that did not need to be computed, so the rule was inapplicable and the complaint untimely. *In re Gray*, 492 B.R. 923 (Bankr. M.D. Fla. 2013) (Williamson, J.).

### 117. Discharge denied for failure to disclose recent financial transactions

Trustee filed an adversary proceeding objecting to debtor's discharge pursuant to sections 727(a)(2)(A) and 727(a)(4)(A), alleging that the debtor concealed assets and made false oaths. During the trial, it came to the court's attention that the debtor may not have reviewed the electronic version of his petition and schedules that had been filed with the court. The hard copy signed by the debtor had certain sections crossed out and words written in, which did not appear on the electronically filed version. Because of the ambiguity as to which document the debtor had signed, the court did not consider the debtor's signature on the electronic petition as a statement made under oath. Instead, the court relied on debtor's statements under oath at the section 341 meeting and Rule 2004 examination that the petition and schedules were accurate. The court then denied the discharge under section 727(a)(4)(A), finding that the debtor had made a "false oath or account." The court found that the debtor had failed to disclose a variety of transactions – including a substantial transfer from a joint checking account to his non-filing spouse, misstatements about income earned in the most recent three years, transfer of a 401K account, debt to his father-in-law, and ownership of a life insurance policy – and the court found that this series of omissions and errors constituted intent to deceive and the omitted information was material to the bankruptcy case. *Warren v. Moore (In re Moore)*, No. 11-00294-8-JRL, 2012 WL 3564168 (Bankr. E.D.N.C. 2012).

### 118. Debtor's discharge revoked for failure to turn over tax refund

The debtor had already received a discharge. After the trustee was unable to recover the non-exempt portion of a tax refund from the debtor, he moved to compel the turnover of that amount, $1,887.27. The court entered an order granting the trustee's motion in directing the turnover of that sum. After the debtor failed to obey the court's order, the trustee sought to have the debtor's discharge revoked under § 727(d)(3) and (a)(6)(A). After commencement of the adversary proceeding, debtor remitted $1,300, leaving a balance of $587.27. The court granted summary judgment to the trustee and revoked the debtor's discharge. *In re Gates*, 2012 Bankr. LEXIS 1681 (Bankr. N.D. Ohio). Judge Harris noted that some courts required a finding of willful and intentional refusal to obey the court's orders, whereas other courts treated it similar to a charge of civil contempt, thus negating the intent requirement. Here, the trustee had established the three steps for civil contempt: (1) the debtor had knowledge of the order; (2) the debtor did in fact violate the order; and (3) the order was specific and definite. This shifted the burden to the debtor to explain her non-compliance, and to provide supporting evidence. Mere assertions by the debtor are insufficient. Here, however, the debtor failed to explain her failure to comply and, therefore, summary judgment was granted to the Trustee.

### 119. Debtors should have been given opportunity to present evidence to justify valuation and list of property on schedules

Trustee objected to debtors' amended claim of exemptions. The debtors represented a value of $2,000.00 on their schedules as the value of "household goods

and furnishings" and a $200.00 value for "wearing apparel." The debtors exempted the entire value of these items under section 522(d)(3). The trustee held a 341 meeting and filed a no asset report on the same day. Then a fire destroyed the debtors' home and its contents. The debtors filed a claim with their insurer for, among other things, $45,924.88 in household goods and furnishings, wearing apparel, medical equipment and living expenses. The U.S. Trustee filed an adversary proceeding against the debtors seeking to revoke their discharge on the grounds that they had undervalued their household goods on Schedule B. The debtors then sought to amend their schedules, but the trustee objected stating that the listed values should be binding on the debtors. The bankruptcy court sustained the objection on estoppel grounds. *Rossi v. Westenhoefer (In re Rossi)*, 2012 Bankr. LEXIS 1168 (B.A.P. 6th Cir. 2012).

On appeal, the BAP determined that the bankruptcy court erred in applying equitable and judicial estoppel to disallow the debtors to amend the exemptions. According to the BAP, the court should have been given the opportunity to present exculpatory evidence showing that the initial property valuation was the result of mistake or inadvertence and that they lacked bad faith in making such valuation. As to equitable estoppel the BAP explained that it could not conclude that the parties relied to their detriment on the debtors' original schedules and that unsecured creditors would be "substantially prejudiced" if the debtors succeeded in amending their exemptions. The BAP did affirm the bankruptcy court's determination, however, that the insurance policy was property of the estate and because it was not scheduled it could not be abandoned by the trustee.

### 120. Fifth Circuit affirms debt as non-dischargeable under section 532(a)(2)(A) despite fact that debt arose from settlement agreement

Debtor appealed a bankruptcy court ruling, affirmed by the district court, that a claim by insurance company against debtor as indemnitor of his corporation's obligations was not dischargeable in bankruptcy under section 523(a)(2)(A). The bankruptcy court held that the over $3 million debt of the debtor as indemnitor was not dischargeable because he had obtained surety bonds for his corporation from the insurance company through actual fraud. The debtor had not only signed for himself, but had forged signatures of his spouse, his brother, and his brother's spouse as indemnitors. After he testified he forged the signatures, the debtor entered into a settlement on the basis of which the district court issued a $3 million consent judgment. The debtor then filed for bankruptcy and sought discharge of this indebtedness. The Fifth Circuit affirmed the decision that the debt was not dischargeable. *Kapetanakis v. First Nat'l Ins. Co. of Am. (In re Kapetanakis)*, No. 11-20306, 2012 U.S. App. LEXIS 11879 (5th Cir. 2012).

The court found the debtor's argument that the insurance company released the non-dischargeable fraud claim through settlement foreclosed by the Supreme Court's decision in *Archer v. Warner*, 538 U.S. 314 (2003). In addition, the insurer showed it would not have issued the bonds without an indemnity signed by the owners of all outstanding stock and by the spouses of those stockholders. The court's determination that the debtor forged the signatures with the intent to deceive the insurer was also supported by the record because, for example, the signatures were affixed at the same time but in different styles and in different colored ink. Finally, the record supported the

determination that the insurer actually and justifiably relied on the indemnity in issuing the bonds.

## Q. TAX ISSUES

### 121. Federal tax lien cannot be avoided under either Chapter 7 or Chapter 13

Debtor had failed to pay federal income taxes for several years totaling nearly $137,000. Consequently, the IRS had filed a Notice of Federal Tax Lien against debtor's property. Debtor subsequently filed Chapter 13 asserting personal property worth only $1,625 and filed a "Complaint to Determine Nature and Extent of Federal Tax Lien." Debtor asserted that under § 506(a), the IRS's secured claim was limited to that amount and that the remainder of its claim was unsecured and under § 506(d) void to the extent it exceeded that amount. While the IRS conceded that its secured claim was limited to $1,625 for purposes of plan confirmation, it maintained that the bankruptcy court was not permitted to void its lien to the extent of any excess. The bankruptcy court ruled in favor of the IRS and held that § 506(d), as interpreted by the Supreme Court in *Dewsnup v. Timm*, 502 U.S. 410 (1992), prevented debtor from voiding, or "stripping down" the lien. Accordingly, it granted the government's motion for judgment on the pleadings. On appeal to the 7th Circuit, that judgment was affirmed. *In re Ryan*, 2013 WL 3380131, 2013 U.S. App. LEXIS 13710 (7th Cir. 2013).The circuit court noted that under *Dewsnup* the term "allowed secured claim" in § 506(d) meant a claim that was allowed under § 502 and secured by a lien enforceable under state law, regardless of whether that claim was deemed secured or unsecured under § 506(a). Debtor, however, argued that § 506(d) should be interpreted differently in Chapter 13 to fulfill the purposes of that chapter. The circuit court disagreed citing *Clark v. Martinez*, 543 U.S. 371 (2005) wherein the Supreme Court held that the language of a statute should be read consistently. In line with that decision, the circuit court held that to rule otherwise would be to "invent a statute rather than interpret one." *Accord In re Woolsey*, 696 F.3d 1266 (10th Cir. 2012).

### 122. Treatment of penalties for late filed tax returns of an insolvent corporation when no underlying tax was due

The IRS's claim arose post-petition when it assessed penalties against debtor under 26 U.S.C. § 6699 due to trustee's failure to timely file debtor S corporation's tax returns for the years 2008 and 2010. (For reasons not clear the IRS abated the penalties for the 2009 tax year.) The penalties of $18,667.17 were asserted by the IRS as an administrative priority expense. The trustee objected since they were not based on any unpaid tax incurred by the bankruptcy estate. The trustee intended to treat the claim as a subordinated penalty claim under § 726(a)(4), but the IRS argued that section to be inapplicable because it applied to only pre-petition claims. Instead, the IRS argued that the penalties were entitled to an administrative expense priority as an actual and necessary cost of preserving the estate. The bankruptcy court found the trustee had not demonstrated a reasonable cause for the late-filed returns within the meaning of § 6699 and allowed the IRS's claim as an administrative expense claim with priority

under § 503(b)(1)(A). On appeal, the Bankruptcy Appellate Panel affirmed on the failure to demonstrate reasonable cause but reversed on the treatment of those penalties as administrative expenses under § 503(b)(1)(A) and remanded the matter for the bankruptcy court to decide if the penalties qualified as administrative expenses for other reasons. *In re 800Ideas.com, Inc.*, 2013 Bankr. Lexis 3550 (9th Cir. BAP July 22, 2013). The Appellate Panel noted that the penalties (a) were not incurred in the operation of a business, (b) did not confer an actual benefit on the estate, (c) did not preserve the estate, and (d) would be a detriment to the unsecured creditors if allowed as an administrative expense. Moreover, the bankruptcy court had not found that the trustee had engaged in any wrongful conduct. Rather, the trustee was under the mistaken belief that he did not need to file the informational returns while the estate remained insolvent and had no assets with which to pay accountants to analyze poorly maintained records and prepare the returns. On these facts, the Appellate Panel did not believe the creditors should bear the cost of the penalties, but nevertheless considered it a "close call" as to whether the tax penalties might be entitled to administrative expense status for other reasons.

In a concurring opinion, Judge Bason noted the difficult situation in which the trustee found himself. There were no funds to pay an accountant which, while not a sufficient excuse for a tax payer outside of bankruptcy, was in his view a different situation for a Chapter 7 trustee who normally defers the filing of tax returns until there are funds with which to prepare them. He asked "What other course of action would be prudent for a chapter 7 trustee?" He also noted the difficulty in retrieving the debtor's records and persuading the debtor's accountants to prepare the returns where those accountants had not been paid for past work and had uncertain prospects of ever being paid for future work. He found the situation analogous to well accepted grounds for not timely filing a tax return such as the taxpayer's death or serious illness or the destruction by casualty of the taxpayer's records. Nevertheless, he also noted that the trustee missed the deadline by approximately thirty-three months, not just a few months. He also proposed that tax penalties might possibly be treated as unsecured penalty claims because they did have pre-petition aspects, arising from the liquidation of the pre-petition business and the untimely filing of the pre-petition tax returns. For that reason he agreed with the reversal as well as the remand to the bankruptcy court to determine if it qualified as an administrative expense priority on any other basis.

### 123. Debtor's bank holding company owns tax refunds

Imperial was the designated parent company in a consolidated tax group that included the bank. Imperial filed tax returns on behalf of itself and the bank for the 2004-2009 tax years. At the end of 2009, the California Department of Financial Institutions closed the bank, and the FDIC was appointed receiver. On the same day, Imperial filed a Chapter 11 petition and thereafter a complaint in the U.S. District Court against the FDIC seeking a declaratory judgment that $30 million of income tax refunds belonged to the bankruptcy estate. The FDIC argued in opposition that the refunds belonged to the bank and cross-motions for summary judgment were filed. The District Court granted Imperial's motion finding that the refunds belonged to the bankruptcy estate and denied the bank's motion. The court found that under a Tax Allocation Agreement between

Imperial and the bank, a debtor-creditor relationship was established and not an agency relationship. The court noted that terms such as "reimbursement" and "payment" in a tax sharing agreement evidenced a debtor-creditor relationship. The bank's arguments that the TAA was not valid and enforceable against the FDIC nor approved by the bank's board of directors were rejected. *Imperial Capital Bancorp, Inc. v. FDIC*, 492 B.R. 25 (S.D. Cal. 2013).

### 124. Workers compensation taxes not entitled to priority

The debtor, a not-for-profit, ran into financial difficulty and failed to make certain payments to the State of Michigan to reimburse the State for various unemployment benefits. The State of Michigan filed proofs of claim seeking the recoupment of these monies. The State alleged the claims were entitled to priority under §507(a)(8) as an excise tax. The Bankruptcy Court noted that the First Circuit in *Massachusetts Div. of Employment and Training v. Boston Regl' Med. Ctr.*, 291 F.3d 111 (1st Cir. 2002) and the Third Circuit in *Reconstituted Comm. Of Unsecured Creditors v. New Jersey*, 396 F.3d 247 3d Cir. 2005) held that unemployment taxes were not entitled to priority and joined those courts in holding the same. *In re Community Memorial Hospital*, Case No. 12-20666 (Bankr. E.D. Mich. May 26, 2013). The court held that in order for a tax to be considered of the kind entitled to priority, it must: (1) be an "involuntary exaction" that is universally applicable to similarly situated persons; and (2) according priority status will not disadvantage private creditors with similar claims. The court found that the tax failed step 2 of the test as under Michigan law private parties could post a surety bond that would diminish the State's obligations. While there was no class of creditors who actually had posted such a bond, the court found the existence of a hypothetical creditor to be sufficient to deny priority status.

### 125. Bankruptcy Code does not extend the deadline to challenge state ad valorem taxes on real estate

Twenty-nine days after the estate property appraiser certified the 2009 tax rolls to the state tax collector, debtor filed a Chapter 11 petition. The tax collector filed a proof of claim in the bankruptcy 36 days later for unpaid real property ad valorem taxes calculated on the appraised value of debtor's investment properties. A person owing such taxes had 60 days after the certificate of the tax rolls to file a challenge to the valuation of the property under applicable state law. Once the deadline had run, state courts would be deprived of jurisdiction to consider the claim. Here, debtor did not timely challenge the assessment with the state agency but did file an objection to the tax claims in the bankruptcy court about four months after the state law deadline, claiming that the actual property values were less than those determined by the state property appraiser. The bankruptcy court held that the debtor's request to have the court re-determine debtor's state ad valorem tax liability was timely filed under §§ 108(a) and 505. The state taxing authority appealed to the district court, which affirmed. However, on further appeal to the 11th Circuit, the ruling was reversed. *In re Read*, 692 F.3d 1185 (11th Cir. 2012). The circuit court determined that under § 505(a)(2)(C) of BAPCPA, Congress had intended to create an exception to the general extension provisions set forth in § 108(a) and that § 505(a)(2)(C) specifically restricted bankruptcy courts from

determining the legality or amount of an ad valorem tax on real estate after the period for contesting such a tax had expired. Therefore, the circuit court reversed the lower courts. [*Author's Comment*: This is an important decision for trustees as it makes it very difficult to timely file in many states a challenge to over-assessed properties.]

### 126. Entire tax refund subject to turnover where debtor's wife was unemployed

Chapter 7 trustee filed a motion to compel turnover of the debtor's income tax refund pursuant to 542(a). The issue was whether the debtor's wife, who did not join in the bankruptcy, owned half of the tax refund. As the court explained, if so, her share would not be payable to the trustee. The bankruptcy court found, however, that the debtor owned the entire tax refund at the time of filing. The debtor's wife was not employed and the tax refund came entirely from the debtor's withheld wages. The bankruptcy court examined Illinois law, determining that the tax return was the debtor's property. Therefore, the bankruptcy court concluded that the entire tax refund became property of the estate and was subject to turnover by the trustee. The bankruptcy court granted the trustee's motion for turnover. *In re Ruhl*, No. 09 B 45933, 2012 Bankr. LEXIS 3001 (Bankr. N.D. Ill. 2012).

## R. ERISA ISSUES

### 127. Bankruptcy court has core jurisdiction over trustee's fees relating to § 704(a)(11) duties

After the Chapter 11 case was converted to Chapter 7, the trustee moved for authority to terminate the debtor's 401(k) plan and for authority to establish a reserve out of plan assets for the cost of administering and terminating the plan. The court granted the motion. Once the trustee completed that task, trustee moved for approval of his fees and those of his counsel for services rendered in connection with termination of the plan. The Department of Labor challenged the jurisdiction of the bankruptcy court to decide the motion. The court ruled in favor of the trustee. *In re Franchi Equipment Co., Inc.*, 452 B.R. 352 (Bankr. D. Mass. 2011). Judge Hoffman noted that § 704(a)(11) required the trustee to perform the obligations required of the administrator of an employee benefit plan where the debtor had previously served as the administrator. The "Code and Rules provide no further directives as to how to meld the trustee, bankruptcy and ERISA responsibilities." Here, the court held that the court had core jurisdiction over the award of fees to a Chapter 7 trustee and his professionals in connection with performing, or assisting the trustee in performing, duties under § 704(a)(11). The court concluded that "trustees literally 'arise under' the Bankruptcy Code. Their oversight and compensation are, without significant exception, within the core federal bankruptcy power delegated to the bankruptcy court."

### 128. Post-petition ERISA Withdrawal Liability is an Administrative Expense

The Third Circuit held that Employee Retirement Income Security Act ("ERISA") withdrawal liability attributable to time post-petition constitutes an administrative expense entitled to priority. *In re Marcal Paper Mills, Inc.*, 650 F.3d 311 (3d Cir. 2011).

Debtor participated in a pension fund for the benefit of its union truck drivers. Debtor filed for relief under chapter 11 and eventually sold its assets to a company that ceased to employ the union drivers. So the union pension fund determined that the debtor had made a "complete withdrawal" from the pension fund under ERISA and assessed the debtor with almost $6 million in total withdrawal liability. The pension fund moved for allowance of an administrative claim in that amount. Debtor objected to the claim's classification of withdrawal liability as an administrative expense and moved to reclassify it as a general unsecured claim. The pension fund, therefore, altered its claim and only sought administrative priority for the portion of the withdrawal liability attributable to post-petition services provided by the union employees.

The court considered §503(b)(1)(A), defining administrative expenses as "the actual, necessary costs and expenses of preserving the estate including . . . wages, salaries, and commissions for services rendered after the commencement of the case." The court stated that an administrative expense must (a) arise from a post-petition transaction with the debtor-in-possession; (b) be beneficial in the operation of the business and (c) be actual and necessary.

Next, the court noted that the purpose of withdrawal liability was to ensure that employers could not avoid their obligation to provide a promised benefit by withdrawing from a plan. In addition, the court considered that withdrawal liability is calculated by first determining the shortfall between plan assets and benefits the plan owes and then withdrawing the employer's share by calculating the proportionate share owed to the employees based on the employer's contribution share over the prior five years.

The court concluded that the union employees were required to continue to work post-petition to keep the debtor in operation, which conferred a benefit on the estate. The portion of the withdrawal liability that corresponded to the post-petition work was owed by the purchaser of the debtor's assets who assumed the promise to provide pension benefits in exchange for necessary work when it purchased the debtor's assets. [*Author's Comment:* This case highlights yet another potential trap for a chapter 11 trustee. Consider withdrawal liability carefully if operating a debtor subject to an ERISA pension fund plan.]

## S. COMPENSATION/SURCHARGE

### 129. Debtor could not use a voluntary Chapter 11 to surcharge the short sale proceeds of lender's collateral

Debtor filed a Chapter 11 petition, thereby initiating a single asset real estate case with respect to its hotel property. Debtor then sought to sell the property for more than the mortgage holder was owed, but was unsuccessful in doing so. It eventually sold the property for several million dollars less than the lender was owed and,

thereafter, filed a motion to surcharge the sale proceeds pursuant to § 506(c). The lender objected, pointing out that it had never consented to a surcharge or a carve-out. Indeed, it was in the process of foreclosing on the property at the time the Chapter 11 was filed and sought to have the Chapter 11 case dismissed, or stay relief granted. During the course of the case, it raised numerous objections to practically every motion or application that the DIP had filed. The court sustained the objection and disallowed the surcharge. *In re TIC Memphis RI 13, LLC*, 498 B.R. 831 (Bankr. W.D. Tenn. 2013)(Kennedy, J.).

The court noted that in order to impose a non-consensual surcharge on a secured creditor, the costs incurred must be both reasonable and necessary. Here, the court found that it was not necessary because the Chapter 11 case served no purpose other than to provide an opportunity to obtain the highest bid possible, which also could have been done in either a Chapter 7 case or through a non-judicial foreclosure. The fact that the lender opted not to credit bid was not sufficient justification for the surcharge either. The court also found that the actions were not reasonable: "These benefits must be direct and not speculative, hypothetical, or unascertainable." Whether the costs of the Chapter 11 case to the holder outweighed any benefit it received was purely speculative according to the court. Indeed, the lender incurred significant costs and delays litigating throughout the Chapter 11 case in an effort to pursue other options. In conclusion, the court found that under the totality of circumstances and particular facts of this case, no surcharge could be imposed notwithstanding that this would result in a harsh outcome to the debtor's professionals who dutifully performed their tasks. [*Author's Comment*: Although, it is risky to proceed without the advance agreement of the lender, benefit can be established under certain circumstances. Contested surcharge motions require an evidentiary foundation to succeed. Here, there did not appear to be any evidence in support of the motion, simply a short sale to which the lender ultimately acquiesced.]

### 130. Commission base excludes funds distributed to co-owner of property sold by trustee

The trustee sold property that was owned by debtor and his non-debtor spouse. Trustee applied for the statutory commission including for a calculation based on the amounts distributed both to the spouse and the bankruptcy estate. The bankruptcy court disallowed the portion distributed to the non-debtor spouse. *In re Eidson*, 481 B.R. 380 (Bankr. E.D. Va. 2012). Trustee had argued that the distribution to the spouse was a distribution to a party in interest and therefore includable in the commission base. The court disagreed. Judge Kenney looked to § 363(j) governing sales of co-owned property which required distribution to the non-debtor co-owner of his or her interest in the proceeds with no deduction for compensation to the trustee. Finding that provision to be the more specific statute, the court held that it would control over the more general statute of § 326(a). [*Author's Comment*: The court misconstrues § 363(j), which has no bearing on the commission amount, only the source of its payment.]

### 131. Trustee's commission base includes distributions to ERISA plan participants

Trustee will have disbursed a total of $9,560,215.70 in ERISA Plan assets, building a statutory commission, based on § 326(a) of $310,056.47. Trustee sought $177,678.24 as the commission compensation. The Department of Labor objected to the court's jurisdiction, to pay any compensation on a statutory basis under § 326(a), and having such an award paid out of the Plan's assets as opposed to the bankruptcy estate. The court ruled in favor of the trustee. *In re The Robert Plan Corp., et al.*, 2012 WL 3597564, 2012 Bankr. LEXIS 3838 (Bankr. E.D. N.Y. 2012). Judge Grossman first disagreed with the Department of Labor that ERISA controlled. Instead, he found that the trustee's responsibility for the ERISA Plan was contained in the Bankruptcy Code and not in ERISA. Moreover, ERISA contained no requirement that an ERISA plan fiduciary such as the trustee even obtain court approval prior to receiving compensation for administering the plan. The DOL took the position that the trustee was improperly setting "his own fees." However, the court found that not to be the case because the trustee did not have the authority to do so under the Bankruptcy Code and was merely complying with the applicable Bankruptcy Code and rules in making an application to the court to approve his compensation and that of his professionals. It is that very process that enabled the DOL to have an opportunity to participate in determining reasonable compensation for the trustee before the trustee had taken any money for the services. "By applying the Bankruptcy Code over the ERISA statutes, the Court is in effect adding a layer of review to a process that is otherwise absent of judicial review." The court noted that Congress could have included a different compensation scheme for Chapter 7 trustees performing the duties set forth in § 704(a)(11), but the fact it did not do so, led the court to conclude that Congress intended to compensate Chapter 7 trustees in the same way they were compensated for all other work under the Bankruptcy Code. Accordingly, the requested commission was approved. The DOL has filed a notice of appeal.

### 132. Trustee entitled to statutory commission

The U.S. Bankruptcy Appellate Panel for the 9th Circuit in *In re Salgado-Nava* Id-11-1389-MkHJu (9th Cir. BAP 2012) reversed the decision of the Bankruptcy Court and entered judgment for the trustee stating that absent extraordinary circumstances, the trustee is entitled to the commission listed in 11 U.S.C. § 326.

The case trustee had originally found that the debtor's case was a no-asset case but sent a routine notice to the taxing authorities advising them of the debtor's bankruptcy and asking them to turn over any tax refunds. In this case, trustee recovered a significant refund and reopened the estate and filed a final report in which he proposed to make a significant distribution to creditors. As part of his final report, he filed a detailed trustee's fee application and sought the full commission, $1,315.41. The Bankruptcy Judge cut it to $750.00 concluding that absent extraordinary circumstances, a trustee should never receive the full commission. In addition, the Bankruptcy Court noted the trustee had earned a lot of commissions that year anyway. Trustee appealed and the NABT and the U.S. Trustee filed *amici* briefs in support and participated in the oral argument.

11 U.S.C. § 330(a)(7) states: In determining the amount of reasonable compensation to be awarded to a trustee (the dependent clause), the court shall treat such compensation as a commission, based on section 326 (the independent clause). The Bankruptcy Appellate Panel first concluded that § 330(a)(7) was a sea change in the law. The percentages were no longer to be treated as a cap, but instead a "commission" as that word is commonly understood. However, the Court concluded that the independent commission clause does not stand alone. The introductory dependent clause states: "In determining the amount of reasonable compensation to be awarded to the trustee…." The Bankruptcy Appellate Panel felt that this dependent clause also has meaning as well. In refining this meaning, the Court noted that Chapter 7 trustees are no longer required to satisfy the *Johnson* factors found in 11 U.S.C. § 330(a)(3). The Court then attempted to harmonize the "reasonableness" required of the dependent clause with the commission standard of the independent clause that follows it. The Court determined that there must be a rational relationship between the commission and the work performed. Therefore, the Court concluded that absent absurd or other extraordinary circumstances, the statutory commission rate is presumptively reasonable.

As an added bonus to the trustee, the Court did not remand this matter to the Bankruptcy Court. It found the trustee established a *prima facie* entitlement to the full commission and entered judgment in his favor.

## T. IFP WAIVERS (28 U.S.C. § 1930(f))

### 133. Reasons for denial of IFP waiver articulated

The bankruptcy court had denied the debtor's application to waive the filing fee, but allowed her to pay it in installments. After making two of the installments, the pro se debtor wrote a letter to the court asking why her fee waiver application had been denied. The court took the opportunity to explain its reasoning. Judge Halfenger noted that § 1930(f)(1) provided that the bankruptcy court "may waive the filing fee." Therefore, it was a discretionary decision of the court and not mandatory. Even so, there were two prongs to the waiver analysis. The first was if the debtor's income was below 150% of the applicable poverty guideline. The second prong, less often seen articulated, was that the debtor must still demonstrate that she is "unable to pay that fee in installments." The court stated that its analysis included whether the debtor had collateral sources of income, such as from family and friends, excessive or unreasonable expenses, whether an attorney or petition preparer was being paid, whether the debtor had property such as tax refunds from which the fee could be paid, and whether there were any extraordinary circumstances. The court explained that a waiver resulted in the case trustee having to administer a no-asset estate for free, which was a substantial disincentive to serve as a trustee and a threat to the ability of the bankruptcy court to provide Chapter 7 debtors with the discharges they seek. "Those desiring a fee waiver must show they face special circumstances establishing that a bankruptcy discharge will afford them out-of-the-ordinary benefits." The court concluded that debtor did not carry her burden of showing she was unable to pay the filing fee in installments despite her financial difficulties and was, therefore, not entitled to a fee

waiver. *In re Williams*, 2013 Bankr. LEXIS 1610 (Bankr. E.D. Wis. April 17, 2013)(Halfenger, J.). [*Author's Comment:* another excellent opinion on fee waivers is *In re Brooks*, 475 B.R. 343 (Bankr. W.D. N.Y. 2012) (Bucki, J.).

### 134. Application to waive filing fee is denied

Along with filing her Chapter 7 petition, debtor filed her application for waiver of the $306 filing fee on the basis that her income was less than 150% of the official poverty line. The bankruptcy court denied the waiver application. *In re Brooks*, 475 B.R. 343 (Bankr. W.D. N.Y. 2012). Judge Bucki held that debtor was unable to meet the second prong of the waiver statute, i.e., that she could not pay the filing fee even in installments. This conclusion was reached on the basis that debtor was entitled to a tax refund of $9,046, against which she had obtained a tax refund anticipation loan of $8,600. The court noted that the $446 fee for the loan was in itself more than enough to have paid the filing fee. Moreover, the court noted that granting a fee waiver was permissive, not mandatory, and the court would not exercise its discretion to grant a filing fee waiver to a debtor who filed for Chapter 7 relief only days after learning about her entitlement to tax refunds totaling approximately 90% of the unsecured debts listed on her bankruptcy petition.

## U. MISCELLANEOUS

### 135. Sanctions imposed against ghostwriting attorneys reversed

Debtor had met with lawyers at the Torrens Law Firm to discuss foreclosure defense services provided by the firm, including the impact that bankruptcy would have on the foreclosure process and the firm's fees for both foreclosure defense work and bankruptcy representation. Debtor paid the firm a $1,000 retainer for foreclosure defense work only. On that same date, a courier filed a pro se Chapter 13 petition for the debtor via a power of attorney. The circumstances behind the petition's preparation and filing were highly disputed. Apparently, after the bankruptcy filing, the debtor's largest business client contacted him regarding his involvement in the bankruptcy case and expressed concern on his continued ability to perform work for the client. Debtor then filed a motion for order to show cause against the law firm. The bankruptcy court held an evidentiary hearing. Debtor contended that he had no knowledge that he had even filed for bankruptcy, but the court found his contention to be untruthful. Nevertheless, the court found that the law firm had fraudulently prepared and filed the pro se petition on debtor's behalf. The law firm maintained that a secretary in the firm had acted as a scrivener when she prepared the petition at debtor's request and that she wrote debtor's oral responses into the corresponding blanks on the petition. The bankruptcy court found that the law firm had acted as ghostwriters by failing to sign the petition and thus perpetrated a fraud on the court. The bankruptcy court suspended the law firm from practice before it for a six-month period and referred the matter to the U.S. Attorney for possible criminal prosecution and to the Florida Bar for further disciplinary proceedings. The district court affirmed. The law firm appealed to the Eleventh Circuit Court of Appeals, which reversed. *In re Hood*, 727 F.3d 1360 (11th Cir. 2013).

The Florida Rules of Professional Conduct 4-3.3(a)(1), 4-8.4(c) and 4-1.2(c) provided that if a lawyer assisted a pro se litigant by drafting a document to be submitted to the court, the lawyer was not obligated to sign the document but was required to indicate "prepared with the assistance of counsel" on the document to avoid misleading the court. The Appellate Court, however, noted that the bankruptcy court had failed to cite the specific Florida Rule regulating the practice of ghostwriting. The Circuit Court determined that the law firm had not "drafted" a document for the debtor but simply recorded answers on a standard fill-in-the-blank Chapter 13 petition form based on debtor's verbal responses. Therefore, there was no fraudulent intent established in the record, and it was an abuse of the court's discretion to suspend the attorneys and otherwise sanction them. Accordingly, the Circuit Court held that the lawyers in the law firm were not subject to the imposition of discipline and reversed and remanded the case.

### 136. Section 1111(b) does not require the lien to be secured by any value in property, just the property itself

Debtor owned a commercial property that was subject to two mortgages, the second being non-recourse. The value of the property was less than the amount of the first mortgage, rendering the second mortgage wholly unsecured. The debtor argued that the unsecured claim should be disallowed arguing that neither state law nor 1111(b) allows the non-recourse claim holder to pursue a deficiency claim against the debtor.

The Seventh Circuit disagreed. The court held that §1111(b) does not require that that a claim be secured by any *value* of the property but only that it be secured by a lien on the property itself. Consequently, the second mortgage claim was allowed and under §1111(b) was to be treated as if it were a recourse claim. *In re Brookfield Commons No. 1 LLC*, 735 F.3d 596 (7th Cir. 2013).

### 137. Common interest doctrine applied to documents

Venture Funds and the Chapter 7 corporate debtor were co-defendants in a pre-petition California state-court lawsuit. After the bankruptcy filing, the trustee sought from defense counsel all files and records relating to the debtor or the firm's representation of the debtor, including all documents and electronically stored information. The co-defendant moved the bankruptcy court for a protective order on the basis that in defending against the litigation, the debtor and Venture Funds operated under a joint defense agreement such that production of the requested materials to the trustee would violate the common interest doctrine, or joint defense doctrine, as it would be tantamount to turning the documents over to the state-court plaintiff with whom the trustee had entered into a joint prosecution agreement in which the plaintiff was to finance and manage prosecution of potential claims against Venture Funds. The trustee's special counsel also served as the plaintiff's counsel. The bankruptcy court denied the motion for protective order and ordered all materials turned over to the trustee with the proviso that the trustee was not to share the materials with the plaintiff or special counsel. If the trustee concluded after reviewing the materials that disclosure to special counsel was necessary in the interest of litigation, the trustee was to first

submit the documents for i*n camera* review to determine whether such disclosure was appropriate. The trustee did so and the court concluded that the documents were privileged and that the privilege had not been waived. However, the trustee was permitted to turn over the documents to his counsel solely for use against Venture Funds in the bankruptcy litigation.

Judge Leonard found that the documents produced for *in camera* review would be protected from disclosure by the attorney-client privilege or the work product doctrine. Disclosure, however, to the debtor under the joint defense agreement did not waive the privilege because of the common interest doctrine applicable here whereby the communication of information between parties that would otherwise be protected by privilege did not waive the privilege, particularly since they were made to advance the shared interests of the debtor and Venture Funds in securing legal advice on the common matter of defending the California litigation. Nevertheless, the parties to the agreement could still use the information protected by the common interest doctrine against each other in subsequent adverse proceedings, and that was the case here. The court concluded that the materials were still protected against disclosure to third parties so neither the trustee nor his counsel could turn over the information to the state-court plaintiff. Thus, the communications could be used only between the parties in the current litigation in the bankruptcy court and for no other purpose. *In re Taproot Systems, Inc.*, 2013 WL 3505621, 2013 BANKR. LEXIS 2784 (Bankr. E.D.N.C. 2013) (Leonard, J.)

### 138. Fourth Circuit permits "Chapter 20" lien-stripping

The debtors in two separate Chapter 13 cases, who previously had received discharges in Chapter 7 cases, proposed Chapter 13 plans in which junior liens on their principal residences would be "stripped off." The bankruptcy court in each of the cases entered an order confirming the plan, and an appeal was taken to the district court, which consolidated the cases and affirmed. The trustee appealed, arguing that BAPCPA created a per se rule barring lien-stripping in a so-called Chapter 20 case, being cases filed within four years of a Chapter 7 bankruptcy that concluded with a discharge. The Fourth Circuit summarized the issue as follows: "The question presented is whether BAPCPA precludes the stripping off of valueless liens by Chapter 20 debtors ineligible for a discharge." After noting that bankruptcy courts were split on the question, the Fourth Circuit also affirmed in its own divided opinion. *In re Davis*, 2013 U.S. App. Lexis 9535, 2013 WL 1926407 (4th Cir. 2013). The majority opinion agreed with the debtors that a Chapter 13 debtor need not be eligible for a discharge in order to take advantage of the protections afforded by that chapter. "Therefore, if the Bankruptcy Code provides a mechanism for stripping off worthless liens absent a discharge, a debtor may avail himself of that relief." The majority opinion found that under § 506(a), an entirely valueless or worthless junior lien was not an "allowed secured claim." The majority held that Congress intended to leave intact the normal Chapter 13 lien-stripping regime where a debtor could otherwise satisfy the requirements for filing a Chapter 20 case. The court further found that a per se rule against lien-stripping was not necessary to prevent abuse of the bankruptcy process given that courts were bound to confirm only plans filed in good faith. The dissent maintained that it was wrong to apply § 506(a)

because the allowed claim of the junior lienholder was certainly secured. The dissent reasoned that the majority had "turn[ed] on its head the basic bankruptcy principle that secured creditors are treated more favorably than unsecured creditors."

### 139. Wholly unsecured lien "stripped off" in Chapter 7

Chapter 7 debtor valued her home at $141,416 subject to a first mortgage of $176,413 and a second mortgage of $44,444. She sought to avoid the second mortgage as wholly unsecured, but the bankruptcy court denied her motion on the basis that § 506(d) did not permit the "strip off" of a wholly unsecured lien. The district court affirmed. On appeal, the 11th Circuit reversed and remanded in an opinion (originally unpublished) just recently published by the Court. *McNeal v. GMAC Mortgage, LLC, et al. (In re McNeal)*, 735 F.3d 1263 (11th Cir. 2012). The Circuit Court followed its 1989 decision, *Folendore v. U.S. Small Bus. Admin.*, 862 F. 2d 1537 (11th Cir. 1989), which held that § 506(d) did provide for the "strip down" of a wholly unsecured lien, whereas the U.S. Supreme Court in *Dewsmup v. Timm*, 502 U.S. 410 (1992), held that "strip down" was not permitted on partially secured liens. A petition for rehearing *en banc* has been filed. [*Author's Comment:* This case is important for trustees attempting to overcome objections by wholly unsecured lienholders to a trustee's sale of property under §§ 363(b) and (f).] *Contra*, *In re Woolsey*, 696 F.3d 1266 (10th Cir. 2012); *Wachovia Mtg. v. Smoot*, 478 B.R. 555 (E.D.N.Y. 2012).

### 140. The WARN Act loses some power

Simply put, the WARN Act requires certain employer to give employees 60 days' notice of plant closings or large layoffs. If the employer fails to do so, the employee can sue for damages. One exception to the WARN Act's provisions is what is known as the "faltering company" exception which applies if the shutdown was due to "unforeseen business circumstances."

Flexible Flyer was already experiencing financial trouble when it was hit with a product recall. Soon after, its lending dried up. This led to filing of bankruptcy. The Fifth Circuit held that the debtor did not have WARN Act liability because the layoffs were caused by the unexpected and dramatic actions of its lenders. *In re Flexible Flyer Liquidating Trust* (5th Cir. Feb. 11, 2013). The court rejected the argument that the product recall should have put the debtor on notice that the end was near and rejected the argument that the lenders' actions were not all that surprising given that the parties already and engaged in workout negotiations. The Fifth Circuit also considered the fact that the debtor appeared to have acted in good faith and acting on a not unreasonable belief that the closings would not have to occur.

### 141. Objections to motion for default judgments overruled

Trustee filed a lawsuit against several defendants. The deadline to file an answer expired without a response from any of them. The clerk entered default. Trustee then obtained a second summons and re-served at different addresses several of the defendants. Again, the deadline expired with no response. The trustee filed a motion for default judgments and served all defendants at all addresses previously utilized. No

timely response was filed. After the deadline, an objection was filed by several defendants. The court overruled the objections and entered the default judgments. M*esser v. GMR, LLC, et al. (In re F3, LLC* ), 2013 WL 1003383, 2013 Bankr. LEXIS 979 (Bankr. S.D. N.Y. 2013). The court followed the precedent set in *Enron Oil Corp. v. Diakuhara*, 10 F.3d 90 (2d Cir. 1993), for finding good cause to set aside entry of the default through a three factor test for determining the existence of good cause: (1) was the default willful; (2) would setting aside default prejudice the adversary; and (3) was a meritorious defense presented. Here, the court found that the defendants did not satisfy their burden of establishing good cause. The court first found that for a willful default to have occurred, service must have been proper. Here, the trustee proffered evidence that created a presumption that proper mail service was received by all defendants. Defendants failed to revoke that presumption, making only conclusory denials of receipt of service or speculating why they did not receive it. The court further found that the defendants' failure to file responsive pleadings amounted to a willful default – a strategic decision on the defendants' part. The court also found that the trustee had adequately stated the prejudicial consequences that would result from the defendants' measures to frustrate recovery in the lawsuit. The trustee alleged that the defendants owed $1.5 million, plus interest accruing at 20% per annum, and that the delay due to the defendants' failure to respond increased the risk that the trustee would not be able to recover. Finally, the court noted that the defaulting parties had failed to present a meritorious defense.

### 142. Loss allocated between defrauded parties

The parties retained Marc Dreier as their counsel to collect monies from the defendant. Dreier negotiated a $6.3 million settlement. After forging his clients' signatures to a revised settlement agreement, he obtained the settlement funds and comingled them with the proceeds of his Ponzi scheme. Dreier never paid the plaintiffs the settlement monies. In Dreier's Chapter 11 case, plaintiffs sued the defendant and the trustee seeking declaratory and other relief regarding the validity of the settlement. The court granted the defendant's motion for summary judgment. *Gardi, et al. v. JANA Partners, LLC, et al. (In re Dreier LLP*, 450 B.R. 452 (Bankr. S.D.N.Y. 2011). Judge Bernstein found that both sides were victims of Dreier's forgery and fraud. It was not an issue of apparent authority to settle because he did not sign his own name, but rather that of his clients, a clear case of forgery. Although the parties were duped, agency law dictated as between two innocent parties, the risk of loss from the unauthorized acts of a dishonest agent fell on the principal that selected the agent. Here, the defendant was justified in believing that the version of the settlement agreement that it received from Dreier contained the plaintiffs' signature. Since the plaintiffs had retained Dreier, the loss had to be borne by plaintiffs.

### 143. Ninth Circuit reverses course and holds that courts can recharacterize debt as equity

In 1986, a Ninth Circuit BAP opinion held that bankruptcy courts could not recharacterize purported debt as equity other than as expressly allowed under §510. *In re Pacific Express, Inc.*, 69 B.R. 112 (B.A.P. 9th Cir. 1986). *Fitness Holdings* did away

with the *Pacific Express* rule and holds that a bankruptcy court may recharacterize debt as equity to the extent allowed under state law. *In re Fitness Holdings International, Inc.*, 2013 WL 1800000 (9th Cir. Apr. 30, 2013).

*Fitness Holdings* involved a complaint filed by the unsecured creditors' committee to recover, as fraudulent transfers, payments made on a promissory note and to characterize certain financing provided by the defendant as equity investments rather than loans. In addressing the reasonably equivalent value prong of §548, the court held that a transfer is not constructively fraudulent, "to the extent the transfer constitutes repayment of the debtor's antecedent or present debt." Consequently, if the transfer is made to satisfy a "right to payment," then the transfer is made for reasonably equivalent value. The issue in *Fitness Holdings* was whether the loan payment should be considered a "right to payment" under state law and the Ninth Circuit affirmatively rejected the holding in *Pacific Express* and held that a bankruptcy court has the authority to recharacterize purported debt as equity under state law.

### 144. Debt converted to equity

A non-insider "creditor" had "loaned" money to the debtor company for $200,000 and then $150,000 to be repaid from royalties and "equity placements." There was no specified interest rate, term of repayment, or maturity date. Two years later, the debtor company filed for Chapter 11 and confirmed a liquidating plan. The bankruptcy court had sustained the trustee's objection to these claims, holding that they actually asserted common equity interests at best and that insufficient evidence of the value of those interests was presented. The district court reversed, applying a *per se* rule that recharacterization could only apply to insiders. The district court cited the 11-factor test for distinguishing between debt and equity set out in *Jones v. United States*, 659 F.2d 618 (5th Cir. 1981), but did not apply those factors because it perceived the rule to prohibit recharacterization for non-insiders. The Fifth Circuit reversed. *Grossman v. Lothian Oil, Inc., et al. (In re Lothian Oil, Inc.)*, 650 F3d 539 (5th Cir. 2011). The circuit court recognized that four other circuits had approved recharacterization grounded in the bankruptcy court's equitable authority under § 105(a). *In re Submicron Systems Corp.*, 432 F.3d 448 (3d Cir. 2006), *In re Dornier Aviation, Inc.*, 453 F.3d 225 (4th Cir. 2006), *In re Hedged Investment Associates*, 380 F.3d 1292 (10th Cir. 2004); and *In re Autostyle Plastics, Inc.*, 269 F.3d 726 (6th Cir. 2001). The Fifth Circuit determined that *Butner v. United States*, 440 U.S. 48 (1979) and § 502(b)(1) supported the bankruptcy court's authority to recharacterize claims without resort to § 105(a). The circuit court noted that the bankruptcy court had properly applied the multi-factor test imported from federal tax law to distinguish between debt and equity and had considered the factors listed in *Jones*. Accordingly, the circuit court determined that the bankruptcy court did not err in recharacterizing the claims as equity. [*Author's Note*: This is important to trustees because without recharacterization there might not be any cause of action for a loan repayment outside of the preference period. However, if payments are made to equity interests rather than on antecedent debt, fraudulent transfer actions can be utilized. Additionally, in certain circumstances, it can reduce the ability of an alleged creditor to credit bid.]

## V. *STERN V. MARSHALL*

### 145. The Fifth Circuit weighs in on *Stern*

Chapter 13 debtor filed a complaint in state court asserting breach of contract and quasi contract theories of liability. Debtor obtained a favorable judgment at trial and retained the majority (but not all) of the judgment on appeal. Debtor's attorneys sought compensation from the bankruptcy court and proving the adage that no good deed goes unpunished, the debtor not only objected to the fee applications but filed state-law counterclaims against them for violations of Texas' deceptive trade practices act and breach of fiduciary duty. The bankruptcy court ruled against the debtor on the merits on some claims and against the debtor based on a lack of damages on the other claims. The bankruptcy court also overruled the objections to the fee applications. On appeal, the district court affirmed the bankruptcy court's decisions.

Before the Fifth Circuit, *In re Frazin*, 723 F.3d 313 (5th Cir. 2013), debtor argued that the bankruptcy court lacked constitutional authority to enter a final order on his state-law counterclaims. The Fifth Circuit became the latest court to note that while the opinion in *Stern* professes to be narrow, its reasoning is "sweeping." The court held that *Stern* was not implicated. The court analogized a motion for compensation with a proof of claim, and held that in order to determine whether the attorneys' fees were reasonable it was necessary to address the question in the counter-claim of whether the attorneys were negligent in rendering their services, whether they engaged in malpractice, and whether they breached their fiduciary duties. On the other hand, the court held that it was not necessary for the bankruptcy court to resolve the deceptive practices question when resolving the fee application and therefore the bankruptcy court did not have constitutional authority to enter a final order on those claims.

Finally, and in keeping with the proud judicial practice of putting the really important stuff in footnotes, the Fifth Circuit dismissed out of hand the notion that parties may waive *Stern* issues by waiting until the court of appeals level to raise *Stern*. The court held that *Stern* seeks to protect the structural interests in Article III, and these interests "cannot be ameliorated by . . . consent or waiver."

### 146. The Fifth Circuit weighs in on *Stern (again)*

Following on the heels of its decision in *Franzin*, the Fifth Circuit waded once again into the icy waters of *Stern*. Debtor filed an adversary complaint alleging various state-law tort and contract claims. The debtor admitted that the actions were non-core and defendants consented to the bankruptcy court entering a final judgment. The bankruptcy court entered a final order denying relief and the district court affirmed.

On appeal, the Fifth Circuit reversed. *In re BP RE, L.P.*, 735 F.3d 279 (5th Cir. 2013). The court held that under *Stern* the bankruptcy court could not constitutionally enter a final order on these purely state law claims whose resolution was not necessary to resolve a proof of claim. The court held that the parties could not consent to the bankruptcy court entering a final order because the constitutional issues implicated in *Stern* are structural and cannot be waived. The court remanded the case back to the bankruptcy court and stated that because the claims were non-core, the bankruptcy

court could issue proposed findings of fact and conclusions of law with the review of the district court.

[*Author's Comment*: On January 14, 2014, the Supreme Court heard arguments in the appeal from the Ninth Circuit's *Bellingham Insurance* decision. The Supreme Court's decision should clarify many of the questions that have arisen regarding what *Stern* does and does not compel.]

### 147. The Seventh Circuit embraces the black hole theory of jurisdiction

After being hit with a large judgment, the debtor filed bankruptcy. In response, the creditor filed an adversary proceeding which sought to prevent the discharge of the debtor's debts under §727 and a declaratory judgment that a trust was the debtor's alter ego. The debtor proved unwilling to cooperate in the adversary proceeding and eventually the creditor moved and received a default judgment against the debtor as a sanction for the debtor's litigation conduct. On appeal before the Seventh Circuit the debtor in *Wellness International Network, Ltd. v. Sharif*, 2013 WL 4441926 (7th Cir. Aug. 21, 2013), for the first time argued that the bankruptcy court lacked constitutional authority to enter a final judgment, default or otherwise, under the Supreme Court's holding in *Stern v. Marshall*.

The Seventh Circuit began its analysis by determining whether the Bankruptcy Court had statutory authority to enter a final order. The court held that the dischargeability causes of action clearly are "core" matters under §157. Further, the Court held that the debtor had waived his ability to argue that the alter ego claim was not core by not raising the issue below.

Next, the Court turned to whether the Bankruptcy Court constitutionally could enter the default judgment. First, the Court rejected the argument that the debtor waived the argument. Instead, the Court held that the question of whether a bankruptcy court can enter a final order and comply with Article III of the Constitution predominately is a structural interest of constitutional government, not merely a personal interest and therefore is not subject to waiver. Next, the Court addressed the constitutional question straight on. The Court made short work of the dischargeability counts holding that the Bankruptcy Court could constitutionally issue a final order on these counts. On the alter ego count, however, the Court came to a different conclusion. The Court held that because the "alter-ego claim is a state-law claim that does not involve 'public rights'," was not necessary to the restructuring of the debtor-creditor relationship, the Bankruptcy Court had no constitutional authority to enter a final order.

Having held that the Bankruptcy Court could not constitutionally enter a final order on the alter ego claim, the Seventh Circuit next turned to how to remedy the Bankruptcy Court's error. The Court rejected the notion that the Bankruptcy Court's "final order" could simply be treated as proposed findings of fact and conclusions of law. The Seventh Circuit held that §157 authorizes bankruptcy courts to "enter" final orders and that unlike in non-core proceedings, "[n]o statutory provision authorizes a bankruptcy court to propose finding of fact or conclusions of law." Instead, the Seventh Circuit adopted a black hole theory and held that when a matter is core but the Bankruptcy Court has no constitutional authority to enter a final order, the Bankruptcy Court is in fact powerless to do anything and that the only remedy is for the District Court to withdraw the reference.

[*Author's Comment*: The Seventh Circuit's decision in Wellness will have far-reaching effects as it is the first Circuit Court to adopt the black hole theory. As noted in previous issues, the Supreme Court has granted cert in the Ninth Circuit's Bellingham Insurance decision. Hopefully, the Supreme Court's decision will clarify (a) whether constitutional challenges can be waived; (b) the constitutional scope of a bankruptcy court's ability to enter final orders; and (c) whether the black hole actually exists. Until then, however, the bankruptcy landscape post *Stern v. Marshall* continues to be widely unpredictable and vary dramatically from Circuit to Circuit.]

## W. PONZI SCHEME CASES

### 148. Madoff trustee barred from recovering from financial institutions due to *in pari delicoto* and standing

*Madoff* involved the SIPA trustee suing major financial institutions under various theories, including aiding and abetting Madoff's fraud. The underlying theme of the actions was the institutions ignored major red flags regarding Madoff's illegitimate operations but looked the other way due to the large banking fees these institutions were receiving. The Second Circuit dealt the trustee a fatal blow. *In re Bernard L. Madoff Investments Securities LLC*, 721 F.3d 54 (2d Cir. 2013). First, the Court held that the doctrine of *in pari delicto* "bars the trustee (who stands in Madoff's shoes) from asserting claims directly against the Defendants on behalf of the *estate* for wrongdoing in which Madoff (to say the least) participated." Second, the Court held that the Trustee does not have standing to pursue various common law claims on behalf of Madoff's customers.

On the *in pari* delicto issue, the Court looked to New State law and held that the doctrine has consistently been applied "to bar a debtor from suing third parties for a fraud in which he participated." The Court then held that "[t]he debtor's misconduct is imputed to the trustee because, as innocent as he may be, he acts as the debtor's representative." The Second Circuit summarily rejected what it called the Trustee's remaining "scattershot" arguments for why a Trustee should not be thwarted by the *in pari delicto* doctrine.

After rejecting the Trustee's attempts to recover on behalf of Madoff's corporation, the Court turned to whether the Trustee could assert claims on behalf of Madoff's customers. The Court held that the Trustee did not and that the prohibition against "third-party standing applies to actions brought by bankruptcy trustees." The Trustee argued that the general prohibition against asserting creditor claims should not apply where "they are generalized in nature, and not particular to any individual creditor." The court held that while the legal theory behind the claims held by customers may be similar, they all involve particularized allegations regarding how the defendants handled each customer's individual account and therefore cannot be considered to be shared by all claimants.

### 149. Ponzi scheme victims not entitled to interest or inflation

Madoff trustee proposed making distributions to victims based on a cash-in/cash-out method, which the Second Circuit upheld. The trustee then faced the question of

whether this method must account for inflation and interest; in other words, whether the victims' "net equity" will be increased based on the time that passed while their money was invested with Madoff. The trustee argued that under SIPA, the victims are not entitled to such an increase and the bankruptcy court agreed. *In re Bernard L. Madoff Investments Securities LLC*, 2013 WL 4778163 (S.D.N.Y. 2013).

The court noted that SIPA defines "net equity" and that it "does not contain any language supporting the including of interest, inflation or other Time-Based Damages." Further, the Court noted that other provisions of SIPA do include time-based adjustments, which leans further support to the fact that the absence of such adjustment in the definition of "net equity" was intentional. The court then turned to whether provided time-based damages would comport with SIPA's purposes—which is to promote investor confidence in the market. The court held that this purpose is achieved by satisfying "customers' legitimate expectations by returning customer accounts in the form they existed on the filing date." The court noted that while in a typical case it is proper to adjust to market realities, such a procedure is impossible in a Ponzi scheme case as the customers' account statement are "complete fabrications." Consequently, "there is no way to know how much each customer's account balance would have been had securities actually been purchased in the market." Further, using some substitute method (such as inflation) is not beneficial because it cannot be said with any certainty that such an approach would "more closely approximat[e] what would have transpired in the market" had the securities actually existed. For these reasons, the court held that excluding time-based damages from the calculation of a customer's net equity provides a result more consistent with the purposes of SIPA.

### 150. Trustee's complaint dismissed under *Twombly/Iqbal*

Debtors, a group of hedge funds, invested almost all of their assets in what turned out to be a Ponzi scheme. The debtors hired the firm to revise their offering circular to correct various misstatements. The offering circular was updated but contained some of the same misstatements as before. The trustee sued the law firm alleging legal malpractice. The district court dismissed the trustee's complaint on the basis of *in pari delicto*. The Seventh Circuit affirmed but for different reasons. *Peterson v. Winston & Strawn LLP*, 2013 WL 4767722 (7th Cir. 2013).

The Seventh Circuit first addressed the *in pari delicto* argument and appeared to carve-out an exception to the doctrine in a case involving law firms. The court held that because clients come to law firms for advice (and sometimes, advice on how to fix problems the client already is aware of), a law firm cannot invoke *in pari delicto* on the basis that the client already knew the relevant facts. The court explained that in such a case, "[t]he fault would not be equal, because [the client] would have hired the law firm for legal expertise rather than factual information." "When the goal of hiring a professional adviser is to cope with the consequences of a known fact, the parties' equal access to the facts is beside the point."

The court, however, affirmed the dismissal of the complaint on the basis that it did not "plausibly allege that the law firm violated any duty to the [Debtors]." The court noted that the complaint alleged that the malpractice arose because the firm failed to alert the debtor's directors of the problems and failed to reveal the problems in the

revised offering circular. The court held, however, that it was the debtors, not the law firm, that made the actual representations in the offering circular and that even if the circular had been changed, such a change would not have provided any benefit to the debtors as the disclosure likely would have led to an even earlier collapse.

The court also rejected the assertion that the firm should have reported the issues to the board of directors. The court held that even if the firm had an obligation to inform the board of directors of the misstatements and the potential misdeeds of the Debtors, the complaint failed to plausibly alleged that alerting the directors would have made a difference because the complaint did not allege facts that suggests that the directors exercised any real responsibility or power over the debtors or that the directors would have exercised those powers and responsibilities. In sum, the court held that the complaint failed to allege facts that plausibly showed that the firm's malpractice caused the damages the trustee sought to recover.

### 151. No fraud illegality exception in the Safe Harbor Provisions of Section 546

On the same day as the *Winston & Strawn* case, the Seventh Circuit issued another decision arising out of the same main bankruptcy case. Here, the Trustee brought preference claims against investors to the extent they received "false profits" from the Ponzi scheme Debtors. The bankruptcy court granted summary judgment for the defendants holding that §545(e) and §546(g) protected the transfers from avoidance as "settlement payments" or payments made in connection with a securities contract. The Seventh Circuit affirmed. *Peterson v. Somers Dublin Ltd.*, 2013 WL 476495 (7th Cir. 2013).

The court held that §546(e) and §546(g) must be read according to their plain language, and that the only fraud exception contained in these provisions is the directive that the provisions shall not apply in cases brought under §548(a)(1)(A). Because nothing in the text of §546(e) or §546(g) contains a general fraud/illegality exception, the Court held that it cannot read one into the text to protect claims for preferences or constructive fraudulent transfer.

### 152. Second Circuit affirms grant of preliminary injunction in Ponzi scheme

After the Madoff Ponzi scheme was exposed, numerous creditors sought to bring fraudulent transfer actions under state law. The Madoff Trustee sought to enjoin those causes of action under § 105 of the Bankruptcy Code and the bankruptcy court granted the trustee's motion. On appeal, the Second Circuit affirmed. The court held that but for the preliminary injunction, "there would ensue a chaotic rush to the courthouse – or rather, multiple courthouses – of those seeking assets that the trustee claims are properly part of the … estate." The Second Circuit also held that but for the injunction, the individual creditor's claims would "draw down assets almost all of which could otherwise be expected to return to the … estate." *In re Bernard L. Madoff Investment Securities, LLC*, 2013 WL 616269 (2nd Cir. 2013).

### 153. Interest payments in connection with a Ponzi Scheme do not constitute "value"

The debtor, a Ponzi scheme operator, entered into and paid principal and interest on various promissory notes prior to the Ponzi scheme's collapse. The trustee sought to recover these payments as fraudulent transfers. Defendant moved for summary judgment arguing that the payment of principal and "reasonable" interest constitutes value under the Bankruptcy Code. *In re Consolidated Meridian Funds*, 2013 WL 366223 (Bankr. W.D. Wash. 2013). The bankruptcy court held that the return of principal does constitute value, but the return of interest, even if reasonable, is still just a payment of "false profit" and therefore does not constitute value under the Code.

### 154. District Court finds extra statutory exception to safe harbor defenses of section 546

In a previous decision arising out of the Madoff Ponzi scheme, the district court held that nothing in the text of §546(e) precluded it from protecting from avoidance as preferences or constructive fraudulent transfers, transfers that are tainted with fraud and illegality. Further, in a previous decision, the district court declined to read an extra-statutory limitation on the types of transfers that may be protected by the safe harbor provisions of §546. In this most recent opinion, however, the district court did impose an extra-statutory limitation to the applicability of §546 in denying motions to dismiss. *I*n re Bernard L. Madoff Investment Securities LLC, 2013 WL 1609154 (S.D. N.Y. 2013).

In this case, the trustee alleged that some defendants had actual knowledge that Madoff was running a fraudulent scheme and that §546 should not apply to these types of bad faith defendants. The district court agreed. The district court explained that its initial opinion applied §546 for two reasons. *First*, the transfers were protected because they were made in connection with a securities contract by a stockbroker (Madoff). *Second,* the transfers were settlement payments because they were the completion of a securities contract between Madoff and the defendants.

The court, however, makes a distinction for those defendants whom the trustee alleges knew that Madoff was a fraud. The court reasons that for these defendants the "securities contracts" between Madoff and the defendants is meaningless because "because if they knew that Madoff Securities was a Ponzi scheme, then they must have known that the transfers they received directly or indirectly from Madoff Securities were not "settlement payments." Similarly, since such defendants are alleged to have known in effect that the account agreements never led to a transaction for the "purchase, sale, or loan of a security," they therefore also must have known that the transfers could not have been made in connection with an actual "securities contract."

The district court also used legislative history and the underlying purpose of the statute to support its ruling. The district court held that the "purpose of [§546] is minimiz[ing] the displacement caused in the commodities and securities markets in the event of a major bankruptcy affecting those industries." The court that "[i]n the context of Madoff Securities' fraud, that goal is best achieved by protecting the reasonable expectations of investors who believed they were signing a securities contract; but a transferee who had actual knowledge of the Madoff Ponzi scheme did not have any

such expectations, but was simply obtaining moneys while he could. Neither law nor equity permits such a person to profit from a safe harbor intended to promote the legitimate workings of the securities markets and the reasonable expectations of legitimate investors."

### 155. Statute of Limitations

The Bankruptcy Court in *In re Petters Company, Inc. et* al (Bankr. D. Minn. 2013) issued a 58-page opinion on the issue of statutes of limitation in avoidance actions. Although the first part of the opinion dealt with an issue of which limitations period under Minnesota law applied the second part of the opinion dealt with an encyclopedic discussion of the theories of "discovery of fraud", "adverse domination" and "equitable tolling". The last part of the opinion dealt with the questions of whether the applicable statute of limitations under Section 544 are tolled when the petition is filed or does the trustee have an extra two years and whether it is the filing of the adversary or the service of complaint which tolls the running of the statute. Bottom line: Trustee prevails.

## CHAPTER 13 CASES

### 1. Carroll v. Logan 735 F.3d 147 (4th Cir 2013).

The Debtors commenced a voluntary proceeding under Chapter 13 of the Bankruptcy Code and confirmed a compromised plan. *Id*. at 149. Approximately three years into the Debtors' repayment term the Debtors became entitled to receive an inheritance of approximately $100,000. *Id*. The Chapter 13 Trustee brought a motion to modify the Debtors' confirmed plan to include "an amount of the Inheritance, if and when received, sufficient to pay in full all of the allowed general unsecured claims." *Id*. The bankruptcy court found that the inheritance was property of the estate and granted the Trustee's motion. *Id*. In upholding the bankruptcy court's ruling, the Fourth Circuit adopted the majority view that § 1306 of the bankruptcy code extends the temporal reach of § 541 to include all property acquired before the Chapter 13 case is closed, dismissed or converted. *Id*. at 151-152.

### 2. Flugence v. Axis Surplus, 738 F.3d 126 (5th Cir. 2013)

The Debtor commenced a voluntary proceeding under Chapter 13 of the Bankruptcy Code and a plan of reorganization was confirmed. *Id* at 127. Approximately three years into the repayment term, the Debtor was injured in a car accident which lead to commencement of a personal injury action in March of 2008. *Id*. The personal injury defendants sought to have the Debtor judicially estopped from pursuing the personal injury claim based on her failure to disclose the claim in the bankruptcy proceeding. *Id*. at 128. The bankruptcy court held that the Debtor was estopped from pursuing the claim but that the bankruptcy trustee could pursue the claim on behalf of creditors *Id*. On appeal, the district court found that the Debtor was not estopped from pursuing the claim, because the claim had not existed at the time the Debtor's initial asset disclosures were made, and thereafter she relied on the advice of her counsel regarding her on-going duty to disclose assets acquired post-petition. *Id.* The Fifth Circuit reversed on appeal, and found that the Debtor had an on-going duty to disclose after acquired assets and therefore that the bankruptcy court did not abuse its discretion in finding that the Debtor was judicially estopped from pursing the personal injury claim. *Id.* at 128-131.

### 3. Drummond v. Welsh, 711 F.3d 1120, (9th Cir. 2013)

Debtors filed a voluntary petition for relief in Chapter 13 proposing to retain their home, three motor vehicles, a tow-behind recreational vehicle, and two ATVs – all of which were encumbered by secured claims. As above-median debtors, the Debtors calculated their disposable income in accordance with the means test which excludes the Debtor's $1,165 monthly social security benefit. The means test calculation concluded that the Debtors' had $218.12 per month in disposable income and accordingly the Debtors proposed to pay their allowed general unsecured claims a total of $14,700 (approximately 8%) over the life of the plan.

The Trustee raised two objections to confirmation of the Debtors' proposed plan as not filed in *good faith* under §1325(a)(3) because: 1) the plan proposed only to make "'miniscule' payments to unsecured claims while they were living in a $400,000 home, making payments on various luxury and unnecessary items and failing to commit one hundred percent of their disposable income to the plan," and 2) the plan failed to utilize any of the Debtor's social security income," *Id*. at 1123-1124.

Applying the 9th Circuit's four factor test for determining if a plan is filed in good faith, the bankruptcy court considered "'(1)whether debtors misrepresented facts in their plan or unfairly manipulated the Bankruptcy Code, (2) the debtors' history of filings and dismissals, (3) whether the debtors intended to defeat state court litigation, and (4) whether egregious behavior is present.'" *Id*. at 1123 (citing *Leavitt v. Soto*, 171 F.3d 1219 (9th Cir. 1999)). The bankruptcy court concluded that none of four factors were present in the instant case and further that the Trustee's objections ignored the fact that payments to secured claims and exclusion of social security income are specifically contemplated in the means test. *Id*. at 1124. The BAP affirmed the bankruptcy court holding that "taking advantage of a provision of the Code, such as calculating disposable income under the test explicitly set out in the Code, is not an indication of lack of good faith." *Id*. at 1124-1125.

After an extensive discussion of the history of the "good faith" requirement in Chapter 13, the 9th Circuit ultimately affirms the BAP's ruling, concluding that "BAPCPA forecloses a court's consideration of a debtor's Social Security income or a debtor's payments to secured creditors as part of the inquiry into good faith under 11 U.S.C. § 1325(a)." *Id*. at 1135.

### 4. Ranta v. Gorman, 721 F.3d 241 (4th Cir. 7.1.2013)

The Debtor filed a voluntary petition for relief under Chapter 13 of the Bankruptcy Code. *Id.* at 243. The Debtor's social security income was excluded from his means test calculation, although included on Schedule I. *Id*. at 243-244. The Debtor proposed a plan based on the disposable income calculated by the means test even though his schedule I (Income) and schedule J (Expenses) indicated that he could actually afford a higher payment when the Debtor's social security benefits were factored into the calculation. The Trustee objected to confirmation alleging both that the Debtor was not dedicating all of his "projected disposable income" to the plan, or, in the alternative, if the social security benefits were excluded, the plan as proposed was unfeasible. The bankruptcy court denied confirmation and the Debtor appealed. The district court, without addressing the issue of whether denial of confirmation is a final, appealable order, affirmed the bankruptcy court's ruling denying confirmation. On appeal, the Fourth Circuit held that denial of confirmation is a final order for purposes of appeal, even if the case has not yet been dismissed. *Id*. at 248. The Fourth Circuit then finds that because social security income is statutorily excluded from the disposable income calculation under the Bankruptcy Code, social security income is excluded from the calculation of "projected disposable income" under § 1325(b)(2) for both above and below median debtors. *Id*. at 253. Further, the Fourth Circuit rejected the Trustee's

argument that if social security income is excluded from the calculation of projected disposable income it must also be excluded from a feasibility analysis. *Id*. at 254.

**5. Branigan v. Davis, 716 F.3d 331 (4th Cir. 5.10.2013)(from Neil's materials)**

The debtors in two separate Chapter 13 cases, who previously had received discharges in Chapter 7 cases, proposed Chapter 13 plans in which junior liens on their principal residences would be "stripped off." The bankruptcy court in each of the cases entered an order confirming the plan, and an appeal was taken to the district court, which consolidated the cases and affirmed. The trustee appealed, arguing that BAPCPA created a per se rule barring lien-stripping in a so-called Chapter 20 case, being cases filed within four years of a Chapter 7 bankruptcy that concluded with a discharge. The Fourth Circuit summarized the issue as follows: "The question presented is whether BAPCPA precludes the stripping off of valueless liens by Chapter 20 debtors ineligible for a discharge." After noting that bankruptcy courts were split on the question, the Fourth Circuit also affirmed in its own divided opinion. In re Davis, 2013 U.S. App. Lexis 9535, 2013 WL 1926407 (4th Cir. 2013). The majority opinion agreed with the debtors that a Chapter 13 debtor need not be eligible for a discharge in order to take advantage of the protections afforded by that chapter. "Therefore, if the Bankruptcy Code provides a mechanism for stripping off worthless liens absent a discharge, a debtor may avail himself of that relief." The majority opinion found that under § 506(a), an entirely valueless or worthless junior lien was not an "allowed secured claim." The majority held that Congress intended to leave intact the normal Chapter 13 lien-stripping regime where a debtor could otherwise satisfy the requirements for filing a Chapter 20 case. The court further found that a per se rule against lien-stripping was not necessary to prevent abuse of the bankruptcy process given that courts were bound to confirm only plans filed in good faith. The dissent maintained that it was wrong to apply § 506(a) because the allowed claim of the junior lienholder was certainly secured. The dissent reasoned that the majority had "turn[ed] on its head the basic bankruptcy principle that secured creditors are treated more favorably than unsecured creditors."

**6. Ryan v. United States, 725 F.3d 623 (7th Cir. 7.8.2013)(from Neil's materials)**

Debtor had failed to pay federal income taxes for several years totaling nearly $137,000. Consequently, the IRS had filed a Notice of Federal Tax Lien against debtor's property. Debtor subsequently filed Chapter 13 asserting personal property worth only $1,625 and filed a "Complaint to Determine Nature and Extent of Federal Tax Lien." Debtor asserted that under § 506(a), the IRS's secured claim was limited to that amount and that the remainder of its claim was unsecured and under § 506(d) void to the extent it exceeded that amount. While the IRS conceded that its secured claim was limited to $1,625 for purposes of plan confirmation, it maintained that the bankruptcy court was not permitted to void its lien to the extent of any excess. The bankruptcy court ruled in favor of the IRS and held that § 506(d), as interpreted by the Supreme Court in Dewsnup v. Timm, 502 U.S. 410 (1992), prevented debtor from voiding, or "stripping

down" the lien. Accordingly, it granted the government's motion for judgment on the pleadings. On appeal to the 7th Circuit, that judgment was affirmed. In re Ryan, 2013 WL 3380131, 2013 U.S. App. LEXIS 13710 (7th Cir. 2013).The circuit court noted that under Dewsnup the term "allowed secured claim" in § 506(d) meant a claim that was allowed under § 502 and secured by a lien enforceable under state law, regardless of whether that claim was deemed secured or unsecured under § 506(a). Debtor, however, argued that § 506(d) should be interpreted differently in Chapter 13 to fulfill the purposes of that chapter. The circuit court disagreed citing Clark v. Martinez, 543 U.S. 371 (2005) wherein the Supreme Court held that the language of a statute should be read consistently. In line with that decision, the circuit court held that to rule otherwise would be to "invent a statute rather than interpret one." Accord In re Woolsey, 696 F.3d 1266 (10th Cir. 2012).

### 7. Shelton v. Citimortgage, Inc., 735 F.3d 747 (8th Cir. 2013).

Chapter 13 Debtors' mortgage company filed its secured claim after the expiration of the claims bar deadline. The Debtors' objected to the claim as untimely and an agreed order disallowing the claim was entered. The Debtors' then commenced an adversary proceeding seeking to avoid the mortgage lien pursuant to 11 U.S.C. § 506(d) "To the extent that a lien secures a claim against the debtor that is not an allowed secured claim, such lien is void, unless—(1) such claim was disallowed only under section 502(b)(5) or 502(e) of this title; or (2) such claim is not an allowed secured claim due only to the failure of any entity to file a proof of such claim under section 501 of this title." The Eighth Circuit joined the Fourth Circuit in *In re Hamlett*, 322 F.3d 342 (2003) and the Seventh Circuit in *In re Tarrow*, 749 F.3d 464 (1984) in holding that disallowance of a secured claim due to untimeliness, without more, is insufficient to support avoidance of the related lien under § 506(d). *Shelton* at 749-750.

### 8. Weber v. SEFCU, 719 F.3d 72 (2nd Cir. 5.8.2013)

On January 10, 2010, SEFCU repossessed the Debtor's vehicle. *Id*. at 73. Four days later, the Debtor commenced a voluntary proceeding under Chapter 13 of the Bankruptcy Code and provided SEFCU written notice of the filing, automatic stay, and requesting return of the vehicle to the Debtor. *Id*. at 74. One week later, SEFCU had still not returned the vehicle to the Debtor and the Debtor commenced an adversary proceeding against SEFCU seeking return of the vehicle as well as damages, attorneys' fees and sanctions. *Id*. at 74-75. SEFCU returned the vehicle to the Debtor on March 5, 2010 and thereafter the bankruptcy court failed to find any "willful" violation of the automatic stay and as such did not award any damages, attorneys' fees or sanctions. *Id*. at 75. The Debtor appealed, and the District Court, relying on *United States v. Whiting Pools, Inc.*, 462 U.S. 198 (1983) found that SEFCU was required to turnover the vehicle to the Debtor immediately upon learning of the Chapter 13 proceeding. *Id*. at 75. Failing to do so, the Court held, was a willful violation of the automatic stay making SEFCU liable for damages and attorneys' fees. *Id*. SEFCU appealed to the Second Circuit. Again relying on *Whiting Pools*, the Second Circuit found that by failing to immediately turnover the vehicle to the Debtor upon learning of the Chapter 13

proceeding, SEFCU inappropriately exercised control over property of the estate in violation of the automatic stay. *Id.* at 77-81. Further, the court concluded that the violation was willful and thus SEFCU is liable for the Debtor's actual damages. *Id.* at 82.

# RECENT INDIVIDUAL CHAPTER 11 CASES

## I. Applicability of Absolute Priority Rule in Individual Chapter 11

a. *In re Friedman*, 466 B.R. 471 (9th Cir. BAP 2012)

After the trial court found that the absolute priority rule was applicable in an individual Chapter 11 case, the debtor and the National Association of Consumer Bankruptcy Attorneys, as amicus curiae, argued to the Ninth Circuit BAP that the absolute priority rule was inapplicable in individual Chapter 11s.

The Ninth Circuit BAP concluded that the absolute priority rule was not applicable in individual Chapter 11 cases. Upon hearing of this decision, lawyers handling individual Chapter 11s in the Ninth Circuit all breathed a sigh of relief. If the absolute priority rule had been applicable in individual Chapter 11s, since a debtor's post-petition income is part of the bankruptcy estate and a debtor would have to pay all senior creditors in full if a dissenting class of creditors was present, most individual Chapter 11 cases would fail. For obvious reasons, this possibility would have been very disconcerting to attorneys handling these types of cases.

b. *In re Stephens*, 704 F.3d 1279 (10th Cir. Ct. App. (OK) 2013)

A year later, the Tenth Circuit Court of Appeals came to the exact opposite conclusion and reversed the Bankruptcy Court, which confirmed a Plan based upon the inapplicability of the absolute priority rule. What was interesting about this case is that a variety of arguments were advanced which could have allowed the Tenth Circuit to circumvent this issue, but the Tenth Circuit decided to disregard the procedural arguments and render the ruling. The Circuit Court disregarded the practical implications of the decision and simply ruled that the language was clear and unambiguous and therefore the plain meaning of the statute should be utilized.

c. *In re Lively*, 717 F.3d 406 (5th Cir. Ct. App. (TX) 2013)

When the Fifth Circuit Court of Appeals was called upon to address the applicability of the absolute priority rule, that Circuit ruled that the statutory exception to Chapter 11's absolute priority rule only covers the individual debtor's post-petition earnings and post-petition acquired property. The Court determined that this was an appropriate middle ground which would allow potential confirmation of individual Chapter 11 Plans while not granting too much power to the debtor. According to the Court, this interpretation was also consistent with the clear and unambiguous language of the pertinent statutes.

## II. Conversion of Chapter 7 Case to Chapter 11

a. *In re Schlehuber*, 489 B.R. 570 (8th Cir. BAP 2013)

The debtor filed a case under Chapter 7 based on his debt primarily being of a non-consumer nature and even though he had substantial income. A creditor argued that since the debtor had the ability to pay back a substantial percentage of his debt, the case should be converted to one under Chapter 11. The Bankruptcy Court ruled that the Court had the discretion to convert the case because of the debtor's ability to repay a substantial portion of his debt. The Eighth Circuit Bankruptcy Appellate Panel determined that the fact that the debtor may have been eligible for Chapter 7 did not preclude the Court from subsequently converting the case to one under Chapter 11 under the circumstances.

It is crucial to note that for reasons that are not clear, the debtor did not argue that a forced conversion to Chapter 11 could create constitutional issues in that doing so would basically be compelling an individual to commit to involuntary servitude. Furthermore, it is unclear in such circumstances as to what would happen if the debtor then fails or refuses to make the required payments in the Chapter 11.

## III. Barring Consecutive Filings

a. *In re Lee*, 467 B.R. 906 (6th Cir. BAP 2012)

The Sixth Circuit Bankruptcy Appellate Panel affirmed in part and remanded in part a case in which an individual Chapter 11 was dismissed as a bad faith filing when the debtor had filed three successive Petitions over a period of less than 18 months, the debtor had failed to prosecute any of the cases diligently, had not complied with filing requirements in any of the cases, failed to pay the filing fees in installments by the deadline set by the Court, and in which the primary motivation for the debtor filing was to stay foreclosure proceedings after the debtor had failed to make any mortgage payments since the filing of her first Chapter 11 case.

b. *In re Colon Martinez*, 472 B.R. 137 (1st Cir. BAP 2012)

The First Circuit Bankruptcy Appellate Panel affirmed the Bankruptcy Court when it dismissed a Chapter 11 proceeding and banned the debtor from filing another case for 180 days after the debtor had filed two successive Chapter 11s in one year and the debtor had both cases dismissed for lack of diligence or failure to comply with Court orders.

## IV. Impact of Confirmed Individual Chapter 11 Plan on Automatic Stay

a. *In re Houlik*, 481 B.R. 661 (10th Cir. BAP 2012)

The Tenth Circuit Bankruptcy Appellate Panel reversed the Bankruptcy Court. The Trial Court found that a creditor had committed a willful violation of the automatic stay by taking certain action after the debtor's Plan had been confirmed and the case was closed. The BAP decided that once the Plan was confirmed and the case was closed, the Bankruptcy Court no longer had jurisdiction and if the debtor possessed a cause of action, it would have to be brought in another Court.

## NINTH CIRCUIT REFUSES TO ALLOW LATE FILING OF 11 U.S.C. § 523 COMPLAINT

The advent of electronic filing in Bankruptcy Court now allows a party to beat a deadline date by filing the operative pleading by 11:59 p.m., whereas before electronic filing, the party may have had to rush down to the Clerk's office to meet a 5:00 p.m. closing. Since attorneys can be notorious procrastinators, the additional time afforded by electronic filing would presumptively eliminate the possibility of blowing a deadline since downloading a pleading from a computer is far less perilous than having to file a hard copy of the document with the Court. However, one should never underestimate the ability of a lawyer to find the means of still not meeting a deadline even with the luxury of being able to file by 11:59 p.m. of the deadline date.

In *Anwar v. Johnson*, 720 F.3d 1183 (9th Cir. Ct. App. (AZ) 2013), that is exactly what occurred when the attorney for *Anwar* missed the deadline by 26 minutes on one 11 U.S.C. § 523 Complaint and on the sister case, missed the deadline by 36 minutes. The attorney sought relief under Local Rule 5005(a)(2), but the Ninth Circuit found that that rule could not preempt Federal Rule of Bankruptcy Procedure 4007(c) which set a 60 day time limit on the filing of such complaints from the date of the first meeting of creditors.

At first glance, this ruling may seem to be rather harsh because the attorney for the moving parties delineated in painful detail all of the technology problems he faced on his end when he desperately tried to file the Complaint by the statutory deadline. The attorney was semi-retired, and was filing the Complaints from his house with the help of his wife, who frankly was not that skilled as to electronic filings. Furthermore, the defendants could not allege that they were necessarily prejudiced by the late filing since they didn't even know that the deadlines had been blown until the next morning when their attorney saw, while reviewing ECF filings, that the Complaint had been filed a day late, albeit first thing in the morning.

Furthermore, courts have allowed relief from the late filings under other circumstances, such as in situations when the court could not receive the filing because of technical problems on its end or actions taken by the defendant which may have contributed to the plaintiff missing the deadline date.

So what were the reasons why the Bankruptcy Court, District Court, and Ninth Circuit turned a deaf ear to the rather strong cries for relief from the moving parties?

Since the undersigned handled the case and argued at the Ninth Circuit, I believe the following factors were very important in the Ninth Circuit's decision:

1. The moving parties had been given almost five additional months to file the Complaints notwithstanding a rather strongly worded objection by the debtors. Plaintiffs had done close to nothing in terms of pursuing their claim prior to

requesting the additional time, but nevertheless were given a very generous period to conduct discovery and prepare and file the Complaints;

2. Both prior to the original deadline and the continued deadline date, plaintiffs simply did not act in a diligent manner. They tried to argue that they acted as expeditiously as possible, but ultimately were dilatory in completing their discovery because of their own conduct. They argued that they had to wait until the last moment to file the Complaint because of the defendants' alleged delay, but the record did not support that delay and the courts were able to ignore that equitable plea;

3. The attorney who belatedly filed the Complaint was trying to do so from his Oregon home even though he had local counsel in Phoenix who could have facilitated the filing, but the Oregon attorney chose not to utilize that option;

4. The Ninth Circuit found it significant that the plaintiff's attorney chose to not begin the filing process until late in the evening of the deadline date, which means he would have absolutely blown the deadline without electronic filing;

5. Though the Ninth Circuit judges may not have noted this, the lawyer actually had missed at least one other deadline in the filing of his briefs during the course of the appellate process, but had been provided with relief by the Court; and

6. All of the courts were clearly concerned with granting relief without the presence of truly extingent circumstances.

Because every court found that no discretion was available for the trial court under the rules, no one knows whether the factual scenario presented would have been adequate to justify relief under the bankruptcy rules if such discretion was allowed. It is difficult to really know how the Court would have decided if given the chance, though one suspects that a court would be uncomfortable granting relief purely on the basis that the sender's computer was "acting up."