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Bankruptcy Law Is Confusing, Even for Nerds: A Case Law Update

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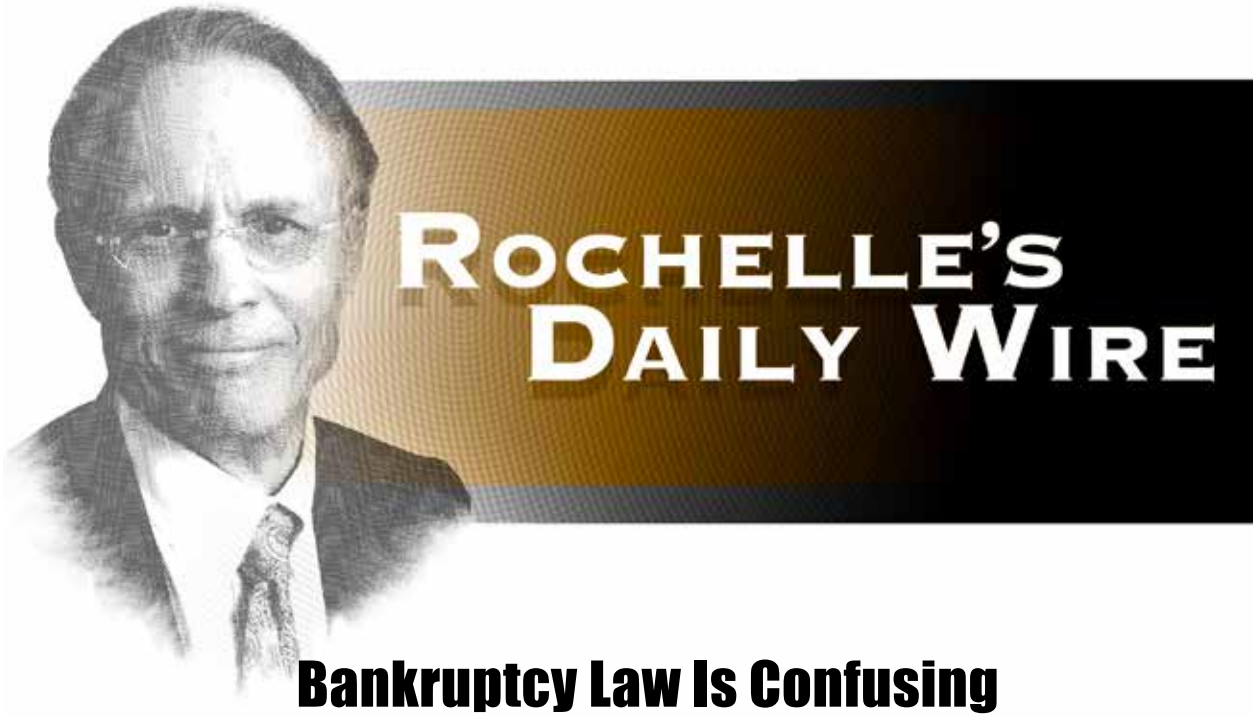

Bankruptcy Law Is Confusing Even for Nerds

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Supreme Court

Decided Last Term

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

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

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

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

The Seventh Circuit Opinion

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

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

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

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

Since the purchaser was buying stock, it was clear to the Seventh Circuit that the transfers were either a settlement payment or a payment in connection with a securities contract. The appeals

court said it was therefore only necessary to decide whether the safe harbor protects transactions "simply [because they were] conducted through financial institutions."

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

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

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

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

The Unanimous Opinion

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

What exactly did the justice mean by her statements?

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

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

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

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

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

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

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

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

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

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

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

The Ninth Circuit Decision

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

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

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

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

All three circuit judges agreed that the purchaser did not automatically become an insider by purchasing the insider's claim. The majority then said that status as an insider entails a "factual

inquiry that must be conducted on a case-by-case basis." To be a non-statutory insider, the appeals court laid out a two-part test. A claim buyer "must have a close relationship with the debtor and negotiate the relevant transaction at less than arm's length."

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

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

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

The Petition for *Certiorari*

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

The Unanimous Opinion

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

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

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

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

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

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

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

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

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

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

The Concurring Opinions

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

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

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

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

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

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

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

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

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

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

High court resolves a circuit split on Section 523(a)(2)(B) and the meaning of "financial condition."

A False Statement About One Asset Isn't Grounds for Nondischargeability

The Supreme Court resolved a split of circuits today by holding that a false statement about one asset must be in writing to provide grounds for rendering a debt nondischargeable under Section 523(a)(2).

The 15-page opinion by Justice Sonia Sotomayor focused primarily on the plain language of the statute and the meaning of the word "respecting." The opinion was unanimous, except that Justices Clarence Thomas, Samuel A. Alito Jr. and Neil M. Gorsuch did not join in a section of the decision where Justice Sotomayor buttressed her conclusion by relying on legislative history surrounding the adoption of the Bankruptcy Code in 1978.

The case pitted courts' aversion to those who lie against the statutory language and its history. In a sense, the result is akin to *Law v. Siegel*, 134 S. Ct. 1188 (2014), where the Supreme Court ruled that the bankruptcy court does not have a "roving commission" to do equity. In *Law*, the high court barred the imposition of sanctions by invading property made exempt by statute, even though the debtor persistently committed fraud.

A ruling the other way would have led to anomalous results. If a smaller lie about one asset could result in nondischargeability, a bigger lie about a debtor's entire net worth would provide no grounds for nondischargeability unless it were in writing.

While courts may not be favorably inclined toward debtors who lie orally to obtain credit, Congress made a decision in Section 523(a)(2)(B) that a materially false statement "respecting the debtor's . . . financing condition" must be in writing to provide grounds for nondischargeability of the related debt.

The Case Below

A client told his lawyers that he was to receive a large tax refund enabling him to pay his legal bills. The lawyers continued working, based on the oral representation.

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

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

The creditor filed a petition for *certiorari*, which the Supreme Court granted on the recommendation of the U.S. Solicitor General, who later submitted an *amicus* brief supporting the debtor, arguing that the Eleventh Circuit was correct, and contending that an oral misstatement about one asset is a statement about "financial condition" that must be in writing before the debt can be declared nondischargeable.

The circuits were split. The Fifth and Tenth Circuit held that a false statement about one asset can result in nondischargeability, while the Eleventh Circuit had joined the Fourth in holding that a statement about any asset must be in writing to provide grounds for nondischargeability.

The justices heard oral argument on April 17.

Another 'Plain Language' Opinion

The creditor-petitioner argued that a statement about a debtor's overall financial condition is the only type of statement "respecting" financial condition that can result in nondischargeability under Section 523(a)(2)(B). According to the creditor, a lie about one asset is not about "financial condition." Rather, the law firm contended that a lie about one asset falls within the ambit of Section 523(a)(2)(A) and leads to a nondischargeable debt because it is a "false representation." Under (a)(2)(A), there is no requirement that a "false representation" be in writing before the debt can be nondischargeable.

As is her style, Justice Sotomayor was quick to the point. In the second paragraph of her opinion, she said that the "statutory language makes plain that a statement about a single asset can be a 'statement respecting the debtor's financial condition.'" If the statement was not made in writing, she said, "the associated debt may be discharged, even if the statement was false."

Justice Sotomayor said that the Bankruptcy Code does not define three critical terms: "statement," "financial condition," and "respecting." Only "respecting" was in dispute, she said.

Looking to several dictionaries, Justice Sotomayor said that "respecting" means "in view of: considering; with regard or relation to: regarding, concerning." At least in the context of the instant case, she said that "related to" does not have a "materially different meaning" than "about," "concerning," "with reference to," or "as regards." The words all have circular definitions, she said.

In the realm of statutory construction and drafting, Justice Sotomayor said that "respecting" "generally has a broadening effect" and "covers not only its subject but also matters relating to that subject." She rejected the notion that (a)(2)(B) only refers to overall financial condition, because that interpretation would read "'respecting' out of the statute."

Broadening her opinion further, she said that a statement is "respecting" financial condition "if it has a direct relation to or impact on the debtor's overall financial condition."

A narrower interpretation, according to Justice Sotomayor, "would yield incoherent results." For example, she said that a false statement, such as, "I am above water," could not result in nondischargeability unless it were in writing, while saying, "I have $200,000 in equity in my house" could lead to nondischargeability. "This, too, is inexplicably bizarre," she said.

Justice Sotomayor traced the language in the Bankruptcy Code to a phrase first adopted by Congress in 1926, which the circuits consistently interpreted to include even one of a debtor's assets. Having used the same word in the Bankruptcy Reform Act of 1978, she said that Congress "intended for it to retain its established meaning."

Justices Thomas, Alito and Gorsuch did not join in the last section of Justice Sotomayor's opinion, where she grounded the result in legislative history underpinning Section 523(a)(2)(B). She quoted from a 1995 Supreme Court decision citing the legislative history as saying that Congress drafted Section (a)(2) in a manner intended to prevent abuse by creditors who might otherwise trap debtors into making statements that could result in denial of discharge.

The opinion is *Lamar, Archer & Cofrin, LLP v. Appling*, 16-1215 (Sup. Ct. June 4, 2018).

Possible for Next Term

What did Congress mean in Sections 365(n) and 101(35A)? Is the right to use a trademark terminated when a trademark license is rejected?

'*Cert* Petition Asks Supreme Court to Overrule *Lubrizol* on Trademark Licenses

Does the rejection of a trademark license mean that the licensee must stop using the trademark?

The circuits are split, but the Supreme Court is being given an opportunity to resolve the question and decide whether the Fourth Circuit was right or wrong in 1985 when it handed down one of most controversial bankruptcy decision of all time, *Lubrizol Enterprises Inc. v. Richmond Metal Finishers Inc.*, 756 F.2d 1043 (4th Cir. 1985).

The licensee of a rejected trademark license filed a petition for *certiorari* in the Supreme Court from the First Circuit's opinion in January in *Mission Product Holdings Inc. v. Tempnology LLC (In re Tempnology LLC)*, 879 F.3d 389 (1st Cir. Jan. 12, 2018). The petition is likely to be considered by the justices at their so-called long conference in late September. We may know as early as September 27 whether the high court will hear the case in the term to begin in October. If *certiorari* is granted, oral argument could take place in December 2018.

The Circuit Split

In *Lubrizol*, the Fourth Circuit held in 1985 that rejecting an executory contract for intellectual property bars the non-bankrupt from continuing to use patents, trademarks and copyrights. Congress responded three years later by adding Section 365(n) and the definition of "intellectual property" in Section 101(35A). Together, they provide that the non-debtor can elect to continue using patents, copyrights and trade secrets despite rejection of a license.

The amendment omitted reference to trademarks. The Senate Report said that the amendment did not mention trademarks because the issue "could not be addressed without more extensive study." In the meantime, Congress said it would "allow the development of equitable treatment of this situation by bankruptcy courts."

As a result of the omission of trademarks from the definition of "intellectual property," the lower courts were split when it comes to deciding whether rejection of a trademark license precludes the licensee from continuing to use the mark. Some courts interpreted Sections 365(n) and 101(35A) as implying a legislative adoption of *Lubrizol* when it comes to trademarks. Other lower courts disagreed.

The Seventh Circuit was the first court of appeals to weigh in when it handed down *Sunbeam Products Inc. v. Chicago American Manufacturing LLC*, 686 F.3d 372 (7th Cir. 2012). The Chicago-based court disagreed with *Lubrizol* and held that "nothing about this process [of rejection] implies that any other rights of the other contracting party have been vaporized." Holding that the right to use the trademark was not terminated by rejection, Circuit Judge Frank Easterbrook noted how *Lubrizol* has been "uniformly criticized" by scholars and commentators.

The split crystalized at the circuit level when the First Circuit handed down *Tempnology* in January. The majority in the 2/1 decision sided with *Lubrizol* and criticized *Sunbeam* for "largely [resting] on the unstated premise that it is possible to free a debtor from any continuing performance obligations under a trademark license even while preserving the licensee's right to use the trademark." The majority favored "the categorical approach of leaving trademark licenses unprotected from court-approved rejection, unless and until Congress should decide otherwise."

The licensee filed a petition for *certiorari* on June 11. Counsel for the petitioner-licensee includes Danielle Spinelli, a former Supreme Court clerk who argued on the winning side in two recent bankruptcy cases, *Czyzewski v. Jevic Holding Corp*., 137 S. Ct. 973 (2017), and *Clark v. Rameker*, 134 S. Ct. 2242 (2014).

The *Tempnology* '*Cert*' Petition

The licensee in *Tempnology* tells the justices in the *certiorari* petition that the First Circuit worsened an existing circuit split on an "openly acknowledged, and longstanding division of authority among the courts of appeals." The petitioner says that the split "is entrenched and will not resolve itself without this Court's intervention."

Arguing that the First Circuit was wrong, the petitioner adopts the approach in *Sunbeam* by contending that rejection of an "executory contract is merely a breach," as provided in Section 365(g). The Boston-based appeals court, it says, confused the power of rejection with the avoidance power.

In addition to *Sunbeam*, the petitioner finds support at the circuit level in the concurring opinion by Third Circuit Judge Thomas L. Ambro in *In re Exide Technologies*, 607 F.3d 957, 964 (3d Cir. 2010). Judge Ambro advocated the same result as the Seventh Circuit on much the same reasoning.

The *Tempnology* petition seeks high court review of a second question: Can the exclusive right to sell a product be terminated by rejection of an executory contract? In other words, is "exclusivity" an intellectual property right that is treated the same for rejection purposes as a trademark and other intellectual property?

Although the petitioner cites scholars in support of its argument that the First Circuit was wrong, there may be no circuit split. Absent a circuit split on exclusivity, the Supreme Court might grant *certiorari* but limit review to the *Lubrizol* issue.

The *certiorari* petition is *Mission Product Holdings Inc. v. Tempnology LLC*, 17-1657 (Sup. Ct.).

***Petitioner contends the Second Circuit was wrong to bar arbitration in view of the Supreme Court's decision in* Epic Systems.**

'*Cert* Petition Wants Discharge Violations to Be Arbitrated

Can a debtor be forced to arbitrate an alleged violation of the discharge injunction under Section 524?

That is the topic of a petition for *certiorari* filed on June 5, asking the Supreme Court to review *Credit One Bank NA v. Anderson (In re Anderson)*, 884 F.3d 382 (2d Cir. March 7, 2018). Despite an arbitration provision in a pre-bankruptcy agreement with a creditor, the Second Circuit upheld the two lower courts and refused to compel arbitration when the debtor mounted a class action contending that the creditor routinely violated the discharge injunction.

Although there is no circuit split on the arbitrability of an alleged discharge violation, the petitioner in *Anderson* contends that the Second Circuit was wrong in light of recently decided *Epic Systems Corp. v. Lewis*, 200 L. Ed. 2d 889, U.S.L.W. 4297 (Sup. Ct. May 21, 2018), where the Supreme Court compelled employees to arbitrate their wages and hours claims governed by the Fair Labor Standards Act.

Indeed, the petitioner in *Anderson* concedes that the Fourth, Fifth and Ninth Circuits agree with the Second Circuit and allow discretion to disregard an arbitration agreement when the lawsuit raises a "core" bankruptcy claim and arbitration would represent a "severe conflict" with the Bankruptcy Code.

The *Anderson* '*Cert*' Petition

Believing that the Second Circuit was wrong in view of *Epic*, the creditor-petitioner in *Anderson* interprets *Epic* to mean "that another federal statute can render an arbitration agreement unenforceable . . . only if that was Congress's clear and manifest intent." The petitioner in *Anderson* believes that "[n]othing in the Bankruptcy Code evidences a clear and manifest congressional intent to displace the Arbitration Act's command as to claims for violation of the statutory discharge injunction."

The petitioner believes that discharge violations are arbitrable because "[t]here is no indication in either [Section 524 or Section 105] . . . that Congress intended to preclude arbitration of Section 524 claims."

In other words, the petitioner believes that an arbitration clause in a pre-bankruptcy agreement can bar a debtor from resorting to bankruptcy court to enforce or seek redress for a violation of discharge. If that were true, a creditor with an otherwise enforceable arbitration agreement could dun a debtor after bankruptcy, knowing that the debtor could enforce his or her discharge only in arbitration.

If courts were to adopt the petitioner's view, many otherwise "core" proceedings in bankruptcy cases would disappear into arbitration. The standard sought by the petitioner might mean that a creditor could force a debtor to arbitrate a claim objection, an objection to the dischargeability of a debt, or even a fraudulent transfer or preference claim.

Possible Disposition of the *Anderson* Petition

Conceding there is no circuit split on the non-arbitrability of "core" claims involving a fundamental bankruptcy right, the petitioner wants the Supreme Court to put the appeals courts on the right track because "the lower courts have been flummoxed by the Bankruptcy Code, which [the Supreme Court] has never addressed for these purposes."

The petitioner well may be correct that *Anderson* cannot be squared with *Epic*, a 5/4 decision. However, the Supreme Court is not a court of error. Along with alleged violations of the U.S. Constitution, most Supreme Court cases resolve circuit splits.

Since there is no circuit split underlying *Anderson*, the petitioner forthrightly asks the Supreme Court, in the alternative, to "grant [the *certiorari* petition], vacate, and remand [to the Second Circuit] in light of its intervening decision in *Epic Systems*." A GVR, as it is called, seems more likely than a straight-up grant of *certiorari*.

The debtor-plaintiff in *Anderson* already waived its right to file a response to the petition for *certiorari*. Like *Tempnology*, the justices are likely to consider the *Anderson* petition and issue a disposition as early as September 27.

Subsequent to *Anderson* but the same day as *Epic*, a bankruptcy court in Florida reached the same result as the Second Circuit. To read ABI's discussion of *In re Bateman*, 14-5369, 2018 BL 181355 (Bankr. M.D. Fla. May 21, 2018), click here.

To read ABI's discussion of the Second Circuit decision in *Anderson*, click here. To read the Anderson *certiorari* petition, click here.

The petition is *Credit One Bank NA v. Anderson*, 17-1652 (Sup. Ct.).

***BAP opinion shows that contempt is virtually impossible to prove in the Ninth Circuit following* Taggart.**

Raising a Circuit Split, Ninth Circuit's *Taggart* Opinion Heads for a '*Cert* Petition

The Ninth Circuit ruled in April that a good faith belief that an action does not violate the discharge injunction precludes finding the creditor in contempt, even if the discharge injunction did apply and the creditor's belief was "unreasonable." *Lorenzen v. Taggart (In re Taggart)*, 888 F.3d 438 (9th Cir. April 23, 2018). *Taggart* means that contempt will be difficult if not impossible to prove in the Ninth Circuit.

On September 7, the appeals court denied a petition for rehearing and rehearing *en banc* in *Taggart*. The circuit court was not persuaded by several *amicus* briefs submitted by law professors, professional organizations, and a former judge, all urging rehearing.

Daniel L. Geyser of Dallas, the debtor's counsel on the rehearing motion in *Taggart*, told ABI that he will be filing a petition for *certiorari* in the Supreme Court. He said there is "a square circuit conflict over a recurring question that is essential to the Code's effective administration." If allowed to stand, he said that *Taggart* "will eviscerate the Code's key mechanism for enforcing the discharge injunction."

Indeed, there is little to deter stay violations without the threat of contempt, and debtors may not be able to afford counsel to enforce their protections if contempt sanctions are generally unavailable.

The First Circuit widened the circuit split in June in deciding *IRS v. Murphy*, 892 F.3d 29 (1st Cir. June 7, 2018).

In *Murphy*, a divided panel on the Boston-based appeals court ruled less than two months after *Taggart* that a government employee who knows there was a discharge may be held in contempt even if the government had a good faith belief that the action did not violate the discharge. Contempt may be found, the First Circuit said, so long as there was an intentional action later found to violate the discharge. To read ABI's discussions of *Taggart* and *Murphy*, click here and here.

Meanwhile, the Ninth Circuit Bankruptcy Appellate Panel handed down an opinion on September 7 interpreting *Taggart* and showing that contempt will be virtually impossible to establish in the Ninth Circuit, even when there has been an adjudicated stay violation.

The BAP's September 7 opinion in *RESS Financial Corp. v. Beaumont 1600 LLC (In re The Preserve LLC)* demonstrates the importance of resolving the circuit split, given the centrality of discharge and the automatic stay in the bankruptcy system.

Before bankruptcy, the corporate debtor in *Preserve* had purchased about 1,300 acres encumbered by a mortgage for almost $40 million. Also before bankruptcy, the lender released the lien on about half of the acreage.

In connection with confirmation of the debtor's chapter 11 plan, the bankruptcy court entered an order declaring that the collateral for the mortgage was 636 acres, representing the original acreage less the portion that was released. The confirmed plan also stated that the collateral was 636 acres.

The debtor defaulted on the plan the following year, resulting in conversion to chapter 7 and the appointment of a trustee. The conversion order lifted the automatic stay to permit foreclosure of the lender's deed of trust.

The lender and its agent both concluded that the release of lien was invalid because it was not accompanied by a recorded map, as allegedly required by California law. The lender's agent therefore initiated foreclosure proceedings with respect to the entire 1,300 acres. Counsel for the chapter 7 trustee quickly demanded that the lender terminate the foreclosure proceedings with regard to the released acreage.

When the lender responded by saying it would not stand down, the trustee initiated an adversary proceeding, asking the bankruptcy judge to declare that the foreclosure proceedings were invalid with respect to the released acreage. The trustee also sought damages for violation of the automatic stay. Without conceding error, the lender then discontinued the foreclosure proceedings.

Litigation continued in the bankruptcy court for more than two years. Following trial, the bankruptcy judge ruled that the lender had committed a willful and intentional violation of the automatic stay after having been informed by the trustee's counsel that the stay protected the property that had been released from lien.

The bankruptcy judge determined that the lender's belief about the inapplicability of the automatic stay was reckless and unreasonable. Ultimately, the bankruptcy court found the lender in contempt and entered judgment in favor of the trustee for about $425,000, representing legal fees incurred by the trustee in litigating the alleged automatic stay violation and related issues.

The lender appealed to the BAP and won.

In a *per curiam*, nonprecedential opinion on September 7, the BAP reversed and remanded the case to the bankruptcy court, ostensibly to determine whether the trustee had established by clear and convincing evidence that the lender had knowledge of the stay and committed a willful violation.

Although the trustee theoretically will have a second bite at the apple on remand, the trustee's chances of prevailing are small because the BAP went on to cite *Taggart* by saying that "a good faith belief that the stay does not apply precludes a finding of contempt, even if the creditor's belief is unreasonable." The bankruptcy court's finding about the lender's unreasonable belief presumably will not support a contempt citation, because *Taggart* says that even an unreasonable belief elides a contempt finding.

Indeed, the lender's good faith belief about the inapplicability of the stay seems beyond cavil because the lender had received several opinions saying that the release of lien was invalid.

Whether or not *Taggart* is set aside in the Supreme Court, *Preserve* will remain required reading because the BAP's opinion is a virtual handbook containing a step-by-step compendium of rules pertaining to contempt citations. Among other things, the opinion highlights the differences between a finding of contempt under the court's inherent powers contrasted with Section 362(k), which applies only to individual debtors complaining about stay violations.

The BAP opinion applies *Taggart* to automatic stay violations, removing any thought that *Taggart* would only govern violations of the discharge injunction.

The BAP opinion is not intended for official publication, but it should be officially published, in this writer's opinion. The opinion is a priceless synthesis of rules pertaining to contempt findings.

The opinion is *RESS Financial Corp. v. Beaumont 1600 LLC (In re The Preserve LLC)*, 17-1357 (B.A.P. 9th Cir. Sept. 7, 2018).

Reorganization

Dismissal

The appeals court avoids ruling broadly on the ability of a golden share or blocking provision to bar a company from filing bankruptcy voluntarily.

Fifth Circuit Issues a Narrow Opinion Requiring Corporate Authority to File a Petition

On direct appeal from a bankruptcy court in Mississippi, the Fifth Circuit was being asked to hand down a blockbuster opinion saying whether a creditor or shareholder could use a so-called golden share or blocking provision to preclude a company from filing bankruptcy.

An opinion directly answering the certified questions would have allowed the New Orleans-based appeals court to adopt, reject or significantly expand the idea that no one can contract away the ability to file bankruptcy or the right to a discharge.

To avoid issuing an advisory opinion, Circuit Judge Carolyn Dineen King instead answered a narrow question closely tailored to the facts. Based on Supreme Court authority from 1945, Judge King held in her May 22 opinion for the Fifth Circuit that a bankruptcy court must dismiss a bankruptcy petition if the filing was not authorized in accordance with the corporate charter.

Judge King took pains to ensure that her opinion would not be interpreted too broadly. She said, for instance, that the result might be different if the ability to block bankruptcy were held by a creditor "with no stake in the company" or if a creditor took an equity interest as a "ruse" to guarantee payment of a debt.

The Bankruptcy Court Opinion

The debtor owned a car rental company. To finance an acquisition, the debtor received a $15 million investment from a diversified financial group. In return, the investor was given 100% of the debtor's preferred equity convertible into 49.76% of the equity. The preferred shareholder was the single largest investor in the company.

An investment bank helped arrange the acquisition. The bank was an affiliate of the preferred shareholder. The investment bank had a $3 million unpaid claim for its services. In his opinion in December, Bankruptcy Judge Edward Ellington of Jackson, Miss., said that the preferred shareholder controlled the affiliated investment bank creditor.

As part of the transaction, the debtor reincorporated in Delaware and provided in the certificate of incorporation that a majority of all classes of equity, voting separately, must approve a "liquidation event" such as bankruptcy.

Without holding a vote of common and preferred shareholders, the company filed a chapter 11 petition. The preferred shareholder responded by filing a motion to dismiss for lack of proper corporate authorization. In opposition, the debtor argued that the creditor, acting through its controlled affiliate, the preferred shareholder, could not bar a bankruptcy filing and thus realize a result it could not achieve directly.

Judge Ellison granted the dismissal motion, holding that the preferred shareholder had the "unquestioned right" to block a voluntary bankruptcy, even though it was controlled by the creditor with the $3 million disputed claim.

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

On February 8, the appeals court granted the petition and expedited the appeal. Oral argument took place on May 2.

To read ABI's report on the bankruptcy court's decision and the certified question, click here.

Judge King's Cautious, Narrow Opinion

Addressing the concepts of golden shares and blocking provisions, Judge King said they are not identical. A blocking provision could be one of several contractual provisions a creditor might use to prevent a debtor from filing bankruptcy. In the bankruptcy context, she said that a golden share is stock that gives a creditor the right to prevent a voluntary bankruptcy.

The case on appeal did not fit within either definition, Judge King said. In any event, opining on the legality of blocking provisions or golden shares would amount to issuing an advisory opinion, which she was unwilling to do.

Instead, Judge King narrowed the question to decide whether the parties could "amend a corporate charter to allow a non-fiduciary shareholder fully controlled by an unsecured creditor to prevent a voluntary bankruptcy petition."

Judge King said that the Bankruptcy Code does not specify who has the right to file a petition for a corporation. In substance, she based her decision on *Price v. Gurney*, 324 U.S. 100, 106 (1945), where the Supreme Court held that state law determines who has authority to file a voluntary petition for a corporation.

Judge King found "no reason to depart from that general rule in this case." She also found no statute or "binding caselaw" that would allow the court "to ignore corporate foundational documents, deprive a *bona fide* shareholder of its voting rights, and reallocate corporate authority to file for bankruptcy just because the shareholder also happens to be an unsecured creditor."

Cases relied upon by the debtor were "not controlling and not to the contrary," Judge King said. They involved "creditors' attempts to appoint non-fiduciary officers and directors with the ability to prevent a bankruptcy filing."

Exploring the facts, Judge King said she *found no evidence* that the requirement for shareholder approval "was merely a ruse" to ensure that the debtor would pay the investment bank's $3 million claim, *even if the banker and the preferred shareholder were treated as a single entity*. In other words, Judge King's holding might not apply in another case where the corporate charter was being used to ensure payment of a debt.

On the other hand, the opinion also means that a creditor and shareholder theoretically can be one entity without disabling the right to vote as a shareholder.

Stressing the limited nature of the holding, Judge King said that the case entailed a *bona fide* shareholder and "goes no further." She said the case did not involve a creditor who "somehow contracted for the right to prevent a bankruptcy or where the equity interest is just a ruse."

Having determined that nothing in federal bankruptcy law precluded enforcement of the corporate charter under the facts of the case, Judge King then analyzed whether the charter was enforceable under Delaware law.

Judge King found no Delaware cases saying whether shareholders could be given the right to decide for or against filing bankruptcy. Fortunately, the debtor abandoned the argument on appeal, so she was not called on to make a so-called *Erie* guess. Therefore, Judge King assumed that Delaware law would allow such a provision.

Next, Judge King examined whether the preferred shareholder violated fiduciary duties. In the first place, the record did not establish that the preferred shareholder was a controlling shareholder and therefore did not have fiduciary duties under Delaware law.

Even if the shareholder were controlling and therefore did have fiduciary duties, Judge King found "a more fundamental defect" in the debtor's argument: The proper remedy for violation of fiduciary duties would "not allow a corporation to disregard its charter and declare bankruptcy without shareholder consent."

Even if the shareholder had violated fiduciary duties, "the proper remedy is not to deny an otherwise meritorious motion to dismiss the bankruptcy petition."

"Instead," Judge King said, the debtor "must seek its remedy under state law" if the shareholder has "breached a fiduciary duty."

Judge King's opinion does not indicate whether a bankruptcy court through some procedural construct would have jurisdiction to determine whether a shareholder had violated a fiduciary duty and thus enable a company to file bankruptcy voluntarily without corporate authorization. For example, it is not clear one way or another whether a company could file a petition and answer a motion to dismiss by contending that the shareholder was violating fiduciary duties.

The opinion is *Franchise Services of North America Inc. v. U.S. Trustee (In re Franchise Services of North America Inc.*), 18-60093 (5th Cir. May 22, 2018).

Executory Contracts & Leases

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

Circuit Split Deepens on Rejection of Trademark Licenses

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

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

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

The Genesis of Section 365(n)

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

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

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

In *Sunbeam*, the Seventh Circuit split with the Fourth in 2012. Judge Easterbrook acknowledged that Section 365(n) does not preserve the right to use trademarks, but at the same

time does not prescribe the consequences of rejection. Judge Easterbrook instead relied on Section 365(g), which teaches that rejection "constitutes a breach" of contract.

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

The First Circuit Case

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

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

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

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

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

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

Judge Kayatta said that *Sunbeam* "largely rests on the unstated premise that it is possible to free a debtor from any continuing performance obligations under a trademark license even while preserving the licensee's right to use the trademark." That premise, he said, is wrong because "effective licensing of a trademark" requires the licensor to continue monitoring and exercising control over the quality of the goods sold under the mark.

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

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

The Dissent

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

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

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

Distribution Rights

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

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

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

The Next Steps

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

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

Do free and clear sales confer interests that are entitled to adequate protection?

Seventh Circuit Opens a Can of Worms on Bankruptcy Sales and Adequate Protection

In a highly theoretical opinion, the Seventh Circuit said that an out-of-the-money creditor in a free and clear bankruptcy sale *might* be entitled to some sale proceeds, thus reducing the recovery by the senior lender even if the lender is not being paid in full.

How's that possible? The Chicago-based appeals court *theorized* that the ability to sell free and clear *might* create an interest in property for which a subordinate creditor *could* be entitled to an adequate protection payment.

Before you panic and conclude that everything you know about bankruptcy sales is about to change, keep in mind that the Seventh Circuit based its July 9 opinion on an assumption that may prove to be wrong when the question arises again.

The Underwater Sales

The circuit court decided two consolidated appeals, both involving an Illinois bulk sale law designed to aid the state in collecting taxes. If state taxes are not paid, the bulk purchaser of a business becomes liable for the taxes under state law.

In parallel bankruptcies, the debtors owed $1.4 million and $600,000, respectively, in state taxes. In sales free and clear of liens and claims under Section 363(f), the properties fetched $5.2 million and $2 million, respectively. However, banks held first liens on the properties for $14 million and $4 million, respectively.

In other words, the first lien lenders would recover only a fraction of their secured claims even if they received all sale proceeds.

The state opposed distribution of the sale proceeds to the senior lenders, contending the state was entitled to be paid in full because the bulk sale law permits collection of the tax debts from purchasers. More cogently, the state argued that its successor liability claims under the bulk sale law amounted to an "interest" in property that was entitled to adequate protection under Section 363(e).

Because the senior lenders were underwater, the bankruptcy judges in Chicago both ruled that the state was entitled to no recovery from the sales.

On appeal, two different district judges remanded for the bankruptcy judges to develop the record by making two findings: (1) what the state would have recovered if the property had not been sold free and clear, and (2) how the state could be compensated for its "interest" given that the lenders had senior liens.

On remand, both bankruptcy judges again denied the state any recovery, ruling that the state's realizable interest was effectively zero. The appeals court allowed direct appeals on both cases.

The Circuit Opinion, Based on an Assumption

Circuit Judge Ilana K. Rovner authored a 29-page opinion upholding the results in the bankruptcy courts, albeit on different grounds that some in the bankruptcy community may find unsettling.

Judge Rovner explained that the Illinois bulk sale law does not affect lien priorities. Indeed, the law does not apply in foreclosure, where the state cannot assert a successor liability claim against a purchaser.

In bankruptcy, however, the state contends that the ability to hold purchasers personally liable has "real value" that is entitled to adequate protection. More specifically, the state claims that a purchaser will pay a higher price because a bankruptcy sale relieves the purchaser of liability for state taxes. Developing the theory further, the state postulates that the purchaser would pay more to avoid the expense and loss of value to the business that would result from foreclosure, where the tax liability would disappear.

Judge Rovner therefore framed the question as whether the state was entitled to adequate protection when the properties were sold free and clear in bankruptcy court.

Significantly, Judge Rovner's entire opinion rests on a critical assumption. Without deciding, she assumed that the state's ability to impose successor liability was an "interest" in the debtor's property that would invoke the concept of adequate protection under Sections 363(e) and 361(1). She made the assumption because the bankruptcy courts had made the same assumption, and the issue was litigated or decided below.

Judge Rovner's own opinion contains language undercutting the assumption. She said that a buyer's inclination to pay a premium for a sale free and clear "is attributable to [the state law] rather than any asset of the estate." If that is true, a sale free and clear would be cutting off a state law right against a purchaser, not an interest in estate property deserving of adequate protection.

Judge Rovner said she was "dubious of the notion" that the state could have recovered all outstanding taxes. She also recognized that allowing the state to recover even a portion of the taxes

"would, in a real sense, permit [the state] to jump the queue of creditors and grant [the state] monetary protection for its interest at the expense of other creditors."

Judge Rovner therefore analyzed several hypotheticals to decide what the state "realistically could have recovered from the purchaser." Even if a purchaser might pay more, the bank, she said, "surely would not be indifferent" if the state were to receive some of the proceeds when the secured lender was not being paid in full. The lender could foreclose, she said, to cut off the tax claims.

Nevertheless, "foreclosure comes with significant costs and can ultimately reduce the net recovery of a bank," Judge Rovner said.

In a settlement to avoid foreclosure, a bank might accept somewhat less if the state were to take less than full payment. Judge Rovner said that compromises between the bank and the state "are more than an abstract possibility." On the other hand, she quoted one of the district judges who said that an interest otherwise entitled to adequate protection "may be worth nothing, in practical terms, in which case the interest holder is entitled to no compensation pursuant to Section[s] 363(e) and 361(1)."

Focusing adequate protection "is where the wheels come off the wagon of [the state's] argument," Judge Rovner said, because "Section 361(1) directs us to consider how much the value of [the state's] interest decreased as a result of the bankruptcy court's free and clear orders." In that regard, she said, "we are still faced with the problem of valuation."

Regardless of whether the trustee or the state bore the burden of proof, she said there was "no evidence as to what [the state] likely would have collected from the purchaser but for the bankruptcy court's Section 363(f) free-and-clear order." In the absence of evidence about how much the state's interest was diminished, Judge Rovner held that the "bankruptcy courts therefore did not err in valuing [the state's] interest at zero for purposes of its right to adequate protection."

What Does the Opinion Mean?

Judge Rovner's opinion has set the stage for the next case where the state and the trustee will present expert witnesses about the incremental value in a bankruptcy sale as opposed to foreclosure.

It has always been this writer's belief that a bankruptcy sale is more valuable than foreclosure for several reasons. Nonetheless, would the state be entitled to the incremental value, rather than the lender who is not being paid in full?

A lender's ability to liquidate collateral in bankruptcy court could be viewed as a right held by a secured creditor, not value inherent in the collateral itself to which adequate protection rights

might attach. Likewise, the bulk sale laws could be seen as creating only a claim against a purchaser, not an interest in the bankrupt seller's property warranting adequate protection.

In a different context, the Ninth Circuit said in *Pinnacle Restaurant at Big Sky LLC v. CH SP Acquisitions LLC (In re Spanish Peaks Holdings II LLC)*, 862 F.3d 1148 (9th Cir. July 13, 2017), that a bankruptcy sale can be the rough equivalent of mortgage foreclosure, in which case the state's tax claims would be extinguished altogether. To read ABI's discussion of *Spanish Peaks*, click here.

In any event, courts in the Seventh Circuit are now taxed with deciding whether the Illinois bulk sale law creates an interest in property entitled to adequate protection. It is by no means clear, however, that the outcome will affect only Illinois.

Most states have laws that confer rights on creditors to pursue claims against purchasers who do not follow procedures required by bulk sale laws. It is also not evident why the issue is confined to bulk sale laws, because subordinate secured creditors could argue that sales free and clear of their liens enhance the purchase price.

The opinion is *Illinois Department of Revenue v. Hanmi Bank*, 17-1575 (7th Cir. July 9, 2018).

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

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

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

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

The Lehman Flip Clauses

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

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

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

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

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

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

Judge Schonfield's Opinion

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

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

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

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

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

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

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

the swap participant." Therefore, when the trustees terminated the swaps, she said "they exercised the rights 'of'" the swap participants.

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

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

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

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

Sales

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

Third Circuit Explains When Sale Orders Are Not Automatically Moot

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Estate Property

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

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

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

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

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

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

The Heller Ehrman Liquidation

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

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

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

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

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

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

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

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

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

The California Court's Analysis

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

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

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

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

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

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

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

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

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

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

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

Jurisdiction & Power

Delaware district judge rules that the bankruptcy court has final adjudicatory power to include third-party releases in confirmation orders.

District Court Finds Constitutional Power to Grant Releases in Confirmation Orders

Unless the Third Circuit or the Supreme Court decides otherwise, bankruptcy courts in Delaware have constitutional authority to issue non-consensual, third-party releases of non-bankruptcy claims along with confirmation of a chapter 11 plan.

In an opinion on September 21, Chief District Judge Leonard P. Stark of Delaware abandoned the insinuation he made 18 months ago, adopted the analysis of Bankruptcy Judge Laurie Selber Silverstein from one year ago and held that the principles of *Stern v. Marshall*, 131 S. Ct. 2594 (2011), do not apply because confirming a reorganization plan with releases is not tantamount to a final judgment on the merits of non-bankruptcy claims.

Alternatively, Judge Stark held that the appeal from the Millennium Lab Holdings II LLC confirmation order was equitably moot because the plan had been consummated and releases could not be revoked without upsetting the plan as a whole. Judge Stark also reached the merits and held that the releases were proper because Judge Silverstein correctly applied Third Circuit criteria.

The Facts

Millennium Lab Holdings II LLC, the chapter 11 debtor, had obtained a $1.825 billion senior secured credit facility and used $1.3 billion of the proceeds before bankruptcy to pay a special dividend to shareholders.

Indebted to Medicare and Medicaid for $250 million that it could not pay, Millennium filed a chapter 11 petition along with a prepackaged plan calling for the shareholders to contribute $325 million in return for releases of any claims that could be made by the lenders. The plan did not allow the lenders to opt out of the releases.

Before confirmation, a lender holding more than $100 million of the senior secured debt filed suit in district court in Delaware against the shareholders and company executives who would receive releases under the plan. The suit alleged fraud and RICO violations arising from misrepresentations inducing the lenders to enter into the credit agreement.

Over objection, Judge Silverstein confirmed the plan in late 2015 and approved the third-party releases. The dissenting lender appealed.

Millennium filed a motion to dismiss the appeal on the ground of equitable mootness, because the plan had been consummated in the absence of a stay pending appeal.

District Judge Stark's Remand

On appeal in district court, the objecting lender contended that the bankruptcy court lacked constitutional power to enter a final order granting third-party releases. Judge Stark's decision in March 2017 could have been read to imply, without holding, that granting the releases was beyond the bankruptcy court's constitutional power to enter a final order because the releases were "tantamount to resolution of those claims on the merits against" the lender.

Rather than rule on the constitutional issue, Judge Stark remanded the case for Judge Silverstein to decide whether she had final adjudicatory authority, either as a matter of constitutional law or as a consequence of the lender's waiver. To read ABI's discussion of Judge Stark's opinion, click here.

Judge Silverstein's Opinion Following Remand

On October 3, 2017, Judge Silverstein handed down an impassioned, 69-page opinion concluding that the limitations on the constitutional power of a bankruptcy court under *Stern* are inapplicable to granting third-party releases because a confirmation order exclusively implicates questions of federal bankruptcy law and raises no issues under state or common law.

Judge Silverstein also analyzed the record and concluded that the objecting lender never raised the constitutional question during or even after confirmation. Citing the prohibition of sandbagging in *Wellness International Network, Ltd. v. Sharif*, 135 S. Ct. 1932 (2015), Judge Silverstein said that the lender could not lie in the weeds and raise constitutional infirmities for the first time on appeal. On the ground of waiver alone, Judge Silverstein found that she was entitled to enter a final order. To read ABI's discussion of Judge Silverstein's opinion, click here.

The objecting lender appealed again to Judge Stark.

The Bankruptcy Court's Confirmation Power Is Unimpaired

Judge Stark's 42-page opinion on September 21 contains a meticulous analysis of Judge Silverstein's decision and a detailed recitation of the parties' arguments. He upheld Judge Silverstein's conclusion that the bankruptcy court had constitutional power to approve third-party releases in a confirmation order. He also granted the motion to dismiss other issues in the appeal on the ground of equitable mootness.

Alternatively, Judge Stark reviewed the merits and ruled that the releases were proper under Third Circuit authority.

As he had done before, Judge Stark said it was proper to consider the constitutional issue before entertaining the motion to dismiss for equitable mootness.

On the constitutional issue, Judge Stark said that *Stern* was inapposite. In the case before the Supreme Court, the bankruptcy judge had conducted a bench trial and ruled on the merits of a counterclaim under state law. Persuaded by Judge Silverstein's opinion on remand, Judge Stark said that she "determined only that the bankruptcy-specific standards for approving nonconsensual releases in a plan were satisfied."

Judge Stark adopted Judge Silverstein's narrow reading of *Stern*. He said the Supreme Court did not address any context other than counterclaims, nor did it "'announce a broad holding addressing every facet of the bankruptcy process,'" quoting Judge Silverstein. To determine the applicability of *Stern*, he said that the "operative proceeding" was plan confirmation, where the bankruptcy court has final adjudicatory power. He explained that approving the releases did not entail an analysis of the merits of the lender's non-bankruptcy claims.

Because he decided the merits of the constitutional issue, Judge Stark did not decide, one way or another, whether the lender had waived the *Stern* question.

Turning to equitable mootness, Judge Stark said that the Third Circuit requires analysis of whether the plan has been substantially consummated and whether granting relief on appeal would "fatally unscramble the plan" or significantly harm third parties.

Substantial consummation was not an issue. However, the lender contended that the appellate court could grant relief without unscrambling the plan. The lender wanted Judge Stark to strike the releases only with respect to its claims and otherwise leave the plan intact.

Rejecting the argument, Judge Stark said that striking the release only as to the lender "would severely undermine the Plan and necessarily harm third parties." He said that the releases "cannot equitably be excised as they were the very centerpiece of the plan." They were, he said, "the inducement for the Equity Holders' $325 million contribution, and without this contribution, there could not have been a reorganization."

He said it would be inequitable were he to allow the lender to sue while also permitting the lender to retain the plan distribution made possible with the contribution from the released parties.

Judge Stark concluded that the plan was equitably moot because it was "unclear" to him "what other practicable relief" he could give the objecting lender.

Finally, Judge Stark examined the merits of the releases, as though he had ruled that the appeal was not equitably moot and the bankruptcy court lacked power to issue a final order with releases.

Because the debtor had indemnified the released parties, Judge Stark said the bankruptcy court had subject matter jurisdiction to issue the releases because there was a conceivable effect on the estate. In view of the bankruptcy court's "extensive findings upon the substantial and uncontroverted record," he said that releases were permissible under Third Circuit precedent.

The opinion is *Opt-Out Lenders v. Millennium Lab Holdings II LLC (In re Millennium Lab Holdings II LLC)*, 17-1461 (D. Del. Sept. 21, 2018).

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

A bankruptcy court's* in rem *jurisdiction overrides a claim of sovereign immunity.

Delaware's Judge Sontchi Writes a Seminal Opinion on Sovereign Immunity

In a scholarly opinion, Chief Bankruptcy Judge Christopher S. Sontchi of Delaware explained when there is or is not a waiver of sovereign immunity allowing a debtor to sue a state or local government in bankruptcy court for a tax refund. The opinion could be applied in other contexts when a state or local government raises a sovereign immunity defense.

Judge Sontchi's intricate dissection of the law features the triumvirate of Supreme Court opinions where the justices quickly backtracked in two later cases after having insinuated earlier in *dicta* that the waiver of sovereign immunity in Section 106(a) is unconstitutional. Were it not for the two later Supreme Court decisions coupled with astute analysis like Judge Sontchi's, bankruptcy courts might lack the power to adjudicate the amount of a state's claim against a debtor or to discharge a state tax claim.

The Facts in Judge Sontchi's Case

In his 66-page opinion on July 25, Judge Sontchi carefully laid out the factual and procedural history of the claims for real estate tax refunds made by a trust created under a confirmed chapter 11 plan. He also minutely described the procedures a debtor must follow under California state law, as a predicate for seeking a refund in state court or bankruptcy court.

For the sake of understanding his conclusions, however, the essential facts are simple: Before bankruptcy, the debtor paid several years of real estate taxes on its electric generating plant. Also before bankruptcy, the debtor initiated proceedings before the California State Board of Equalization, or SBE, claiming refunds because the assessments were allegedly too high.

After confirmation, the creditors' trust in substance filed suit against the SBE and the county, asking Judge Sontchi to value the property, reduce the assessments, and direct the county to pay refunds based on lower assessments. The SBE made the equivalent of a motion to dismiss, contending that sovereign immunity left the bankruptcy court without jurisdiction to lower the assessments.

Judge Sontchi agreed and dismissed the proceedings against the SBE seeking to lower the assessments.

The Statutory Waiver of Sovereign Immunity

The creditors' trust sued under Section 505(a), which provides that bankruptcy courts, under certain circumstances, "may determine the amount or legality of any tax, . . . whether or not previously assessed, whether or not paid, and whether or not contested before and adjudicated by a judicial or administrative tribunal of competent jurisdiction."

The Third Circuit, according to Judge Sontchi, has held that Section 505(a) is a jurisdictional statute that was enacted "to clarify the bankruptcy court's jurisdiction over tax claims."

The Third Circuit also held that a sovereign immunity defense is jurisdictional in nature. Thus, the Bankruptcy Code may confer jurisdiction through Section 505(a), but the court will have no jurisdiction if the government has a sovereign immunity defense. The state's sovereign immunity (or lack of it) therefore comes to the fore.

Facially, however, Section 106(a)(1) by its terms abrogates sovereign immunity with respect to claims under Section 505. Judge Sontchi therefore analyzed whether Section 106(a)(1) withstood constitutional scrutiny to waive sovereign immunity for the trust's suit under Section 505.

Governing Supreme Court Authority

In the Supreme Court's seminal decision on sovereign immunity, *Seminole Tribe of Florida v. Florida*, 517 U.S. 44 (1996), the majority in the 5/4 decision used a footnote to describe a dissenter as interpreting the majority opinion to prohibit federal jurisdiction to enforce bankruptcy laws against the states. The majority said that the dissent's conclusion was "exaggerated." *Id*. at 72.

Two years later, the Third Circuit nonetheless applied *Seminole Tribe* to hold that Section 106(a) is "unconstitutional to the extent that it purports to abrogate state sovereign immunity in federal court." *Sacred Heart Hospital v. Dept. of Public Welfare (In re Sacred Heart Hospital)*, 133 F.3d 237, 245 (3d Cir. 1998). According to Judge Sontchi, most but not all circuits agree.

In bankruptcy cases, the Supreme Court later began to backtrack, else discharge, fresh start and reorganization might become unattainable for some debtors.

In *Tennessee Student Assistance Corp. v. Hood*, 541 U.S. 440 (2004), the high court was asked to decide whether Section 106(a) was unconstitutional.

The high court ducked the larger issue in *Hood* by holding that the dischargeability of a student loan was not a suit against the state in terms of Eleventh Amendment sovereign immunity. Rather, the Court said, discharge was an *in rem* proceeding where "the bankruptcy court's jurisdiction over the *res* is unquestioned." *Id*. at 448. The Court went on to say that "the exercise of its *in rem* jurisdiction to discharge a debt does not infringe state sovereignty." *Id*.

Ducking the larger question again two years later, the Supreme Court held in *Central Valley Community College v. Katz*, 546 U.S. 356 (2006), that the power to avoid and recover a preference operates "free and clear of the State's claim of sovereign immunity," since the preference power has been a "core aspect" of bankruptcy "since at least the 18th century." *Id*. at 373.

In *Katz*, Judge Sontchi said that the Supreme Court "refused to abide by the *dicta*" in *Seminole Tribe*.

Waiver by Consent

Although the Supreme Court twice undermined *Seminole Tribe* in the bankruptcy arena, Judge Sontchi said he remained bound by the Third Circuit's opinion in *Sacred Heart* and could not rely on Section 106(a) to override the SBE's claim of sovereign immunity.

The creditors' trust nonetheless argued several theories of waiver. Judge Sontchi held that the SBE had not waived sovereign immunity by having previously participated in preliminary stages of litigation in bankruptcy court over the refund claim. The state, he said, had neither filed a claim nor "joined any causes of action" that would constitute waiver.

The trust, however, gained more (but not enough) traction with the waiver of sovereign immunity by consent arising from the states' ratification of the U.S. Constitution and the Bankruptcy Clause. Still, Judge Sontchi said, every law labeled "bankruptcy" may not impinge on sovereign immunity.

Cobbling together the notion of consent by ratification of the Constitution with *Katz* and *Hood*, Judge Sontchi said that sovereign immunity will not bar "proceedings that effectuate the *in rem* jurisdiction of bankruptcy courts." He proceed to analyze whether the tax refund claims invoked the court's *in rem* jurisdiction.

"[M]erely because the estate may have a claim for a tax refund is not enough to invoke the *in rem* jurisdiction of the bankruptcy court," Judge Sontchi said. Essentially, he concluded that assessing the value of the plant would not invoke *in rem* jurisdiction over estate property when the claim for a refund pertained to taxes already paid, because ruling on the value of the plant would "not actually affect rights in the Facility."

On the other hand, Judge Sontchi said there would be *in rem* jurisdiction to value the property had the refund claim pertained to post-petition payments or if the state were lodging a claim for unpaid taxes.

The case at hand, according to Judge Sontchi, "is nothing more than a state law claim for a sum of money. To disallow a sovereign immunity defense in this situation would . . . allow a wholesale suit for money damages."

Judge Sontchi capped off his decision by finding no ancillary jurisdiction to sidestep sovereign immunity.

In substance, Judge Sontchi held that sovereign immunity left the court without jurisdiction to determine the proper assessment with respect to taxes that already had been paid, but there would be jurisdiction if the taxes had not been paid because the state would be seeking to collect taxes from estate property.

The trust was not left without a remedy, however, because the trust could utilize the California courts to contest the assessments. Once the assessments were determined, Judge Sontchi's opinion indicates there would be no sovereign immunity bar to proceedings seeking the payment of tax refunds.

The opinion is *In re La Paloma Generating Co. LLC*, 17-12700 (Bankr. D. Del. July 25, 2018).

Makewhole Premiums

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

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

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

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

Litigation in the Lower Courts

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

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

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

Reversal in the Third Circuit

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

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

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

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

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

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

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

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

Judge Ambro Rejects *MPM Silicones*

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

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

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

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

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

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

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

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

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

Second Circuit Splits with Third on Makewholes Occasioned by Bankruptcy

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

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

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

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

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

The MPM Silicones Chapter 11 Plan

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

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

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

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

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

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

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

Makewholes

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

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

To overcome the effect of automatic acceleration that was the key to denial of a makewhole, the creditors contended that they should have been permitted to deaccelerate the debt. Judge Parker

rejected that argument too, saying that "the automatic stay barred rescission of the acceleration of the notes."

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

Till Inapplicable in Major Chapter 11s

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

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

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

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

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

Equitable Mootness

The debtor argued that the appeals court should dismiss the appeal on the ground of equitable mootness, because the plan had long since been implemented. Citing *In re Chateaugay Corp.*, 988 F.2d 322 (2d Cir. 1993), Judge Parker said that the "chief consideration" is whether the "appellant

sought a stay of confirmation." If a stay was sought, the circuit will allow relief on appeal if it is "at all feasible" without knocking the props out from under the plan.

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

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

Contractual Subordination

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

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

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

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

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

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

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

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

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

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

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

The Circuit Split

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

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

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

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

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

Plans & Confirmation

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

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

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

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

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

The Tortured History of Transwest Resort Properties

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

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

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

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

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

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

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

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

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

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

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

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

Judge Smith said that Section 1123(b)(5) allows modification of a secured lender's claim, while Section 1129(b)(2)(A)(i)(I) "expressly allows a debtor to sell the collateral to another entity

so long as the creditor retains the lien securing its claims, yet the statute does not mention any due-on-sale requirement . . . ."

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

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

One Accepting Class Per Plan Is Enough

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

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

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

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

The Concurring Opinion

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

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

Judge Friedland wrote a concurring opinion to say that objecting to the plan as *de facto* substantive consolidation may have enabled the lender to block confirmation. She said that the

"problem" was "that the plan effectively merged the debtors without an assessment of whether consolidation was appropriate" under Ninth Circuit standards.

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

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

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

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

To warrant 'designation,' a claim purchaser must have an 'ulterior motive' beyond self-interest.

Buying Just Enough Unsecured Claims to Defeat Confirmation Is Ok, Ninth Circuit Says

Buying barely enough unsecured claims to defeat confirmation of a plan is not reason in itself for barring a secured creditor from voting the purchased claims against confirmation of a chapter 11 plan, according to the Ninth Circuit.

In *Figter Ltd. v. Teachers Ins. & Annuity Association of America (In re Figter)*, 118 F.3d 635, 639 (9th Cir. 1997), the Ninth Circuit ruled that a secured creditor was entitled to vote unsecured claims against confirmation of a chapter 11 plan when the lender had purchased all the claims in the class. In his June 4 opinion, Ninth Circuit Judge N. Randy Smith expanded *Figter* by ruling emphatically that a secured creditor is not in bad faith by purchasing just enough claims to defeat confirmation, thereby adversely affecting other creditors.

Owed about $4 million, the secured creditor spent $13,000 on advice of counsel to purchase just over half in number of the chapter 11 debtor's unsecured claims. The purchased claims represented only 10% of the unsecured class in amount.

The lender's counsel testified that the client made no attempt at purchasing all unsecured claims. The client's motivation, the lawyer said, was to acquire a blocking position and do what was best for the lender.

Although the debtor had the required two-thirds vote in amount in the unsecured class to confirm the plan, the debtor was facing defeat because a majority in number of unsecured creditors were not voting in favor of the plan as required by Section 1126(c). The plan would pay unsecured creditors in full in a few months.

The debtor moved to "designate" the unsecured claims purchased by the lender under Section 1126(e), which provides that the court "may designate any entity whose acceptance or rejection of such plan was not in good faith . . . ." In substance, "designate" means to disallow voting.

The bankruptcy court designated the claims and later confirmed an amended version of the plan. Judge Smith said that the bankruptcy court based designation on just two facts: (1) the lender did not offer to purchase all unsecured claims, and (2) voting the purchased claims against the plan would give the lender an "unfair advantage" and would be "highly prejudicial" to other creditors.

The district court affirmed, but the Ninth Circuit reversed.

Judge Smith said that the Bankruptcy Code does not define "good faith" as used in Section 1126(e). *Figter*, he said, defined "bad faith" as an attempt to "secure some untoward advantage over other creditors for some ulterior purpose." Judge Smith quoted *Figter* as holding that designation applies to creditors who were "'not attempting to protect their own proper interests, but who were, instead, attempting to obtain some benefit to which they were not entitled.'"

According to *Figter*, "bad faith explicitly does not include 'enlightened self-interest, even if it appears selfish to those who do not benefit from it,'" Judge Smith said. Therefore, purchasing claims to obtain a blocking provision and to protect a creditor's own claim "does not demonstrate bad faith or an ulterior motive," *Figter* held.

Purchasing all unsecured claims was only one factor prompting the *Figter* court to find good faith, Judge Smith said. He cited Second Circuit authority for the proposition that purchasing claims to block a plan is not bad faith in itself.

Judge Smith faulted the bankruptcy court for not analyzing the lender's motivation and failing to identify an "ulterior motive." Citing *Figter*, he said that self-interest and ulterior motive are not identical. Ulterior motive is attempting to obtain a benefit to which the creditor is not entitled, Judge Smith said, again citing *Figter*.

Examples of bad faith, according to Judge Smith, include purchasing a claim to block a lawsuit against the purchaser or buying claims to destroy a competitor's business. "There must be some evidence beyond negative impact on other creditors," Judge Smith said.

In sum, the bankruptcy court erred by making no findings about the lender's motivation and by considering the effect on other creditors without evidence of bad faith.

The opinion is *Pacific Western Bank v. Fagerdala USA-Lompoc Inc. (In re Fagerdala USA-Lompoc Inc.)*, 16-35430 (9th Cir. June 4, 2018).

Narrow reading of 'equitable mootness' in* Tribune *is limited to cases involving a dispute between two classes.

Delaware District Judge Upholds Horizontal 'Gifting' in a Chapter 11 Plan

To no one's surprise, a district court in Delaware held that so-called horizontal gifting does not offend the chapter 11 confirmation standards.

In his August 21 opinion, District Judge Richard G. Andrews reached the merits of gifting after ruling that the appeal from confirmation was equitably moot.

The debtor had $500 million in secured debt and a business concededly not worth more than $300 million. The prepackaged chapter 11 plan called for converting secured debt to equity. The secured creditors made what is known as a gift to unsecured creditors in the form of cash and stock to holders of unsecured notes worth no more than 6% of the claims in the class. Trade and other unsecured creditors were to be paid in full.

The noteholder class voted against the plan, but Bankruptcy Judge Kevin J. Carey confirmed the plan last year. A holder of about $500,000 in unsecured notes appealed from the confirmation order and unsuccessfully sought a stay pending appeal.

The noteholder argued that the appeal was not equitably moot because the appellate court could order payment of its claim in full without upsetting the plan as a whole.

Judge Andrews rejected the argument, saying there was no method under the Bankruptcy Code to permit paying the appellant in full without paying all other noteholders in full. Paying one creditor in the noteholder class, he said, would offend Section 1123(a)(4) and its requirement of making identical payments to all creditors in a class.

Judge Andrews declined to expand *In re Tribune Media Co.*, 799 F.3d 272 (3d Cir. Aug. 19, 2015), where the Third Circuit declined to dismiss an appeal for equitable mootness because it would not be unfair if one class were forced to pay back $30 million.

Even if he could pay one noteholder and not the others, Judge Andrews said it was "unclear which party the court may order to fund such a recovery." He distinguished *Tribune* by saying it was an intercreditor dispute involving a reallocation between two classes that would not upset the overall plan. Unlike *Tribune*, he said there was no readily identifiable set of creditors against whom disgorgement could be ordered.

Judge Andrews concluded that the appeal was equitably moot because he could not give the appellant a higher recovery than other noteholders "within the confines of the Bankruptcy Code"; paying noteholders the same as trade creditors "would require undoing the plan and would necessarily harm third parties"; and there was no other "practicable relief" the court could grant.

Although finding the appeal to be equitably moot, Judge Andrews analyzed the merits and upheld confirmation.

The appealing noteholder argued that the plan unfairly discriminated and thus violated Section 1129(b)(1).

Like Delaware District Judge Gregory M. Sleet in *Law Debenture Trust Co. of New York v. Tribune Media Co. (In re Tribune Media Co.)*, 12-1072, 2018 BL 269729 (D. Del. July 30, 2018), Judge Andrews applied the so-called Markell test to determine whether there was unfair discrimination. The test raises a rebuttable presumption of unfair discrimination if a similar class receives "a materially lower percentage recovery." To read ABI's discussion of *Tribune Media*, click here.

Although Judge Andrews noted that the Markell test says nothing about gifting, he said the bankruptcy court properly applied the test and found no improper discrimination. He said that *In re Genesis Health Ventures Inc.*, 280 B.R. 339 (D. Del. 2002), presented "virtually identical facts" involving horizontal gifting, where a senior creditor makes a gift to an inferior class.

Judge Andrews said that *Genesis I* found that gifting rebuts the presumption of unfair discrimination when senior lenders redirect a portion of the recovery to which they otherwise would have been entitled.

Judge Andrews also ruled that the appealing noteholder was not harmed as a consequence of the larger recovery by trade creditors because "all unsecured creditors did significantly better than they would have outside of chapter 11 or under a plan of liquidation."

Judge Andrews said that the case on appeal was not a prohibited form of so-called vertical class-skipping because there was no distribution to a class junior to the bondholders.

The opinion is *Hargreaves v. Nuverra Environmental Solutions Inc. (In re Nuverra Environmental Solutions Inc.)*, 17-1024 (D. Del. Aug. 21, 2018).

Eighth Circuit insulates parishes and church schools from substantive consolidation.

Non-Bankrupt Nonprofit Entities Are Not Subject to Substantive Consolidation

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

The SunEdison Plan

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

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

Deemed Consent

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

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

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

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

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

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

Jurisdiction

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

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

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

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

A Second Bite at the Apple

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

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

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

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

District Court Endorses Opt-Out to Confirm Substantive Consolidation Plans

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

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

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

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

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

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

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

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

Committees

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

Existence of a Committee Precludes Tolling the Statute for Adverse Domination

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

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

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

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

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

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

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

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

did not lack motivation to sue just because its chosen course of action proved to be unsuccessful in the end."

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

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

Stays & Injunctions

Caution: Do not use heavy machinery.
Reading this story may induce drowsiness.

Third Circuit Explores the Limits of Channeling Injunctions Protecting Insurers

The Third Circuit delved into the netherworld of so-called channeling injunctions protecting both companies that used asbestos and insurers that provided coverage.

The August 14 opinion by Circuit Judge Thomas L. Ambro explores the outer limits of channeling injunctions by defining when creditors cannot sue insurance companies and must collect their claims only from an asbestos trust created as part of a chapter 11 plan.

The appeal involved W.R. Grace & Co., whose bankruptcy soon will have kept platoons of lawyers fully employed for two decades. Grace confirmed a reorganization plan in 2011, 10 years after filing a chapter 11 petition.

The confirmed plan created a trust to pay asbestos claims and contained a channeling injunction protecting both the debtor and its insurers.

What is a channeling injunction? Judge Ambro described it as "an injunction that channels [asbestos] liability to a trust set up to compensate persons injured by the debtor's asbestos." He said it "can also protect the interests of non-debtors, such as insurers."

Giving rise to the appeal, asbestos claimants had sued insurance companies that had provided Grace with workers' compensation and employers' liability coverage, based on the insurers' right but not obligation to inspect the company's facilities.

After the plaintiffs sued in Montana state court, the insurance companies sought a declaratory judgment in bankruptcy court in Delaware. The bankruptcy court granted the insurers' motion for summary judgment and ruled that the channeling injunction enjoined the plaintiffs from suing the insurance companies.

Divining what he called "a befuddling maze of defined terms," Judge Ambro upheld the bankruptcy court's conclusion that the insurance companies' policies were covered by the channeling injunction. However, that wasn't the end of the story, because a channeling injunction can go only so far as Section 524(g) allows in protecting non-debtor third parties.

With respect to Section 524(g), Judge Ambro remanded the case to the bankruptcy court, where the result may be the same after another few years of litigation.

The remainder of this story is tedious and boring. We recommend turning to something more engaging unless you're involved in asbestos bankruptcies.

For a channeling injunction to protect a third party, the claims must arise "'by reason of' one of four statutory relationships between the third party and the debtor," Judge Ambro said, citing Section 524(g)(4)(A)(ii). Judge Ambro examined two of the four.

First, Judge Ambro examined whether the Montana claimants were seeking to hold the insurance companies "directly or indirectly liable for the conduct of, claims against, or demands on" Grace, as required by Section 524(g)(4)(A)(ii). Citing the Third Circuit's decision in *In re Combustion Engineering Inc.*, 391 F.3d 190, 234-235 (3d Cir. 2004), as amended (Feb. 23, 2005), he said that the statute limits the permissible scope of the injunction to claims based on derivative liability, meaning that the insurance companies' liability must "arise by reason of" the provision of insurance to Grace.

Judge Ambro remanded the case to the bankruptcy court, saying that the "proper inquiry is to review the law applicable to the claim being raised against the third party (and when necessary to interpret state law) to determine whether the third-party's liability is wholly separate from the debtor's liability or instead depends on it."

Judge Ambro said the circuit court could not rule on the question because it was not fully briefed.

Next, Judge Ambro analyzed the so-called statutory relationship requirement, also in Section 524(g)(4)(A)(ii). In that regard, he again remanded the case for the bankruptcy judge to review "the applicable law to determine the relationship's legal relevance to the third-party's alleged liability."

Similar to the derivative liability requirement, Judge Ambro said the bankruptcy court should "examine the elements necessary to make [a claim under Montana law] and determine whether [the] provision of insurance to Grace is relevant legally to these elements."

Again, he said the record was not sufficiently developed to make the determination on appeal.

The opinion is *Continental Casualty Co. v. Carr (In re W.R. Grace & Co.)*, 17-1208 (3d Cir. Aug. 14, 2018).

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

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

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

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

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

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

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

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

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

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

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

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

The direct appeal is *Davis v. Tyson Prepared Foods Inc. (In re Garcia),* 17-3247 *(*10th Cir.); argument Sept. 26, 2018.

Compensation

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Fraudulent Transfers

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

The PAH Facts

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

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

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

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

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

Judge Stark Agrees with Judge Gross

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

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

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

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

Summarizing why he was denying an interlocutory and direct appeal and sounding as though he would affirm on the merits, Judge Stark said that the "bankruptcy court's reading of the safe

harbor is supported by the plain language of the statute, and its careful analysis followed controlling Third Circuit and Supreme Court precedent."

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

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

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

Fraudulent Transfer Claims Aren't Capped by Creditors' Losses

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

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

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

The Busted LBO

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

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

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

The Fraudulent Transfer Suit

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

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

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

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

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

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

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

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

Judge Gross said that "'for the benefit of the estate' does not mean for the benefit of creditors," because "estate" means all legal and equitable interests of the debtor.

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

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

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

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

Children were the initial transferees of tuition payments, thus giving schools the 'good faith' defense to fraudulent transfers.

Structured Finance Protects Tuition Payments from Fraudulent Transfer Suits

Universities successfully used concepts from structured finance in fending off suits to recover tuition payments as constructively fraudulent transfers.

Bankruptcy trustees around the country have sued colleges and universities to recover fraudulent transfers when parents file bankruptcy and have paid tuition for children over age 18. The March 28 opinion by Chief Bankruptcy Judge Carla E. Craig of Brooklyn, N.Y., collects cases coming out both ways. Some find constructively fraudulent transfers, while others do not.

In the case before Judge Craig, a parent paid tuition for his children both before and after he filed a chapter 11 petition. Following conversion to chapter 7, the trustee sued the universities to recover pre- and post-petition tuition payments. The trustee contended that pre-petition payments were constructively fraudulent transfers under the Bankruptcy Code and state law and that post-petition payments were unauthorized post-petition transfers under Section 549.

Judge Craig granted summary judgment to the universities dismissing the adversary proceedings. She held that the universities were not the initial transferees and were therefore entitled to the good faith defense as subsequent transferees under Section 550(b).

The successful defense hinged on how the universities structured tuition payments.

The universities all created accounts for and in the name of the students. Payments by parents went into the accounts and were applied toward tuition when the students registered for classes. Parents, even though they may have supplied the funds, had no right to access the accounts without the students' permission. If the students were to withdraw, refunds went to the students, and not to parents who may have made the deposits initially.

Judge Craig ruled that the universities were not the initial transferees because undisputed facts showed that the parent did not have dominion or control over the students' accounts when the debtor made transfers into the accounts. After the initial transfers, she said, the debtor could not access the accounts without the students' authorization. Rather, she said, the students had dominion and control over their accounts.

Judge Craig said that the accounts were "akin to bank accounts," meaning that the universities, in their roles with respect to the accounts, "were mere conduits in the initial transfer from the debtor to his children." The universities had dominion and control only after the students took actions that resulted in the payment of tuition, but then the schools were subsequent transferees.

Since the universities were subsequent transferees, they were entitled to the good faith defense in Section 550(b). The trustee did not question the universities' good faith, making them eligible for summary judgment.

Judge Craig's theory lets the universities off the hook but puts the debtor's children in the firing line as initial recipients of fraudulent transfers. As initial transferees, the children cannot raise the good faith defense.

Even though the children may have exposure, a trustee might not sue the children because they are likely judgment proof and themselves may be able to discharge liability by filing chapter 7. Or, the children could raise the theories cited by Judge Craig that have been relied upon by courts finding no fraudulent transfer resulting from tuition payments. Given the familial relationship, children likely have a better shot at beating a suit on the merits than would a college or university.

The opinion is *Pergament v. Hofstra Univ. (In re Adamo)*, 16-8122 (Bankr. E.D.N.Y. March 28, 2018).

Preferences & Claims

Eleventh Circuit abandons the notion that new value must remain unpaid to offset a preference.

Circuit Split Narrows on the New Value Defense to a Preference

Narrowing a split among the circuits, the Eleventh Circuit no longer requires that new value remain unpaid on filing to qualify as a defense to a preference.

As it now stands, the Fourth, Fifth, Eighth, Ninth and Eleventh Circuits do not limit the new value defense to subsequent advances of credit that remain unpaid on the filing date. According to the August 14 opinion by Eleventh Circuit Judge Julie E. Carnes, "the Seventh Circuit held, without much discussion, that Section 547(c)(4) does require new value to remain unpaid."

Similarly, she said that the Third Circuit "also stated in a conclusory fashion [in *dicta*] that Section 547(c)(4) requires new value to remain unpaid."

In reality, the Eleventh Circuit was not reversing a prior holding. Judge Julie Carnes, not to be confused with Chief Judge Ed Carnes, said that her court's prior statement in *Charisma Investment Company N.V. v. Airport Systems Inc. (In re Jet Florida System Inc.)*, 841 F.2d 1082 (11th Cir. 1988), was *dicta* and therefore was not binding.

Commenting on Judge Carnes' opinion, Charles Tatelbaum of Miami told ABI, "It's about time."

The Facts in the Eleventh Circuit

The appeal to the Eleventh Circuit involved a typical preference, albeit for big bucks. The supplier to a chain of grocery stores was paid more than $550,000 in the 90-day preference period before bankruptcy. Also during the preference period, the supplier provided new value by delivering goods worth some $435,000.

The supplier conceded that the payments satisfied all of the elements of a preference under Section 547(b).

However, the supplier raised the so-called ordinary course defense under Section 547(c)(2) and the new value defense under Section 547(c)(4). The bankruptcy court rejected the ordinary course defense.

Relying on *Jet Florida*, the bankruptcy court did not allow the supplier to offset new value that the debtor had paid before filing. As a result, the bankruptcy court held the supplier liable for a net of about $440,000 in preferences. Had the defense been allowed, it is possible that the supplier may have had no preference liability at all.

The bankruptcy court certified a direct appeal, which the Eleventh Circuit accepted. The supplier only raised the new value defense on appeal.

Jet Florida's *Dicta*

In *Jet Florida*, the creditor had raised the new value defense under Section 547(c)(4), which allows a creditor to offset "new value" given after a preferential transfer that was "(A) not secured by an otherwise unavoidable security interest; and (B) on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor."

The bankruptcy court in *Jet Florida* concluded that the creditor had not given new value as a matter of fact. Agreeing that the creditor had not given new value, the circuit court in *Jet Florida* upheld the finding of a preference.

In the course of the decision, however, the Eleventh Circuit said that the new value defense has "generally been read to require . . . that the new value must remain unpaid." *Id.* at 1083.

Because the statement about remaining unpaid was not necessary to the decision in *Jet Florida*, Judge Carnes said it was *dicta* and was therefore not binding on the court.

Plain Language Saves the Supplier

Analyzing the issue anew, Judge Carnes said that the "plain language" of Section 546(c)(4) "does not require new value to remain unpaid." She also said that "policy considerations strongly disfavor the trustee's position" that new value must remain unpaid to provide an offset to a preference.

Judge Carnes found nothing in the language of Section 546(c)(4) allowing an offset "only for new value that remains unpaid." Instead, she said, the "plain language" in subsections (A) and (B) allow the defense "so long as the transfer that pays for the new value is itself avoidable."

Judge Carnes buttressed her conclusion by analyzing the history of preferences. Under the predecessor to the current preference statute, Section 60c of Bankruptcy Act of 1898 said there was an offset for "such new credit remaining unpaid." The "remaining unpaid" language, she said, was omitted from the Bankruptcy Code, to be replaced by "something substantively different" in the confusing double negatives now found in subsections (A) and (B).

Judge Carnes cited the Commission on the Bankruptcy Laws of the U.S. for recommending before adoption of the Code that the "remaining unpaid" provision be eliminated.

Even if Congress had not intended to make a change from prior law, Judge Carnes said she would reach the same conclusion from "the unambiguous statutory language."

Policy Considerations Point in the Same Direction

Requiring new value to remain unpaid "would hinder the policy objective of encouraging vendors to continue extending credit to financially troubled debtors," Judge Carnes said. Otherwise, a supplier who senses financial trouble would have a "strong disincentive" to continue delivering goods, for fear that preference liability would increase.

Judge Carnes described a hypothetical where a supplier received $5,000 in payments and made $5,000 in advances during the preference period. If "remaining unpaid" were a requirement, the supplier would be liable for the entire $5,000. If it did not matter, the supplier's maximum liability would be $1,000, she said.

Giving suppliers incentives to cut off customers in financial trouble would hasten bankruptcy, while harming both the debtor and other creditors, Judge Carnes said.

The trustee made a virtually unintelligible argument based on the word "otherwise" in subsection (B). Judge Carnes said that no court had accepted the argument and some have rejected it.

Judge Carnes remanded the case to recalculate the amount of the preference, if any, for which the supplier would be liable.

The opinion is *Kaye v. Blue Bell Creameries Inc. (In re BFW Liquidation LLC)*, 17-13588 (11th Cir. Aug. 14, 2018).

Mediation can result in a binding settlement even without a written agreement.

A Casually Written Email by Counsel Can Be an Agreement in the Second Circuit

An exchange of emails with a mediator can constitute a binding settlement, even if the parties never sign a written agreement, the Second Circuit said in a nonprecedential opinion.

The opinion drives home an important practice point: A casually written email can be a binding contract. Unless you intend for an email to be binding, always say that agreement depends on negotiating and signing a definitive settlement agreement.

As plan administrator, Lehman Brothers Holdings Inc. was in mediation with one of some 250 defendants in a so-called clawback suit where Lehman was attempting to recover payments made after bankruptcy. The amount of the payment the defendant would make was the only issue in mediation. The mediation took place while the defendants' motion was *sub judice* seeking dismissal of the adversary proceeding.

The mediator sent Lehman and the defendant an email confirming that they had accepted his proposal and agreed on the amount of a payment in settlement of Lehman's claim against that defendant. Lehman then sent the defendant the draft of a written settlement agreement. According to the defendant, the agreement contained additional terms that had never been discussed, much less agreed upon in mediation, such as the timing and manner of payment, the identity of the parties to the settlement, the scope of releases, and other terms.

Subsequently, the defendant requested changes in the agreement to which Lehman agreed. According to the bench opinion by Bankruptcy Judge Shelley C. Chapman in March 2017, the defendant's counsel sent Lehman an email saying its client would sign the written agreement as revised.

According to Judge Chapman, she issued her opinion granting the motion to dismiss the adversary proceeding against the defendant and others hours after the defendant's counsel said the client would sign the agreement. A few days later, the defendant said it would not sign the settlement agreement.

Lehman filed a motion to enforce the settlement agreement, which Judge Chapman granted.

In her bench opinion, Judge Chapman said the refusal to sign the settlement was a "change of heart" because she had granted the motion to dismiss, not for lack of intent not to be bound absent

a signed, written agreement. Applying the factors required by *Winston v. Mediafare Entertainment Corp.*, 777 F.2d 78 (2d Cir. 1985), Judge Chapman ruled that the settlement agreement was enforceable, although unsigned.

District Judge Denise Cote upheld Judge Chapman, and so did the Second Circuit in a *per curiam* opinion on July 18.

The circuit court analyzed the four *Winston* factors one by one. Two were in favor of finding a settlement, and two were not. The appeals court said it was a "close case."

On telling the mediator there was agreement on the settlement amount, the appeals court said the defendant "did not expressly reserve the right not to be bound in the absence of a writing." The first *Winston* factor therefore weighed in favor of finding an intent to be bound, the circuit said.

There was no partial performance, so the second *Winston* factor weighed against finding an agreement.

The third factor weighed in favor of an agreement, the circuit said, because the defendant's failure to identify disagreement on any material issues was "strong evidence" of agreement. The appeals court "comfortably" concluded that signing the agreement was the only remaining step, because the defendant "reneged" on the agreement only after the bankruptcy judge ruled that she would dismiss the adversary proceeding.

The fourth factor concerns the regularity with which writings are required. That factor was in favor of the defendant because Lehman conceded that no settlements had been in effect during the entire Lehman bankruptcy without a written agreement.

The circuit court said that the "balance tips in favor of finding an intention to be bound," given the absence of an express reservation of rights and the lack of material terms remaining to be negotiated.

It is unclear whether the appeals court would have found a binding agreement had the defendant not later said it would sign the settlement. However, the appeals court focused on the original email exchange when the mediator notified the parties that they had agreed on the settlement amount. The opinion therefore might be understood to stand for the proposition that there was a binding agreement at the earlier point in time, because the amount was the only issue in mediation.

Nonetheless, the opinion is nonprecedential, so its precedential value is limited.

The opinion is *Shinhan Bank v. Lehman Brothers Holdings Inc. (In re Lehman Brothers Holdings Inc.)*, 17-2700 (2d Cir. July 17, 2018).

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Perishable Commodities Act

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

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

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

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

By virtue of its *en banc* opinion on Feb. 22, the Ninth Circuit has now aligned itself with the Second, Fourth and Fifth Circuits by holding that a transaction must be a "true sale" before a purchaser of accounts receivable can acquire an interest in a wholesaler's accounts ahead of the interests of produce suppliers who are beneficiaries of a PACA trust.

The PACA Loophole and the Split

Congress adopted PACA to protect farmers who were usually unpaid when a fresh produce wholesaler declared bankruptcy. The statute creates a statutory trust protecting growers by putting them ahead of accounts receivable *lenders*. Farmers, however, do not have recourse under PACA against *purchasers* of receivables. In deciding whether a financial institution is immune from PACA, the Second, Fourth and Fifth Circuits have first required the court to decide whether a true sale actually occurred and, second, to examine whether the sale was commercially reasonable.

In *Boulder Fruit* in 2001, the Ninth Circuit made a loophole in PACA by holding that the court need only decide whether a transaction was commercially reasonable before cutting off PACA protection. There was no threshold test in the Ninth Circuit to determine whether the transaction was a true sale so long as the transaction denominated itself as a sale of receivables.

Finding itself bound by *Boulder*, a three-judge panel of the Ninth Circuit ruled against farmers in a *per curiam* decision, *S&H Packing & Sales Co. v. Tanimura Distributing Inc.*, 850 F.3d 446 (9th Cir. Feb. 27, 2017). In a concurring opinion, two judges on the panel argued that *Boulder Fruit* was "wrongly decided" and urged the circuit to sit *en banc* to bring "the Ninth Circuit into line with the other circuits that have considered the issue."

The Ninth Circuit granted rehearing *en banc* in June, heard oral argument in September and overruled *Boulder Fruit* in an opinion for the majority written by Circuit Judge Ronald M. Gould.

The Majority's Opinion

Judge Gould held that the court must first "conduct a threshold true sale inquiry" before deciding whether a hypothecation of accounts receivable was "commercially reasonable." He based his decision on "the logical outcome of reading PACA, PACA's legislative history, and consideration of PACA's purpose."

In particular, legislative history told Judge Gould that "our focus should be on the true nature of the transactions at issue." The court, he said, "must focus on the true substance of PACA-related transactions and not on artificial indicators or labels." Later, he added, "labels . . . should be of little or no significance."

The lender argued that the result would be absurd if it had paid full value for receivables and was later required by PACA to pay farmers a second time for the same receivables.

Judge Gould said the lender was "wrong to describe the scenario as absurd. It is instead the result of a Congressional choice."

Judge Gould analogized PACA to state laws pertaining to general contractors, subcontractors and owners of real estate, because state law can force an owner to pay twice, just like a PACA lender. If an owner has not obtained releases of liens by subcontractors, the owner must pay the subcontractors a second time even if the owner has paid the general contractor. The PACA lender can pay twice if it has not policed the borrower to ensure that suppliers have been paid with the proceeds of its loans.

On remand, Judge Gould instructed the court to "use all the tools at its disposal . . . to determine whether the agreement was in substance a true sale or in substance a lending agreement."

The facts of the case suggest that the transaction was a secured loan rather than a true sale of accounts receivable, because the lender could force the wholesaler to buy back receivables proven uncollectable.

Judge Gould lauded the concurring opinion in the panel decision. He said, "This opinion is in substantial agreement with arguments made in [Circuit] Judge [Michael J.] Melloy's concurrence and draws heavily therefrom." Judge Melloy, from the Eighth Circuit, was sitting by designation on the three-judge panel.

The Dissent

In an opinion written by Circuit Judge Sandra S. Ikuta, the dissenters contended as a matter of policy that the majority's rule "allows the trust to accept the benefit of a loan agreement but disregard the obligation to repay it."

With regard to the law, Judge Ikuta relied on "basic trust principles" for the proposition that a trustee does not violate his/her fiduciary duty to trust beneficiaries by obtaining a secured loan.

Judge Gould answered the argument by saying that PACA imposes duties beyond those in trust law. He said that the dissenters gave "too little weight to the protective purposes of PACA" and disregarded "the purpose of PACA to protect agricultural growers."

Judge Gould clerked on the Sixth Circuit and the Supreme Court before being appointed to the Ninth Circuit in 1999. Judge Ikuta clerked for the Ninth Circuit and Supreme Court before her appointment to the circuit bench in 2006.

To read ABI's report on the decision by the three-judge panel and the concurrence, click here.

The opinion is *S&H Packing & Sales Co. v. Tanimura Distributing Inc.*, 14-56059 (9th Cir. Feb. 22, 2018).

Consumer Bankruptcy

Fair Debt Collection Practices Act

***Thomas Ambro on the Third Circuit answers a question the Supreme Court left open in* Henson v. Santander.**

FDCPA Applies to Debt Collectors Even if They Own the Debt

The Third Circuit jumped through a loophole the Supreme Court left open intentionally in *Henson v. Santander Consumer USA Inc.*, 137 S. Ct. 1718 (2017), by holding a debt purchaser is subject to the federal Fair Debt Collection Practices Act, or FDCPA, if its principal business is the collection of debts.

In *Henson*, the maiden opinion by newly-appointed Justice Neil M. Gorsuch, the headline holding was: Someone who purchases a defaulted debt is not a "debt collector" and is therefore not subject to the FDCPA, 15 U.S.C. § 1692, *et seq*.

A bank in *Henson* had purchased a debt already in default that had been originated by another lender. The opinion was often (but incorrectly) interpreted to mean that the FDCPA can never apply to a debt collector who has purchased a defaulted debt for its own account. However, Justice Gorsuch was careful to highlight two questions the Court did not decide:

(1) The debtor argued that the bank came within the FDCPA because it regularly collected debts for another. Justice Gorsuch said that question was not raised in the petition for *certiorari*, and the Court did not agree to review it; and
(2) Justice Gorsuch said the Supreme Court had not agreed to address another aspect of the definition of a debt collector in Section 1692a(6), which includes someone "in any business the principal purpose of which is the collection of any debts."

In his August 7 opinion for the Third Circuit based on the "plain text" of the statute, Circuit Judge Thomas L. Ambro latched onto the second unresolved question by holding that the FDCPA applies to "an entity whose principal purpose of business is the collection of any debts . . . regardless of whether the entity owns the debts it collects."

The Facts in the Third Circuit

The facts on the appeal before Judge Ambro were similar to those in *Henson*, except that the plaintiff in *Henson* had not argued below that the bank's principal business was debt collection.

In the Third Circuit, the plaintiffs owned a home subject to a mortgage owing to a bank taken over by the Federal Deposit Insurance Corp. Initially, they continued making monthly payments

after the takeover, but the FDIC neither cashed nor returned the checks. Eventually, the plaintiffs stopped sending monthly checks.

The FDIC declared the loan in default and sold it to a purchaser who demanded payment in full in an amount more than the plaintiffs owed. Having made several communications that might violate the FDCPA, the purchaser initiated foreclosure proceedings.

The homeowners filed suit in district court, alleging violations of the FDCPA. In several pleadings, the defendant-purchaser admitted that its sole business was acquiring and collecting debts.

Following a bench trial but before the district court rendered its decision, the Supreme Court handed down *Henson*. After additional briefing, the district court ruled that the purchaser was a debt collector and was liable for having violated the FDCPA.

The purchaser appealed, contending in the Third Circuit that it was not a debt collector subject to the FDCPA because it owned the debt.

Judge Ambro's Analysis

The FDCPA applies to a "debt collector" but not to a "creditor." A "debt collector" is defined as someone who uses the mails or interstate commerce "in any business the principal purpose of which is the collection of any debts" or someone "who regularly collects" debts owed to "another." 15 U.S.C. § 1692a(6).

A "creditor" under the FDCPA is someone who extends credit or is someone "to whom a debt is owed." The term "creditor" excludes "any person to the extent that he receives an assignment or transfer of a debt in default solely for the purpose of facilitating collection of such debt for another." 15 U.S.C. § 1692a(4) and (6).

Before *Henson*, the law in the Third Circuit followed the so-called default test in *Pollice v. National Tax Funding L.P.*, 225 F.3d 379, 403 (3d Cir. 2000), where the purchaser of a debt is a debt collector subject to the FDCPA if the debt was purchased after default.

Under *Pollice*, the purchaser in Third Circuit appeal would have been a "debt collector," but Judge Ambro said that *Henson* "recently repealed the 'default' test we followed."

Judge Ambro said that only one circuit court since *Henson* has ruled on the FDCPA in a precedential opinion. In that case, the District of Columbia Circuit held that the defendant was not a debt collector because there was no evidence that the bank's principal business was the collection of debt or that it was collecting the debt for someone else.

Addressing "the task before us today," Judge Ambro said that no circuit has issued a precedential opinion "on *Henson*'s applicability to the 'principal purpose' definition of 'debt collector.'" Picking what *Henson* held and what it did not hold, he said that *Henson* "affects" but "did not decide" who "fits the 'principal purpose' definition of 'debt collector.'"

Judge Ambro said that the phrase "any debt" as used in the statute does "not distinguish to whom the debt is owed." In contrast, he said, "debts owed or due . . . another" only applies to the "regularly collects" definition.

Contending that it could not be a debt collector because it also met the definition of creditor, the purchaser in substance argued that the definitions are mutually exclusive. Judge Ambro rejected the argument because, "following *Henson*, an entity that satisfies both is within the [FDCPA's] reach."

Whether the defendant owns the debt, Judge Ambro said, "does not resolve whether that entity is a debt collector." Because the purchaser conceded that its principal business was collecting debts, Judge Ambro held that the debt buyer was subject to the penalties in the FDCPA because it was a "debt collector under the 'principal purpose' definition."

To read ABI's discussion of Henson, click here.

The opinion is *Tepper v. Amos Financial LLC*, 17-2851 (3d Cir. Aug. 7, 2018).

Discharge/Dischargeability

Seven weeks apart, two circuits reach diametrically different conclusions about good faith as a defense to an intentional act that violates the discharge injunction.

First Circuit Splits with the Ninth over Good Faith Defense to Discharge Violation

Over a comprehensive dissent, the First Circuit ruled that the Internal Revenue Service intentionally violates the discharge injunction when an IRS employee knows there was a discharge but nonetheless "takes an intentional action" later found to violate the discharge, even if the IRS had a good faith belief that its action did not violate the discharge.

The First Circuit's June 7 opinion represents a stark split with a decision handed down by the Ninth Circuit less than seven weeks ago: *Lorenzen v. Taggart (In re Taggart)*, 888 F.3d 438 (9th Cir. April 23, 2018), petition for panel rehearing and rehearing *en banc* filed June 6, 2018. Although the First Circuit dissent cited *Taggart*, the majority did not.

The First Circuit's dissent underscores an arguably longstanding circuit split on the question of whether good faith is a defense to an alleged violation of the discharge injunction.

The majority opinion for the First Circuit, holding that good faith is not a defense to contempt, was written by Circuit Judge Norman H. Stahl. Joining the majority opinion was retired Supreme Court Associate Justice David H. Souter, sitting by designation. The dissent was by Circuit Judge Sandra L. Lynch.

The Facts in the First Circuit

The debtor filed a chapter 7 petition and received a discharge. The IRS was aware of the discharge.

Among his $600,000 in total debt, the debtor owed the IRS about $550,000 in taxes. The IRS had a good faith basis for believing that the taxes were not dischargeable under Section 523(a)(1)(C) because the debtor, allegedly, had willfully attempted to evade payment of the taxes. The IRS therefore took the position that the tax debt was not automatically discharged under Section 523(c)(1). Thus, the IRS did not object to the dischargeability of the debt before the debtor received his general discharge.

After entry of the general discharge, the IRS repeatedly notified the debtor of its belief that the taxes were not automatically discharged. After the IRS eventually levied against an account receivable owing to the debtor, he filed an adversary proceeding in bankruptcy court seeking a

declaration that the debt indeed had been discharged. Allegedly because of mental infirmities afflicting the assistant U.S. Attorney (AUSA) who represented the IRS, the government presented insufficient evidence, leading the bankruptcy judge to grant summary judgment declaring that the taxes were discharged. The IRS did not appeal the ruling that the debt was discharged.

The debtor later filed a complaint against the IRS under 26 U.S.C. § 7433(e), seeking sanctions for willful violation of the discharge injunction by issuing levies against his assets. In defense, the IRS argued there was no willful violation because the government reasonably believed that the debt was not discharged.

The bankruptcy judge found a willful violation and ruled in favor of the debtor. On appeal, the district court remanded for the bankruptcy court to consider the AUSA's mental impairment.

On remand, the IRS and the debtor reached a partial settlement narrowing the issues. To avoid extensive litigation over the AUSA's mental impairment and whether his impairment would give the government a defense, the IRS agreed that the debtor could have $175,000 in damages if an appellate court ultimately were to rule that a reasonable belief that the debt was excepted from discharge was not a defense to contempt.

The bankruptcy court decided that good faith was not a defense and ruled against the IRS. The district court affirmed, and the IRS appealed.

The Majority Opinion

Given the stipulation limiting the issue on appeal, Judge Stahl said the appeals court would decide whether the IRS's good faith belief meant there was no willful violation of the discharge injunction under Section 7433(e).

Adopted in 1998, Section 7433(e) allows a taxpayer to recover damages from the U.S. if the IRS, in connection with the collection of taxes, "willfully violates any provision of" the automatic stay under Section 362 of the Bankruptcy Code or Section 524 and its injunction barring the collection of discharged debt.

Judge Stahl said that the statute defines neither "willfully" nor the phrase "willfully violates." To find a meaning for the terms, he surveyed the definition given those words by the circuit courts when the statute was adopted in 1998.

Although the dissenter disagreed about unanimity among the courts of appeals, Judge Stahl said that the circuit courts agreed that the "phrase 'willful violation' had an established meaning in the context of violations of the automatic stays [*sic*] as of 1998: a creditor willfully violated the automatic stay if it knew of the automatic stay and took an intentional action that violated the

automatic stay. A good faith belief in a right to the property was not relevant to determining whether the creditor's violation was willful."

Judge Stahl next concluded that Congress intended to give the same meaning to violations of the discharge injunction, in part because "the plain language of Section 7433(e) does not distinguish between" violations of the automatic stay and discharge.

Although Judge Stahl said he was relying "primarily" on what Congress understood "willful violation" to mean in 1998 on adopting Section 7433(e), he said that later First Circuit decisions hewed to the same definition for violations of both the automatic stay and the discharge injunction.

Although the dissenter disagreed, Judge Stahl said that his definition of "willful violation" did not entail an overbroad interpretation of the wavier of sovereign immunity in Section 7433(e).

The IRS contended that Judge Stahl's interpretation would force the government to seek a declaration about the dischargeability of debts for tax fraud, even though Section 523(a)(1)(C) excepts them from discharge automatically.

Judge Stahl rejected the argument, finding "policy considerations" against "allowing the IRS to attempt to collect purportedly discharged debts without facing potential consequences." He said the IRS had several alternatives.

First, the IRS could have filed an objection to the dischargeability of the debt, although it was not required to do so before the entry of the general discharge. Second, the IRS could have filed an adversary proceeding and sought a declaration about dischargeability before beginning collection activity.

Third, the IRS could have attempted to collect the debt, as it had done in the case at bar, and gamble that the bankruptcy court would find for the government and rule that the taxes were not discharged.

The Dissent

In dissent, Judge Lynch said that her panel was handing down the first circuit court opinion construing "willfully violates" in Section 7433(e). The majority, she said, "gets this one wrong."

Judge Lynch said her circuit was the first to deprive the government of sovereign immunity when acting "on a reasonable and good faith belief." In Section 7433(e), she found no indication of a waiver of immunity "where the IRS acts reasonably and in good faith," even if the belief turns out to be erroneous.

Rather than following circuit law, Judge Lynch would have adopted the approach of the Supreme Court where she said the justices held in the context of Section 523 that a willful injury includes only acts that "were specifically intended to cause injury, not all intentional acts that resulted in injury."

Of special significance, Judge Lynch disagreed with the majority's statement that the circuits were in agreement before 1998. Although the majority opinion reflected the holding of seven circuits, she said that the First, Fifth and Sixth Circuits would allow a good faith defense to an alleged willful stay violation. Where she said the "majority attempts to deny the existence of this circuit split," Judge Lynch said that those three circuits "had held that the mere knowledge of a stay was insufficient to show a 'willful violation.'"

In addition to older authority from those three circuits, she cited *Taggart*, decided by the Ninth Circuit on April 23. She read the Ninth Circuit as allowing a good faith defense. "Indeed," she said, "the Ninth Circuit does not even impose a reasonableness requirement." For ABI's discussion of *Taggart*, click here.

Judge Lynch placed significant reliance on Section 523(a)(1)(C), which does not "require the IRS to first obtain a judicial determination that an exception to discharge applies." The subsection, she said, "means that Congress chose not to require that the IRS seek a pre-collection determination from the bankruptcy court." [Emphasis in original.]

"Given that Congress created this exception to discharge and did not require the IRS to seek a pre-collection determination that the tax debts are not dischargeable, there is no reason to say that the IRS should incur the risk of having damages found against it even if it acted on a reasonable and good faith belief," Judge Lynch said.

Are There Grounds for *Certiorari*?

The First Circuit's decision and *Taggart* are very much at odds. The Ninth Circuit permits a good faith defense to a discharge violation, while the First Circuit does not.

Should the losing parties in either circuit petition for *certiorari*, they surely will claim there is a circuit split. However, the majority on the First Circuit found no circuit split, although the dissenter did.

By ruling on Section 7433(e), the First Circuit was not construing the same statute as the Ninth. If a *certiorari* petition is based on divergent opinions by the two circuits just seven weeks apart, the justices might shy away from granting the petition because the underlying statutes are not the same.

However, there surely is a lack of clarity about the availability of a good faith defense when a panel of the First Circuit cannot agree on whether there is a circuit split. The Supreme Court might decline to grant *certiorari* until there is a decision more starkly raising a circuit split. *Taggart* might become a better vehicle for *certiorari* after the Ninth Circuit disposes of the pending petition for rehearing and rehearing *en banc*.

Although the dissent in the First Circuit says there is a circuit split about the good faith defense generally, the dissenter also said her panel was the first appeals court to rule on Section 7433(e). Even though the underlying issue is applicable to Sections 362 and 524 of the Bankruptcy Code, the Supreme Court might not be inclined to grant *certiorari* to the First Circuit and review the first decision on Section 7433(e).

All things considered, *Taggart* therefore might be the better vehicle for *certiorari*. The debtor in *Taggart* contends that the Ninth Circuit's opinion represents a split with the Fourth and Eleventh Circuits on the availability of a good faith defense.

If there is a petition for *certiorari* in *Taggart*, the Supreme Court may request the opinion of the U.S. Solicitor General on whether to grant or deny the petition, known as a CVSG for "consider the views of the Solicitor General." A CVSG would allow the government to weigh in on the existence of a split (or not) and presumably urge the justices to review the case.

Given the outcome in the First Circuit, the government well may urge a grant of *certiorari* in *Taggart*, especially if *certiorari* to the First Circuit is less likely.

Either case would enable the Supreme Court to rule on a fundamental, recurring issue in bankruptcy law: Does good faith allow a creditor to escape the consequences of an intentional violation of the principal relief a debtor obtains through bankruptcy?

The opinion is *IRS v. Murphy*, 17-1601 (1st Cir. June 7, 2018).

An unreasonable but good faith, subjective belief that there is no injunction bars a finding of contempt in the Ninth Circuit.

Violation of Discharge Is Now Difficult to Prove in the Ninth Circuit

A creditor's subjective, good faith belief that its action does not violate the discharge injunction precludes finding the creditor in contempt, even if the discharge injunction did apply and the creditor's belief was "unreasonable," the Ninth Circuit ruled in an April 23 opinion.

The opinion appears to mean that a creditor can act in good faith even if the creditor's belief is unreasonable. In other words, litigation in the Ninth Circuit over contempt of the discharge injunction will focus on the creditor's subjective good faith, without regard to whether the creditor's belief was right or wrong, reasonable or unreasonable.

The facts were horribly complex. With apologies for oversimplification, we summarize the facts as follows:

Before bankruptcy, the debtor transferred his interest in a closely held corporation. After the debtor received his chapter 7 discharge, two other shareholders sued the debtor in state court for transferring his interest without honoring their contractual right of first refusal. They also sued the transferee of the stock.

After the debtor raised his discharge as a defense in state court, the parties agreed he would not be liable for a monetary judgment. The state court eventually ruled in favor of the creditors and unwound the transfer.

The creditors then sought attorneys' fees as the prevailing parties, invoking a fee-shifting provision in the shareholders' agreement. The state court ruled that the debtor "returned to the fray" and thereby made himself liable for post-discharge attorneys' fees.

Meanwhile, the debtor reopened his bankruptcy case, seeking to hold the creditors in contempt for violating the discharge injunction. The bankruptcy judge sided with the debtor and imposed sanctions. The Bankruptcy Appellate Panel reversed the finding of contempt, ruling that the creditors' good faith belief that their actions did not violate the injunction absolved them of contempt.

Meanwhile, the state appellate court and a federal district court in related litigation both ruled that the debtor's participation in the litigation did not constitute returning to the fray, thus taking

away the grounds for imposing attorneys' fees and lending credence to the notion that the creditors did technically violate the injunction.

In sum, judges disagreed over whether the discharge injunction applied to the litigation to recover attorneys' fees.

The debtor appealed the BAP's opinion to the Ninth Circuit, where Circuit Judge Carlos T. Bea upheld the BAP and found no contempt. In the process, he expanded the defenses available to someone charged with contempt of a discharge injunction.

To impose sanctions, existing Ninth Circuit precedent requires the debtor to show that the creditor knew the discharge injunction was applicable and prove that the creditor intended the actions that violated the injunction. In the case at hand, knowledge of the applicability of the injunction was the only issue.

Based on *In re Zilog Inc.*, 450 F.3d 996 (9th Cir. 2006), Judge Bea said that knowledge of the injunction cannot be proven by merely showing that the creditor was aware of the bankruptcy. Citing a footnote in *Zilog*, he went on to hold that "the creditor's good faith belief that the discharge injunction does not apply to the creditor's claim precludes a finding of contempt, even if the creditor's belief is unreasonable."

Judge Bea acknowledged that his interpretation of *Zilog* is "somewhat at tension" with two other Ninth Circuit precedents. Although Judge Bea said that *Zilog* was binding, it is arguable that the footnote in *Zilog* was *dicta* and therefore was not binding. Regardless of whether *Zilog* was binding or not, Judge Bea's opinion is now law in the Ninth Circuit, although it is unclear whether it was necessary for him to rule that an unreasonable belief is not actionable.

Based on his reading of *Zilog*, Judge Bea concluded, like the BAP, that the creditor had a good faith belief that the discharge injunction was inapplicable on the theory that the debtor had "returned to the fray." The creditor's belief in that regard was strengthened because the state trial court agreed.

Recall, however, that the state appellate court and the district court took the opposite view by concluding that the debtor had not "returned to the fray" but had been compelled to litigate. In other words, judges disagreed about the applicability of the injunction.

Although the creditors' belief in the inapplicability of the injunction ultimately was proven wrong, Judge Bea said that "their good faith belief, even if unreasonable, insulated them from a finding of contempt."

Judge Bea's opinion applies a subjective test with respect to belief in the inapplicability of the injunction. Moreover, there is no contempt even if the creditor's subjective belief is unreasonable.

Consequently, it seems that reliance on counsel's advice would always absolve a client from contempt liability in the Ninth Circuit.

Judge Bea's opinion also seems to stand for the proposition that there is no contempt if reasonable minds could differ on the applicability of the injunction. Since it's often debatable whether the discharge injunction applies, contempt henceforth may be difficult to prove in the Ninth Circuit.

Because an unreasonable belief is not grounds for a finding of contempt, an argument evidently must be at least frivolous before there is contempt.

We submit that the appeals court could have reached the same result on more narrow grounds by finding good faith since the trial judge in state court supported the creditors' belief by ruling that the injunction did not apply. By ruling more narrowly, the appeals court could have avoided pronouncing a rule that gives creditors license to disregard discharge injunctions by making pretextual arguments.

It is not clear from the opinion whether the same contempt standard applies to violation of the automatic stay. If it does, the automatic stay will have lost its teeth in the Ninth Circuit.

The opinion is *Lorenzen v. Taggart (In re Taggart)*, 888 F.3d 438 (9th Cir. April 23, 2018); petition for rehearing and rehearing *en banc* denied Sept. 8, 2018.

Illinois judges disagree on whether direct payments to a mortgagee are "under the plan" and must be made in full to obtain a chapter 13 discharge.

Judges Split on Denial of Chapter 13 Discharge for Missing Direct Mortgage Payments

Bankruptcy judges in Illinois disagree on whether a chapter 13 debtor who fails to make all direct payments on a home mortgage is eligible for a discharge.

Adopting the minority approach, Bankruptcy Judge Thomas L. Perkins of Peoria, Ill., ruled in March that failure to make direct payments on a nondischargeable mortgage is not grounds for denying a chapter 13 discharge. To read ABI's discussion of Judge Perkins' opinion, *In re Gibson*, 582 B.R. 15 (Bankr. C.D. Ill. March 5, 2018), click here.

Chief Bankruptcy Judge Laura K. Grandy of East St. Louis, Ill., confronted a similar case where the confirmed chapter 13 plan called for the debtors to make direct payments to the home mortgage lender going forward. Payments through the trustee cured arrears.

At the end of the plan, the trustee filed a notice saying that the arrears had been cured and that the debtors had made all payments required to be made to the trustee. The debtors filed a motion for entry of discharge, stating they had made all payments required by the plan.

Fifteen days before the deadline for objecting to discharge, the mortgage lender filed a response to the trustee's notice stating that the mortgage was in arrears by almost $71,000. The lender did not object to the entry of discharge, perhaps because the mortgage debt would not be discharged in any event under Sections 1322(b)(5) and 1328(a)(1).

Neither the chapter 13 trustee nor any creditor objected, so Judge Grandy entered the debtor's discharge under Section 1328(a).

One month after the entry of discharge, the chapter 13 trustee filed a complaint to revoke discharge under Section 1328(e), alleging that the debtors had obtained their discharges by fraud. The debtors' counsel argued that the motion for a discharge was accurate because direct payments allegedly were not "under the plan."

Judge Grandy said in her August 28 opinion that she "respectfully" disagrees with Judge Perkins because she believes that direct payments to a mortgagee are "payments under the plan," as required by Section 1328(a). Direct payments are "under the plan," she said, because they "must be addressed in that plan."

However, Judge Grandy did not revoke the debtors' discharges. Because the lender's response told the chapter 13 trustee in advance of discharge that the debtors had not made all payments, she allowed the discharge to stand under Section 1328(e) because the trustee knew about the alleged fraud before discharge.

Given the trustee's tardy objection to discharge, Judge Grandy said it was unnecessary to decide "whether or not the debtors' statement that they completed all plan payments was fraudulent."

She ended her opinion with an admonition, saying it was "entirely possible that such statements may rise to the level of fraud." Therefore, she said, debtors "are advised to carefully consider the accuracy and truthfulness of statements made in their motions for discharge."

The opinion is *Simon v. Finley (In re Finley)*, 18-4011 (Bankr. S.D. Ill. Aug. 28, 2018).

A nondischargeability judgment under Section 523 doesn't require prejudgment interest at the lower federal rate.

Prejudgment Interest at the Higher State Rate Can Be Ok on Nondischargeability

If a creditor obtains a judgment after trial in bankruptcy court finding a debt nondischargeable for fraud, shouldn't the court award prejudgment interest at the federal rate because the award was made under federal law, Section 523(a)(2)(A)?

Answer: Not necessarily. The Ninth Circuit held that the bankruptcy court properly exercised discretion in awarding prejudgment interest at the higher state rate.

After litigating for two years in state court, the debtor filed bankruptcy on the eve of trial. The creditors sued in bankruptcy court, where they ultimately prevailed on their nondischargeability complaint when the bankruptcy judge awarded them damages plus prejudgment interest at the California rate of 7% rather than the 0.4% federal rate.

The Ninth Circuit Bankruptcy Appellate Panel upheld the larger interest award, and the debtor appealed again.

To no avail, the debtor contended that the bankruptcy court was obliged to award prejudgment interest, if any, at the lower federal rate because the claim was based on federal law, namely Section 523(a)(2)(A). The Ninth Circuit disagreed in a non-precedential, *per curiam* opinion on June 18, upholding the bankruptcy court's exercise of discretion.

The circuit court recited the general proposition that prejudgment interest is left to the sound discretion of the trial court, informed by "substantial evidence" regarding "considerations of fairness," with the goal of making "the wronged party whole."

The appeals court said the record "well supports" the bankruptcy court's exercise of discretion.

Relevant factors included the filing of bankruptcy on the eve of a trial that would have been held in state court, where the judge would have imposed prejudgment interest at the state rate. Moreover, the elements of fraud under California law "are much like the elements that must be shown in a nondischargeability proceeding," the circuit court said.

Were the case in federal court under diversity jurisdiction, the circuit court noted that "the California rate would have applied."

In April, we reported *Hamilton v. Elite of Los Angeles Inc. (In re Hamilton)*, 584 B.R. 310 (B.A.P. 9th Cir. April 17, 2018), where the Ninth Circuit BAP held that a creditor who obtains a pre-petition judgment on a debt that is later declared nondischargeable is entitled to post-judgment interest at the state rate throughout. To read ABI's discussion of *Hamilton*, click here.

The opinion is *Zenovic v. Crump (In re Zenovic)*, 17-60017 (9th Cir. June 18, 2018).

Fraudsters get no sympathy from the Sixth Circuit on dischargeability.

Penalties for Fraud Are Nondischargeable Despite Chapter 13's 'Superdischarge'

Penalties for fraudulently obtaining government benefits are nondischargeable despite the so-called superdischarge in chapter 13, according a May 29 opinion from the Sixth Circuit.

The circuit court was reviewing two cases with nearly identical facts. In both cases, an individual fraudulently obtained unemployment benefits by failing to disclose employment income. After discovering fraud, the state imposed orders of restitution and penalties for fraudulently obtaining unemployment benefits.

The restitution and penalties for one debtor were approximately $6,900 and $27,000, respectively, and $4,300 and $16,700 for the other. In other words, the penalties were about four times larger than the benefits that were fraudulently obtained.

In the debtors' chapter 13 cases, the state objected to the dischargeability of both the restitution awards and the penalties. The debtors conceded that the restitution awards were nondischargeable under Section 523(a)(2)(A) as money obtained by "false pretenses, a false representation, or actual fraud."

However, the debtors argued that the penalties were dischargeable in chapter 13 because they fell under Section 523(a)(7) as a "fine, penalty, or forfeiture payable" to a governmental unit that "is not compensation for actual pecuniary loss."

Although debts covered by Section 523(a)(7) are ordinarily nondischargeable, the superdischarge in Section 1328(a)(2) makes (a)(7) penalties dischargeable once chapter 13 debtors complete their plan payments. (Section 523(a)(2) debts are not covered by the superdischarge in Section 1328(a)(2) and remain nondischargeable in chapter 13.)

One bankruptcy judge ruled that the penalties were dischargeable, and the other held that they were not. On appeal in district court, the penalties were held nondischargeable.

Circuit Judge Eugene E. Siler, Jr. concluded that the penalties were nondischargeable.

Judge Siler was most persuaded by *Cohen v. de la Cruz*, 523 U.S. 213 (1998), where the Supreme Court held that treble damages for fraud are nondischargeable under Section 523(a)(2). He described *Cohen* as holding that "penalties associated with fraud should be regarded as essentially the same as the fraud itself."

Judge Siler rejected several arguments offered by the debtors. To the contention that exceptions to discharge are construed strictly against the creditor, he said that bankruptcy benefits the "honest but unfortunate" debtor.

The debtors relied on the rule of construction that a more specific statute, like Section 523(a)(7), should control over the more general provision in Section 523(a)(2). However, Judge Siler found no authority for the proposition that a debt may not be covered by two subsections in Section 523(a). Indeed, he said the subsections are not mutually exclusive.

Significantly, Judge Siler read the Supreme Court's recent decision in *Husky International Electronics Inc. v. Ritz*, 136 S. Ct. 1581 (2016), to mean that a debt can be nondischargeable under both subsections (a)(2) and (a)(7).

Judge Siler held that the penalties arose "from fraud perpetrated against the Agency," thus making the penalties nondischargeable under subsection (a)(2).

In *Husky*, the Supreme Court held that a debt can be nondischargeable for "actual fraud" under Section 523(a)(2)(A) even if the debtor made no misrepresentation to the creditor. To read ABI's discussion of *Husky*, click here.

The opinion is *Andrews v. Michigan Unemployment Insurance Agency*, 16-2383 (6th Cir. May 29, 2018).

Bankruptcy court may overrule a state court that rules incorrectly on the discharge of a debt.

Sixth Circuit Expounds on a Loophole in the *Rooker-Feldman* Doctrine

The Sixth Circuit expounded on a loophole in the *Rooker-Feldman* doctrine that will sometimes allow a bankruptcy court to disregard a state court judgment upholding the validity and enforceability of a mortgage.

Named for two Supreme Court decisions, *Rooker-Feldman* means that federal courts lack subject matter jurisdiction to review judgments by state courts. In other words, someone cannot mount a lawsuit in federal court amounting to an appeal from a state court judgment.

In *Hamilton v. Herr* (*In re Hamilton*), 540 F.3d 367 (6th Cir. 2008), the Sixth Circuit laid down a rule dealing with situations where *Rooker-Feldman* collides with discharge under Section 524(a).

Hamilton involved a situation where a state court had ruled that a debt was not discharged. Could the debtor then ask the bankruptcy court, in effect, to overrule the state court and hold that the debt was discharged? Would the debtor's resorting to bankruptcy court violate *Rooker-Feldman*?

As Sixth Circuit Judge John M. Rogers said in his July 18 opinion, *Hamilton* means that "state courts may interpret discharge orders, but only if they do so correctly. Otherwise, they violate Section 524(a) by modifying the discharge order . . . . When a state court interprets the discharge order incorrectly, its judgment is void *ab initio* and therefore poses no *Rooker-Feldman* bar to subsequent review in the lower federal courts."

The applicability of *Hamilton* was the centerpiece of the appeal before the Sixth Circuit.

The Unrecorded Mortgage

In her chapter 7 petition in 2004, the debtor scheduled a second mortgage on her home as a secured claim. The debtor received her discharge, not knowing that the lender failed to record the mortgage until three months after bankruptcy. Recordation occurred about a month before discharge, thus apparently in violation of the automatic stay.

The debtor stopped paying the mortgage about two years after bankruptcy. More than 10 years after bankruptcy, the lender began foreclosure in state court. The state court ruled that the second mortgage was valid and enforceable. Just before the foreclosure sale, the debtor filed a chapter 13

petition and initiated an adversary proceeding to avoid the lien under the Section 544(a) strong-arm powers.

The debtor proffered two theories. The bankruptcy court did not rule on the first, where she sought to avoid the mortgage under the strong-arm powers, contending that it was never properly perfected.

Instead, the bankruptcy court ruled in her favor on a second theory: that the mortgage had never attached because a nonstandard provision in the mortgage required recordation as a condition to attachment.

The Bankruptcy Appellate Panel reversed, based on *Rooker-Feldman*. Although the first theory was raised in the BAP, the panel did not rule on the issue, thus preserving the question for Sixth Circuit review. To read ABI's discussion of the BAP opinion, click here.

The Circuit's Opinion

To rule on the applicability of *Rooker-Feldman*, Judge Rogers analyzed both of the debtor's theories. He concluded that the doctrine precluded granting relief under the second theory but not the first.

The second claim – that the mortgage was unenforceable because the lien never attached – was barred by *Rooker-Feldman* because it amounted to an appeal from the state court's judgment that the mortgage was valid and enforceable. To rule in the debtor's favor, Judge Rogers said, "the bankruptcy court would need to reach a conclusion precisely opposite from the state court on the issue of whether the lien attached."

Consequently, *Hamilton* did not apply to that theory, because Section 524(a) "only protects debtors from being held *personally liable* for discharged debts," Judge Rogers said. [Emphasis in original.] The discharge injunction, he said, does not prohibit a creditor from foreclosing on a valid lien that existed before bankruptcy.

By upholding the validity of the lien, the state court in no manner affected the debtor's personal liability. Thus, the bankruptcy court improperly ruled in favor of the debtor.

On the other hand, Judge Rogers ruled that *Rooker-Feldman* did not prelude the bankruptcy court from granting relief under the strong-arm power. Recall that neither the bankruptcy court nor the BAP had ruled on that theory.

The strong-arm theory rested on the notion that the mortgage was never validly perfected because it was recorded in violation of the automatic stay. *Rooker-Feldman* therefore did not

apply, Judge Rogers said, because "it does not invite the bankruptcy court to review the state court's handiwork."

Judge Rogers went on to say that the "bankruptcy court could accept the state court's judgment as completely correct when entered, yet still rule for [the debtor] on the ground that the lien was never perfected."

Because the strong-arm theory had not been litigated, the circuit court reversed and remanded for the claim to "be decided in the first instance in the court or courts below." The appeals court expressed no view on the validity of the strong-arm theory.

The Chapter 13 Debtor's Standing

The lender argued on appeal that the chapter 13 debtor had no standing, contending that the strong-arm claim was property in the earlier chapter 7 case and was not part of the later chapter 13 estate.

The question of whether only the chapter 13 trustee could prosecute the strong-arm claim was not an issue because the trustee consented to the debtor's motion for derivative standing.

Judge Rogers said that the lender offered "no suggestion why [the strong-arm] claims would not have been included in" the chapter 13 estate. He said that the lender's argument was "inconsistent with the text of Section 544(a)[, which] indicates that Section 544(a) rights are granted anew each time the debtor files for bankruptcy."

The opinion is *Isaacs v. DBI-ASG Coinvestor Fund III LLC (In re Isaacs)*, 17-5815 (6th Cir. July 18, 2018).

Circuit court bases its decision on the omission of Section 523(a)(16) from Section 1328(a).

Chapter 13 Discharges Post-Filing Condo Assessments in the Ninth Circuit

Resolving a split among the lower courts in its jurisdiction, the Ninth Circuit ruled that condominium assessments coming due after a chapter 13 filing will be discharged when the debtor completes plan payments.

The debtor moved out of her condominium unit before filing a chapter 13 petition. Her plan called for surrendering the unit, which sat unoccupied for more than four years during the chapter 13 case. The lender eventually foreclosed about six months before the debtor completed her plan payments.

Before the debtor received her discharge, the condominium association brought suit to determine the dischargeability of the post-filing assessments that arose between the filing date and foreclosure. Affirmed in district court, the bankruptcy court ruled that the post-filing assessments arose post-petition and were not discharged.

The Ninth Circuit reversed in a July 10 opinion by District Judge Eduardo C. Robreno of Philadelphia, sitting by designation. An amendment to the statute by the Bankruptcy Reform Act in 1994 played a key role in the decision.

In the early 1990s, the Seventh and Fourth Circuits reached different results about post-filing assessments in chapter 7 cases. The Chicago-based court held that post-filing condominium assessments were dischargeable, theorizing that the obligations arose when the debtor purchased the unit before bankruptcy, even though the liability was unmatured and contingent on filing.

The Fourth Circuit split with the Seventh by holding that post-filing assessments were not dischargeable because they ran with the land and arose each month.

Congress intervened in 1994 on the side of the Fourth Circuit with Section 523(a)(16), which provides that condominium or cooperative assessments due and payable after filing are not dischargeable. By virtue of Section 523(a), that subsection is applicable to discharges in chapters 7, 11 and 12, but only to chapter 13 hardship discharges under Section 1328(b).

Significantly, the Section 523(a) exception from discharge is not applicable to the so-called superdischarge that the debtor received under Section 1328(a) upon completing her plan payments.

In deciding how to rule, Judge Robreno mentioned that a chapter 13 discharge is broader than the discharge in any other chapter. In addition, he said that bankruptcy is designed to provide a fresh start and that provisions in the Bankruptcy Code are to be construed liberally in favor of debtors.

Also in terms of policy, Judge Robreno said that the "definition of claim is very broad." Based on several factors, he concluded that post-petition assessments are prepetition claims even though they are unmatured and contingent on filing.

Judge Robreno said that the debtor's personal liability for post-filing assessments met the Ninth Circuit's "fair contemplation" test for categorizing claims as prepetition. He also noted that unmatured and contingent debts are discharged under Section 1328(a).

The liability for post-filing assessments, according to Judge Robreno, was created when the debtor purchased the unit, not as a "result of a separate, post-petition transaction."

In chapter 13, Judge Robreno said, the only exceptions to discharge are in Section 1328(a)(1)-(4). "Notably absent," he said, is a reference to Section 523(a)(16). He concluded that the omission of Section 523(a)(16) from Section 1328(a) "was purposeful."

Judge Robreno bolstered his conclusion that the assessments were dischargeable by reference to the legislative history accompanying Section 523(a)(16), where the House Report said that post-filing assessments are dischargeable "[e]xcept to the extent that the debt is nondischargeable under" Section 523.

Near the end of his opinion, Judge Robreno said there was "no legal basis for distinguishing between whether [the debtor] retained possession of her condominium unit post-petition and, thus, continued to enjoy the benefit of occupancy at no cost, or, instead, surrendered it at some point."

Read literally, the quotation might mean that a debtor could remain in possession of a condominium unit during chapter 13 and escape liability for assessments if the condominium association slept on its rights and did not take action to recover payments due after filing. However, the statement may only relate to Judge Robreno's rejection of the association's argument for liability based on notions of equity.

The opinion is *Goudelock v. Sixty-01 Association of Apartment Owners*, 16-35384 (9th Cir. July 10, 2018).

Courts are split on whether personal liability to produce suppliers results in a nondischargeable debt under Section 523(a)(4).

Personal Liability for a PACA Trust Is Dischargeable, Judge Mark Says

On an issue where the lower courts are split, a bankruptcy judge in Miami decided that officers of a produce wholesaler are not saddled with nondischargeable debts if suppliers of perishable agricultural commodities are unpaid.

Deciding a question he called "a close one," Bankruptcy Judge Robert A. Mark concluded that a trust created under the Perishable Agricultural Commodities Act (7 U.S.C. § 499a, *et seq*.), or PACA, does not give rise to a "technical trust" and therefore does not result in a nondischargeable debt under Section 523(a)(4) for committing fraud "while acting in a fiduciary capacity." Although the Eleventh Circuit has not ruled on the precise issue, Judge Mark interpreted authority from the Atlanta-based appeals court as mandating the outcome.

PACA and the Case at Hand

To protect farmers and suppliers who were usually unpaid when a fresh produce wholesaler declared bankruptcy, Congress originally adopted PACA in 1930 by imposing a floating trust on a purchaser's inventory and proceeds. Among other things, PACA creates a statutory trust protecting growers and suppliers by putting them ahead of accounts receivable lenders.

The chapter 7 debtors owned and operated a fresh produce wholesaler that was subject to PACA. Before bankruptcy, the officers had been sued under PACA by produce suppliers. The suit ended in a stipulation of settlement where the company and the officers took on joint and several liability for almost $300,000. When the officers later filed bankruptcy, little had been paid.

The produce suppliers sued in bankruptcy court to declare that the debt was nondischargeable under Section 523(a)(4). They contended that their produce, once sold, became the corpus of a PACA trust and that the debtors had fiduciary duties to ensure that enough proceeds remained to pay their invoices in full.

The debtors filed a motion to dismiss, which Judge Mark granted in his August 6 opinion.

Judge Mark's *Ratio Decidendi*

Judge Mark said the Bankruptcy Code does not define "fiduciary capacity." The "only clear consensus," he said, is that "acting in a fiduciary capacity means something more than simply having fiduciary duties." Citing *Quaif v. Johnson*, 4 F.3d 950, 953 (11th Cir. 1993), only a technical trust falls under Section 523(a)(4). Although courts agree there must be a technical trust, Judge Mark said there is no "consensus" about "what constitutes a 'technical trust.'"

In the Eleventh Circuit, Judge Mark said, a technical trust is not created involuntarily, like a resulting or constructive trust. Rather, a technical trust arises voluntarily, like an express trust.

Because Section 523(a)(4) pertains only to debts incurred "while acting" in a fiduciary capacity, Judge Mark said that a technical trust must exist before the alleged defalcation.

There is no technical trust under PACA, Judge Mark said, "until a court imposes additional duties . . . after a prior showing of malfeasance."

Critically, the Eleventh Circuit has held that PACA does not require segregation, allows comingling, and permits the use of trust assets for other purposes "prior to a showing of dissipation," Judge Mark said. The ability of a PACA dealer "to comingle trust assets with other assets precludes a finding that a PACA trust is a technical trust," the judge ruled. As additional support, he cited the Fifth Circuit for holding that the ability to use trust assets for another purpose "is fatal to finding that a technical trust exists."

Demonstrating the division of authority, Judge Mark cited the Sixth Circuit and the Ninth Circuit Bankruptcy Appellate Panel, which held in non-PACA cases that segregation is not required. He also conceded that "a majority of [lower] courts" have held that PACA trusts are technical trusts. He took issue with those decisions because, in his view, "an identified trust *res* without a segregation requirement is not enough."

As further support for his conclusion, Judge Mark cited the Fifth and Seventh Circuits, which both held that failure to pay proceeds of lottery ticket sales did not involve a technical trust.

Judge Mark ended his opinion by saying he would certify the question for direct appeal to the Eleventh Circuit.

The opinion is *Coosemans Miami Inc. v. Arthur (In re Arthur)*, 17-1378 (Bankr. S.D. Fla. Aug. 6, 2018).

Arbitration

New case seems inconsistent with Second Circuit's prior opinion compelling arbitration over an automatic stay violation.

Second Circuit Bars Arbitration in a Class Action for Violating the Discharge Injunction

Often solicitous of financial institutions caught up in bankruptcy litigation, the Second Circuit nonetheless held that the bankruptcy court properly exercised its discretion by refusing to allow arbitration in a class action alleging a violation of the Section 524 discharge injunction.

The unanimous opinion on March 7, written by Circuit Judge Rosemary S. Pooler, casts doubt on the continuing influence of *MBNA America Bank v. Hill*, 436 F.3d 104 (2d Cir. 2006). *Hill* stood for the proposition that a court in the Second Circuit must order arbitration in a class action alleging a willful violation of the Section 362 automatic stay.

The new decision from the Second Circuit came down two days after the Supreme Court issued its opinion in *U.S. Bank NA v. The Village at Lakeridge LLC*, 15-1509 (Sup. Ct. March 5, 2018), prescribing the standard of appellate review for mixed questions of law and fact. The Second Circuit did not cite *Lakeridge* and might have stated the standard of review differently had it analyzed the high court's new authority regarding bankruptcy appeals.

Judge Pooler's decision picked the winner between two district judges in New York who had reached diametrically opposite results on the same facts. Another winner is Bankruptcy Judge Robert D. Drain of White Plains, N.Y., who made the decision that was upheld by the Second Circuit on March 7.

The Class Action

An individual got a chapter 7 discharge covering credit card debt. Despite the discharge, the credit card lender continued reporting the debt as charged off rather than discharged in bankruptcy. After having received a discharge, the debtor reopened the chapter 7 case and filed a class action in bankruptcy court alleging that the failure to report the debt as discharged was an attempt at bringing pressure to repay the debt and thus violated the discharge injunction under Section 524 of the Bankruptcy Code.

The lender filed a motion to compel arbitration, relying on a provision in the credit card agreement calling for arbitration of "any controversy." Bankruptcy Judge Drain denied the motion to compel arbitration in May 2015, and the lender took an immediate appeal, permitted by the Federal Arbitration Act.

District Judge Nelson S. Román of White Plains upheld denial of the motion to compel arbitration. Interpreting *Hill*, he said that a bankruptcy judge has discretion to "override an arbitration agreement" if the lawsuit is a core proceeding based on provisions of the Bankruptcy Code that "inherently conflict" with the Federal Arbitration Act.

Judge Román found the lawsuit to be core, even though it was a class action, because "discharge is clearly a right created by federal bankruptcy law" and all class members were bankrupts. He next held that arbitrating claims under Section 524 "would necessarily jeopardize the objectives of the Bankruptcy Code."

In *Hill*, the Second Circuit had compelled arbitration in a class suit alleging a violation of the automatic stay when the debtor had received a discharge, the case had been closed, and the automatic stay was no longer in effect. Judge Román distinguished *Hill* because the case before him involved the discharge injunction, which is the "central purpose" of bankruptcy and remains in effect "even after the conclusion of the bankruptcy proceedings."

"[A]rbitration of a discharge violation would jeopardize this central objective," Judge Román said. To the *Hill* analysis, Judge Román added a fourth consideration: uniformity. He said that the need for uniformity was "compelling" because there could be "wildly inconsistent" results in arbitration.

In a case decided in October 2015 called *Belton v. GE Capital Consumer Lending Inc. (In re Belton)*, Vincent L. Briccetti reached the opposite result, also interpreting *Hill*. To read ABI's discussion of *Belton*, click here. Judge Briccetti and the Second Circuit both denied motions in *Belton* for leave to appeal.

As it turns out, the Second Circuit largely adopted Judge Román's logic, aided by an *amicus* brief submitted by Professors Ralph Brubaker, Robert M. Lawless and Bruce A. Markell and Tara Twomey of the National Consumer Bankruptcy Rights Center.

Mootness

The Second Circuit considered whether the appeal was moot because the lender was willing to update the credit reports for everyone in the class.

Judge Pooler ruled that the appeal was not moot because "the question presented and the relief sought both remain unsettled."

The ruling on mootness is significant because the result in *Hill* turned in part on the creditor's repayment of debt allegedly collected in violation of the automatic stay. Therefore, a defendant's ploy like the one in *Hill* may no longer suffice to kill off an appeal in the Second Circuit.

The Standard of Appellate Review

Next, Judge Pooler dealt with the standard of review, which she said "has been inconsistently or improperly applied by this Court."

Without citing *Lakeridge*, which had been decided two days earlier in the Supreme Court, and without analyzing whether the case presented mixed questions of law and fact, Judge Pooler said that the court would conduct *de novo* review of the core status of the suit. Similarly, she said, the review is *de novo* regarding the bankruptcy court's conclusion that arbitration would cause a "severe conflict" with the Bankruptcy Code.

After *Lakeridge*, appellate courts must decide that review is primarily legal in nature, rather than factual, before concluding that review is *de novo*. Judge Pooler did not undertake that analysis.

In deciding whether review is *de novo* or for clear error, *Lakeridge* tells appellate courts to examine whether review primarily entails a legal or factual analysis. Finding a "severe conflict" between arbitration and the Bankruptcy Code might entail either a legal or factual analysis.

Depending on the particular facts giving rise to the alleged violation of the discharge injunction, appellate review might invoke the plain error rule if the appellate court's task focuses more on the facts underlying the conclusion of "severe conflict."

The Merits

Hill taught that the court has discretion to disregard an arbitration agreement if the proceeding is core and presents a "severe conflict" with the Bankruptcy Code. In deciding whether the class plaintiff-debtor in the new cases should have been obliged to arbitrate, *Hill* therefore provided the legal precedent, but the facts in that case were "easily distinguished," Judge Pooler said.

Because the creditor conceded that the issue was core, Judge Pooler was only required to analyze whether Congress intended for the statutory right to a discharge to be non-arbitrable, thus giving the bankruptcy court discretion to refuse to compel arbitration.

Judge Pooler said that discharge is the "foundation" and the "central purpose" of bankruptcy. Therefore, arbitrating a claimed violation of the discharge injunction would "seriously jeopardize" the proceeding because (1) the discharge injunction is integral to providing a fresh start, (2) the claim was made in "an ongoing bankruptcy matter," and (3) the bankruptcy court's equitable power to enforce its own injunctions is "central to the structure of the Code."

Perhaps undercutting *Hill*, Judge Pooler said that the "putative class action does not undermine this conclusion" because the automatic stay in *Hill* had become moot by closing the debtor's bankruptcy case.

Attempting to distinguish *Hill*, Judge Pooler said that violation of the discharge injunction, as opposed to an automatic stay violation, offends "the central goal of bankruptcy," contrasted with a violation of the automatic stay, which is no longer in effect in a closed case.

Further, Judge Pooler said the discharge injunction was "still eligible for active enforcement," compared with the automatic stay, which had lapsed. Judge Pooler did not consider that damages could be sought for a violation of the automatic stay by reopening a closed bankruptcy case.

Without citation of authority, Judge Pooler said that the discharge injunction is "enforceable only by the bankruptcy court and only by a contempt citation." Arbitration therefore presented "an inherent conflict with the Bankruptcy Code," Judge Pooler said, because "the bankruptcy court alone has the power to enforce the discharge injunction."

Having found an "inherent conflict," Judge Pooler quickly concluded that the bankruptcy judge did not abuse his discretion in ruling out arbitration.

What Remains of *Hill*?

It is at least arguable that *Hill* should have required Judge Pooler to impose arbitration. Since the Second Circuit was not sitting *en banc*, her three-judge panel could not overrule *Hill*.

In *Hill*, the issue was also core, but the appeals court required arbitration, overruling the two lower courts.

The *Hill* court concluded that arbitration would not "seriously jeopardize the objectives of the Bankruptcy Code," in part because the automatic stay "is not so closely related to an injunction that the bankruptcy court is uniquely able to interpret and enforce." In the March 7 opinion, Judge Pooler neglected to note that the discharge injunction can be raised as an affirmative defense in any court.

Hill also found significance in the fact that the plaintiff's bankruptcy case had been closed. However, the debtor's case also had been closed in the appeal before Judge Pooler, but the bankruptcy judge had reopened the case to permit the filing of the class action.

Hill, therefore, may be limited in the future to class actions in district court seeking redress for violations of the automatic stay. *Hill* might not require arbitration if the debtor alone seeks damages for an automatic stay violation under Section 362(k), and *Hill* might not apply to a class action in bankruptcy court seeking redress for an ongoing violation of the automatic stay.

The March 7 decision presents an opportunity for the Second Circuit to sit *en banc*, either to set aside Judge Pooler's opinion or overrule *Hill* outright. However, *en banc* rehearing is exceedingly rare in the Second Circuit. Stay tuned nonetheless.

The opinion is *Credit One Bank NA v. Anderson (In re Anderson)*, 16-2496 (2d Cir. March 7, 2018); petition for *certiorari* filed June 5, 2018.

Wages & Dismissal

Dissenter contends that the majority misread the circuit's own precedent.

Ninth Circuit Creates Split on Appellate Standard for 'Consumer Debt' Determination

Either creating a circuit split or accentuating an existing split, a divided panel of the Ninth Circuit disagreed on the standard of appellate review on appeal from an order from the bankruptcy court deciding whether an obligation is a consumer or business debt under Section 707(b)(1).

The issue is akin to the question in *U.S. Bank NA v. The Village at Lakeridge LLC*, 15-1509 (Sup. Ct.), where the Supreme Court will decide this term whether the standard of appellate review for non-statutory insider status is *de novo* or clearly erroneous, or a combination of both.

The appeal in the Ninth Circuit turned in large part on that court's own precedent in *Zolg v.Kelly (In re Kelly)*, 841 F.2d 908, 911 (9th Cir. 1988). The majority and the dissent couldn't even agree on what *Kelly* meant.

The majority read *Kelly* to mean that a home mortgage can be either a consumer or business debt, depending on the "primary purpose" of the loan. The dissent understands *Kelly* to mean that a home mortgage, as a matter of law, is always a consumer debt. The majority and dissent also disagree about the appellate standard prescribed by *Kelly*.

The Facts

A man who lived in Jackson, Wyo., had worked 25 years for a luxury hotel chain, earning $225,000 a year. Hoping for advancement to a more senior executive position, he applied for a job at a luxury resort in Aspen, Colo. Although offered a job in Aspen for $300,000, he could not afford either to rent or buy a home in Aspen, where home prices are higher than in Jackson.

The new employer sweetened the offer by granting him a $500,000 mortgage toward the purchase of a home in Aspen. The new employer also gave him a guaranteed annual bonus to cover the below-market interest on the loan.

He took the job, but his wife and children remained in Wyoming. The home he purchased in Aspen was too small for his entire family. He continued using banks in Wyoming and did not move the registration of his car to Colorado.

The man considered the house in Aspen to be a "placeholder" because his new employer was planning to develop a new resort in Jackson, allowing him to move back to Wyoming and join his family.

After the economy crashed in 2008, the new employer terminated plans for the new resort in Wyoming. Abandoning hope of returning to Wyoming, he sold his home in Jackson, and his family joined him in Aspen.

Four years after taking the job in Aspen, the man resigned and later filed a chapter 7 petition, owing $550,000 on the loan from his employer.

The employer moved to dismiss the chapter 7 petition for abuse under Section 707(b)(1), contending his debts were primarily consumer, thus making him ineligible and requiring him to convert the case to either chapter 13 or chapter 11 if he wanted a discharge eventually.

The bankruptcy judge held a trial and denied the motion to dismiss, concluding that the Colorado mortgage was a business debt, making him eligible for chapter 7 because his debts overall were "primarily" business debts. On appeal, the Ninth Circuit Bankruptcy Appellate Panel upheld the bankruptcy court.

The Majority Opinion

Writing for herself and Circuit Judge Marsha S. Berzon, Circuit Judge Morgan Christen upheld the BAP in an opinion on Oct. 16 that appears to mean that characterization of a debt as consumer or business is a fact to be found by the trial court and reviewed for clear error, not a legal conclusion that an appellate court can review *de novo* based on undisputed facts.

The employer contended that appellate review should be *de novo* because the underlying facts were undisputed. The employer also argued that a home mortgage is always a consumer debt. Judge Christen disagreed on both counts.

Judge Christen interpreted *Kelly* to mean that a court must divine the "primary purpose" of a debt in deciding whether the obligation is consumer or business. *Kelly* held, in her view, that home mortgages are usually but not always consumer debts. She disputed the dissenter's understanding of *Kelly* to mean that home mortgages are always consumer debts.

The debtor's "multiple motives" for taking the mortgage required the bankruptcy court to engage "primarily" in a "factual, rather than legal, inquiry." Since the decision in the bankruptcy court was essentially a factual inquiry, the appellate standard is clear error, Judge Christen said.

Judge Christen admitted that the courts are split on the standard of review, with the Eighth Circuit BAP also holding "that the purpose of a debt is a factual finding reviewed for clear error." The Fifth and Tenth Circuits, she said, hold to the contrary.

Judge Christen cited a number of undisputed facts to buttress the bankruptcy court's conclusion that the mortgage primarily had a business purpose. She therefore concluded that the bankruptcy

court did not clearly err in finding that the mortgage was "undertaken for a business purpose connected with furthering his career, rather than a personal, family or household expense."

The Dissent

Circuit Judge Jacqueline H. Nguyen dissented, saying that the majority applied "the wrong standard of review, creating a circuit split in the process."

Judge Nguyen interpreted *Kelly* as meaning, "in no uncertain terms," that the trial court makes a predominantly legal determination subject to *de novo* review when the facts are not in dispute. She counted the Fourth, Fifth, Sixth and Tenth Circuits as also holding that the characterization of consumer debt is subject to *de novo* review.

Beyond the appellate standard, Judge Nguyen said that the majority were wrong on the merits, because she understood *Kelly* to mean that "all loans to purchase a home are consumer debt."

Finality

Like the BAP, the appeals court addressed the question of whether denial of a motion to dismiss under Section 707(b) is a final order eligible for appeal to the circuit.

Without dissent from Judge Nguyen, Judge Christen followed the "majority of circuits" by holding that denial of a motion to dismiss under Section 707(b) is a final order because it conclusively determines a discrete issue resolving the debtor's eligibility for a discharge in chapter 7.

Judges Christen and Nguyen were both appointed by President Barack Obama.

In a similar case, *Bushkin v. Singer (In re Bushkin)*, 15-1285, 2016 BL 236937 (B.A.P. 9th Cir. July 22, 2016), the Ninth Circuit BAP classified living expenses as business debts if they were intertwined with a profit motive. The appeal to the circuit in *Bushkin* was being held in abeyance pending the decision in this case. To read ABI's discussion of *Bushkin*, click here.

The opinion is *Aspen Skiing Co. v. Cherrett (In re Cherrett)*, 873 F.3d 1060 (9th Cir. Oct. 16, 2017).

Although there may be standing to appeal, failure to object can bar an appeal under doctrines of waiver or forfeiture.

Ninth Circuit Widens Split on Failure to Object and Standing to Appeal

The Ninth Circuit explained when the failure to appear or object results in the loss of the right to appeal an order entered in bankruptcy court.

Basically, the failure to object or appear does not result in a loss of standing to appeal. Assuming there is a pecuniary interest at stake, standing on the sidelines instead can result in waiver or forfeiture, as District Judge Matthew F. Kennelly of Chicago explained in his May 29 opinion for the Ninth Circuit. Judge Kennelly was sitting by designation.

Although failure to appear or oppose may or may not result in loss of appellate standing depending on the circuit where the issue arises, the outcome often may end up being the same by invocation of the doctrines of waiver and forfeiture.

The Ninth Circuit Case

A chapter 7 trustee filed a motion to assume an executory contract. Individuals who had a pecuniary interest in the contract were given notice, but they did not file an objection, nor did they appear in court in opposition. At the hearing, the bankruptcy judge announced he would grant the motion as being unopposed.

Before the bankruptcy judge signed an assumption order, the individuals filed a motion for reconsideration, stating reasons for denying the assumption motion. Rather than treat the failure to oppose as a default, the bankruptcy judge denied the reconsideration motion on the merits.

After entry of the assumption order, the individuals appealed. The district judge dismissed the appeal for lack of standing, ruling that the appellants were not aggrieved parties because they had not opposed or appeared in opposition to the assumption motion.

Judge Kennelly reversed and remanded.

The Circuit Split on Standing

The district court relied on *dicta* from a 1985 Ninth Circuit opinion saying that objecting or appearing in bankruptcy court is "usually" a prerequisite to being an "aggrieved person" with standing to appeal. That case, however, was decided on other grounds.

Judge Kennelly said that the circuits are split on whether attendance or objection are prerequisites to being an aggrieved person with standing to appeal. The Seventh Circuit requires objection to confer appellate standing, while the Fourth Circuit does not, he said.

Siding with the Fourth Circuit, Judge Kennelly said, "We do not automatically toss a litigant out of court for noncompliance with a trial court rule without allowing the litigant to explain why the noncompliance should be excused."

Bankruptcy standing, according to Judge Kennelly, concerns whether someone is "'aggrieved,' not whether one makes that known to the bankruptcy court." He therefore held that "an appellant's failure to attend and object at a bankruptcy court hearing has no bearing on the question of whether that appellant has standing to appeal."

Although failure to attend and object may result in waiver or forfeiture, "it does not present a jurisdictional standing issue," Judge Kennelly said.

Although they are often used interchangeably, Judge Kennelly said that waiver and forfeiture are different concepts. Forfeiture is the failure to assert a right in a timely fashion, while waiver is the intentional relinquishment or abandonment of a right.

Because the appellants had objected in their motion for rehearing, Judge Kennelly said they had not waived their arguments against assumption. On the other hand, he said, "the question of forfeiture is open for determination on remand."

Since the appellants clearly had a pecuniary interest, they had standing to appeal. On remand, Judge Kennelly instructed the district court to decide whether the appellants forfeited their opposition to the assumption motion and whether the bankruptcy court's order should be reversed for plain error.

The opinion is *Harkey v. Grobstein (In re Point Center Financial Inc.)*, 16-56321 (9th Cir. May 29, 2018); rehearing and rehearing *en banc* denied July 12, 2018.

Debtors with too much student loan debt are functionally ineligible for any form of bankruptcy relief.

Chicago District Judge Reestablishes Chapter 13 Debt Limits on Student Loans

A district judge in Chicago reversed Bankruptcy Judge Janet S. Baer, who had ruled in December that having student loans exceeding the chapter 13 unsecured debt limit does not require dismissing an individual's chapter 13 petition.

In his August 31 opinion, District Judge Robert M. Dow, Jr. held that the plain language of Section 109(e) makes a debtor with huge student loan debt ineligible for chapter 13 and provides "cause" to dismiss or covert the case under Section 1307(c). When a debtor is ineligible for chapter 13, failing to dismiss is an abuse of discretion, he held.

The chapter 13 debtor owed about $570,000 on student loans and another $22,500 on credit cards. He was living paycheck to paycheck, Judge Baer said. His monthly take-home pay of some $2,700 left him with about $475 in disposable income.

Under an income-based repayment plan, the debtor had been repaying his student loans at the rate of $268 a month. If he continued the payments for 25 years, any unpaid balance would be forgiven. The amount of his monthly payment would increase or decrease depending on a rise or fall in his income.

Section 109(e) provides that "[o]nly an individual with regular income that owes, on the date of filing of the petition, noncontingent, liquidated, unsecured debts of less than $394,725 . . . may be a debtor under chapter 13 of this title." Section 1307(c) says that "the court may" may dismiss or convert a case "for cause." The subsection lists 11 nonexclusive examples of "cause," but excessive unsecured debt is not one of them.

Bankruptcy Judge Baer had rejected the debtor's argument that his student loans were principally contingent debts because a large portion would likely be forgiven. However, Judge Baer said that nothing in Section 109(e) requires dismissal, and Section 1307(c) makes dismissal or conversion discretionary.

Judge Baer denied the motion to dismiss, explaining why chapter 13 was in the best interests of creditors and the debtor. *In re Pratola*, 578 B.R. 414 (Bankr. N.D. Ill. Dec. 27, 2017).

The chapter 13 trustee appealed. In district court, the debtor conceded that his student loans were not contingent.

Saying that he "respectfully disagrees" with Judge Baer, District Judge Dow reversed and remanded the case for the bankruptcy court to choose between dismissal or conversion. One by one, Judge Dow refuted the arguments made by Judge Baer. He said that Congress made a "bright-line rule" in Section 109(e).

Judge Dow said he was "not unsympathetic to the policy concerns raised by the Bankruptcy Court, . . . but the power to create such an exception to Section 109(e) lies with Congress rather than the courts."

In March, Chief Judge Catherine J. Furay of Madison, Wis., agreed with Judge Baer and also declined to dismiss a chapter 13 petition when student loans along exceeded $394,725. Judge Furay concluded that creditors were better off in chapter 13. She also explained why the debtor was not eligible for chapter 7 and that chapter 11 would be infeasible. *See In re Fishel*, 17-14180, 2018 BL 113642 (Bankr. W.D. Wis. March 30, 2018). There was no appeal from Judge Furay's decision.

If a student loan borrower is also ineligible for chapter 7, the debtor has no forum to test the dischargeability of student loans under Section 523(a)(8). In that circumstance, a debtor already in an income-based repayment program might argue that Judge Baer was wrong and that the debt is contingent and therefore does not count toward the chapter 13 debt limit.

To read ABI's discussions of the decisions by Judges Baer and Furay, click here and here.

The opinion is *Stearns v. Pratola (In re Pratola)*, 18-213 (N.D. Ill. Aug. 31, 2018).

New York judge rules that the* IRS Handbook *is not controlling on auto expenses for the means test.

On the Means Test, a Single Debtor Can Take Deductions for Two Cars

On an issue dividing the lower courts, Bankruptcy Judge Alan S. Trust of Central Islip, N.Y., ruled that a single individual can claim a deduction for two automobiles in calculating the means test to determine whether the debtor's case represents "presumptive abuse."

The U.S. Trustee filed a motion to dismiss, contending that the debtor could take a deduction for only one automobile. If one of the deductions were eliminated, the debtor would have failed the means test, and his case would have been dismissed for presumptive abuse under Section 707(b)(2) unless he were to convert to chapter 13.

In his Jan. 11 opinion, Judge Trust analyzed the case as a question of statutory construction.

On line 11 of Form 122A-2, the debtor claimed ownership of two cars. On line 12, he listed auto expenses of $616, the exact amount shown on the IRS Local Standards for the New York metropolitan area for someone who owns two cars.

The trustee argued that the court instead should follow the *IRS Handbook*, which allows a single person a deduction for only one car.

Judge Trust said that Section 707(b)(2)(A)(ii)(1) does not tell the court to refer to the *IRS Handbook*. Rather, he said, the subsection says the deduction "shall be" determined by the National and Local Standards. The Local Standards applicable to autos allow a deduction for one or two autos "and [do] not expressly limit a single-person household debtor's operation costs to one vehicle," the judge said.

The "fact that the *IRS Handbook* could be read to conflict with the statute and official form is irrelevant for a presumed abuse case, because Congress did not expressly build the *IRS Handbook* into the statute nor did the Judicial Conference of the U.S. build the *IRS Handbook* into the official form," Judge Trust said.

Consequently, Judge Trust found no presumed abuse because he allowed the single debtor with no dependents to take deductions for the two autos he owned. He held that "the *IRS Handbook* is not controlling and in fact would be at odds with the Means Test as defined, none of which limit a single-person-household debtor to one vehicle expense where the debtor actually owns or leases two or more vehicles."

The opinion is *In re Addison*, 16-74856, 2018 BL 10506 (Bankr. E.D.N.Y. Jan. 11, 2018).

With no circuit authority, lower courts are split on the fate of standing trustees' fees when a chapter 13 case is dismissed before confirmation.

No Statutory Fees for Standing Chapter 13 Trustees if Dismissal Precedes Confirmation

With no authority as yet from the courts of appeals, the lower courts are divided on the right of a standing trustee to retain his or her statutory fees if a chapter 13 case is dismissed before confirmation.

Bankruptcy Judge Mary Ann Whipple of Toledo, Ohio, decided that the "plain language" of Section 1326(a)(2) takes precedence over 28 U.S.C. § 586(e), which "lacks such clarity," she said.

The case involved joint chapter 13 debtors who paid about a $10,500 to the standing chapter 13 trustee. The plan was never confirmed, and the case was dismissed. The bankruptcy court approved the trustee's final report and dismissed the case, calling for the trustee to retain about $900 in statutory fees and return the remainder to the debtors.

One of the debtors sought reconsideration, disallowance of the trustee's statutory fees, and disgorgement of the fee that the trustee had retained.

In her Sept. 29 opinion, Judge Whipple said that the *Handbook for Chapter 3 Standing Trustees*, published by the Executive Office of the U.S. Trustees, provides no guidance. If a chapter 13 case is dismissed before confirmation, the *Handbook* says that the standing trustee must reverse the payment of the percentage fee "if there is controlling law in the district requiring such reversal."

The *Handbook* is equivocal because, as Judge Whipple said, the two controlling statutes point in different directions.

Section 1326(a)(2) says that if a plan is not confirmed, "the trustee shall return any [payments made by the debtor] not previously paid out and not yet due and owing to creditors . . . to the debtor, after deducting any unpaid claim allowed under Section 503(b)."

Seemingly to the contrary, Section 586(e) provides that the standing trustee "shall collect such percentage fee from all payments received by [the standing trustee] under plans in the cases under" chapters 12 and 13.

Judge Whipple said that none of the courts of appeals had resolved the conflict in the two sections, and the lower courts are in disagreement. She said there is no controlling law in her district.

In deciphering which statute to follow, Judge Whipple said that the "plain language of Section 1326 is clear." When a chapter 13 case is dismissed before confirmation, she said that use of the word "shall" requires the standing trustee "to return all such payments, including the statutory percentage fee being held by the trustee, after deducting any allowed administrative expense claims."

By comparison, Judge Whipple said that Section 586(e)(2) "lacks such clarity," in part because it deals with collection but not ultimate disposition.

Consequently, Judge Whipple granted the motion for reconsideration, modified the dismissal order, and required the trustee to pay the statutory fee to the debtor.

The opinion is *In re Lundy*, 15-32271, 2017 BL 347466 (Bankr. N.D. Ohio Sept. 29, 2017).

Plans & Confirmation

Split decision allows a lender to take property out of an estate automatically.

Eleventh Circuit Requires No Objection to Overturn a Final Confirmation Order

In the words of the dissenter, the Eleventh Circuit penned an opinion on Dec. 11 "that will impede the effectiveness of our bankruptcy system and will undermine its purpose."

The majority held that property covered by Georgia's pawn statute, although remaining in the debtor's possession, automatically drops out of the estate once the redemption period elapses. Even a chapter 13 plan is incapable of paying the lender's claim in full and allowing the debtor to retain his car.

More surprisingly, the majority held that the title lender was not required to file an objection to confirmation of the plan. Although the lender also did not appeal confirmation of the plan, the majority nonetheless held that the confirmed plan did not bind the creditor because the lender had previously filed a motion to declare that the car was no longer estate property.

The decision has a number of shortcomings, among them the majority's lack of discussion of Section 541(b)(8), which gives only limited protections to pawn brokers and title lenders. The opinion does not explain why a confirmed plan is not binding and thereby insinuates that a creditor need not oppose confirmation if a related issue is in litigation.

The majority opinion, written by a circuit judge appointed by President Donald Trump, means that states can pass laws eviscerating debtors' rights under the Bankruptcy Code by taking property automatically out of the estate. The opinion also says that state laws prevail unless Congress has shown an intent for the Bankruptcy Code to be paramount.

The Typical Title Loan

The debtor obtained a loan before bankruptcy, secured by the title to his car, but he retained possession of the car. Before the redemption period elapsed under state law, the debtor filed a chapter 13 petition. The debtor did not pay off the title loan within the additional 60 days provided by Section 108(b).

Georgia's automobile pawn statute gives the borrower a 30-day grace period after maturity to redeem the car. If not redeemed, title automatically passes to the lender.

After the additional 60 days had run, the lender filed a motion to declare that the car was no longer property of the estate and to modify the automatic stay permitting repossession of the car.

The debtor opposed the motion, which was not decided before the bankruptcy court confirmed the chapter 13 plan.

The lender had filed a secured claim. Approved by a confirmation order that the lender did not appeal, the plan provided for paying the claim in full with interest at 5%.

At the hearing on the stay relief motion after confirmation, the lender conceded that it had not objected to confirmation. The bankruptcy judge denied the stay relief motion, holding that the car remained property of the estate even after expiration of the extended redemption period. The bankruptcy court also held that the lender was bound by the confirmed plan.

The district court affirmed, holding that the chapter 13 plan could modify the lender's rights. To read ABI's discussion of the district court opinion, click here.

The Eleventh Circuit reversed in a Dec. 11 opinion by Circuit Judge Kevin Newsom. Judge Newsom was Articles Editor for the *Harvard Law Review*. After clerking on the Ninth Circuit, he clerked on the Supreme Court for Justice David H. Souter.

The Plan Was Not Binding

Judge Newsom first ruled that the plan was not binding because the title lender had not "slept on its rights" by failing to object to confirmation of the plan.

"[O]n the unique facts of this case," Judge Newsom said, the lender's motion to modify the stay "adequately preserved its position." He said there was "no substantive difference between the styled-as-such [objection to confirmation] that the dissent would seemingly require and the motion for relief [from the stay that the title lender] actually filed."

The lender "put the *substance* of its position . . . squarely before the bankruptcy court," Judge Newsom said. [Emphasis in original.] He went on to say that the lender was not required to file a confirmation objection to preserve the contention that the car was no longer estate property, because that issue "was adequately teed up" in the stay relief motion.

Although Judge Newsom said the facts of the case were "unique," his opinion could be interpreted to mean that previously filed pleadings in chapter 11 or 13 cases will suffice as confirmation objections, although not denominated as such. Evidently, the bankruptcy judge must scour the docket for pleadings raising issues that might also pertain to confirmation.

Even if the lender had preserved the issue, Judge Newsom's opinion does not explain why the appeal was not moot as a consequence of the confirmation order that the lender did not appeal.

The Car 'Dropped Out' of the Estate

Next, Judge Newsom held that the car "dropped out" of the estate by "the 'automatic' operation of Georgia's pawn statute." He said that a "clear majority" of lower courts have held that property subject to a pawn statute can cease automatically to be estate property.

Judge Newsom cited *Butner v. U.S.*, 440 U.S. 48, 55 (1979), and *Barnhill v. Johnson*, 503 U.S. 393, 398 (1992), for the proposition that property interests are created and defined by state law. However, he did not mention *Barnhill's* more important holding that federal law nonetheless determines the time of a transfer, an issue not discussed but pertinent to the case at hand.

Since state law automatically divests an owner of title, Judge Newsom said that the Bankruptcy Code could alter the outcome "only if we find some clear textual indication that Congress intended that result."

The "likeliest candidate," Judge Newsom said, was the automatic stay. Section 362(a), though, "has no application to the particular circumstances of this case," he said.

Although conceding that "some courts" have held that the automatic stay tolls an unexpired redemption period, Judge Newsom cited Section 108(b) as making the automatic stay inapplicable. Were it otherwise, he said, the general would control the specific, and Section 108(b) would be superfluous.

Although the automatic stay prevents creditors from prying assets out of the estate, Judge Newsom said "it does not separately prevent those assets from evaporating on their own — as here, 'automatically' — pursuant to the ordinary operation of state law."

Next, Judge Newsom said that Section 541 does not freeze estate property as of the filing date. The statute, he said, "neither clearly says nor unambiguously implies . . . that a bankruptcy estate, once created, necessarily remains static."

Finally, Judge Newsom held that Section 1322(b)(2) "has no field of application in this case." Although that section allows a chapter 13 plan to modify the claims of secured creditors, it did not apply because the car was no longer estate property by the time of confirmation.

Joining Judge Newsom's opinion was District Judge Federico A. Moreno from the Southern District of Florida, sitting by designation.

The Dissent

Circuit Judge Charles R. Wilson, appointed by President Bill Clinton, dissented, saying this "should be an easy case," because "a confirmed chapter 13 bankruptcy plan enjoys a preclusive, binding effect."

The law, he said, "required an objection before plan confirmation, not a retroactive recasting of motions as objections."

Judge Wilson pointed to the lender's concession in bankruptcy court and the bankruptcy judge's consequently finding that the lender had not filed an objection to confirmation. Reviewed for clear error, that finding, he said, "is insurmountable." He also said there was "ample evidence to support the fact that [the lender] *affirmatively declined* to object." [Emphasis in original.]

Therefore, Judge Wilson said he would have ruled that the lender was "bound by the confirmed plan."

Taking the stay relief motion as a confirmation objection, Judge Wilson said, means that "judges will need to scour the docket prior to each confirmation hearing."

Next, Judge Wilson cited *United Student Aid Funds Inc. v. Espinosa*, 559 U.S. 260 (2010), for the idea that even an "illegal" plan provision binds a creditor.

With regard to the question of estate property, Judge Wilson said that "state law cannot operate to alter the bankruptcy estate after its creation — and it certainly cannot serve to dispossess the bankruptcy estate of property."

On the filing of the chapter 13 petition, the lender had a secured claim that the debtor could modify under Section 1322(b)(2). Congress, Judge Wilson said, "provided no mechanism for property of the estate to evaporate."

Judge Wilson pointed to Section 541(b)(8) as authority for the idea that the car remained estate property. That section was added along with the BAPCPA amendments in 2005 to give additional protections to pawn brokers and title lenders.

Section 541(b)(8) says that estate property does not include tangible property, other than written evidences of title, if the property is collateral for a loan, the property is in the possession of the lender, the debtor has no obligation to repay the loan, and the debtor has not redeemed the property within the time provided by state law.

Judge Wilson said that the section would have applied if the lender were in possession of the car, but that was not the case.

The majority cited Section 541(b)(8), but as evidence of a situation where property can drop out of the estate automatically. Arguably, Congress intended for Section 541(b)(8) to be the only circumstance when a title lender or pawn broker can automatically obtain title to property after bankruptcy, and that section by its terms was inapplicable to the case at hand.

Overview

The majority opinion gives states the ability to write laws automatically taking property out of a bankruptcy estate. Theoretically, states could make reorganization impossible in chapter 13 or chapter 11 by transferring all manner of property automatically to lenders or other creditors.

By requiring specific evidence that Congress intended for the Bankruptcy Code to override state law, the majority would make bankruptcy law less uniform and more a reflection of the idiosyncrasies of state law. Judge Newsom seemed to import rules regarding implied repeal of federal statutes to cases involving federal preemption of state law.

The majority opinion in some ways resembles *WD Equipment v. Cowen (In re Cowen)*, 849 F.3d 943 (10th Cir. Feb. 27, 2017), where the Tenth Circuit held that passively holding an asset of the estate, in the face of a demand for turnover, does not violate the automatic stay in Section 362(a)(3) as an act to "exercise control over property of the estate." The majority opinion and *Cowen* both chip away at the primacy of the Bankruptcy Code and diminish debtors' rights and remedies.

The issue decided in *Cowen* is on direct appeal to the Tenth Circuit in *Davis v. Tyson Prepared Foods Inc. (In re Garcia)*, 17-3247 (10th Cir.), where the debtor will presumably ask for *en banc* argument or rehearing. For ABI's discussion, click here.

A debtor who does not redeem a car is not without relief. Presumably, the loan typically would be far smaller than the value of the car, thus allowing the debtor to mount a constructive fraudulent transfer suit against the lender. Nonetheless, the cost of an avoidance suit will be greater than and in addition to the cost of confirming a plan. Notably, a pawn broker or title lender entitled to retain property is still subject to an avoidance action under Section 541(b)(8).

The opinion is *Title Max v. Wilber (In re Wilber)*, 876 F.3d 1302 (11th Cir. Dec. 11, 2017), petition for rehearing *en banc* denied Feb. 14, 2018.

On direct appeal, Seventh Circuit upholds Bankruptcy Judge Thorne by allowing chapter 13 debtors to retain anticipated refunds from earned income tax credits.

Seventh Circuit Allows Anticipated Tax Refunds to Be Offset by Expenses in Chapter 13

Affirming Bankruptcy Judge Deborah L. Thorne on direct appeal, the Seventh Circuit held that a chapter 13 debtor can prorate an earned income tax credit in calculating disposable income and may offset the tax refund income with "reasonably necessary expenses to be incurred throughout the year."

The appeals court rejected the chapter 13 trustee's argument that the tax credit should be turned over in full to allow an extra payment to creditors, without deduction for any expenses.

The Poverty Level Debtor's $4,000 Tax Credit

A single mother of three children, the below-median income debtor had an annual income of about $30,000, well below the median income threshold of $87,000 in Chicago. Calculating projected monthly income, the debtor included a proration for her anticipated earned income tax credit of about $4,000 a year.

After several amendments to her schedules, the debtor proposed a 48-month plan paying her creditors $74 a month, an amount equal to her calculation of monthly disposable income. Creditors would receive a total of about $6,000. In other words, the plan would have paid creditors three or four times more were the tax refunds earmarked in full for creditors, without deduction.

In calculating disposable income, the debtor in substance included several one-time expenses that she could not incur or pay without using the earned income tax credit, such as buying beds for her sons, who were sleeping on air mattresses. The appeals court said that the additional expenses allowed the debtor to "retain some, or even all, of her tax credits."

Even with the extra income from the tax refund and the additional expenses, Judge Thorne found that the debtor had "a pretty skinny budget overall."

The chapter 13 trustee objected to confirmation, arguing that the debtor should turn over the entire amount of the earned income tax refund when received to fund additional payments to creditors.

Consolidating three chapter 13 cases raising identical issues, Judge Thorne overruled the objections and confirmed the debtors' plans in March 2017. Judge Thorne later certified an issue for direct appeal. The Seventh Circuit agreed to hear the direct appeal, saying there was no authority from the Supreme Court or the Seventh Circuit saying whether tax credits are disposable income.

Interestingly, the trustee and the debtor agreed that tax credits are disposable income. Prompting a dissent from one judge on the panel, the appeals court nonetheless went on to decide the next question: Can a debtor prorate tax credits to be offset by anticipated expenses?

The Seventh Circuit Opinion

In his March 22 opinion, Circuit Judge Joel M. Flaum agreed with the parties and held that tax credits are included in "currently monthly income," as defined in Section 101(10A)(A) and referred to in Section 1325(b)(1).

Nonetheless, Judge Flaum said that including tax credits within currently monthly income "does not mean that the debtor must pay the entire tax credit to the trustee as disposable income."

To retain some or all of the tax refunds, the trustee argued that the debtor must file a motion to amend the plan every time a refund comes in. Judge Flaum said that Judge Thorne rejected that idea "to alleviate the burdens that the motion-to-modify process imposes on trustees, debtors, and the court."

Judge Flaum likewise rejected the argument, relying on *Hamilton v. Lanning*, 560 U.S. 505 (2010), where the Supreme Court adopted a "forward-looking approach" and said that "the court may account for changes in the debtor's income or expenses that are known or virtually certain at the time of confirmation."

Judge Flaum said that Judge Thorne "properly allowed *Lanning* to calculate [the debtor's] projected disposable income," because her receipt of the tax credit refund was "virtually certain."

On the other hand, Judge Flaum said, the trustee's argument "is just another version of the rigid mechanical approach the Supreme Court rejected in *Lanning*." In contrast, Judge Thorne's approach of offsetting expenses against anticipated tax refunds "is exactly the kind of forward-looking approach that the Supreme Court endorsed in *Lanning*."

In a two-page opinion, Circuit Judge Daniel A. Manion concurred in part and concurred in the judgment, but not in a fashion undercutting the holding regarding the treatment of expenses to offset tax refunds.

Judge Manion said the circuit should not have accepted the case because the trustee and the debtor agreed on the issue that Judge Thorne certified for direct appeal. However, he concurred with the remainder of the opinion, holding "that the bankruptcy court did not abuse its discretion in overruling the trustee's objections to the debtor's chapter 13 plan." He would have expressed no opinion "on whether the earned income tax credit qualifies as income under the Bankruptcy Code" because there was "no adverse briefing on the issue and the resolution would not affect the outcome."

The opinion is *Marshall v. Blake*, 17-2809 (7th Cir. March 22, 2018).

'Value' doesn't mean 'present value' in Section 1325(b)(1)(A), Judge Lorch says.

Courts Split over Interest on Unsecured Claims in 100% Chapter 13 Plans

On an issue where the lower courts are about evenly divided, Bankruptcy Judge Basil H. Lorch, III of Evansville, Ind., ruled that a chapter 13 debtor who is not devoting all disposable income to the plan can confirm the plan by paying unsecured creditors in full, *without interest*.

The debtor would have disposable income of more than $80,000 over the course of the proposed five-year plan. Timely filed proofs of unsecured claims amounted to some $17,000, and payments under the plan would total about $51,000. Although the chapter 13 plan would pay unsecured claims in full, the debtor was not proposing to pay interest on unsecured claims.

The chapter 13 trustee objected to confirmation, contending that Section 1325(b)(1) requires interest on unsecured claims. The trustee argued that the statutory language in subsection (b)(1), "as of the effective date of the plan," modifies the word "value" in subsection (b)(1)(A) to mean that the plan must pay the present value of the claims and therefore includes interest.

Also relying on Section 1325(b)(1), the debtor contended that unsecured creditors are not entitled to interest. The debtor interpreted the quoted language as modifying both subsections (A) and (B) by specifying the date when the court must make the calculation.

Listing decisions coming down on both sides, Judge Lorch said in his September 13 opinion that the courts are "equally divided." The *Norton* and *Collier* treatises take opposite positions on the outcome, with *Collier* on the debtor's side.

Judge Lorch adopted the approach of Bankruptcy Judge Thomas L. Perkins of Peoria, Ill., in *In re Gillen*, 568 B.R. 74 (Bankr. C.D. Ill. 2017). To read ABI's discussion of *Gillen*, click here.

Like Judge Perkins, Judge Lorch believes that "as of the effective date of the plan" would have appeared immediately after "value" if Congress had intended for plans to pay the present value of unsecured claims.

Also like Judge Perkins, Judge Lorch observed that unsecured creditors in chapter 13 have no right to immediate payment at the beginning of the case, unlike secured creditors or even unsecured creditors in solvent chapter 7 cases.

Requiring interest on unsecured claims would produce an "anomalous result," Judge Lorch said, because Section 1322(a)(2) permits deferred payments on priority claims without interest.

The opinion is *In re McKinney*, 18-70417 (Bankr. S.D. Ind. Sept. 13, 2018).

Courts are also split on whether a five-year plan begins on confirmation or on the first chapter 13 plan payment.

Colorado Judge Differs with Two Circuits on Chapter 13 Payments Beyond Five Years

Disagreeing with the Third and Seventh Circuits, Bankruptcy Judge Elizabeth E. Brown of Denver held that the bankruptcy court lacks discretion to allow a final payment on a chapter 13 plan more than five years after the first plan payment.

A couple confirmed a chapter 13 plan obligating them to pay about $900 a month for five years. Less than a year after confirmation, the husband lost his job. The court approved a modified plan lowering the monthly payment to $10, with a proviso that the couple file amended schedules and an amended plan within 30 days after the husband got a new job.

When the husband was employed again, they informed their bankruptcy lawyer, but he had forgotten about the proviso.

After the couple completed their plan payments, the chapter 13 trustee remembered the proviso, analyzed their tax returns, and calculated a $17,000 shortfall had the couple amended the plan on time.

The debtors and the trustee agreed to a stipulation allowing the couple to pay off the $17,000 over several months after the final plan payment. Without advance approval from the court, the couple went ahead and paid the additional $17,000 so they could obtain a chapter 13 discharge.

In her Jan. 23 opinion, Judge Brown declined to approve the stipulation but converted the case to chapter 7, where the couple nonetheless may obtain a discharge.

Judge Brown tackled two major questions on which the courts are split. First, she was tasked with deciding when the clock on the five years begins to run. If the period begins with the first payment after confirmation, the $17,000 payment would have fallen within the five-year window and she would have approved the stipulation, giving them a chapter 13 discharge.

Unfortunately for the debtors, Judge Brown sided with those courts that start the clock running with the first payment after filing, thus causing the $17,000 payment to occur beyond five years.

If the five years begins running on the first payment after confirmation, debtors would be saddled with "additional burdens," Judge Brown said, because they would be making monthly payments for more than five years, since confirmation usually does not occur at the first

confirmation hearing. We recommend reading Judge Brown's opinion in full text to appreciate her reasoning for deciding that the clock begins running on the first plan payment after filing.

Judge Brown was therefore required to address the second question: Does the court have discretion to allow a final payment beyond five years?

The Third and Seventh Circuits have found discretion to allow a final payment after five years. *See In re Klaas*, 858 F.3d 820 (3d Cir. 2017); and *Germeraad v. Powers*, 826 F.3d 962 (7th Cir. 2016). For ABI's discussion of those cases, click here and here.

Judge Brown instead adopted the conclusions of the Tenth Circuit Bankruptcy Appellate Panel and several bankruptcy courts that do not permit payments outside of five years. Although Judge Brown was technically not bound by the Tenth Circuit BAP, ruling otherwise would have assured a reversal were she appealed.

Again, we recommend reading the opinion in full on the issue of discretion to make a late payment.

Even if she had sided with the circuit courts, Judge Brown said she would not have changed her ruling.

The debtors were not blameless, she said, because they made lower payments for three years after the plan should have been modified to increase the monthly payments. The debtors, she said, were "not directly culpable for this failure because they timely informed their attorney."

Nevertheless, she said, the clients "must be held accountable for the acts and omissions of their attorney."

Judge Brown also said she did not want to "send a message to other debtors that they are free to ignore plan requirements when it suits them and then cure the default . . . if discovered by the trustee or some other party."

The opinion is *In re Humes*, 11-39684, 2018 BL 35274 (Bankr. D. Colo. Jan. 23, 2018).

Lower courts split three ways on 401(k) contributions and the calculation of disposable income in chapter 13.

District Court Allows 401(k) Contributions in Chapter 13 Up to the IRS Limits

On an issue where there is a dearth of appellate authority, District Judge Elizabeth Erny Foote of Shreveport, La., sided with the majority of bankruptcy courts by holding that voluntary post-filing contributions to a 401(k) plan are not included in a chapter 13 debtor's calculation of disposable income so long as the contributions do not exceed the amounts allowed by the Internal Revenue Service.

The appeal demonstrates the obstacles that the Supreme Court erected in *Bullard v. Blue Hills Bank*, 135 S. Ct. 1686 (S. Ct. 2015), to appeals from orders denying confirmation of chapter 13 plans.

The husband and wife debtors filed a chapter 13 plan where the husband would make voluntary 401(k) contributions throughout the life of their five-year plan, deducting the payments from the calculation of disposable income in determining the amount to be paid to creditors. The bankruptcy judge denied confirmation, because the contributions represented 12% of the husband's gross income. However, the bankruptcy judge said he would confirm a plan with a 3% contribution.

The bankruptcy judge confirmed the plan after the debtors amended their plan by reducing the 401(k) contribution to 3%. The debtors then appealed confirmation of their own plan. The debtors could not appeal from denial of their first plan because *Bullard* holds that denial of confirmation is not a final order.

Reversing the bankruptcy court's limitation on retirement plan contributions in her May 23 opinion, Judge Foote meticulously laid out the legislative quagmire on the question of whether 401(k) payments can be deducted from the calculation of disposable income in Section 1325(b)(2)(A). Statutory interpretation is further complicated by the hanging paragraphs added to Section 541(b)(7) by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.

Courts have three answers to this question. Judge Foote said that a majority allow debtors to shelter contributions not exceeding the limits allowed by the IRS. A second group of courts do not allow deductions for retirement plans, and the third permits contributions not larger than the debtor was making before filing.

Judge Foote followed the majority approach, because she read the plain meaning of the statute as demonstrating "that Congress intended to exclude retirement contributions from available disposable income as defined by the code in Section 1325(b)."

Judge Foote had another holding of significance for debtors, stemming from the bankruptcy judge's finding that the plan was not filed in good faith given the size of the retirement plan contributions.

Judge Foote held that "the amount contributed by a debtor within the legal limits established by the Internal Revenue Service cannot be the sole basis for determining that a plan has been filed in bad faith." She remanded the case for the bankruptcy judge to make a redetermination of good faith based on the appropriate Fifth Circuit standard.

We recommend reading the opinion in full text for Judge Foote's thoughtful analysis of the statute and case law on all sides of the issue. The opinion is available at 2018 U.S. Lexis 86761 or 2018 BL 183240.

Editorial comment: Now that traditional employer-sponsored pensions are rapidly disappearing and being replaced by 401(k)s, courts that effectively prohibit or limit voluntary pension contributions are sentencing debtors to poverty in their retirements. This writer doubts that Congress intended for the effects of chapter 13 to persist so long after the completion of plan payments. (The foregoing commentary reflects the opinion of the writer, not ABI.)

The opinion is *Miner v. Johns*, 17-879 (W.D. La. May 23, 2018).

Valuation

Fifth Circuit notches a victory for chapter 13 debtors retaining mobile homes.

Valuation of a Retained Mobile Home Does Not Include Delivery and Setup Costs

The costs of delivering and setting up a mobile home to be retained by a debtor under a chapter 13 plan "must be excluded from the mobile home's valuation under Section 506(a) of the Bankruptcy Code," according to the Fifth Circuit.

The chapter 13 plan promised to pay the secured value of the mobile home over the life of the plan plus 5% interest. To determine value for cramdown under Sections 1325 and 506(a), the lender argued that the bankruptcy court should include $4,000 in costs that would be incurred in delivering the house to the site, along with expenses in blocking, leveling and anchoring the house as required by state law.

Relying on the Supreme Court's decision in *Associates Commercial Corp. v. Rash*, 520 U.S. 953 (1997), the bankruptcy court overruled the lender's objection to confirmation and held that the valuation should not include delivery and setup costs. The district court affirmed, prompting the lender to appeal a second time.

In her opinion on August 13, Circuit Judge Jennifer Walker Elrod upheld the lower courts. The debtor did not submit a brief, but the U.S. Trustee supported the bankruptcy judge's decision.

The case was governed by Section 506(a)(1) and (a)(2). The former provides that a secured claim is allowed "to the extent of the value of such creditor's interest in the estate's interest in such property." It goes on to say that such "value shall be determined based on the purpose of such valuation and of the proposed disposition or use of such property."

Subsection (a)(2), added by the BAPCPA amendments in 2005, provides that the value of personal property "shall be determined based on the replacement value of such property . . . without deduction for costs of sale or marketing."

Quoting *Rash*, Judge Elrod said that the "'proposed disposition or use' of the collateral is of paramount importance." *Id.* at 962. Rejecting an argument proffered by the lender, she held that subsection (a)(2) "should not be construed to the exclusion of" subsection (a)(1).

Judge Elrod also attached significance to footnote 6 in *Rash*, where Justice Ginsburg said, "A creditor should not receive portions of the retail price, if any, that reflect the value of *items the debtor does not receive* when he retains his vehicle, items such as warranties, inventory storage,

and reconditioning." *Id.* at 965. [Emphasis added.] Judge Elrod also said that the later addition of subsection (a)(2) in the BAPCPA amendments "does not conflict with *Rash*."

Weaving the principles together, especially the idea that setup and delivery costs were not services the debtor would receive, Judge Elrod held that "delivery and setup costs of a mobile home retained by a debtor must be excluded from the mobile home's valuation under Section 506(a)." She said the U.S. Trustee correctly argued that delivery and setup costs are not costs of sales or marketing but, instead, are additional costs like sales taxes and service agreements.

Judge Elrod said her holding "accords with the determination of all courts that have addressed the issue." The lender could cite "no caselaw to the contrary," she said.

The opinion is *21st Mortgage Corp. v. Glenn (In re Glenn)*, 17-60533 (5th Cir. Aug. 13, 2018).

Compensation

In the Fifth Circuit, chapter 7 trustees lock in higher compensation.

Fifth Circuit Holds that Chapter 7 Trustees Presumptively Get Statutory Commissions

The Fifth Circuit sided with the Seventh by holding that the statutory commission for a chapter 7 trustee in Section 326(a) is presumptively reasonable and must be allowed by the bankruptcy court except in exceptional circumstances that "should be a rare event."

Since the 2005 BAPCPA amendments to Section 330, Circuit Judge Leslie H. Southwick said in his Jan. 26 opinion that two approaches have developed regarding the allowance of commissions for a chapter 7 trustee. Led by the Seventh Circuit, some courts, he said, hold that the sliding-scale commissions in Section 326(a) are "not simply a maximum but also a presumptively reasonable fixed commission." Some of those courts nonetheless say that the commission can be adjusted in "extraordinary circumstances."

Other courts do not view the commission rate as presumptively reasonable but allow compensation, functionally speaking, after applying the "reasonableness" standards in Section 330(a)(3).

Judge Southwick explained that the 2005 amendments removed a chapter 7 trustee from the professionals explicitly subject to the Section 330(a)(3) factors. Those standards still apply to chapter 11 trustees and other professionals.

Although Section 330(a)(1)(A) still says that a trustee must be allowed "reasonable compensation" for "actual, necessary" services, the BAPCPA amendments also added Section 330(a)(7), which provides that in "determining the amount of reasonable compensation to be awarded to a trustee, the court shall treat such compensation as a commission, based on Section 326."

While Judge Southwick did not say so, the amendments generally were viewed as ensuring that a trustee in a lucrative case would receive the maximum commission to make up for "no asset" cases entailing nothing more than the $60 flat fee under Section 330(b).

Judge Southwick decided to follow the Seventh Circuit, believing that the amendments established a "commission-based award" as opposed to the "compensation-based awards" granted pre-BAPCPA. To continue fixing "reasonable" compensation after BAPCPA, he said, would give "little practical effect to the amended language."

Judge Southwick held, "Section 330(a)(7) therefore treats the commission as a fixed percentage, using Section 326 not only as a maximum but as a baseline presumption for reasonableness in each case."

He recognized that "Section 330 still allows a reduction or denial of compensation," but only in a "rare event" where "'exceptional' is the key."

The opinion is *LeJeune v. JFK Capital Holdings LLC (In re JFK Capital Holdings LLC)*, 16-31151, 2018 BL 27630 (5th Cir. Jan. 26, 2018).

Ethical issues abound when a committee counsel's own financial interest conflicts with its client's interests.

Ninth Circuit Requires Explicit Objection to Avoid Forfeiting an Appeal

Ostensibly to avoid a conflict with its own client, the attorneys for a creditors' committee forfeited the right to appeal because the firm did not explicitly lodge an objection on its own behalf to a structured dismissal that left the estate with nothing to pay fees.

In an opinion on July 25, the Ninth Circuit expounded on a circuit split the appeals court had widened on May 29 in deciding *Harkey v. Grobstein (In re Point Center Financial Inc.)*, 890 F.3d 1188 (9th Cir. May 29, 2018); rehearing and rehearing *en banc* denied July 12, 2018. To read ABI's discussion of *Point Center*, click here.

The proposed settlement before the Ninth Circuit in the new appeal may have been defective under *Czyzewski v. Jevic Holding Corp*., 137 S. Ct. 973 (2017). To lodge and preserve a *Jevic* objection, counsel for the committee might have been required first to withdraw as attorneys for the creditors, then oppose a transaction that was beneficial to its former clients. Laudably more loyal to unsecured creditors than to its own financial interest, the committee's counsel did not withdraw and did not object on their own behalf, thus losing the ability to appeal, according to the Ninth Circuit.

The New Ninth Circuit Case

A chapter 11 trustee had been appointed for a corporate debtor that owned valuable real estate. The trustee negotiated a so-called structured dismissal where the lender would take title to the property in exchange for secured debt. The lender agreed to carve out $150,000 for distribution to unsecured creditors and another $350,000 to pay the trustee and his professionals.

With dismissal the eventual result, the estate would have nothing to pay other chapter 11 administrative expenses, such as fees earned by counsel for the debtor and the committee. The $350,000 was couched as a surcharge against the lender's collateral under Section 506(c). By skipping over administrative claimants, the $150,000 payment to unsecured creditors had no similar statutory justification.

The bankruptcy court approved the sale before the Supreme Court handed down *Jevic*.

At the hearing to approve the sale, counsel for the debtor and committee filed objections for their clients. However, the firms did not file written objections on their own behalf. At the hearing,

both firms stated that they were representing their clients and never said they objected to the sale in their own right as administrative creditors.

After the bankruptcy court approved the sale, the two firms filed notices of appeal on their own. No appeal was filed on behalf of the debtor or the committee. There being no stay pending appeal, the sale closed.

On a first appeal, the district court dismissed the appeal, finding that the two firms did not have standing because they had not appeared and objected on their own in bankruptcy court.

Point Center

While the appeal was pending from the district court's dismissal, the Ninth Circuit decided *Point Center*. On a circuit split, the Ninth Circuit took the side holding that attendance or objection are not prerequisites to being an aggrieved person with standing to appeal. Although the appellant had standing, the Ninth Circuit held in *Point Center* that the appellant's failure to object in bankruptcy court nevertheless could result in waiver or forfeiture. The circuit court remanded the case for the lower courts to determine whether the appellant had forfeited the right to appeal.

Forfeiture Found in the New Case

On the question of whether the firms had forfeited their right to appeal, the opinion for the Ninth Circuit by Sixth Circuit Judge John M. Rogers, sitting by designation, said that neither firm had "explicitly objected" to the sale in bankruptcy court. Ordinarily, he said, the circuit would remand for the lower court to determine whether there was forfeiture.

According to Judge Rogers, the case at hand was "unusual" because the elements of forfeiture had been thoroughly briefed and argued, albeit in the context of "attendance and objection" in bankruptcy court. The record, he said, was therefore "sufficient" for deciding whether there had been forfeiture.

Although the bankruptcy court on its own was concerned with how other administrative claims would be paid, Judge Rogers said there was no "clear indication" at the approval hearing that the two firms were appearing or objecting on their own behalf. He said there was a "total failure to inform the bankruptcy court that they intended to pursue their own interests."

Despite the bankruptcy judge's concern that committee counsel would not be paid, Judge Rogers said that the "contextual evidence . . . is simply not enough to undo what the record makes clear: the law firms were at the hearing and objecting on behalf of their clients."

Avoiding a conflict was also used against the committee's counsel. Like the district court, Judge Rogers doubted that the committee's counsel would have created a conflict with its own

client by raising an objection that the money earmarked for unsecured creditors instead should be applied to chapter 11 administrative expenses. The "logical conclusion," Judge Rogers said, was that the firm was appearing and objecting only on behalf of the committee, which believed that the sale price was too low.

For Judge Rogers, the dispositive fact was the lack of "any evidence" that someone appeared or objected in bankruptcy court on behalf of the firms or "otherwise informed the bankruptcy court" that someone was representing the two firms.

Having decided that the firms forfeited their objection, Judge Rogers added belt and suspenders by reaching the merits and finding no clear error by the bankruptcy court in ruling that the trustee and his professionals were entitled to payment under Section 506(c), which allows a surcharge against a lender's collateral. He also ruled that the settlement was in the best interests of unsecured creditors because the trustee had been unsuccessful in selling the property to anyone aside from the secured lender.

The Unresolved *Jevic* Question

Were the committee's counsel oblivious to a conflict with its own clients, the firm could have argued that earmarking for unsecured creditors violated the principle that *Jevic* later ratified.

Here are ethics questions that are left unresolved: (1) During negotiations on the sale, how could the committee's counsel have avoided an ethical problem by negotiating on the firm's own behalf and seeking to redirect some or all of the $150,000 to the payment of administrative expenses?; (2) Since the committee was objecting to the sale price as inadequate, could the firm have objected on *Jevic* grounds without violating an ethical obligation?; (3) After the deal was struck, could the firm have withdrawn as counsel for the creditors' committee before the approval hearing and opposed a settlement that was beneficial to its own former client? (N.B.: The bankruptcy judge, according to Judge Rogers, refused to allow committee counsel to withdraw alongside filing an appeal.); and (4) Did appealing violate an ethical obligation to the committee?

The opinion is *Reed & Hellyer APC v. Laski (In re Wrightwood Guest Ranch LLC)*, 16-56856 (9th Cir. July 25, 2018).

Courts split on allowing compensation to a chapter 7 trustee when the case is converted to chapter 13 before distributions were made.

Chapter 7 Trustee Is Paid in a Case Converted to Chapter 13

Courts are split on whether a chapter 7 trustee earns a fee if the case converts to chapter 13 before the trustee makes distributions.

In a case pending before Bankruptcy Judge Elizabeth D. Katz of Springfield, Mass., the chapter 7 trustee and his counsel ran up some $12,000 in time charges investigating the debtor's potentially nonexempt assets. Before the trustee collected any assets or made any distributions, the debtors converted the case to chapter 13 over the trustee's objection.

The trustee sought an allowance of compensation for himself and his attorneys as an expense of administration in the chapter 13 case. Although not contesting the reasonableness of the fees, the debtor argued that the trustee was not entitled to compensation under Section 326(a).

"In a case under chapter 7 or 11," that section provides that the court "may allow reasonable compensation under section 330 . . . for the trustee's services not to exceed" a sliding scale that begins at 25% and shrinks to 3% "upon all moneys disbursed or turned over in the case by the trustee . . . ."

The courts are split, Judge Katz said. A majority allow reasonable compensation based on *quantum meruit* for pre-conversion work. More recently, she said, courts are shifting away from *quantum meruit* and disallowing compensation under Section 326(a) if the trustee has made no disbursements.

Judge Katz took a different tack. She did not read Section 326(a) as precluding an award of compensation in a converted case. The section, she said, "is explicitly reserved for limiting trustee compensation '*[i]n a case under chapter 7 or 11*.'" [Emphasis in original.]

Judge Katz therefore allowed the full amount of compensation sought by the trustee because the debtor had only objected under Section 326(a).

The opinion is *In re Bartlett*, 18-30060 (Bankr. D. Mass. Sept. 19, 2018).

Section 502(b)(4) shields debtors from overreaching lawyers in a new context.

Bankruptcy Judge Regulates the Unregulated Debt-Reduction Service Industry

A bankruptcy judge on Long Island, N.Y., interpreted Section 502(b)(4) to mean that a debt-reduction service provider ordinarily will not have an allowable claim based on the client's outstanding debt when the client files bankruptcy.

Bankruptcy Judge Robert E. Grossman of Central Islip, N.Y., described the debt-reduction service business as a "rapidly growing" industry "with little to no regulation" that serves clients who are "often unsophisticated, have limited means, and are facing severe financial hardship."

The service provider filing a claim in the case before him was a licensed attorney who, according to Judge Grossman, was "operating in a professional manner."

The husband and wife clients, who later filed a chapter 13 petition, came to the service provider with about $125,000 in unsecured debt. Among other things, the written agreement called for the clients to pay 39% of any negotiated debt reductions and a 20% flat fee based on total outstanding debt if the agreement were terminated.

Over 13 months before bankruptcy, the service provider took $1,450 a month from the debtors' bank account. The payments, totaling $18,850, covered the $2,900 flat fee for setting up the account plus a 39% contingency fee of $5,339 for debt reductions that were negotiated before bankruptcy. The service provider had applied the remainder toward the payment of claims that were settled.

The clients filed bankruptcy a month after terminating the agreement. The service provider filed a claim for about $17,250, representing the 20% contingency fee that was due on termination based on outstanding debt. The service provider conceded that he had been paid in full for the negotiated debt reductions.

The debtors objected to the claim because they were proposing a 100% plan. Judge Grossman sustained the objection in his May 18 opinion and expunged the claim in its entirety, nonetheless recognizing that the court must be "sensitive to the rights attorneys have to enter into a written agreement."

Judge Grossman did not reach the issue of whether the fee arrangement was enforceable under state law or whether it was an unenforceable penalty.

Instead, he said the controversy was governed by Section 502(b)(4), which disallows a claim "for services of an . . . attorney of the debtor, [if] such claim exceeds the reasonable value of such services."

Judge Grossman reasoned that the "reasonable value" of service in Section 502(b)(4) should be measured "under both a federal standard and under state rules of professional conduct." Because the debtors had filed a legally sufficient claim objection, he said the burden shifted to the creditor to prove that the amount of the claim was reasonable.

Since the creditor had been fully compensated for services provided to the debtors before filing, Judge Grossman said he could "think of no scenario where a $17,248.03 flat fee for termination, in addition to the guaranteed minimum fee already paid, would constitute reasonable value for debt reduction services for unsettled debts."

Judge Grossman said his conclusion "furthers the stated purpose" of Section 502(b)(4) "to prevent overreaching by attorneys to the detriment of unsecured creditors in bankruptcy." The result, he said, "also protects the unsophisticated debtor facing severe financial hardship."

The opinion is *In re Regino*, 16-74352 (Bankr. E.D.N.Y. May 18, 2018).

Split grows on whether 'substantial contribution' claims are limited to chapters 9 and 11.

"Substantial Contribution" Claim Allowed in Chapter 13

Swimming against the tide and deepening a split of authority, courts in Michigan granted an administrative claim to a creditor for making a "substantial contribution" in a chapter 13 case, when Section 503(b)(3)(D) only explicitly authorizes claims of that type in chapters 9 and 11.

As retained counsel for a chapter 7 trustee, a law firm objected to an exemption claimed by husband and wife debtors in annuities worth about $100,000. Before the objection was adjudicated, the debtors converted the case to chapter 13. The firm was not retained in the chapter 13 case.

When the chapter 13 trustee didn't pursue the objection, the law firm did. Ultimately, the bankruptcy court disallowed the exemption. As a result, the debtors were forced to amend their plan and provide for 100% payment to unsecured creditors.

The law firm then sought allowance of an administrative claim for having made a substantial contribution to the chapter 13 case.

The bankruptcy court in Michigan allowed the "substantial contribution" claim in the amount of about $23,000 for the lawyers' work during the chapter 13 case, relying on *Mediofactoring v. McDermott* (*In re Connolly North America LLC*), 802 F.3d 810 (6th Cir. Sept. 21, 2015), where the Sixth Circuit held that bankruptcy courts have discretion to allow an administrative claim to a creditor in chapter 7 who made a substantial contribution.

On appeal, the debtors argued it was error to allow a "substantial contribution" claim in chapter 13, because Section 503(b)(3)(D) only explicitly authorized allowance of an administrative claim for making a "substantial contribution in a case under chapter 9 or 11 of this title." The debtors also contended that *Mediofactoring* was not controlling because that case involved chapter 7, and they were in chapter 13.

Relying on *Mediofactoring*, District Judge Paul D. Borman of Detroit rejected the debtors' arguments in an opinion on Nov. 15 and upheld the bankruptcy court's allowance of a "substantial contribution" claim.

Mediofactoring, according to Judge Borman, stands for the proposition that use of the word "including" in Section 503(b) "confers discretion on a bankruptcy court to award administrative expenses on a case-by-case basis, and that the express mention of Chapter 9 and Chapter 11 in

Section 503(b)(3)(D) does not negate that fact." He also said, "Nothing about the statutory interpretation in [*Mediofactoring*] is unique to the Chapter 7 context."

Judge Borman said that a "substantial contribution" claim is allowable outside of chapters 9 and 11 depending upon "the totality of the pertinent facts, and the relevant equitable considerations."

There was "no question," Judge Borman said, that the law firm conferred a substantial benefit because creditors stand to recover 100% as a result of disallowance of the exemption claim. Because the chapter 13 trustee did not object to the exemption, the lawyers benefitted the estate when no one else was willing to do so.

Judge Borman also rejected the argument that *Lamie v. U.S. Trustee*, 540 U.S. 526, 124 S. Ct. 1023, 157 L. Ed. 2d 1024 (2004), bars allowance of the administrative claim. There, the Supreme Court held that Section 330(a)(1) precludes allowance of compensation to a debtor's counsel from estate funds if the attorneys were not retained under Section 327.

Lamie, Judge Borman said, dealt with payment of compensation under Section 330(a)(1), while the case before him was based on Section 503(b), "a different statutory provision entirely." He said there was no authority for the notion that *Lamie* "has anything to do with Section 503(b)(3)(D)."

Recently, a bankruptcy court in California followed *Mediofactoring*, joined the minority, disagreed with the Third Circuit, declined to follow its own Bankruptcy Appellate Panel, and found discretion to allow a "substantial contribution" claim in chapter 7. *In re Maqsoudi*, 566 B.R. 40 (Bankr. C.D. Cal. April 3, 2017). For ABI's discussion of *Maqsoudi*, click here. To read about *Mediofactoring*, click here.

The opinion is *Sharkey v. Stevenson & Bullock PLC (In re Sharkey)*, 17-11237, 2017 BL 409909 (E.D. Mich. Nov. 15, 2017).

Exemptions

Fourth Circuit avoids a result that would have left some debtors ineligible for any exemptions.

Three Circuits Approve Extraterritorial Application of a State's Exemptions

Joining the Eighth and Ninth Circuits and handing down another debtor-friendly opinion, the Fourth Circuit cleaned up some of the mess that Congress made in Section 522(b)(3)(A) regarding exemptions claimed by individuals who change their domicile before filing bankruptcy.

The May 4 opinion by Circuit Judge Robert B. King rejected plausible interpretations of the statute that could leave some debtors ineligible for any exemptions, state or federal.

The debtor moved to West Virginia from Louisiana four months before filing bankruptcy. Utilizing Louisiana's exemption statute, he claimed exemptions for about $3,500 of personal property located in West Virginia.

The trustee objected to the exemptions, contending that Louisiana exemptions could not be applied extraterritorially in view of the Supreme Court's presumption against extraterritoriality. The bankruptcy court allowed the exemptions and was upheld on appeal by District Judge Irene M. Keeley of Clarksburg, W.Va.

Again upholding the exemptions in the circuit court, Judge King characterized Judge Keeley's opinion as "well reasoned" and "comprehensive." To read ABI's discussion of Judge Keeley's opinion, click here.

The Statutory Mess

Attempting to prevent abuse, Congress made a hash out of Section 522(b)(3)(A) and compounded the problem by adding the so-called hanging paragraph, which, Judge King said, "has been the subject of some dispute in the bankruptcy courts."

Generally, a debtor is eligible for exemptions in the state where the debtor had been domiciled for 730 days before bankruptcy. To deter exemption shopping by people who would move within two years before bankruptcy to take advantage of another state's more generous exemptions, Section 522(b)(3)(A) provides that the debtor must take exemptions from the state where he or she resided for the largest part of the 180-day period before the 730-day period.

The statute had a problem, however, because Section 522(b)(3)(A) would leave some debtors eligible for no exemptions. To fill the gap, Congress added the hanging paragraph, which allows

the debtor to claim federal exemptions specified in Section 522(d) if (b)(3)(A) makes a debtor ineligible for any state's exemptions.

The Case at Hand

The trustee conceded that the debtor could invoke Louisiana exemptions under Section 522(b)(3)(A) for property located in Louisiana. However, the trustee disputed the claim for exemptions covering the debtor's property in West Virginia, even though Louisiana does not limit the application of its exemptions to Louisiana residents or to property in Louisiana.

The trustee argued for the presumption against extraterritoriality, also known as the anti-extraterritoriality approach, under which a bankruptcy court may not give extraterritorial effect to any state's exemption laws. His theory would have precluded the debtor from using Louisiana law to exempt property in West Virginia.

The Fourth Circuit's Analysis

Judge King said that "almost all courts" have rejected the trustee's theory because it "would lead to nonsensical results." An example: Debtors who move would be ineligible for exemptions because they likely would have no property in their former domicile, the only state in which they could have exemptions under the anti-extraterritoriality approach. Judge King said that the only bankruptcy court to adopt this theory was "promptly overturned on appeal."

The second minority view, called the preemption approach, would permit a debtor to apply a state's exemption laws to nonresidents and out-of-state property, even if state law does not allow extraterritorial effect. Like Judge Keeley, Judge King rejected the idea. If "Congress had intended to override state laws limiting the use of exemption schemes to in-state residents or in-state property, it would not have placed the hanging paragraph in Section 522(b)(3)," he said.

The preemption approach, he said, would make the hanging paragraph applicable only to debtors who had resided in foreign countries.

Judge King adopted the so-called state-specific approach, which is followed by the Eighth and Ninth Circuits and a majority of courts. He said it best embodies congressional intent and the bedrock principle that "exemptions are entitled to the most liberal construction in favor of the debtor."

Judge King said there were no principles of Louisiana law that would bar out-of-state debtors from utilizing Louisiana's exemption statute. He also rejected the trustee's reliance on the Supreme Court's presumption against extraterritoriality.

Citing Fourth Circuit precedent, Judge King said that the presumption does not apply to conduct that occurs largely within the U.S. Therefore, he allowed the debtor to rely on Louisiana law and exempt property in West Virginia.

A Proposal to 'Fix' Section 522

In the circuit court, *pro bono* co-counsel for the debtor was Eugene Wedoff, the immediate past president of American Bankruptcy Institute and a former bankruptcy judge in Chicago.

In a message to ABI, Judge Wedoff said that "Section 522 is very much in need of a Congressional 'fix.'"

Judge Wedoff believes that Congress should "make the debtor immediately subject to the exemption law of the state to which a debtor has moved, but cap the homestead exemption and perhaps other very large exemptions for two years after the move at the level set by the debtor's former state of domicile."

Judge Wedoff said that his proposal would "eliminate the 'millionaire's loophole' that Congress was concerned about in BAPCPA without creating the confusion caused by applying a state's exemptions to debtors who are no longer domiciled in that state."

The "simplest fix," Judge Wedoff said, would be "a set of uniform federal exemptions, but that is very unlikely to be politically possible."

The opinion is *Sheehan v. Ash*, 17-1867 (4th Cir. May 4, 2018).

Selling a home after filing chapter 7 does not destroy the homestead exemption.

Fifth Circuit Expands *Hawk* to Permit Sale of a Home After a Chapter 7 Filing

In *Hawk v. Engelhart (In re Hawk)*, 871 F.3d 287 (5th Cir. Sept. 5, 2017), the Fifth Circuit held that property in an exempt individual retirement account on the filing date does not lose its exempt status if it is converted to nonexempt property after the filing of a chapter 7 petition. In other words, the snapshot rule is a shield for the debtor, not a sword in the hands of a trustee.

In a March 7 opinion, the Fifth Circuit expanded *Hawk* to cover homesteads, thus allowing a chapter 7 debtor to sell a home after filing but not lose the exemption even if the proceeds were not reinvested in another house.

The debtor, who waived his discharge, owned a home in Texas on the filing date. There were no objections to the claimed homestead exemption. With the bankruptcy court's approval seven months after filing, the debtor sold his home for $364,000, but he did not reinvest the proceeds in another home within the six-month window in Texas for maintaining an exemption in the proceeds. Instead, the debtor used the proceeds to pay some of his debts.

The chapter 7 trustee mounted an adversary proceeding against the debtor and the recipients of the proceeds, contending that the proceeds belonged to the estate because they lost their exempt status six months after the sale.

The bankruptcy judge ruled that the proceeds were exempt because the home was exempt on the filing date. The district court reversed before the Fifth Circuit decided *Hawk*, and the debtor appealed.

In the Fifth Circuit, the trustee argued that *Hawk* was inapplicable because that case involved a retirement account, not a homestead.

In a *per curiam* opinion on March 7, the Fifth Circuit reversed the district court and reinstated the judgment of the bankruptcy court dismissing the trustee's lawsuit. The Fifth Circuit saw "no reason why *Hawk*'s analysis should not also apply to Texas's homestead exemption." The court said that the "proceeds" rule under the Texas exemption statute "expands rather than limits the scope of the exemption."

In terms of policy, the circuit court said that fixing the exemption once and for all on the filing date avoids "the uncertainty that the trustee's position would inject into the large number of chapter 7 cases that bankruptcy courts confront."

In *Hawk*, the three-judge panel on the Fifth Circuit granted rehearing and set aside the opinion it had filed only seven weeks earlier. To read ABI's discussion, click here.

The opinion is *Lowe v. DeBerry (In re DeBerry)*, 17-50315 (5th Cir. March 7, 2018).

Splitting with the Sixth Circuit, the Tenth Circuit BAP does not require equity to claim a homestead exemption.

Homestead Exemption Must Be Paid in Full Before a Sale Is Permitted, BAP Says

Laying the groundwork for a split of circuits, the Tenth Circuit Bankruptcy Appellate Panel built on *Czyzewski v. Jevic Holding Corp*., 137 S. Ct. 973 (2017), and *Law v. Siegel*, 134 S. Ct. 1188 (2014), by holding that a chapter 7 trustee cannot scheme with secured creditors to sell a home out from underneath a debtor without paying the homestead exemption in full, even when there is little or no equity in the property above secured debt.

If there is another appeal and the Tenth Circuit rules the same way, there will be a split with the Sixth Circuit on the question of whether a debtor can claim a homestead exemption without having any equity in the property. A split would also enable the Supreme Court to decide whether a trustee can sell a home without paying a homestead exemption in full.

Unless the Sixth Circuit reverses course or the Supreme Court takes up the issue, individuals who file chapter 7 petitions in four states are at risk of losing their homes even if the sale price will not pay their exemptions in full. Homeowners in six states are shielded from the same fate unless the Tenth Circuit reverses the BAP.

The Trustee's Scheme to Generate Fees at the Debtor's Expense

In two chapter 7 cases filed about the same time, the debtors each owned homes, which they scheduled as having values somewhat less than the sum of mortgages and tax liens on the properties. The debtors claimed homestead exemptions, however.

The trustee appointed in both cases found buyers who were offering to pay about $5,000 more than the encumbrances on both properties. The trustee also negotiated a stipulation with the Internal Revenue Service where the government consented to the sale of the properties and agreed to carve out $10,000 in each case for distribution to unsecured creditors. In addition, the IRS agreed to a further $60,000 reduction in the government's recovery on its tax liens in each case by allowing the trustee to pay his fees and the real estate broker's commissions from the sale proceeds.

If the sales had been approved, the debtors would have received nothing for their homestead exemptions, while the trustee and broker together would have taken home more than $60,000 for their services in each case. Unsecured creditors would have recovered only $10,000 in each case.

For the debtors, the proposed deal was worse than simply losing their homes without anything for their homestead exemptions. The government's agreement to carve out $10,000 for unsecured creditors and allow payment of the fees would have increased the debtors' nondischargeable tax debts and left them with no equity to apply toward the purchase of new residences.

The future looking bleak, the debtors both prevailed on the bankruptcy judge to convert their cases to chapter 13. Conversion mooted the trustee's incipient sale motions. In both cases, the bankruptcy judge upheld the debtors' homestead exemptions, over the trustee's objections. The conversion to chapter 13 mooted the trustee's appeals from the homestead exemption rulings.

Following conversion, the chapter 7 trustee filed applications for allowances of more than $30,000 in compensation in each case for himself and his counsel. In an encyclopedic opinion on Dec. 14, 2016, Chief Bankruptcy Judge R. Kimball Mosier of Salt Lake City ruled that a trustee cannot sell an individual debtor's home without paying the homestead exemption in full, in cash.

Citing Section 330(a)(4)(A), Judge Mosier denied the fee applications because the trustee's services were not necessary, did not benefit the estate, and "could work a substantial harm on the debtors if they were approved." In substance, he explained why he would not have approved the sales had the debtors not converted the cases to chapter 13. To read ABI's discussion of Judge Mosier's opinion, click here.

The trustee appealed to the Tenth Circuit BAP but lost again in a Nov. 30 opinion by Bankruptcy Judge Sarah A. Hall. The BAP reached the same result in barring a trustee from selling overencumbered property, albeit on somewhat narrower grounds than Judge Mosier.

Abandon, Don't Sell Without Equity

To determine whether the trustee was entitled to compensation, Judge Hall analyzed Section 330(a)(4)(A), which bars the allowance of compensation if the services "were not reasonably likely to benefit the debtor's estate [or] necessary to the administration of the case."

Regarding the necessity of the trustee's services, Judge Hall held that "abandonment of the homesteads would have better comported with a chapter 7 trustee's ultimate duties and responsibilities." The Bankruptcy Code, abundant caselaw, and the *Handbook for Chapter 7 Trustees* promulgated by the Office of the U.S. Trustee Program "emphatically" supported the bankruptcy court's decision, Judge Hall said.

Judge Hall cited the *Handbook* for the proposition that a trustee should abandon property when liquidation would not produce a "meaningful" distribution for unsecured creditors. Similarly, she cited caselaw holding that a sale of fully encumbered property is generally prohibited, to prevent trustees from generating fees for themselves in a sale that produces nothing for unsecured creditors.

With regard to the Bankruptcy Code, Judge Hall said that equity for unsecured creditors "is what authorizes a trustee to exercise his powers of sale under Section 363 in the first place, because liquidation should not be for the benefit of the estate's secured creditors." Although a carve-out for unsecured creditors might be appropriate in some circumstances, she said that an agreement with a secured creditor to create equity "is suspect and presents opportunities for collusion."

Since the proposed sale would have benefitted primarily the trustee and secured creditors, Judge Hall concluded that the services were not necessary in the administration of the estates.

Again unsuccessfully, the trustee contended that his services were nonetheless reasonably likely to benefit the estate.

On that issue, Judge Hall said that the bankruptcy court's finding of lack of benefit to the estate was not reversible error, "regardless of whether its legal determinations were correct or incorrect."

The trustee argued that his services benefited the estate, based on the notion that the debtors lacked equity and were not entitled to homestead exemptions.

Under Utah and federal law, exemptions must be liberally construed in favor of debtors, Judge Hall said. Under Utah law, she said that debtors are entitled to homestead exemptions even if they have no equity in their homes. The exemption, she said, arises from title and possession, although the exemption is limited in dollar amount.

Therefore, the trustee was not entitled to compensation under Section 330(a)(4)(ii) because there was no benefit to the estate, since the trustee should have abandoned the properties.

The trustee also argued there could have been benefit to the estate because he could have sold the properties under Section 363(f).

There was no *bona fide* dispute, and therefore no ability to sell under Section 363(f)(4), because, Judge Hall said, the bankruptcy court had upheld the debtors' homestead exemptions, among other things.

Similarly, there was no right to sell under Section 363(f)(5), which would have applied were the debtors compelled to accept monetary satisfaction for their interests.

The Utah exemption statute does not permit a sale unless the price would pay the exemption in full. The trustee therefore could not have sold under Section 363(f)(5), thus shutting the door to the idea that the trustee could have conferred benefit on the estate.

Judge Hall upheld the denial of all the trustee's requested fees by saying it made "no sense whatsoever to sell the homesteads and incur administrative expenses [of about $60,000 in each

case] in order to get only $10,000 to unsecured creditors and at the same time deny debtors their homesteads."

"All bankruptcy professionals," she said, "must exercise billing judgment."

Significant Circuit Splits in the Offing

If the trustee appeals again and if the Tenth Circuit affirms, there will be a split of circuits on two major issues.

In *Brown v. Ellmann (In re Brown)*, 851 F.3d 619 (6th Cir. March 20, 2017), the Sixth Circuit decided a strikingly similar case with a diametrically opposite result. In *Brown*, the debtor had owned an overencumbered home, but she did not initially claim a homestead exemption. Instead, she originally signaled her intention to surrender the house.

The trustee in *Brown* cobbled together a deal to sell the home for less than the first mortgage. The first mortgagee agreed to take a haircut on the senior mortgage, carve out $6,000 for the second mortgagee, and leave a small surplus for unsecured creditors. The debtor later claimed an exemption and opposed the sale, unsuccessfully.

The Sixth Circuit upheld the sale, holding that the debtor was not entitled to claim a homestead exemption under Michigan without equity in the property. Aside from the distinction that the two cases arose under the exemption laws of different states, the Tenth Circuit BAP split with the Sixth Circuit on the validity of a homestead exemption in the absence of equity in the property.

More fundamentally, the Sixth Circuit allowed selling a home out from underneath a debtor without paying the homestead exemption in full, whereas the Tenth Circuit BAP would not allow a sale under analogous circumstances.

Brown also widened a split in its own right by holding that a sale order is not automatically mooted by Section 363(m) if the appellate court can grant some relief without affecting the validity of the sale.

The Tenth Circuit BAP cited to *Brown* in passing, but without addressing in depth how the two cases reached fundamentally different results.

To read ABI's discussion of *Brown*, click here.

Jevic and *Siegel* Influence the BAP

The BAP buttressed its conclusions by referencing two recent Supreme Court decisions.

In a passing reference, the BAP said that "*Jevic* stands for the proposition that neither the parties, nor the courts, are free to circumvent the Bankruptcy Code's rules and policies regarding priorities and distributions through manipulation of substantive and procedural protections." The reference to *Jevic* in a footnote shows that the high court's decision on limiting structured dismissal informs the result in other contexts, such as exemptions.

The BAP also cited *Law v. Siegel* for the idea that homestead exemptions are "sacrosanct" and can be denied "only on statutory bases enumerated in the Bankruptcy Code."

Although the BAP case was not "strictly analogous" to *Law v. Siegel*, Judge Hall said the effect was the same: "to deprive debtors of their homestead exemptions on a basis other than one enumerated in the Code."

Moreover, she said, the debtors had not been accused of any fraudulent behavior, like the debtor in *Law v. Siegel*. The "scheme" to sell the homes by negotiating with the IRS was "nothing more than an attempt to do indirectly what the Bankruptcy Code and Utah exemption statutes prevent him from doing directly."

On behalf of the National Consumer Bankruptcy Rights Center and the National Association of Consumer Bankruptcy Attorneys, Tara A. Twomey submitted an *amicus* brief on behalf of the debtors.

The opinion is *Jubber v. Bird (In re Bird)*, 577 B.R. 365 (B.A.P. 10th Cir. Nov. 30, 2017).

Courts are divided when an exemption claim collides with the government's right of setoff.

Exemption Claim Overrides the Government's Right of Setoff, District Judge Says

On an issue where the courts are hopelessly divided, a district court in Richmond, Va., ruled in favor of the debtor by barring the Internal Revenue Service from setting off a tax refund when the debtors were claiming an exemption in the refund.

In her September 10 opinion, District Judge M. Hannah Lauck also rejected the government's claim of sovereign immunity.

Twice this week, we have featured Judge Lauck in this column. On September 10, we described how the Fourth Circuit adopted her opinion regarding appellate standing and equitable mootness. *Mar-Bow Value Partners LLC v. McKinsey Recovery & Transformation Services US LLC (In re Alpha Natural Resources Inc.)*, 17-2268, 2018 BL 321354 (4th Cir. Sept. 6, 2018). To read the ABI discussion, click here.

Simple Facts, Difficult Question

A couple filed a chapter 7 petition in May 2014, owing the IRS about $13,500 in unpaid taxes for the years 2008 through 2010. For the year 2013, the couple were entitled to a refund of some $3,000 for overpayment of taxes.

Using Virginia's $5,000 wildcard exemption, the debtors claimed an exemption in the entire $3,000 refund. The IRS did not object to the exemption.

After the debtors filed their 2013 tax return in June 2014, the IRS notified the couple that it was offsetting the refund against the unpaid taxes.

Later, the couple sued the IRS in bankruptcy court, seeking a declaration that their exemption precluded setoff.

On cross motions for summary judgment, Bankruptcy Judge Keith L. Phillips of Richmond ruled in favor of the couple. He concluded that the debtors' exemption took precedence over the IRS's right of setoff and directed the IRS to turn over the $3,000 to the debtors. Judge Lauck affirmed in a 35-page opinion. She agreed with Judge Phillips that the debtors' right to an exemption "supersedes" the government's right of setoff.

Exemption vs. Setoff: Who Wins?

Deciding whether an exemption overrides the right of setoff is "a difficult legal issue," Judge Lauck said. Courts around the country "have taken varying approaches, and reached contrary outcomes, when addressing the interplay of setoffs and exemptions under the Bankruptcy Code." Even federal courts in Virginia do not agree, she said.

Judge Lauck demonstrated that the debtors properly claimed an exemption in the $3,000 under Virginia law and Section 522 of the Bankruptcy Code. On the other hand, the government had a right of setoff under Section 553, which provides that nothing in the Bankruptcy Code, aside from Sections 362 and 363, affects "any right of a creditor to offset a mutual debt . . . ."

Judge Lauck said the courts "have struggled to reconcile Sections 522 and 553, resulting in courts reaching conflicting outcomes."

Significantly, Judge Lauck said that the standard of appeal for disallowance of setoff is abuse of discretion, because the applicability of Section 553 "is permissive, rather than mandatory." A bankruptcy court, she said, "may exercise its equitable discretion to determine whether to apply an offset provision in the Bankruptcy Code."

Similarly, Judge Lauck said that the government's ability to credit an overpayment of taxes against a tax liability is "discretionary" under Section 6402 of the IRS Code.

The government, however, argued that the tax refund never became estate property, precluding the exercise of a right of exemption. Although some courts have ruled otherwise, Judge Lauck agreed with the majority to hold that the right to a refund became property of the estate on the filing date in 2014 because the debtors' right to the refund had vested on December 31, 2013.

Since the refund was estate property, Judge Lauck said the IRS was required to comply with the Bankruptcy Code and could not "unilaterally take property from the bankruptcy estate" by exercising a right of setoff. However, she did not rest her opinion on the government's failure to lodge a timely objection to the exemption claim.

Weighing the government's right of offset against the debtors' right to an exemption, Judge Lauck concluded that the bankruptcy court "did not abuse its equitable discretion in holding that the IRS's right of setoff under Section 553 appropriately gave way to the Debtors' claimed exemption under Section 522."

"Section 553 is permissive in application, not mandatory," Judge Lauck said, and "prioritizing Section 522 over Section 553 best supports the fundamental goals of the Bankruptcy Code." She went on to say that "Section 533's permissive application must yield to Section 522's unqualified authorization to Debtors to exempt property pursuant to its requirements."

Because the standard of appeal was abuse of discretion, Judge Lauck conceivably could have upheld the bankruptcy court even had Judge Phillips reached the opposite legal conclusion. Nonetheless, Judge Lauck said that Judge Phillips "did not err in [his] application of the law."

Judge Lauck gave primacy to the debtors' exemption. Because "Section 553's applicability is permissive, rather than mandatory, and because nothing similarly narrows the scope of Section 522, the Court finds Section 522's exemption rights superior to Section 553's setoff rights. Such an interpretation gives meaning to both sections without nullifying either."

Although Judge Lauck found "persuasive arguments on either side of the debate," she concluded that Judge Phillips did not err on the legal issue "and did not abuse [his] discretion in disallowing the setoff . . . because compelling circumstances exist to disallow setoff."

In a footnote, Judge Lauck said that the Fourth Circuit issued a nonprecedential opinion in 1996 finding that a right of setoff cannot be exercised against an exempt asset.

Sovereign Immunity

The government argued that sovereign immunity divested the bankruptcy court of jurisdiction to bar setoff. According to the IRS, there was no waiver of sovereign immunity under Section 106(a)(1) because none of the 59 listed provisions of the Bankruptcy Code creates a cause of action allowing the debtors to bar an exercise of setoff.

Judge Lauck rejected the government's sovereign immunity argument. She said that the debtors' suit "directly implicates Sections 522 and 553," which are both listed in Section 106(a)(1). Because "resolving the case requires resolving the tensions between Sections 522 and 553" she said "the case squarely falls within the scope of Sections 522 and 553."

The government argued there was no waiver of sovereign immunity, since neither section creates a cause of action. Judge Lauck said that the argument lacked merit, because Section 106(a)(2) allows the court to "hear and determine any issue arising with respect to" the sections enumerated in Section 106(a)(1).

Section 106 waived sovereign immunity, according to Judge Lauck, because the two sections "constitute the heart of the case."

The opinion is *U.S. v. Copley*, 16-207 (E.D. Va. Sept. 10, 2018).

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Automatic Stay

Ninth Circuit splits with the First on the interpretation of Section 106(a).

Circuits Split on Sovereign Immunity and Emotional Distress Damages for a Stay Violation

The waiver of sovereign immunity in Section 106(a) allows an individual to collect damages for emotional distress resulting from the government's willful violation of the automatic stay, according to the Ninth Circuit.

The Ninth Circuit created a split of circuits because the First Circuit had held in *U.S. v. Rivera (In re Rivera)*, 432 F.3d 20 (1st Cir. 2005), that Section 106(a) does not waive sovereign immunity for emotional distress damages resulting from a stay violation.

Daniel Geyser of Dallas, who prevailed in the Ninth Circuit on behalf of the debtors, told ABI that "Congress waived sovereign immunity to put the government on equal footing with private parties." The damage award, he said, "holds the government accountable for its actions — just as Congress intended."

The Debtor Wins and Loses Below

After a couple filed their chapter 13 petition, the Internal Revenue Service sent several notices demanding payment of back taxes and threatening to levy on their bank accounts. The bankruptcy judge held the IRS in contempt of the automatic stay and imposed $4,000 in damages for "significant emotional harm."

On appeal, the IRS conceded there was a stay violation but contended that the doctrine of sovereign immunity insulates the government from claims for emotional distress under Section 362(k). A district judge in Oregon agreed, reversed the bankruptcy court, and ordered the complaint dismissed. To read ABI's discussion of the district court opinion, click here.

The debtor appealed and won a reversal in an August 30 opinion written for the Ninth Circuit by District Judge Cynthia A. Bashant, sitting by designation from the Southern District of California.

The Relevant Bankruptcy Code Provisions

Section 106(a)(1) waives sovereign immunity "as to a governmental unit" with regard to 59 provisions in the Bankruptcy Code, including Section 362. Section 106(a)(3) enables the court to "issue" an "order . . . or judgment" against a governmental unit, "including an order or judgment awarding a money recovery, but not including an award of punitive damages."

Section 362(k) provides that "an individual injured by any willful violation of a stay provided by this section shall recover actual damages, including costs and attorneys' fees, and, in appropriate circumstances, may recover punitive damages."

Removing what otherwise would have been an issue on appeal, the Ninth Circuit had held in 2004 that "actual damages" in Section 362(k) includes damages for emotional distress. *See Dawson v. Washington Mutual Bank, F.A. (In re Dawson)*, 390 F.3d 1139, 1148 (9th Cir. 2004).

The Government's Argument

Urging the appeals court to uphold the district court, the government relied on *U.S. v. Nordic Village Inc.*, 503 U.S. 30 (1992), where the Supreme Court ruled that Section 106, as it was then written, did not unequivocally subject the government to claims for monetary relief. At the time, Section 106 only said that the term "creditor" when used in the Bankruptcy Code applies to "governmental units" and that "an issue arising under such a provision binds governmental units."

Congress responded to *Nordic Village* two years later by amending Section 106 to contain an explicit waiver of sovereign immunity. The government argued in the Ninth Circuit that the amendment only permits recovery of money unlawfully in the government's possession.

The Circuit's *Ratio Decidendi*

To analyze whether the waiver of sovereign immunity extends to damages for emotional distress, Judge Bashant began with the Supreme Court's rule that a waiver of sovereign immunity must be "unequivocally expressed." *U.S. v. Bormes*, 568 U.S. 6, 9–10 (2012) (quoting *Nordic Village*, 503 U.S. at 33–34).

Judge Bashant said that the government's argument based on *Nordic Village* "is not plausible in light of the [amended] statute's text." She said that Section 106(a) "plainly waives sovereign immunity for court-ordered monetary damages under the waiver's enumerated provisions, although the damages may not be punitive."

Emotional distress damages, Judge Bashant said, "are a form of monetary relief — compensatory damages — but they are not punitive." Given *Dawson*'s holding that emotion distress damages are permitted under Section 362(k), she held that "Section 106(a) waives sovereign immunity for emotional distress damages under Section 362(k)."

The Split with the First Circuit

Judge Bashant ended her opinion by explaining why the Ninth Circuit would not follow the First Circuit's decision in *Rivera*.

Based on the so-called temporal approach, the First Circuit pronounced a convoluted theory to immunize the government for emotional distress damages sought under Section 105 for a willful stay violation.

The First Circuit understood the 1994 amendments in Section 106 to waive sovereign immunity only as to forms of monetary relief that were understood to exist at the time. Since damages for a willful stay violation in 1994 had not been understood to include emotional distress damages, the First Circuit did not find a clear intent to waive sovereign immunity.

Judge Bashant declined to follow the First Circuit because she said the "plain language of the statute is dispositive."

The First Circuit also latched onto Section 106(a)(5), which provides that nothing in the section creates "any substantive claim for relief . . . not otherwise existing under this title, the Federal Rules of Bankruptcy Procedure, or nonbankruptcy law."

Judge Basant rejected the reliance on Section 106(a)(5), saying it did not "graft a temporal restriction onto the waiver's scope."

Judge Basant reversed the district court and remanded for the district court to consider the government's appeal on the merits.

Is the Issue '*Cert*-worthy'?

Since here is now a split of circuits, the government could file a petition for *certiorari* seeking review in the Supreme Court. The government may not bother because the issue seldom arises given that the IRS does not have a policy calling for violation of the automatic stay.

In view of the remand for the district court to analyze the merits, the judgment in the court of appeals is not a final order and thus may not warrant the granting of *certiorari*. However, the high court will sometimes review a non-final order that raises a pure issue of law not likely to be affected by remand.

All things considered, the Ninth Circuit's decision is not a compelling candidate for a grant of *certiorari*. In terms of a circuit split involving the automatic stay, the Supreme Court will have a far more consequential case in *Lorenzen v. Taggart (In re Taggart)*, 888 F.3d 438 (9th Cir. April 23, 2018) (petition for panel rehearing and rehearing *en banc* filed June 6, 2018). *Taggart* merits Supreme Court review because the First Circuit handed down contrary decision seven weeks later in *IRS v. Murphy*, 892 F.3d 29 (1st Cir. June 7, 2018).

Murphy and *Taggart* raise the question of whether good faith is a defense to sanctions for violating the discharge injunction. The Ninth Circuit held that good faith is a defense, while the

First Circuit held it is not. The Ninth Circuit must deal with the petition for rehearing before there can be a *certiorari* petition. To read ABI's discussion of those cases, click here and here.

The opinion is *Hunsaker v. U.S.*, 16-35991 (9th Cir. Aug. 30, 2018).

Second Circuit approves a stay-violation defense in a nonprecedential opinion.

Simply Initiating Events that Later Violate the Stay Is Not a Stay Violation

Someone accused of indirectly violating the automatic stay has two lines of defense, thanks to a Jan. 25 opinion from the Second Circuit.

A creditor had a judgment against the soon-to-be debtor. When the 10-year lien of the judgment was about to expire, the creditor applied to state court before the debtor's bankruptcy for an order extending the lien. Although the court granted the extension, the order extending the lien was not docketed.

The judgment creditor did not know that the county clerk had never filed the extension order until the trustee sued to void the lien under the strong-arm powers.

According to the unsigned, nonprecedential summary opinion, the Second Circuit said that the creditor's counsel then contacted the county clerk "to inquire why the [creditor's] timely filed but inexplicably undocketed extension order did not appear" on the docket. In response to the inquiry, the state court clerk then entered the lien-extension order after the filing of the bankruptcy petition.

The bankruptcy court found the creditor in contempt for violating the automatic stay under Section 362(a)(4) as "any act to create, perfect, or enforce any lien against property of the estate."

The district court reversed in August 2016, setting aside the contempt finding and holding that the entry of the lien after filing was not "reasonably foreseeable." The district court said that the creditor "must intend or at least reasonably anticipate bringing about the consequences of his act." The district judge said that the "act must have as its purpose the creation of the lien, not just that the act gave rise to the lien as a collateral result of the act."

The Second Circuit upheld the district court's reversal of the contempt finding, saying, however, that the case did not turn on "reasonable foreseeability."

The appeals court said the creditor's counsel "merely asked the [state court clerk] what happened to his timely filed extension order." There was "no indication," the opinion says, that the creditor asked the clerk to correct the mistake, nor was there any evidence suggesting that the creditor "engaged in anything other than a simple factfinding inquiry."

The Second Circuit said that the automatic stay "does not prohibit all acts which coincidentally set in motion the creation" of a lien. Rather, there must be an act "to create, to perfect, or to enforce a lien."

"Because [the creditor] engaged only in factfinding and did not attempt to create, perfect, or enforce its lien, [the creditor] did not violate the stay."

To read ABI's discussion of the district court opinion, click here.

The opinion is *Pereira v. 397 Realty LLC (In re Heavey)*, 16-3227 (2d Cir. Jan. 25, 2018).

California judge won't bar the debtor from settling for more than the original $6 million in compensatory damages while forsaking $40 million in punitive damages earmarked for public interest groups.

Judge Refuses to Vacate Opinion Socking a Bank with $40 Million in 'Punies'

In March, Bankruptcy Judge Christopher M. Klein of Sacramento, Calif., imposed more than $46 million in compensatory and punitive damages on a bank for foreclosing and evicting a couple from their home although the lender knew they had filed a chapter 13 petition expressly to halt foreclosure. The judgment included $40 million in punitive damages for what Judge Klein called a "Kafkaesque nightmare of stay-violating foreclosure." *Sundquist v. Bank of America NA*, 566 B.R. 563, 571 (Bankr. E.D. Cal. March 23, 2017).

Months later, the parties reached a confidential settlement requiring the judge to expunge his opinion from the public record. Judge Klein said the proposed settlement created a "hostage standoff" that he characterized as "a naked effort to coerce this court to erase the record."

In an opinion on Jan. 18, Judge Klein's response to vacating his opinion was "No chance. No dice."

The Genesis of the Settlement

The parties responded to the $46 million judgment with cross motions for rehearing. The bank claimed there was evidence justifying total exculpation. The debtors countered with arguments that they should be entitled to more than $9 million in compensatory damages.

Mediation ensued and resulted in a proposed settlement giving the debtors an undisclosed amount totaling considerably more than Judge Klein's $6 million judgment.

In his March opinion, Judge Klein had earmarked the $40 million in punitive damages for five California law schools and two nonprofit groups to "be used only for education in consumer law and delivery of legal services in matters of consumer law." The settlement called for the law schools and nonprofit groups to receive about $300,000.

There was a catch: The settlement would require Judge Klein to vacate his March opinion, which excoriated the bank for its contemptuous behavior. Although the parties could have settled between themselves without court approval, they needed the judge's blessing to vacate his opinion.

The intended recipients of the punitive damages opposed vacating the opinion but took no position on the settlement otherwise. Judge Klein took the settlement under submission in October, with the question of vacating his March decision being a primary sticking point.

Judge Klein handed down his decision on Jan. 18. He crafted an elegant solution designed to ameliorate the lender's legitimate concerns while leaving his opinion on the public record, available for citation by other judges in other cases.

The Hostage Standoff

As a result of his opinion in March, Judge Klein said "the situation is now bigger than the" debtors. The "public-interest component cannot be ignored" because "some things are not appropriate to sweep under the carpet."

Under *American Games Inc. v. Trade Products. Inc.*, 142 F.3d 1164 (9th Cir. 1998), Judge Klein said he had equitable discretion to vacate his opinion, or not. Once decisions have been entered after trial, he said that attempts to "'buy and bury' adverse judgments are viewed with caution."

In deciding how to exercise discretion, Judge Klein said the record did not suggest "that the facts constitute an anomalous or isolated incident that might unfairly besmirch an otherwise upstanding defendant." He said the lender had shown no remorse, made no apology, made no promise to reform, and had not accepted responsibility for its actions.

"To name and to shame [the lender] on the public record in an opinion that stays on the books serves a valuable purpose casting sunlight on practices that affect ordinary consumers," Judge Klein said. Under the circumstances, the proper method for erasing the opinion is to reverse it on appeal, he said.

The Solution

Releases in the agreement would alleviate any concern on the part of the bank that the debtors might mount another lawsuit after collecting the settlement. On the other hand, Judge Klein said the bank had legitimate concerns, although remote, that the doctrine of issue preclusion (sometimes called offensive collateral estoppel) might enable a third party to sue the lender and contend that some of the issues were decided in the $46 million judgment.

To contour a solution giving the bank the protection it legitimately needed, Judge Klein undertook an extensive analysis of the Restatement (Second) of Judgments. In that respect alone, his opinion is worth reading in full text.

To give the parties most of what they wanted, Judge Klein said he would vacate the portion of his judgment awarding damages to the debtors while closing the adversary proceeding "without dismissing the adversary proceeding and without erasing the opinion." Vacating the damage award would remove finality and preclude a third party from raising a claim of issue preclusion.

To add belt and suspenders, Judge Klein said his order on the motion to vacate the judgment would provide that the legal and factual issues were not "sufficiently firm to be accorded preclusive effect."

Judge Klein granted the parties' wish by keeping the terms of settlement secret. He did say that the debtors would receive a "substantial premium" over the original award of about $6 million.

The "public interest" component of the original punitive damage award would be "indirectly honored in the settlement" because the debtors obliged themselves to give about $300,000 to the consumer advocacy programs.

The opinion is *Sundquist v. Bank of America NA (In re Sundquist),* 14-2278, 2018 BL 17263 (Bankr. E.D. Cal. Jan. 18, 2018).

Circuits split on power of bankruptcy courts to impose punitive or criminal contempt sanctions.

Bankruptcy Courts Cannot Impose Punitive Contempt Sanctions, District Judge Says

Confronting an issue where the circuit courts are divided and the Second Circuit has been silent, Vermont's Chief District Judge Geoffrey W. Crawford decided that bankruptcy courts lack "statutory and inherent powers" to impose punitive contempt sanctions.

The Sanctions in Bankruptcy Court

In three chapter 13 cases, the bankruptcy court had imposed a total of $375,000 in sanctions on a mortgage servicer for billing debtors for fees without first filing the required notices under Bankruptcy Rule 3002.1(c). Previously, the servicer had been "chastised" by a bankruptcy judge in North Carolina for violating the rule. In one of the three cases, the servicer had already agreed to pay a $9,000 sanction for sending erroneous mortgage statements for three years, but it did not halt the practice.

The bankruptcy judge said that the $9,000 sanction two years earlier had failed to achieve its intended remedial effect of deterring the servicer from sending out "inaccurate account statements." Since she had given the servicer "an opportunity to bring its practices in line with the mandates of Rule 3002.1," the bankruptcy judge felt that "the time has come for 'the imposition of severe sanctions.'"

To read ABI's report on the bankruptcy court opinion, click here.

The servicer appealed and won in Judge Crawford's Dec. 18 opinion.

The Bankruptcy Court's Limited Powers

To arrive at an award of $75,000, the bankruptcy judge had relied on Bankruptcy Rule 3002.1(i)(2), which authorizes the court to "award other appropriate relief." For the remaining $300,000, the bankruptcy court used Section 105(a) and the court's inherent powers.

Addressing whether the bankruptcy court indeed possessed power, Judge Crawford said that the circuits "have been deeply divided for many years on the question of whether bankruptcy courts have power to punish criminal contempts or impose punitive sanctions." The Second Circuit, he said, has not addressed the question.

Judge Crawford then summarized the evolution of the bankruptcy court's contempt powers under the Bankruptcy Rules, as influenced by the Supreme Court's 1982 decision in *Northern Pipeline*. The current iteration of the rules governing contempt — Bankruptcy Rules 9020 and 9014 — impose procedural rules but "provide no source of substantive authority," the judge said.

On the question of power, Judge Crawford said "that the prevailing trend in the development of bankruptcy law over recent years has been to place ever-tightening limits on bankruptcy courts' contempt authority." He said that "the better-reasoned authorities favor the narrower construction of the bankruptcy court's statutory and inherent punitive sanction power."

Judge Crawford was persuaded by the Ninth Circuit, which "held that neither Section 105 nor the bankruptcy court's inherent authority were proper sources of authority for the imposition of a serious punitive sanction." *In re Dyer*, 322 F.3d 1178 (9th Cir. 2003). He also found favor with the Fifth Circuit's holding that bankruptcy courts lack constitutional power to exercise criminal contempt power. *In re Hipp Inc.*, 895 F.2d 1503 (5th Cir. 1990).

Judge Crawford found fault with the logic of the First and Eighth Circuits, which were more liberal in vesting punitive power in bankruptcy courts.

Although the bankruptcy court may lack power in itself to address serious misconduct, Judge Crawford ended his opinion by mentioning that the district court has power to impose criminal contempt sanctions.

On remand, Judge Crawford said the bankruptcy court may "refer the matter to the district court" if it determines "that exercise of that authority would be appropriate." Alternatively, he said, the bankruptcy court "may take steps to enforce its orders short of punitive sanctions of the scope and type imposed in these cases."

The opinion is *PHH Mortgage Corp. v. Sensenich*, 16-256, 2017 BL 452882 (D. Vt. Dec. 18, 2017).

Lender cannot hide behind a disclaimer to avoid sanctions for violating the discharge injunction, Ninth Circuit BAP holds.

BAP Upholds $119,000 in Contempt Sanctions; Tells Lender to Modify Its Forms

The Ninth Circuit Bankruptcy Panel used an opinion upholding $119,000 in compensatory damages to declare that a lender must change its standard forms for borrowers who have received a discharge, and that it cannot use a boilerplate disclaimer to disguise a willful violation of the discharge injunction.

The BAP also interpreted Ninth Circuit opinions to mean that a bankruptcy court can award punitive damages so long as they are "relatively mild."

The debtors owned a home that they scheduled for surrender to the lender. They moved out, the debtors received their discharges, and the lender later obtained an order modifying the automatic stay.

After the debtors received their discharges, the mortgage lender began calling and writing for the next two years, until the lender finally began foreclosure proceedings.

After two years of dunning letters and calls, the debtors reopened their case and filed a motion to hold the lender in contempt of the discharge injunction, employing Ninth Circuit law, which holds that someone who commits a knowing violation of the discharge injunction under Section 524(a)(2) can be held in contempt under Section 105(a).

At a hearing with witnesses, the lender conceded it was aware of the discharge. The remaining issues at trial were the lender's intent and damages.

Among other defenses, the lender contended it had no liability because some of the correspondence was required by state and federal regulations. Other correspondence included a disclaimer, which said that the lender was making no effort to collect if the debtor was in bankruptcy or had received a discharge.

One of the debtors testified that the lender called two or three times a day for a year after discharge and that she answered the call about 20 times. Based on documents and testimony, the bankruptcy judge found that the lender made 100 calls and sent 19 letters. The judge granted $119,000 in compensatory damages ($1,000 for each call and letter) for emotional distress based on the debtors' testimony, among other things, that the lender's attempts to collect caused physical ailments and almost broke up their marriage.

The bankruptcy court did not impose punitive damages. The judge said he "probably" would have imposed punitive damages but did not believe he had the authority under Ninth Circuit law.

The lender appealed to the BAP, and the debtors cross appealed the denial of punitive damages.

In a Dec. 22 opinion for the BAP, Bankruptcy Judge Robert J. Faris upheld the $119,000 damage award but reversed and remanded, with instructions allowing the bankruptcy judge to enter final judgment for "relatively mild noncompensatory fines," issue proposed findings for the district court on punitive damages, or refer the contempt issue to the district court.

Judge Faris held that the calls and letters were knowing and willful violations of the discharge injunction, despite the lenders' defenses. He recognized a tension between discharge and the lender's obligation to give the debtors notices of foreclosure.

To resolve the tension, Judge Faris said that the lender may communicate but "only to the extent necessary to preserve or enforce its lien rights, and may not attempt to induce the debtor to pay the debt." In that regard, he upheld the bankruptcy court's findings that the communications "went far beyond what was necessary" to protect lien rights and were "meant to induce" the debtors to make payments after discharge.

Even if some of the notices did not violate the discharge injunction, Judge Faris agreed that the bankruptcy court "correctly noted that the cumulative effect of all of the letters demanding money created the perception that [the debtors] needed to pay" the lender.

With regard to the disclaimer, Judge Faris saw no reason for the lender to obscure the fact, which it knew, that the debtors had received a discharge. He said the lender gave no reason why it sent "generic" notices when it knew the debtors were discharged. He said the lender "could and should prepare notices that are consistent with the known legal status of borrowers."

The failure to use proper notices, he said, reflected either incompetence, which he doubted, or "a deliberate effort to induce confused borrowers to pay discharged debts."

On the debtors' cross appeal, Judge Faris said that some bankruptcy judges have interpreted *Knupfer v. Lindblade (In re Dyer)*, 322 F.3d 1178 (9th Cir. 2003), to mean that bankruptcy courts may only impose "relatively mild noncompensatory fines."

Other bankruptcy courts have found power to impose punitive damages that are "relatively mild."

However, they are characterized, Judge Faris said the Ninth Circuit allows awards that are "relatively mild."

Without saying how the bankruptcy judge should rule, Judge Faris remanded with instructions to consider imposing a fine or punitive damages that are "relatively mild." Alternatively, the bankruptcy court could make proposed findings and recommend that the district court enter judgment for punitive damages or refer the matter to the district court to consider criminal contempt.

The opinion is *Ocwen Loan Servicing LLC v. Marino (In re Marino)*, 577 B.R. 772 (B.A.P. 9th Cir. Dec. 22, 2017).

Bankruptcy Judge Colleen A. Brown of Burlington, Vt., changes her position on Section 362(c)(3)(A).

A Convert Joins the Minority Interpretation of the Repeat-Filing Stay Termination

Twelve years ago, retired Bankruptcy Judge A. Thomas Small of Raleigh, N.C., said that Section 362(c)(3)(A) "stands out" among the "head-scratching opportunities" found in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, or BAPCPA. *In re Paschal*, 337 B.R. 274, 277 (Bankr. E.D.N.C. 2006).

For someone whose chapter 7, 11 or 13 case was dismissed within a year of a new filing, Section 362(c)(3)(A) calls for the automatic stay to terminate in 30 days "with respect to any action taken with respect to a debt or property securing such debt . . . with respect to the debtor."

At a hearing that must be held within the 30-day period on motion by the debtor or a party in interest, the bankruptcy court may continue the stay "as to any or all creditors" upon a showing that the new case was filed "in good faith as to the creditors to be stayed."

There are at least three interpretations of Section 362(c)(3)(A), which was designed to some greater or lesser degree (depending on your interpretation of the statute) to punish a repeat-filing debtor, and maybe also to punish the debtor's innocent creditors (intentionally or not).

According to a July 20 opinion by Bankruptcy Judge Colleen A. Brown of Burlington, Vt., the majority invoke what they contend is the plain meaning of Section 362(c)(3)(A) to conclude that the stay terminates only as to property of the debtor but not with respect to property of the estate.

In the case before Judge Brown, the third filing came within one year of dismissal of the second. Before the filing of the third petition, a mortgagee had initiated foreclosure. Had Judge Brown followed the majority, the automatic stay precluding foreclosure would persist because the home was property of the estate.

Judge Brown said that the majority's interpretation "would have scant practical effect in deterring repeat filings."

The minority, according to Judge Brown, believe that the stay automatically terminates in its entirety as to the repeat-filing debtor, the debtor's property and the property of the estate, but not as to the debtor's spouse in a joint case if the spouse is not a repeat filer.

Judge Brown cited Bankruptcy Judge Robert E. Grossman of Central Islip, N.Y., who found "an inherent flaw in both the majority and minority reasoning." Focusing on different parts of the statute, Judge Grossman terminated the stay as to the debtor, property of the debtor and property of the estate, but only if the creditor had begun judicial proceedings before bankruptcy. To read ABI's discussion of Judge Grossman's opinion, click here.

Judge Brown had taken sides with the majority in an opinion she had written less than two years after the adoption of BAPCPA. Nonetheless, she was persuaded by commentators and later decisions to change her approach.

To abandon her earlier interpretation of Section 362(c)(2)(A), Judge Brown analyzed the four Supreme Court decisions interpreting BAPCPA. She also considered the concept of *stare decisis*.

Setting aside her earlier ruling, Judge Brown now joins the minority because she believes that terminating the stay as to the debtor, the debtor's property and property of the estate "is consistent with congressional intent . . . because it meaningfully penalizes a debtor who files multiple bankruptcy cases . . . and fails to show a good faith basis for doing so."

Judge Brown also declined to follow Judge Grossman because his decision, in her view, "does not align as clearly with congressional purpose as the minority approach."

The opinion is *In re Goodrich*, 17-10500 (D. Vt. July 20, 2018).

Municipal Debt Adjustment & Puerto Rico

Two circuits and a BAP now invoke 'equitable mootness' to dismiss appeals from orders confirming chapter 9 municipal debt adjustment plans.

Eleventh Circuit Endorses the Applicability of 'Equitable Mootness' in Chapter 9

Courts considering the issue are now unanimous: The doctrine of equitable mootness applies in chapter 9 just like it does in chapter 11 as the result of an August 16 Eleventh Circuit opinion in the wake of the Jefferson County, Ala., municipal bankruptcy.

The Jefferson County Chapter 9 Plan

Until Detroit sought chapter 9 protection in 2013, Jefferson County's filing in 2011 had been the largest-ever municipal bankruptcy. The county listed long-term debt of $4.23 billion, including about $3.2 billion in defaulted sewer bond debt where the bondholders could look only to the sewer system for payment. The county's chapter 9 plan, confirmed in November 2013, reduced sewer debt to about $1.8 billion from $3.2 billion.

To pay off the old sewer bondholders at a substantial discount, the county issued about $1.8 billion in new sewer bonds. The plan locked in rate increases to be paid by sewer customers every year for 40 years and gave the bankruptcy court continuing jurisdiction to compel the rate increases. The county implemented the plan a few days after confirmation, issuing new bonds in the process.

Ratepayers had objected to confirmation and appealed the confirmation order to the district court, but the county filed a motion to dismiss the appeal, arguing that the appeal should be dismissed on the grounds of equitable mootness.

District Judge Says No Equitable Mootness in Chapter 9

District Judge Sharon Lovelace Blackburn of Birmingham, Ala., wrote a 50-page opinion in September 2014 denying the motion to dismiss the appeal. She held that equitable mootness was not applicable in a chapter 9 municipal bankruptcy, although she said that "some parts of the confirmation order may be impossible to reverse," such as the validity of the newly issued bonds.

Still, reversal meant that she might later void the provisions in the plan locking in annual rate increases that had been included for the benefit of the purchasers of the new sewer bonds.

Judge Blackburn allowed an interlocutory appeal, resulting in the August 16 opinion by Circuit Judge Adalberto Jordan.

Eleventh Circuit Joins Two Other Courts

Judge Jordan said that the Supreme Court has neither endorsed nor rejected the concept of equitable mootness in chapter 11 cases. He said that every circuit to consider the issue has allowed some formulation of equitable mootness.

The Eleventh Circuit, Judge Jordan said, has applied equitable mootness in chapter 11 and "assumed without deciding that it applies in chapter 7 cases." The appeals court had not addressed the question in chapter 9, however.

Judge Jordan said the "correct result was to join the Sixth Circuit," which had upheld the use of equitable mootness in 2016 in the context of Detroit's municipal bankruptcy. Similarly, the Ninth Circuit Bankruptcy Appellate Panel employed equitable mootness in the Stockton, Calif., debt adjustment in 2015.

Seeing "no reason to reject the doctrine here," Judge Jordan said there was "no respect in which [the] principles [of equitable mootness] are bound to come into play any less in the chapter 9 context than in the contexts of chapters 11 or 13."

Indeed, he said, "these principles will sometimes weigh more heavily in the chapter 9 context precisely because many people will be affected by municipal bankruptcies."

Having decided that equitable mootness applied in chapter 9, Judge Jordan proceeded to rule that it required dismissal of the appeal in Jefferson County's case. He said that the ratepayers never sought a stay pending appeal and had not attempted to expedite the appeal, although those facts in themselves were not determinative.

The appeal had to be dismissed, according to Judge Jordan, because "the County and others have taken significant and largely irreversible steps in reliance on the unstayed plan." Even if the appellate court only struck the bankruptcy court's continuing jurisdiction, he said it "would seriously undermine actions taken in reliance on the confirmation order."

To bolster his conclusion, Judge Jordan "briefly" looked at the merits and saw no injustice in allowing the county to bind elected officials decades into the future. He noted how elected officials "can bind their successors . . . to all kinds of unavoidably long-lasting financial effects, sometimes irreversibly."

The opinion is *Jefferson County, Alabama v. Bennett*, 15-11690 (11th Cir. Aug. 16, 2018).

Puerto Rico's toll road bonds don't have statutory liens, circuit court rules.

First Circuit Gives Puerto Rico Bondholders a Second Bite at the Apple

In a pair of opinions on August 8, the First Circuit gave bondholders a second opportunity to prove they are being improperly denied revenue securing the bonds issued by Puerto Rico's instrumentalities. Alluding to two hurricanes that devastated the island commonwealth and its economy, the appeals court did not suggest how the district court should rule on remand but said in both opinions that circumstances have changed dramatically since the lower court ruled last year.

The PREPA Receivership Appeal

After the Supreme Court ruled that Puerto Rico was ineligible for chapter 9 municipal bankruptcy, Congress quickly adopted the Puerto Rico Oversight, Management, and Economic Stability Act, or PROMESA (48 U.S.C. §§ 2161 *et. seq.*), creating the Financial Oversight and Management Board of Puerto Rico. Exercising its exclusive authority several months later, the Oversight Board initiated court-supervised debt restructuring proceedings in the District of Puerto Rico for Puerto Rico and its instrumentalities, including the Puerto Rico Power Authority, known as PREPA.

The Chief Justice selected District Judge Swain of New York to oversee the PROMESA proceedings in Puerto Rico.

Holders of revenue bonds issued by PREPA alleged that the power authority breached a promise to raise rates enough to cover debt service. Under Section 362(d)(1) of the Bankruptcy Code, incorporated into PROMESA by 48 U.S.C. § 2161(a), they sought modification of the automatic stay so they could petition another court to place PREPA in receivership and seek a rate increase.

Judge Swain denied the motion in September 2017 on three grounds. With regard to two of them, she ruled in substance that Sections 305 and 306 of PROMESA, 48 U.S.C. §§ 2165 and 2166, precluded her from ceding authority or jurisdiction to another court. Alternatively, she concluded there was no "cause" to modify the stay because the balance of harm tipped in favor of Puerto Rico.

First Circuit Judge William J. Kayatta, Jr. reversed and remanded on the first two grounds and remanded on the third.

Section 305 of PROMESA is modeled after Bankruptcy Code Section 904, dealing with municipal bankruptcies. Section 305 precludes the court from interfering with the "governmental powers of the debtor."

To read Section 305 so broadly as to prohibit lifting the automatic stay, Judge Kayatta said, "would effectively wipe out" the ability to modify the automatic stay. Although Section 305 prohibits the bankruptcy court from interfering with governmental powers, he said it does not preclude the court from lifting "the stay to allow another court to do what the bankruptcy court cannot do."

Although Judge Kayatta agreed that allowing a "robust receivership" might have a "deleterious impact" on the ability to restructure Puerto Rico's finances, he said it "might be possible to grant tailored relief [so that] the receiver may only take specific steps to protect the creditor's collateral."

Next, he addressed Section 306 of PROMESA, which gives the court exclusive and original jurisdiction. That section, he said, is not unique to PROMESA. "Rather, it is the general rule for bankruptcies."

According to Judge Kayatta, the grant of exclusive jurisdiction "has to our knowledge never limited the bankruptcy court's power to allow others to act on the debtor's property with the permission of the bankruptcy court." He therefore reversed Judge Swain and held that Section 306 does not prevent the court from finding "cause" to lift the stay and permit the bondholder to petition for a receivership.

In what Judge Kayatta called a "brief section," Judge Swain had ruled alternatively that she would not modify the stay even if she had power to do so. He said that Judge Swain did not assess "the extent to which" bondholders "might be irreversibly harmed" or whether PREPA was adequately protecting the bondholders' interests. In sum, Judge Kaytatta wanted Judge Swain to give more detail explaining how she "weighed on each side the balance of the harms."

Since the "situation on the ground . . . has changed greatly" in the last year, "in the wake of Hurricanes Irma and Maria," Judge Kayatta said it was "best to allow the bondholders to file a new and updated request for relief from the automatic stay" so that Judge Swain could "focus on the merits of that request free of any thought that the request is categorically precluded."

The Toll Road Bondholder Appeal

Holders of $65 million in uninsured bonds issued by the Puerto Rico Highways and Transportation Authority mounted an adversary proceeding alleging that the authority was diverting toll revenue that is subject to their statutory lien.

The bondholders asserted a statutory lien evidently to avoid the operation of Section 552(a) of the Bankruptcy Code, which, with exceptions, cuts off security interests from attaching to property acquired after filing.

For the first time in their reply brief in bankruptcy court, the bondholders recognized what may have been a mistake and argued, alternatively, that they held a security interest. Invoking a local rule, Judge Swain barred the new argument and proceeded to rule that the bondholders did not have a statutory lien.

Because the statutory lien was the only basis for asserting lien rights, Judge Swain denied relief from the stay and denied the request for adequate protection. The bondholders appealed.

Writing the opinion for the First Circuit, Judge Kayatta concluded that Judge Swain did not abuse her discretion by disallowing arguments based on a security interest, although he said it was a "close call." He therefore proceeded to analyze whether the bondholders held a statutory lien.

Judge Kayatta described how the Bankruptcy Code creates three mutually exclusive categories of liens: security interests, judicial liens and statutory liens. Quoting Section 101(37) of the Bankruptcy Code, he said that a statutory lien arises "solely by force of a statute." He said that Puerto Rico's enabling statute permits the authority to secure bonds but does not "require that it do so." In the case of the toll road bonds, the pledge was voluntary and thus was not a statutory lien because the lien did not "attach automatically."

Since the statutory lien – which he found not to exist – was the only basis for the appeal, Judge Kayatta upheld the denial of a modification of the stay.

However, Judge Kayatta said the bondholders' waiver of an argument based on a security interest "is not permanent," as Judge Swain herself had observed. He granted the bondholders permission to file "any updated motions for relief," presumably to seek a modification of the stay and adequate protection based on the assertion of a security interest.

Judge Kayatta also dealt with Judge Swain's alternative decision to deny a modification of the stay. Because she had dealt with the issue "briefly," he said it was necessary for Judge Swain "to revisit these rulings anew" by identifying the "precise nature and extent" of the collateral, the value of the collateral at filing, and the amount required for the operation of the toll roads. As he did in his other Aug. 8 opinion, he said that "much has transpired since September 2017." He also said the circuit's opinion should not imply how Judge Swain should rule on remand.

The opinions are *Ad Hoc Group of PREPA Bondholders v. Financial Oversight and Management Board for Puerto Rico (In re Financial Oversight and Management Board for Puerto Rico)*, 17-2079, and *Peaje Investments LLC v. Financial Oversight and Management*

Board for Puerto Rico (In re Financial Oversight and Management Board for Puerto Rico), 17-2165 (1st Cir. Aug. 8, 2018).

Defining collateral by reference in a UCC-1 is held invalid in Puerto Rico's bankruptcy.

Avoiding Powers Under PROMESA May Be Applied Retroactively

Presiding over Puerto Rico's financial restructuring, District Judge Laura Taylor Swain explained the dangers of incorporation by reference when perfecting a security interest.

Puerto Rico's retirement system was authorized by statute to issue secured debt. Commonly known as ERS, the retirement system issued bonds in 2008 that were to be secured by ERS's revenue, among other things. The UCC-1 financing statement described the collateral as the property shown on the security agreement that was attached.

However, the security agreement described the collateral as having the meaning defined in the statute that authorized issuance of secured bonds. The statute or its definition of collateral was not attached to the financing statement.

In 2015, UCC-3 continuation statements were filed, and they contained complete descriptions of the collateral. However, the continuation statements identified the debtor as ERS but did not use the new, official name that had been given to ERS after the bonds were issued.

Acting on behalf of ERS in Puerto Rico's debt adjustment proceedings under the Puerto Rico Oversight, Management, and Economic Stability Act, or PROMESA (48 U.S.C. §§ 2161 *et. seq.*), the island commonwealth's Financial Oversight and Management Board sought a declaratory judgment that the bondholders' security interest was unperfected and could be avoided under Section 544(a), incorporated by Section 301 of PROMESA.

In a 32-page opinion on August 17, Judge Swain granted the Board's motion for summary judgment and declared the security interest to be unperfected.

Judge Swain's analysis was straightforward and comparatively simple. Although a financing statement need only "reasonably" identify the collateral under UCC § 9-110, she cited caselaw for the proposition that a collateral description by reference may only refer to a document attached to the UCC filing or to another document on file in the UCC clerk's office.

Judge Swain therefore held that the original UCC-1s in 2008 failed to perfect the security interest. The UCC-3s in 2015 fared no better.

Between the issuance of the bonds in 2008 and the filing of the continuation statements, the formal name of ERS was changed. The UCC-3s referred to ERS, not to the retirement system's new, formal name.

Under UCC § 9-503(a)(1), the debtor's name on a financing statement must be the name "on the public organic record most recently filed with or issued or enacted by the registered organization's jurisdiction." The debtor's trade name is insufficient under UCC § 9-503(c), according to Judge Swain.

The UCC-3s failed to perfect the security interest, Judge Swain said, because ERS "functions as a trade name, the use of which Article 9 expressly provides is insufficient."

To salvage the security interest, the bondholders argued that the Board could not use Section 544(a) to invalidate a security interest granted before the enactment of PROMESA. In that respect, Judge Swain conceded that statutes are "ordinarily construed as prospective only." She also said that the Bankruptcy Code has been interpreted to be prospective only.

However, she said that "PROMESA was enacted specifically to enable Puerto Rico to address its current debt crisis." To apply Section 544(a) only to bonds issued after the enactment of PROMESA "would . . . eviscerate (directly and by implication) the availability to Puerto Rico of lien avoidance mechanisms that are the core debt relief tools," Judge Swain said.

Judge Swain went on to say that "the incorporation of the arsenal of avoidance powers into PROMESA would have been meaningless, in addressing Puerto Rico's financial situation, if they could only be invoked in connection with debt incurred . . . following the enactment of the statute."

Judge Swain therefore held that Section 544(a) could be employed retroactively to avoid an unperfected security interest granted before the adoption of PROMESA.

The bondholders are appealing.

The opinion is *Financial Oversight and Management Board for Puerto Rico v. Altair Global Credit Opportunities Fund (A) LLC (In re Financial Oversight and Management Board for Puerto Rico)*, 17-213 (D. P.R. Aug. 17, 2018).

PROMESA's authority is in the Territories Clause of the Constitution, District Judge Swain says.

Constitutionality of the Puerto Rico Oversight Board Upheld in District Court

The Puerto Rico Oversight, Management, and Economic Stability Act, or PROMESA (48 U.S.C. §§ 2161 *et. seq.*), does not violate the Appointments Clause of Article II, Section 2, Clause 2 of the U.S. Constitution, even though members of the Financial Oversight and Management Board of Puerto Rico were not nominated by the President and confirmed by the Senate, according to District Judge Laura Taylor Swain.

Aurelius Investment LLC and affiliates filed a motion in August 2017 seeking dismissal of Puerto Rico's debt arrangement proceedings, arguing that the filing of the petition on behalf of the Commonwealth of Puerto Rico by the Oversight Board under Title III of PROMESA violated the Appointments Clause.

Holders of Puerto Rico general obligation bonds joined Aurelius but were opposed by the Oversight Board, the official unsecured creditors' committee, and COFINA bondholders, among others.

Judge Swain held a hearing on the motion to dismiss in January. In her 35-page opinion on July 13, Judge Swain held that PROMESA and the Oversight Board were properly constituted under the Territories Clause of the Constitution, Article IV, Section 3, Clause 2.

The Constitution of the Oversight Board

In June 2016, the Supreme Court ruled 5-2 that Congress excluded Puerto Rico from chapter 9 municipal bankruptcy and precluded the island commonwealth from adopting local laws to deal with the insolvencies of its instrumentalities, such as municipal power and water companies. Within days, Congress adopted PROMESA to afford the island an ability to deal with its crushing debt burden.

After an initial effort at negotiating a compromise with creditors out of court, the Oversight Board commenced debt adjustment proceedings for the commonwealth and its instrumentalities beginning on May 3, 2017. Aurelius contended in its motion to dismiss that the requirements of Title III of PROMESA were not satisfied because the Oversight Board was allegedly an unlawful entity, since its members were appointed in violation of the Appointments Clause.

The Oversight Board, the only entity authorized to initiate debt adjustment proceedings, is "an entity within the government of Puerto Rico," Judge Swain said, but "it is not subject to the supervision or control by the Governor of Puerto Rico . . . or the Legislature of Puerto Rico."

The Oversight Board is constituted of seven members, one appointed at the sole discretion of the President and six selected from a list of candidates provided by leaders of Congress. If any members appointed by the President were not on the congressional list, Senate confirmation would be required. Since the six were all on the list, there was no Senate confirmation.

Judge Swain's Analysis

Rejecting arguments by Aurelius, Judge Swain's opinion is a lesson in history about the governance of territories of the U.S., citing Supreme Court opinions going back to the eighteenth century.

Judge Swain explained that the Appointments Clause prescribes methods for appointing "Officers of the United States." In turn, the clause distinguishes between "principal officers," who must be nominated by the President and confirmed by the Senate, and "inferior officers," who may be appointed by the President alone, or by courts or heads of departments.

For Judge Swain, the "principal question" was whether members of the Oversight Board had to be appointed under the Appointments Clause. She held, though, that "Congress has plenary powers under the Territories Clause to establish governmental institutions for territories . . . that would not comport with the requirement of the Constitution if they pertained to governance of the United States." She noted that Congress cited the Territories Clause as the sole authority for enacting PROMESA.

Judge Swain then proceeded to find "that neither Presidential nomination nor Senate confirmation of the appointees of the Oversight Board is necessary as a constitutional matter . . . because the members of the Oversight Board are not 'Officers of the United States' subject to the Appointments Clause."

In sum, Judge Swain said that "the Oversight Board is a territorial entity and its members are territorial officers." Therefore, she said, "Congress had broad discretion to determine the manner of selection of the Oversight Board."

Judge Swain summarized her analysis and holding by saying that the "Oversight Board is an instrumentality of the territory of Puerto Rico . . . , that its members are not 'Officers of the United States' who must be appointed" under the Appointments Clause, "and that there is accordingly no constitutional defect in the method of appointment provided by Congress for members of the Oversight Board."

Consequently, Judge Swain denied the motion to dismiss the PROMESA proceedings.

The opinion is *In re The Financial Oversight and Management Board for Puerto Rico*, 17-3283 (D.P.R. July 13, 2018).

Bondholders won a skirmish but may still lose the war with Puerto Rico.

Two Courts Seemingly Differ on the Nature of Puerto Rico's PROMESA Proceedings

Two federal courts handed down decisions, both on July 13, about the status of the Financial Oversight and Management Board of Puerto Rico and the nature of proceedings under the Puerto Rico Oversight, Management, and Economic Stability Act, or PROMESA (48 U.S.C. §§ 2161 *et. seq.*).

Whether the two decisions are in conflict is arguable, and it's an open question as to whether the decision handed down by the Court of Federal Claims, or COFC, might eventually disrupt Puerto Rico's court-supervised debt arrangement proceedings.

This week, we reported on *In re The Financial Oversight and Management Board for Puerto Rico*, 17-3283 (D.P.R. July 13, 2018), where District Laura Taylor Swain, sitting in the District of Puerto Rico, ruled on July 13 that the appointment of members of the Oversight Board did not violate the Appointments Clause of the U.S. Constitution. To read the story, click here.

Also on July 13, Chief Judge Susan G. Braden of the COFC ruled that she had exclusive jurisdiction over claims by bondholders that they are entitled to compensation from the U.S. government because actions taken under PROMESA deprived them of property in violation of the Due Process Clause of the U.S. Constitution. Judge Braden therefore denied the government's motion to dismiss the bondholders' lawsuit. In the process, she cast doubt on some of the underpinnings of Judge Swain's opinion.

Significantly, Judge Braden stayed further proceedings in her court pending "final judgment" in Judge Swain's case.

If it makes your head swim, you're not alone. Interpreting the ultimate effect of the two decisions is like trying to predict the outcome of a chess match after the first two moves.

Judge Swain's Ruling

After the Supreme Court ruled that Puerto Rico was ineligible for chapter 9 municipal bankruptcy, Congress quickly adopted PROMESA. Months later, the Oversight Board, exercising its exclusivity authority, initiated court-supervised debt restructuring proceedings for Puerto Rico and its instrumentalities in the District of Puerto Rico. The Chief Justice tapped District Judge Swain of New York to oversee the PROMESA proceedings in Puerto Rico.

In the case before Judge Swain, bondholders argued that PROMESA violated the Appointments Clause because the Oversight Board was not appointed by the President and confirmed by the Senate.

In her July 13 opinion, Judge Swain denied the bondholders' motion to dismiss the PROMESA proceedings, concluding that "the Oversight Board is a territorial entity and its members are territorial officers" and therefore not subject to the Appointments Clause.

The Suit in the Court of Federal Claims

Attacking PROMESA, bondholders had opened a different front in the COFC less than a month before the motion to dismiss in Judge Swain's court.

In the Washington, D.C.-based COFC, the bondholders alleged they had suffered an unconstitutional taking of property because the Oversight Board required the Puerto Rico legislature to pass a law depriving them of collateral for their bonds. In the COFC, the bondholders sought compensation from the government for the property they allegedly lost.

The U.S. government filed a motion to dismiss, contending that Judge Swain had exclusive jurisdiction over the claims raised in the COFC. Also on July 13, Judge Braden denied the motion to dismiss.

Jurisdiction in the COFC

Judge Braden explained that the Tucker Act (28 U.S.C. § 1491) gives the COFC exclusive jurisdiction over claims for "just compensation" under the Takings Clause of the Fifth Amendment. However, the statute provides that Congress may withdraw Tucker Act jurisdiction by showing its "unambiguous intention."

The government argued that Judge Swain had exclusive jurisdiction because Section 2126(a) of PROMESA gives exclusive jurisdiction to the District of Puerto Rico for any action "arising out of this chapter, in whole or in part."

Judge Braden disagreed, holding that the COFC has jurisdiction because Section 2126(a) of PROMESA does not demonstrate the required "unambiguous intention."

No PROMESA Preemption

The government argued that PROMESA preempted the Tucker Act.

Judge Braden rejected the argument, because she found no "comprehensive remedial scheme" in PROMESA to compensate creditors for unconstitutional takings of property.

Significantly Judge Braden held that "the Tucker Act and PROMESA are capable of 'coexistence,'" because bondholders can "seek adjudication against the United States for 'just compensation' in the [COFC] and declaratory relief, if requested, in the [District of Puerto Rico]."

If there is a potential flaw in Judge Braden's decision, it could be her finding of no "comprehensive remedial scheme" because PROMESA and the Bankruptcy Code are carefully crafted to protect and compensate creditors for their rights in collateral.

Oversight Board Is a Federal Entity

Because the Tucker Act applies to claims against the U.S., the government sought dismissal by arguing that the Oversight Board is an entity of Puerto Rico.

Even though PROMESA provides that the Oversight Board "shall not be considered a department, agency, establishment or instrumentality of the Federal Government," Judge Braden said that characterizations in federal statutes are not binding on courts when it comes to deciding whether an organization is a government entity.

Judge Braden concluded that PROMESA met the three tests for concluding that the bondholders' suit is a suit against the government.

In the process, Judge Braden rejected the government's argument that PROMESA was enacted "pursuant to Congress' Article IV plenary authority over the territories," the theory that Judge Swain used in ruling that the Appointments Clause did not apply to the Oversight Board.

Although conceding that Congress has "broad latitude" over territories, Judge Braden said "*that authority* does not supplant the role of federal courts in protecting fundamental constitutional rights." [Emphasis in original.]

Judge Braden said that "the Takings Clause claim is alleged against the Oversight Board, as a federal entity." Therefore, she ruled, "Congress authorized the [COFC] with jurisdiction to adjudicate that claim."

Takings Suit Is Stayed

At the end of her opinion, Judge Braden took note of two disputes pending before Judge Swain, including the motion to dismiss that Judge Swain denied on July 13. Should the bondholders prevail in those litigations, Judge Braden said that the "appropriate remedy" may call for declaring that the actions by the Oversight Board were "unlawful," requiring the restoration of the bondholders' collateral.

Although Judge Braden denied the government's motion to dismiss for the reasons discussed above, she said that "the interests of justice require that this case be stayed, at least until a decision and final judgment is entered in each of the above-referenced cases" before Judge Swain.

What Does It All Mean?

Superficially at least, the two July 13 opinions seem inconsistent. One court concludes that the Oversight Board is a federal governmental entity, and the other says members of the board are "territorial officers."

The conclusions may not be inconsistent, however, because it's conceivable that both are correct. A territorial officer may fit the definition of a governmental officer for the purpose of a Takings Clause suit but not with regard to the applicability of the Appointments Clause.

Appeals will go to different circuits. The Puerto Rico PROMESA decision will be reviewed in the First Circuit, but the COFC decision would go to the Court of Appeals for the Federal Circuit. However, the COFC decision likely is not a final order, meaning there will be no immediate appeal absent leave to appeal.

Consequently, there may be an appeal to the First Circuit but no appeal on the related issue to the Federal Circuit. If there are appeals to both circuits, and if the two circuits' decisions seem inconsistent, the Supreme Court would be the final arbiter.

Will the differing decisions foster settlement talks or embolden either side? Can Puerto Rico afford to settle with the bondholders? If Puerto Rico and the bondholders want to settle, will other creditors allow them to if it means smaller recoveries for them?

Is litigation ever the best method for resolving a bankruptcy?

If both July 13 decisions stand, the PROMESA proceedings could proceed to an ordinary conclusion, because Judge Braden only denied a motion to dismiss. She did not even hint, one way or the other, at whether bondholders were deprived of property without due process. In other words, the suit in her court could proceed to conclusion, and Judge Braden might decide there was no Taking Clause violation because the bondholders' constitutional rights were protected under PROMESA.

Or, if Judge Braden finds there was an unconstitutional taking, she might fashion a recovery against the U.S. for bondholders' losses as a consequence of PROMESA. A valid claim against the U.S. government doesn't necessarily mean that the PROMESA court cannot approve and implement a debt arrangement.

Also recall how Judge Braden said that the suit in her court and the PROMESA proceedings "are capable of 'coexistence,'" because bondholders can "seek adjudication against the United States for 'just compensation' in the [COFC] and declaratory relief, if requested, in the [District of Puerto Rico]." Likely as not, bondholders will raise Takings Clause claims in opposition to any arrangement proposed by Puerto Rico. Therefore, Judge Swain might make the declaratory judgment to which Judge Braden referred.

Reversal of Judge Swain's decision is another matter. If there was an Appointments Clause violation, the PROMESA proceedings could unravel, allowing bondholders to push Puerto Rico to the wall unless Congress fashions another statute.

It's a mess. That's all there is to say. That's what happens when two courts share jurisdiction over one pot of limited resources.

The opinion is *Altair Global Credit Opportunities Fund (A) LLC v. U.S.*, 17-970 (Ct. Fed. Cl. July 13, 2018).

Judge refuses to issue declaratory judgments about Puerto Rico's use of tax revenues.

No Quick Exit for Any Creditors from Puerto Rico's Financial Mess, Judge Says

The New York district judge overseeing Puerto Rico's debt restructuring in substance said that no one will hit a home run through litigation and take home all the marbles. Instead, the Jan. 30 opinion by District Judge Laura Taylor Swain has the effect of forcing creditors of all stripes to participate in mediation and slog through the process of plan negotiation and confirmation.

Since May will be the first anniversary of Puerto Rico's debt restructuring under the Puerto Rico Oversight, Management, and Economic Stability Act, or PROMESA (48 U.S.C. §§ 2161 *et. seq.*), some creditor groups have sought a quick exit, especially since Hurricane Maria destroyed the island's infrastructure last September, along with any progress toward debt adjustment.

The creditor group with perhaps the best odds of staging a quick victory was the holders of general obligation bonds, sometimes known as constitutional debt because the bonds carry the island commonwealth's full faith and credit. Holders of the bonds, known as GO bonds, contend they are entitled to full and timely payment, even "in times of economic scarcity."

The GO bondholders therefore filed an adversary proceeding in which they contended that certain tax revenue cannot be used for any purpose other than the payment of constitutional debt and must be segregated for them alone. In response, Puerto Rico filed a motion to dismiss, which Judge Swain granted in her 19-page opinion on Jan. 30.

Judge Swain divided the claims for relief into two categories: She dismissed about a third for failure to state a claim on which relief could be granted. She dismissed the remainder for lack of subject matter jurisdiction.

The first category includes claims for declaratory judgments that certain tax revenues cannot be used for any purpose other than the payment of constitutional debt and must be segregated. Although they arose from a live, otherwise justiciable controversy, Judge Swain said they ran afoul of Section 305 of PROMESA and therefore failed to state a claim.

Section 305 prohibits the court from interfering with any of Puerto Rico's governmental powers or income unless the "Oversight Board consent or the plan so provides." Granting declaratory relief with respect to segregating tax revenue, Judge Swain said, would "result in declarations and injunctions that would directly restrict" Puerto Rico's use of tax revenue.

Because there was no consent by the Board and no plan, Judge Swain dismissed that portion of the complaint for failure to state a claim because "Section 305's prohibition is not limited to remedies that are directly coercive," she said.

In the second category, the claims ask the judge to rule that certain tax revenue is not Puerto Rico's property; the island commonwealth is a mere conduit; constitutional debt is secured by statutory liens; certain tax revenues are "special revenues" that can be applied only in compliance with provisions of chapter 9 that are applicable under PROMESA; and using certain tax revenue other than in payment of constitutional debt would be an unconstitutional taking of property.

Judge Swain said the second group of claims did not pass constitutional muster and therefore failed to state a claim because there was no "case or controversy."

Although the bondholders were seeking declaratory judgments, not injunctions, Judge Swain explained that "even significant disagreement" by itself does not state a claim unless there is "a specific live controversy of sufficient immediacy and reality to warrant the issuance of a declaratory judgment."

According to Judge Swain, there is no case or controversy because those claims sought "abstract declarations of the parties' respective relationships to the subject revenues, without application of the relief to resolve any current concrete dispute." Thus, the judge said, they "seek advisory opinions and do not frame justiciable controversies."

On the claim about unconstitutional takings, Judge Swain said that Puerto Rico has not made any "final decision" about how to treat the taxes in question. The takings claim, she said, "is not ripe for adjudication."

Judge Swain therefore dismissed the claims in the second category for lack of subject matter jurisdiction given the absence of a constitutional case or controversy.

Since Judge Swain dismissed the adversary proceeding, the bondholders can appeal to the First Circuit. Even if Judge Swain was wrong about the second category and there is a live controversy, those claims might also run afoul of Section 305 because they could have the effect of tying up the commonwealth's tax revenue before a plan is approved.

The opinion is *ACP Master Ltd. v. Commonwealth of Puerto Rico (In re Financial Oversight and Management Board for Puerto Rico)*, 17-189 (D. P.R. Jan. 30, 2018).

Can plaintiffs sue Puerto Rico government officials in their individual capacities? Two district judges disagree.

District Judges Starkly Disagree on the Scope of the PROMESA Automatic Stay

Two district judges in Puerto Rico starkly disagree about the applicability of the automatic stay to "ordinary course" litigation against commonwealth officials.

On April 30, District Judge William G. Young of Boston, sitting in Puerto Rico by designation, held that the automatic stay under the Puerto Rico Oversight, Management, and Economic Stability Act barred a suit against a commonwealth governmental official in his individual capacity, even though Puerto Rico itself was not named as a defendant.

Saying he "disagrees" with Judge Young, Chief District Judge Gustavo A. Gelpí ruled on May 14 that the automatic stay does not apply. He allowed a plaintiff to recover a judgment against a government official in his individual capacity.

Although the two cases are procedurally distinguishable, the First Circuit may be tasked with deciding whether Puerto Rico can hide behind PROMESA to halt lawsuits having nothing to do with the island's insolvency.

The Newest Case

In Judge Gelpí's case, a prisoner sued non-governmental third parties for inadequate medical care. The defendants included Puerto Rico governmental officials in their official and individual capacities. Much later, the plaintiff accepted a $50,000 settlement without specifying how the settlement would be apportioned among the defendants. Two weeks before Puerto Rico initiated its financial restructuring under PROMESA (48 U.S.C. §§ 2161 *et. seq.*), Judge Gelpí directed the defendants to pay the $50,000 within 90 days.

When Puerto Rico began its restructuring on May 3, 2017, PROMESA imposed an automatic stay by incorporating Section 922(a) of the Bankruptcy Code. That section automatically enjoins a suit against a government "officer" that "seeks to enforce a claim against" the government.

In the process of paying $40,000 after commencement of the PROMESA proceedings, the non-governmental defendants said that Puerto Rico had agreed the pay the remaining $10,000. Puerto Rico did not object to the statement but filed a notice regarding the automatic stay.

Months later, the plaintiff filed a motion seeking to compel Puerto Rico to pay the remaining $10,000.

Judge Young's Earlier Case

Judge Young ruled on a suit by several individuals seeking money damages for wrongful incarceration in violation of the U.S. Constitution and local law. Knowing that PROMESA would bar suit for damages against the commonwealth, the plaintiffs only sued individuals in their personal capacities.

Admitting that a decision either way would be "unfair," Judge Young decided to apply the stay, saying the complaint was among "the types of suits contemplated by PROMESA that require an automatic stay because the defense is funded" by the government of Puerto Rico.

Judge Gelpí's Analysis

The statute underlying both cases was a commonwealth law giving Puerto Rico the right but not the obligation to defend and indemnify governmental officials sued in their individual capacities. In Judge Gelpí's case, Puerto Rico had agreed long before bankruptcy to defend and indemnify the one official who was still liable on the judgment in his individual capacity.

Puerto Rico argued that PROMESA's automatic stay applied because the commonwealth had indemnified the official for a judgment against him in his individual capacity. Judge Gelpí disagreed, holding that the stay "does not apply to individual capacity claims," even when Puerto Rico has agreed to defend and indemnify.

Judge Gelpí followed his decision from August 2017, where he held that PROMESA's automatic stay did not apply to a $2 million lawsuit against Puerto Rico's superintendent of police for a police shooting that was claimed to be "a reckless and grossly negligent use of excessive force." *Guadalupe-Baez v. Pesquera*, 269 F. Supp. 3d 1 (D.P.R. 2017).

Judge Gelpí bolstered his decision by reference to Puerto Rico's sovereign immunity under the Eleventh Amendment and First Circuit authority holding that defense of a suit is not a waiver of immunity. If Puerto Rico is not being sued when it defends an official, he theorized that "it is not liable for any awards or settlements." Since the government is not liable, the stay does not apply because the plaintiff is not collecting a claim against the commonwealth.

Judge Gelpí disagreed with Judge Young on two counts. First, he disagreed with the notion that PROMESA contemplates an automatic stay covering officials in their individual capacities. Second, he was not persuaded by the argument that recruiting government workers would be harmed by permitting individual-capacity suits to proceed. He said that the effect on recruitment

"is a matter for the Commonwealth to consider when agreeing to represent officials . . . and [settle] on their behalf." It is not a matter for the court to consider, he said.

Judge Gelpí therefore held that he had power to compel the individual to pay the judgment in his personal capacity because the indemnification agreement was between the official and the government, not between the government and the plaintiff. However, the judge conceded that he did not have power to compel the government to pay the settlement.

To read ABI's report on Judge Young's case, click here. For Judge Gelpí's decision from last year, click here.

The opinion is *Colon-Colon v. Negron-Fernandez*, 14-1300 (D.P.R. May 14, 2018).

On tough automatic stay cases, let the PROMESA judge decide.

Puerto Rico Judge Has a Third Answer to the PROMESA Automatic Stay Question

Since district judges in Puerto Rico disagree about the applicability of the automatic stay under the Puerto Rico Oversight, Management, and Economic Stability Act, one district judge came up with a solution: Impose the stay, but tell the plaintiff to move for modification of the stay in the court handling Puerto Rico's debt restructuring.

The opinion on May 16 by District Judge Francisco A. Besosa of San Juan included a hint that the PROMESA court should seriously consider modifying the stay to ensure protection of the plaintiff's constitutional rights.

In the case before Judge Besosa, a prisoner filed suit under 42 U.S.C. § 1983, alleging that the conditions of his confinement violated the Eighth Amendment because, as a potential witness, his life was in danger since he was being housed in the general prison population. He sought both an injunction and $3 million in monetary damages.

Twice before, Judge Besosa had refused to impose PROMESA's automatic stay in 42 U.S.C. § 2161, saying that a provision PROMESA, 42 U.S.C. § 2106, specifically provides that nothing in the statute will relieve Puerto Rico from complying with federal law. However, Puerto Rico filed a motion for rehearing and won.

Puerto Rico began its debt restructuring under PROMESA on May 3, 2017. Over the ensuing year, "the parameters of the automatic stay [became] more precise," Judge Besosa said. His opinion cites cases going both ways with regard to "ordinary course" litigation, noting that the stay has been held not applicable to petitions for *habeas corpus* and to suits seeking only injunctions and not monetary damages.

Reciting cases that have imposed the PROMESA stay, Judge Besosa concluded that "PROMESA and precedent from this district establish that the automatic stay encompasses [the plaintiff's] Section 1983 action."

Reflecting his point of view, Judge Besosa cited cases where the First Circuit had applied the PROMESA stay to appeals in Section 1983 suits. He also cited *Ruíz-Colón v. Rodriguez*, 17-2223, 2018 U.S. Dist. Lexis 74455 (D.P.R. April 30, 2018), where District Judge William G. Young imposed the stay on a prisoner's suit for violation of constitutional rights. For ABI's discussion of *Ruíz-Colón*, click here.

Judge Besosa concluded that the stay was invoked automatically because Puerto Rico was shouldering the expense of litigation and would be liable for judgments. Still, he was "mindful" that the plaintiff was seeking compliance with the Constitution.

Although he imposed the stay, Judge Besosa said the plaintiff could seek a modification of the stay from the district judge responsible for Puerto Rico's financial restructuring under PROMESA.

Last week, ABI reported *Colón-Colón v. Negron-Fernandez*, 14-1300 (D.P.R. May 14, 2018), a decision by Chief District Judge Gustavo A. Gelpí. The decisions by Judges Besosa and Gelpí are difficult if not impossible to reconcile because Judge Gelpí seemed reluctant to impose the stay on ordinary course litigation, even in a case not involving the plaintiff's constitutional rights. To read ABI's discussion of Judge Gelpí's decision, click here.

The opinion is *Betancourt-Rivera v. Vázquez-Garced*, 17-2040 (D.P.R. May 16, 2018).

Sixth Circuit narrowly rules that a community health service is not a governmental unit and is thus eligible for chapter 11.

Sixth Circuit Panel Splits on the Attributes of a 'Governmental Unit'

A nonprofit provider of community health services is not a governmental unit and is therefore eligible for chapter 11 reorganization, even though 95% of its budget is covered by state funding, according to two judges on the Sixth Circuit.

Noting that the Supreme Court has classified the Red Cross and Amtrak as governmental instrumentalities, the dissenter "easily" concluded on the same facts that the organization is an instrumentality of the state and is therefore ineligible for chapter 11.

The debtor is not out of the woods, however, because the appeals court has asked the Kentucky Supreme Court to determine in substance whether participation in the state pension program is based on an executory contract subject to rejection.

The Debtor's History and Structure

A nonprofit organization, the debtor is the primary provider of mental health services for the state in seven Kentucky counties. Formed in 1996, the debtor provides local services that previously were performed by the state Department of Mental Health. Many of the original employees had worked for the state. To ensure they would not lose their state pensions, the governor issued an executive order allowing the debtor to join the state pension system. Legacy employees and new hires are all covered by the state pension system.

Required contributions to the state pension system grew dramatically in recent years. The debtor said it could not provide mental health services while continuing to contribute to the state pension system. The debtor filed a chapter 11 petition to reject its relationship with the pension system because there was no statutory mechanism to withdraw.

Seeking dismissal of the chapter 11 case, the pension system contended that the debtor is a governmental unit and therefore ineligible for chapter 11. Alternatively, the pension system sought a declaration that the relationship with the pension system is a statutory obligation that cannot be rejected like an executory contract.

The bankruptcy court and the district court sided with the debtor on both issues. The pension system appealed to the Sixth Circuit.

The Statute

Under Section 109(d), only a "person" may be a chapter 11 debtor. A "person" is defined in Section 101(41) to exclude most governmental units. Pertinent to the case at hand, Section 101(27) defines "governmental unit" to be an "instrumentality" of a state.

In her majority opinion on August 24, Circuit Judge Jane B. Stranch said that no circuit court has developed a test to divine whether an entity is a state instrumentality. She liberally cited *In re Las Vegas Monorail Co.*, 429 B.R. 770 (Bankr. D. Nev. 2010), which has been the leading authority to decide whether an entity that seemingly performs governmental functions is a bankruptcy-ineligible governmental unit.

To conclude that the Monorail was not a governmental unit, Bankruptcy Judge Bruce A. Markell confronted a certificate that the debtor had executed to obtain tax-exempt financing. To give bond investors assurance that the Monorail could not file bankruptcy, the certificate stated that the company was an instrumentality of the state.

Judge Markell overcame the certificate by alluding to Nevada law saying that any monorail in the state is a "person" and not a municipality. He also noted that the monorail had no power of eminent domain, no taxing power, and no sovereign immunity. Of most importance, Judge Markell said that the "low level of state control" showed that the monorail was not a municipality. He said that state control was in the nature of regulation or oversight, like casinos or taxicabs. He noted that creditors had no ability to look to the state for payment.

Markell is now the Professor of Bankruptcy Law and Practice at the Northwestern Univ. Pritzker School of Law.

The Majority's Analysis

Although governmental control is not determinative in itself, Judge Stranch said it "plays a critical role in identifying state instrumentalities." Her disagreement with the dissent, she said, stems from the "'degree of control" that is required.

Judge Stranch said that governmental control over day-to-day activities is not necessary. To analyze the degree of control, she evaluated five factors.

First, the state did not create the debtor. It was incorporated by private individuals. Second, the state does not appoint the debtor's officers. Third, the debtor does not function pursuant to an enabling statute, although it is subject to state regulation and "recognition."

Fourth, the debtor receives 95% of its funding from three public sources. However, Judge Stranch said the debtor does not receive direct appropriations. Its funding sources are "generally

available to state and non-state entities alike." Fifth, the state "cannot destroy" the debtor's corporate existence.

Synthesizing the factors, Judge Stranch said the debtor is "a unique entity with some features that might seem to belong to a state agency and others that would be entirely inconsistent with a governmental designation." All the factors, she said, "suggest" that the debtor "is not a government entity."

Judge Stranch said that governmental control is not the only consideration. Possessing "commonly recognized governmental attributes, for example, would give pause."

The debtor, she said, does not have governmental attributes, such as the power of eminent domain or the ability to levy taxes. Although the debtor "may have attempted to claim the defense of sovereign immunity in litigation, that claim has never been adjudged in its favor."

Considering all factors, Judge Stranch concluded that the organization is eligible for chapter 11 relief because the state did "not create [the debtor], does not in the normal course of events choose its leadership, does not govern its operations through an enabling statute, does not fund it through a mechanism that is normally reserved for public entities, and cannot unilaterally destroy it."

The Dissent

Circuit Judge David M. McKeague issued a vigorous dissent in an opinion as long as the majority's.

Paraphrasing a dictionary, he said that the debtor is an "instrumentality" if "it 'serves as an intermediary or agent through which one or more [traditional government] functions of a controlling [state or municipality] are carried out.'"

Because "instrumentality" has the same definition for state and federal entities, Judge McKeague said that the Supreme Court in a constitutional context had found the Red Cross and Amtrak to be governmental instrumentalities. He suggested that the court should not "reject the Supreme Court's mandated, ordinary-meaning approach to a mere statutory definition."

The Certified Question

To the satisfaction of two of the three appeals court judges, the debtor established its eligibility for chapter 11 relief. The retirement system, though, had also appealed from the finding in bankruptcy court that its relationship with the debtor was contractual, allowing rejection as an executory contract under Section 365.

The retirement system argued on appeal that the relationship was purely statutory and thus beyond the rejection power.

On a certified question, the two-judge majority asked the Kentucky Supreme Court to decide whether the debtor's participation in the retirement system is "based on a contractual or statutory obligation."

The appeals court majority said that the answer from Kentucky's high court may not necessarily decide all the issues regarding rejection. If the Kentucky court decides that the relationship is statutory, the majority said "the relatively minor issue of whether that obligation must be faithfully maintained during the pendency of proceedings under 28 U.S.C. § 959(b) would remain."

The opinion is *Kentucky Employers Retirement System v. Seven Counties Services Inc.*, 16-5569 (6th Cir. Aug. 24, 2018).