2019 Winter Leadership Conference

Current Events and Hot Topics

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University of Maine School of Law; Portland, Maine

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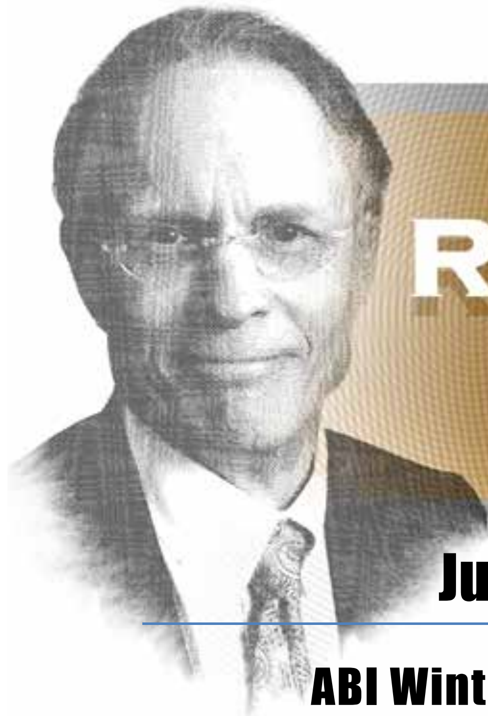
American Bankruptcy Institute; New York

CONCURRENT SESSION

2019



ROCHELLE'S DAILY WIRE

Judges' Hot Topics

ABI Winter Leadership Conference
Saturday, December 7, 2019, 9:45 A.M.
Rancho Palos Verdes, California

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Puerto Rico

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The justices recognized the practical effects of the decision they will make on Puerto Rico and precedent that could undermine the governance of territories and Washington, D.C.

Supreme Court Hears Argument on Constitutionality of Puerto Rico's Debt Restructuring

The Supreme Court heard oral argument yesterday in the case to decide whether the appointment of the members of the Financial Oversight and Management Board of Puerto Rico violated the Appointments Clause of the Constitution because they were not nominated by the President and confirmed by the Senate.

In the worst case, the nation's high court could hand down a ruling that vaporizes three years of work toward restructuring Puerto Rico's debt. However, the justices' grasp of the practical aspects of the case suggest that they will at least give the Senate and the President a chance to resurrect the Oversight Board's work.

In the best case, the Supreme Court will reverse the First Circuit and hold that the Board members did not require Senate confirmation, thus validating the steps already taken to adjust the debt of the island commonwealth.

In the 80 minutes of oral argument, the justices continually focused on the precedential effects of the opinion they would issue. They clearly understood that invaliding the Oversight Board could mean that the governments of territories and even the District of Columbia had been formed in contravention of the Constitution.

The Proceedings Below

After the Supreme Court ruled in June 2016 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.*). PROMESA was designed so that the island commonwealth could restructure its unsupportable mountain of debt.

The members of the Oversight Board were not nominated by the President and confirmed by the Senate. Instead, PROMESA allowed the President to appoint one member of the Oversight Board. The President selected six more 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 have been required. Since the six were all on the list, there was no Senate confirmation.

The Oversight Board commenced debt-adjustment proceedings for the commonwealth and its instrumentalities beginning on May 3, 2017, in district court in Puerto Rico. Aurelius Investment LLC and affiliates filed a motion in August 2017 seeking dismissal of Puerto Rico's debt-

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arrangement proceedings, arguing that the filing of the petition on behalf of the Commonwealth of Puerto Rico by the Board under Title III of PROMESA violated the Appointments Clause. The Oversight Board, the official unsecured creditors' committee, and COFINA bondholders, among others, opposed Aurelius.

District Judge Laura Taylor Swain of New York, sitting in the District of Puerto Rico by designation, handed down an opinion in July 2018 holding that PROMESA and the Board were properly constituted under the Territories Clause of the Constitution, Article IV, Section 3, Clause 2. *In re The Financial Oversight and Management Board for Puerto Rico*, 318 F. Supp. 3d 537 (D.P.R. July 13, 2018). To read ABI's discussion of the district court opinion, click here.

On appeal, the First Circuit reversed, holding that the appointment of the members of the Oversight Board violated the Appointments Clause of the Constitution because they were not nominated by the President and confirmed by the Senate. Relying on the *de facto* officer doctrine, the appeals court went on to rule that its opinion would "not eliminate any otherwise valid actions of the Board prior to the issuance of our mandate in this case." *Aurelius Investment LLC v. Commonwealth of Puerto Rico*, 915 F.3d 838 (1st Cir. Feb. 15, 2019). For ABI's report on the First Circuit opinion, click here.

Initially, the First Circuit held up the issuance of the mandate for 90 days, giving the Senate time to confirm the appointment of the Board members. Later, the appeals court entered an order that in substance operated as a stay to remain in effect until a decision could be handed down from the Supreme Court.

The Oversight Board filed a petition for *certiorari* on April 23, 2019. Four other petitions followed, by the U.S. Solicitor General, Aurelius, the official creditors' committee, and a labor union in Puerto Rico. With unusual alacrity, the Supreme Court granted *certiorari* on June 20.

The justices are confronting two questions: (1) Should the members of the Oversight Board have been nominated by the President and confirmed by the Senate; and (2) if the appointment was unconstitutional, does the *de facto* officer doctrine validate actions already taken by the Oversight Board?

Back and Forth at Oral Argument

Oral argument gave no definitive clue as to how the Court will rule. There was a surprising ideological split involving some of the justices.

Justice Sonia Sotomayor, who was the most vocal at the outset, seemed skeptical about the formation of the Oversight Board without nomination and Senate ratification. Justices Elena Kagan and Ruth Bader Ginsburg were likewise skeptical in the first half of oral argument when the attorney for the Oversight Board tried to explain why the First Circuit was wrong.

In contrast, Justices Neil M. Gorsuch and Brett M. Kavanaugh appeared to take a more practical approach and seemed partial to the notion that the appointment passed constitutional muster.

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Oral argument pitted two former U.S. Solicitors General against one another. Donald B. Verrilli, Jr., argued on behalf of the Oversight Board, while Theodore B. Olson took the case for Aurelius, a major bondholder. Verrilli was Solicitor General for five years under President Barack Obama, while Olson was Solicitor General for three years under President George W. Bush.

The Principal Deputy Solicitor General, Jeffrey B. Wall, argued on behalf of the government, contending there was no violation of the Appointments Clause.

The Elusive Constitutional Principle

Existing Supreme Court precedent didn't seem to give the justices much guidance for how they should rule. Part of the argument was devoted to formulating a test to determine whether the Oversight Board should have been seated only after Senate confirmation.

Late in oral argument, the lawyer for bondholder Aurelius agreed with Justice Gorsuch on a test proposed by the Oversight Board's counsel: Was the board acting primarily locally or primarily nationally?

Naturally, the Oversight Board argued that its members were performing primarily local functions because they were supplanting Puerto Rico's legislature and governor. Aurelius, on the other hand, contended that the board's work was primarily national given the billions of dollars in play and the effect of the PROMESA proceedings on creditors throughout the U.S.

Justice Kagan framed what she called a "functional test." She asked whether the Oversight Board was "doing the sorts of things that would be done by state officials in states, or are they doing the sorts of things that would be done by federal officials."

The Oversight Board wants the justices to focus on the precedent they will set. For example, the board's counsel argued that upholding the First Circuit "would federalize some number of officers who have always been thought of as territorial or local, whether in D.C. or in the territories."

While the lawyer for the Oversight Board had rough sledding, the justices were equally rough on counsel for the bondholder. Chief Justice John G. Roberts, Jr., along with Justices Ginsburg and Kavanaugh, seemed to focus on the local effects of the board's work. Justice Gorsuch suggested that PROMESA took local power away from the governor and the Puerto Rico legislature and gave it to the Oversight Board.

Oral argument had moments of levity overlaying deadly serious practical concerns. Justice Samuel A. Alito asked counsel for Aurelius, "Are you and your client here just to defend the integrity of the Constitution, or would one be excessively cynical to think that something else is involved here involving money?"

The lawyer for the Oversight Board answered the question at the end of argument when he contended that Aurelius would "fight ratification by the Board tooth and nail for years and years

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to come and do everything possible to keep this thing in a situation [where] they have the hope to get a different Board that will accomplish their objectives."

Remedy

If the Court decides that the board contravened the Constitution, it is a fair guess that the justices will follow the First Circuit and invoke the *de facto* officer doctrine to ratify actions already taken by the Oversight Board. Ruling otherwise would set off a maelstrom of litigation and might end up forcing the Supreme Court to decide whether equitable mootness is valid doctrine in federal practice.

If the Court finds that the board should have been nominated and confirmed, counsel for the board asked the justices to delay the issuance of the mandate for six months, pointing to *Northern Pipeline Construction Co. v. Marathon Pipe Line Co.*, 458 U.S. 50 (1982), as precedent. There, the Court found that the jurisdictional underpinnings of the bankruptcy court contravened the constitution, but the justices gave Congress six months to rectify the statutory mess. As it turned out, Congress did not act in time.

In the case of the Bankruptcy Code, a patchwork of local rules enabled bankruptcy courts to continue functioning. For Puerto Rico, a lapse in the board's power could produce chaotic results.

The appeal is *Financial Oversight and Management Board for Puerto Rico v. Aurelius Investment LLC*, 18-1334 (Sup. Ct.).

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Dissenter in the First Circuit recommends that the Supreme Court hear and reverse an opinion allowing Puerto Rico to withhold payments from bondholders.

First Circuit Puerto Rico Bondholder Opinion Is Primed for *Certiorari*

Reading like a memorandum directed to the Supreme Court, three judges on the Third Circuit wrote a statement explaining why the justices should deny *certiorari* from a pivotal ruling in the Puerto Rico debt restructuring.

In a pair of opinions handed down on March 26, the First Circuit ruled that Puerto Rico's secured bondholders cannot compel payment before their rights are sorted out under the island commonwealth's debt adjustment plan. In substance, the March opinions preclude bondholders from taking home their collateral immediately, thereby short-circuiting the restructuring.

The bondholders' insurer filed a motion for rehearing *en banc* from one of the opinions. Responding to a vigorous dissent by one circuit judge from denial of rehearing, the judges from the March three-judge panel wrote another opinion explaining why their original interpretation of the statute was correct.

Both appeals arose in Puerto Rico's debt restructuring under the Puerto Rico Oversight, Management, and Economic Stability Act, or PROMESA (48 U.S.C. §§ 2161 *et. seq.*). With modifications, PROMESA incorporates large swaths of chapter 9 governing municipal debt adjustments. Congress was required to enact PROMESA because the Supreme Court ruled that the commonwealth is not eligible for chapter 9 and that Puerto Rico cannot adopt laws to deal with its own insolvency.

The First March 26 Opinion

In one opinion on March 26, Circuit Judge Juan R. Torruella upheld dismissal of a lawsuit by holders of Puerto Rico general obligation bonds who sought declarations that would have restricted Puerto Rico's use of tax revenue. The bondholders did not seek rehearing; the mandate issued; and there was no petition for *certiorari*. *Aurelius Capital Master Ltd. v. Commonwealth of Puerto Rico (In re Financial Oversight and Management Board for Puerto Rico)*, 919 F.3d 638 (1st Cir. March 26, 2019). To read ABI's discussion, click here.

In their suit resulting in the first March 26 opinion, holders of GO bonds wanted the district court to rule that certain tax revenue, known as restricted revenue, could not be used for any purpose other than the payment of their bonds and other constitutional debt and must be segregated for them alone.

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The Second March 26 Opinion

The second opinion on March 26 was also written by Judge Torruella. He again upheld the district court by ruling that nothing in PROMESA enables bondholders to compel payment on their bonds during the course of proceedings and before confirmation of a plan. *Assured Guaranty Corp. v. Financial Oversight and Management Board for Puerto Rico (In re Financial Oversight and Management Board for Puerto Rico, as Representative for the Puerto Rico Highways and Transportation Authority)*, 919 F.3d 121 (1st Cir. March 26, 2019). To read ABI's report, click here.

In April, bondholders responded to Judge Torruella's second March 26 opinion by filing a petition for rehearing and rehearing *en banc*.

Without opposition from Puerto Rico, the First Circuit denied the rehearing motions on July 31. The order did not say whether any circuit judge other than the dissenter would have granted rehearing.

Joined by the two other judges from the original panel, Circuit Judge William J. Kayatta, Jr. issued a statement on July 31 explaining why the March 26 decision was correct. He was responding to Circuit Judge Sandra L. Lynch, who wrote a lengthy dissent from denial of rehearing *en banc*. She believes that further hearing was warranted by the First Circuit, and "if not by this court, then by the Supreme Court."

The statement by Judge Kayatta reads like the panel's memorandum to the Supreme Court explaining why the justices should deny *certiorari*.

Judge Lynch's Dissent

Judge Lynch wrote a 16-page, single-spaced dissent explaining why the three-judge panel was wrong in March. She believes that Puerto Rico "must continue to pay pledged special revenues to bondholders during a bankruptcy proceeding."

Making a case for the Supreme Court to grant *certiorari*, Judge Lynch said that the "issue is of extraordinary importance: it goes well beyond [Puerto Rico's debt restructuring] as to both potential municipal and state defaults, affects special revenue bonds nationwide, and has Constitutional implications."

However, Judge Lynch correctly interpreted the panel's March 26 opinion. She said the "bondholders cannot receive payment of special revenues promised to them . . . unless [Puerto Rico] *voluntarily* makes such payment." [Emphasis in original.]

According to Judge Lynch, the alternative for the bondholders — filing a motion to modify the automatic stay — was a "burden" that Congress "likely" did not intend.

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Judge Kayatta's Statement for the Panel

Judge Kayatta's four-page statement for the panel is a skillful explanation of how Sections 922 and 928 work together. In his view, the statute allows, but does not require, a municipal debtor to continue paying special revenue bonds during the course of a proceeding and before adoption of a restructuring plan.

Judge Kayatta seems to say that Judge Lynch wrote what she though the law ought to be, not what Congress wrote.

Judge Kayatta defined the issue as follows: Without a modification of the automatic stay, may bondholders file a lawsuit to compel payment of pledged special revenues? He said that the March opinion explained why Sections 922 and 928 "do not afford creditors a shortcut to bypass the requirement of obtaining traditional stay relief." He said that the statutes do not even "remotely" suggest that a municipality is compelled to pay bondholders.

Instead, Judge Kayatta said that the statutes preserve the bondholders' pre-petition liens, allowing the creditor to "assert its right to those funds during the plan-of-adjustment phase."

Judge Kayatta's interpretation accords with the notion under the Tenth Amendment that the federal government cannot tell states how to use their revenue and with the understanding that the automatic stay is not a taking of property under the Fifth Amendment. The ability of municipalities to pay special revenue bonds, if they wish, allows them to attempt to preserve their creditworthiness.

Any ambiguity in the statute, Judge Kayatta said, "is simply not broad enough to allow one to read these sections as allowing the bondholders to commence a collection action without first obtaining leave of court."

The statement and dissent on rehearing is *Assured Guaranty Corp. v. Financial Oversight and Management Board for Puerto Rico (In re Financial Oversight and Management Board for Puerto Rico, as Representative for the Puerto Rico Highways and Transportation Authority)*, 18-1165 (1st Cir. July 31, 2019).

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The appeal to the Supreme Court may become moot if the Senate confirms the appointment of the existing members of the Puerto Rico Oversight Board.

Supreme Court to Say Whether Puerto Rico Oversight Board Was Constitutionally Appointed

With extraordinary alacrity, the Supreme Court granted *certiorari* on June 20 to decide whether the appointment of the members of the Financial Oversight and Management Board of Puerto Rico violated the Appointments Clause of the Constitution because they were not nominated by the President and confirmed by the Senate.

In the order granting *certiorari*, the justices accelerated the briefing schedule and directed that oral argument be held on October 15 or 16, the second week of arguments in the Court's new term.

It is unclear whether the high court will eventually hear or decide the case, because the President on June 18 sent nominations of the current Board to the Senate for confirmation. Should the Senate confirm the appointment of the current Board members, the appeal in the Supreme Court presumably will become moot in large part, if not entirely.

The Puerto Rico case is the second bankruptcy matter that the Supreme Court has decided to review in the next term. By ruling on *Ritzen Group Inc. v. Jackson Masonry LLC*, 18-938 (Sup. Ct.) (cert. granted May 20, 2019), the high court will shed more light on what is or is not a final order conveying a right of appeal in a bankruptcy case. For ABI's discussion of *Ritzen*, click here.

The Proceeding Below and the Motion for a Stay

After the Supreme Court ruled in June 2016 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.*). PROMESA was designed so that the island commonwealth could restructure its unsupportable mountain of debt.

The members of the Financial Oversight and Management Board of Puerto Rico were not nominated by the President and confirmed by the Senate. Instead, PROMESA allowed the President to appoint one member of the Oversight Board. The President selected six more 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 have been required. Since the six were all on the list, there was no Senate confirmation.

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, in district court in Puerto Rico.

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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 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.

District Judge Laura Taylor Swain of New York, sitting in the District of Puerto Rico by designation, handed down an opinion in July 2018 holding that PROMESA and the Board were properly constituted under the Territories Clause of the Constitution, Article IV, Section 3, Clause 2. *In re The Financial Oversight and Management Board for Puerto Rico*, 318 F. Supp. 3d 537 (D.P.R. July 13, 2018). To read ABI's discussion of the district court opinion, click here.

On appeal, the First Circuit reversed, holding that the appointment of the members of the Oversight Board violated the Appointments Clause of the Constitution because they were not nominated by the President and confirmed by the Senate. Relying on the *de facto* officer doctrine, the appeals court went on to rule that its opinion would "not eliminate any otherwise valid actions of the Board prior to the issuance of our mandate in this case." *Aurelius Investment LLC v. Commonwealth of Puerto Rico*, 915 F.3d 838 (1st Cir. Feb. 15, 2019). For ABI's report on the First Circuit opinion, click here.

Without prompting from the parties, the First Circuit held up the issuance of the mandate for 90 days, giving the Senate time to confirm the appointment of the Board members. The appeals court did not enter a stay.

The Oversight Board filed its petition for *certiorari* on April 23. Four other petitions followed, by the U.S. Solicitor General, Aurelius, the official creditors' committee, and a labor union in Puerto Rico.

The justices of the Supreme Court met in conference on Thursday, June 20, to consider the petition. Ordinarily, the Court issues orders granting or denying petitions on the following Monday. Instead, the Court issued its order on June 20 granting the petition, setting out a briefing schedule, and stating that oral argument will be held on October 15 or 16, the second week the justices will hear arguments in the coming term.

Meanwhile, the First Circuit had declined to issue a stay at the Board's request but instead further delayed issuance of the mandate until July 15. On June 18, the Oversight Board filed a motion again asking the First Circuit to delay issuance of the mandate until the Supreme Court finally disposes of the appeal. The Board asked the appeals court to act by June 24, so time enough would remain to ask the Supreme Court for a stay pending appeal.

The Questions Presented

The justices granted *certiorari* to review two questions: (1) Did the Appointments Clause of the Constitution require Senate confirmation of the members of the Oversight Board; and (2) does

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the *de facto* officer doctrine allow the Board to continue acting validly prior to the issuance of the mandate?

The first briefs are due by July 25, with the last briefs due on October 8. The justices slapped page limits on all the briefs, with the longest allocated 20,000 words.

Senate confirmation of Board members would seemingly moot the appeal in the Supreme Court. However, the Board told the First Circuit "there is virtually no possibility that the Senate will confirm the Board members before the mandate issues on July15."

Even if the chief issues become moot following Senate Confirmation, questions remain regarding the validity of actions taken by the Board before and after the First Circuit's opinion. It is questionable whether the Supreme Court would reach out to decide those more amorphous questions if the issue in chief becomes moot. If questions remain, the Court might remand the case to the First Circuit.

The appeal is *Financial Oversight and Management Board for Puerto Rico v. Aurelius Investment LLC*, 18-1334 (Sup. Ct.).

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The appeals court is attempting to avoid chaos despite ruling that the appointment of Puerto Rico Oversight Board members violated the Appointments Clause of the Constitution.

First Circuit Cans the Puerto Rico Oversight Board as Unconstitutionally Appointed

Reversing the district court, the First Circuit threw the Puerto Rico debt restructuring into a cocked hat by declaring that the appointment of the members of the Financial Oversight and Management Board of Puerto Rico violated the Appointments Clause of the Constitution because they were not nominated by the President and confirmed by the Senate.

The appeals court attempted to limit damage by declaring that the ruling will not go into effect for 90 days, allowing the President and the Senate in the meantime to validate the appointments to the Board or to reconstitute the Board in accordance with the Appointments Clause.

Relying on the *de facto* officer doctrine, the First Circuit ruled that its opinion would "not eliminate any otherwise valid actions of the Board prior to the issuance of our mandate in this case." In other words, the appeals court is allowing the Board to continue functioning for 90 days and will not unravel any actions already taken by the Board.

But that's not the end of the story. The bondholders who brought the appeal wanted the First Circuit to dismiss Puerto Rico's debt restructuring and invalidate all of the Board's prior actions.

By having been denied some of the relief they sought, the bondholders are entitled to file a petition for rehearing *en banc* in the First Circuit or, more likely, a petition for *certiorari* in the Supreme Court.

Until a petition for *certiorari* is denied or the First Circuit's opinion becomes final, there will be a pall of uncertainty over the ongoing debt restructuring under the Puerto Rico Oversight, Management, and Economic Stability Act, or PROMESA (48 U.S.C. §§ 2161 *et. seq.*).

The Challenge to the Board

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 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.

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District Judge Laura Taylor Swain, sitting in the District of Puerto Rico by designation, held a hearing in January 2018 and issued a 35-page opinion in July, holding that PROMESA and the Board were properly constituted under the Territories Clause of the Constitution, Article IV, Section 3, Clause 2. *In re The Financial Oversight and Management Board for Puerto Rico*, 17-3283 (D.P.R. July 13, 2018). To read ABI's discussion of the district court opinion, click here.

The bondholders appealed, asking the First Circuit to invalidate the appointment of the Board and suggesting that the appeals court should declare that the Board's actions have been invalid. In a 55-page opinion on February 15 by Circuit Judge Juan R. Toruella, the bondholders won the argument on the Appointments Clause.

The Circuit Court's Rulings

The appeal was a contest between two former Solicitors General, Theodore B. Olson for the bondholders and Donald B. Verrilli, Jr. for the Board. Olson won the day in large part, just as he did in the Supreme Court in *Bush v. Gore*.

The opinion is of greatest significance for constitutional law scholars. Reminiscent of the turmoil created in the bankruptcy courts by *Northern Pipeline*, the remedies portion of the opinion attempts to limit the damage caused by overturning the Board's appointment. *Cf. Northern Pipeline Construction Co. v. Marathon Pipeline Co.*, 102 S. Ct. 2858 (1982).

Differing from the district court, the First Circuit ruled that the Territorial Clause did not displace the Appointments Clause in naming members of the Board. Judge Toruella reasoned that the Appointments Clause is the more specific provision in the Constitution and controls over the more general Territorial Clause.

Next, the appeals court had no difficulty deciding that the Board members were "officers of the U.S.," because they occupy a continuing position and exercise significant authority pursuant to laws of the U.S. In that regard, Judge Toruella noted that major federal appointments to Puerto Rico's civil government in the first half of the 20th century were made under the Appointments Clause, apart from a short period of military administration following the Spanish-American War.

From there, Judge Toruella explained why the Board members were not "inferior officers": because they "are answerable to and removable only by the President and are not directed or supervised by others who were appointed by the President and confirmed by the Senate."

Since they therefore were "principal officers," Judge Toruella found a constitutional violation because they were not appointed by the President and confirmed by the Senate.

The Remedy

Judge Toruella said the bondholders wanted the appeals court to dismiss the PROMESA proceedings. He said they "suggest that we ought to deem invalid all of the Board's actions until today."

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The bondholders wanted a constitutionally reconstituted Board to ratify, or not, the unconstitutional Board's actions. (Imagine the complexities and uncertainty in deciding whether to set aside actions taken in reliance on final court orders.)

Judge Toruella said there was "unlikely" to be a "perfect solution." He sought a remedy "to reduce the disruptions that our decision may cause." He found salvation in the severability clause in PROMESA, allowing him to set aside Board appointments without invalidating the entire legislation.

Judge Toruella overruled the bondholders' desire to dismiss the PROMESA proceedings, saying that dismissal would "cast a specter of invalidity over all of the Board's actions until the present day." Instead, he adopted the *de facto* officer doctrine.

Described as an "ancient tool of equity," he said the doctrine confers validity on actions taken by someone acting under an official title even though the appointment is later discovered to be improper.

Declining to dismiss the PROMESA proceedings, Judge Toruella said that the appeals court would "not eliminate any otherwise valid actions of the Board prior to the issuance of our mandate in this case." In that respect, he alluded to the Federal Elections Commission, where the Supreme Court did not invalidate the Commission's past acts, although the members had been appointed in contravention of the Appointments Clause.

Judge Toruella said the appeals court would not issue the mandate for 90 days, giving the President and the Senate time to "validate the currently defective appointments or reconstitute the Board in accordance with the Appointments Clause." In the meantime, he said, "the Board may continue to operate as until now."

What's Next?

Will the President quickly nominate and the Senate confirm the current members of the Board? By their actions so far, the Board members have made as many enemies as they have friends.

And if the President and the Senate do not act, what then? Will the First Circuit extend the deadline? Unlike the situation in *Northern Pipeline*, there can't be a local court rule to serve as a temporary fix.

There is a different President who may not be partial to sitting Board members selected by the former President. And even if the President goes along, will the Senate confirm?

Under PROMESA as written, six members of the Board were selected by the majority and minority leaders of the House and Senate. The initial selection mechanism is now invalid, because the President exercises the power of appointment, not the House and Senate.

And even if the Board is reappointed, uncertainty will remain unless the bondholders allow the First Circuit opinion to become final or the Supreme Court denies *certiorari*. And if the

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composition of the Board changes, will the members rethink the decisions and policies of their predecessor?

We decline to guess how this mess works out.

The opinion is *Aurelius Investment LLC v. Commonwealth of Puerto Rico*, 18-1671 (1st Cir. Feb. 15, 2019).

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Artificial Intelligence

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Lawyers' Duty of Tech Competence

Professor Lois R. Lupica
Maine Law Foundation Professor of Law
University of Maine School of Law

Lawyers' Duty of Tech Competence

In 2012 the ABA adopted "technology amendments" to the Model Rules:

- Updating the Comments to Rule 1.1 on lawyer technological competency;
- A new Rule 1.6 provision, addressing a lawyer's obligation to take reasonable measures to prevent inadvertent or unauthorized disclosure of information relating to the representation.

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Lawyers' Duty of Tech Competence Rule1.1 Comment [8]

- Maintaining learning and skill consistent with an attorney's duty of competence includes keeping "abreast of changes in the law and its practice, including the benefits and risks associated with relevant technology, . . ."

Duties of Competency, Diligence, Confidentiality and Safekeeping Client Property

- As lawyers rely more and more on technologies, and as those tools become more advanced and more complex, lawyers must be sure that they understand how those technologies work.

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Louisiana Rule on Professionalism (not its rules of professional conduct)

- I will use technology, including social media responsibly. My words and actions, no matter how conveyed, should reflect the professionalism expected of my as a lawyer.
- I will stay informed about changes in the law, communication, and technology, which affect the practice of law.

Louisiana Opinion

- **IF** a lawyer is going to use technology, the lawyer has a duty to comply with Rules 1.1 (competence), 1.3 (diligence), 1.4 (communication) and 1.15 (safekeeping property).
  - Lawyers must use technology competently and diligently. … Lawyers also have an obligation to diligently weigh the use of potential technology considering variables such as risk and a client's individual capacity or availability to use that technology.

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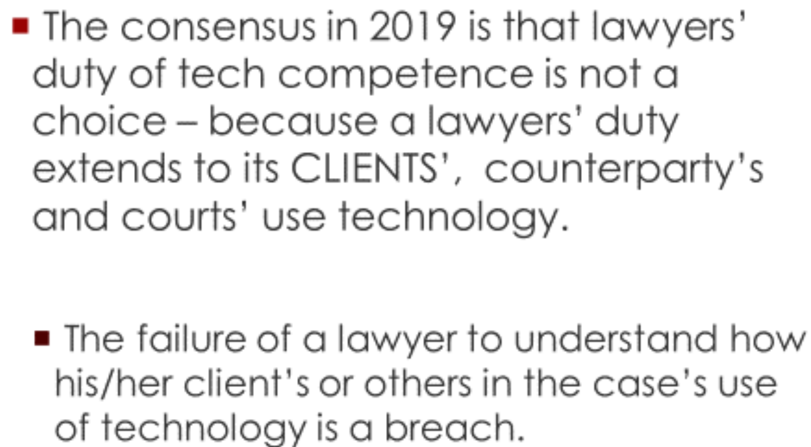
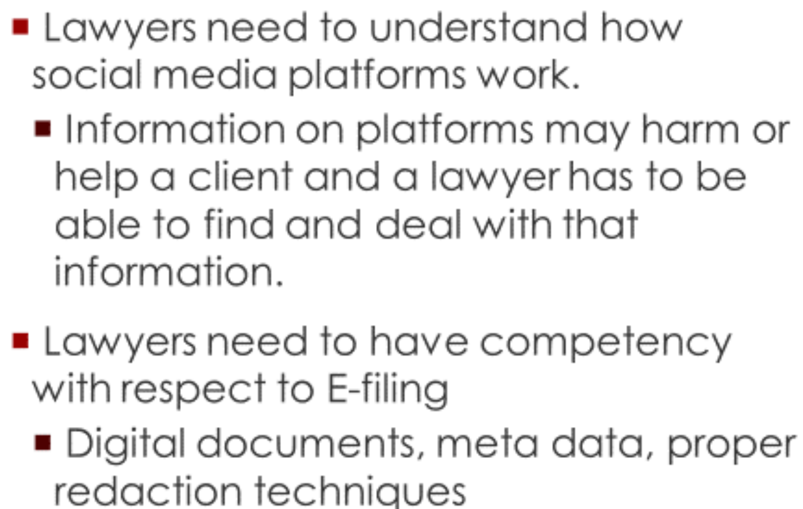

The consensus in 2019 is that lawyers' duty of tech competence is not a choice – because a lawyers' duty extends to its CLIENTS', counterparty's and courts' use technology.
The failure of a lawyer to understand how his/her client's or others in the case's use of technology is a breach.


Lawyers need to understand how social media platforms work.
Information on platforms may harm or help a client and a lawyer has to be able to find and deal with that information.
Lawyers need to have competency with respect to E-filing
Digital documents, meta data, proper redaction techniques

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- Lawyers must have a basic understanding of e-discovery and electronically stored information.
- Lawyers must understand of how client communication technology can impact duty of confidentiality.

- Lawyers must understand how to be cybersecure.
  - "Cybersecurity" includes a broad range of issues relating to preserving individuals' and institution's digital privacy.
  - It is a matter of "**when**," and not "if" digital records will get hacked.

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- Law firms tend to be targets:
  - they have, store and use highly sensitive information about their clients, and
  - the information in their possession is more likely to be of interest to a hacker and likely less voluminous than that held by the client.

Artificial Intelligence

Artificial Intelligence is the science and engineering of teaching computers how to learn, reason, communicate and come to conclusions.

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- We have to deal with the "black box" challenge.

Duty to Supervise

- Delegate to a person
- Delegate to a tech tool.

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- Over-delegation
- Under-delegation

Duties of Client Confidentiality

- Client confidentiality: confidences that clients share with their lawyers.
- Confidences can also be "shared" with AI-powered tools – and lawyers need to ensure that client confidences remain secure.

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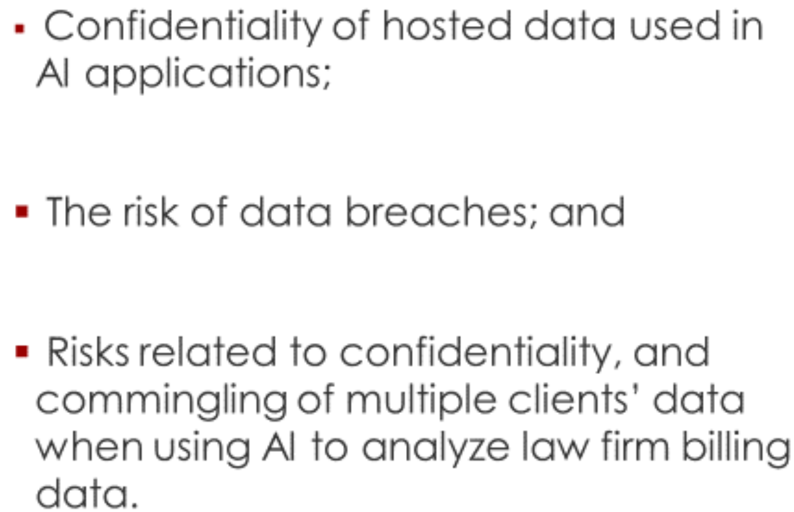

Unauthorized Practice of Law

- Expert systems
- Legal chatbots
  - AI-powered programs that interact with users who have legal issues by simulating a conversation or dialogue.

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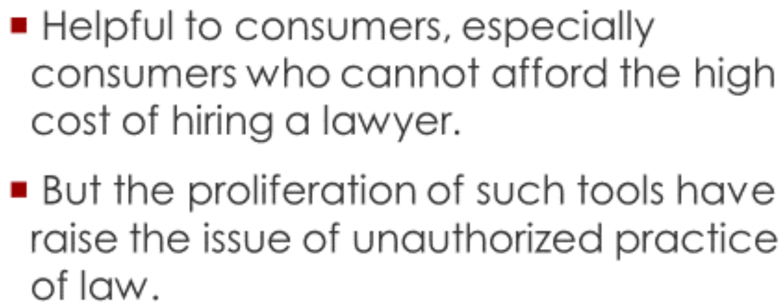

- Permitting regulated business to use technology to deliver legal services. State will establish ethical standards.
- Allowing non-lawyers, subject to regulation, to provide specified legal advice and services.
- Allowing entities that provide legal or law-related services to be owned by non-lawyers (subject to regulatory oversight).
- Allowing non-lawyers to hold a financial interest in law firms.

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- A lawyer's duty of competence includes keeping abreast of changes in law and in legal practice – and these changes, in 2019-2020, inevitably involve technology.

- It has been said that too many lawyers don't take this duty to keep up with technology seriously enough,
- Not just AI-based technology
  - But even more mundane things like practice management platforms, and other tools that make it easier and more efficient to practice law.

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"We need to have some understanding of what's going into an AI tool and what's coming out of it."

THE STATE BAR OF CALIFORNIA STANDING COMMITTEE ON PROFESSIONAL RESPONSIBILITY AND CONDUCT FORMAL OPINION NO. 2015-193

- An attorney lacking the required competence for e-discovery issues has three options:
  - (1) acquire sufficient learning and skill before performance is required;
  - (2) associate with or consult technical consultants or competent counsel; or
  - (3) decline the client representation. Lack of competence in e-discovery issues also may lead to an ethical violation of an attorney's duty of confidentiality.

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UCC Financing Statements

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How the Circuits Differ on the Sufficiency of a Financing Statement

By: Hon. Michael A. Fagone
U.S. Bankruptcy Judge
Bangor, Maine

A security agreement is a contract that creates and defines a security interest, affecting the rights of a borrower and a lender. A financing statement is a document filed in a public place for the purpose of perfecting a security interest as to third parties. *See* U.C.C. § 9-310(a). A financing statement that does not indicate the collateral covered by the financing statement is insufficient. *See* U.C.C. § 9-502(a)(3). In order to perfect security interests covering many types of collateral, a financing statement must sufficiently indicate the collateral. *See* U.C.C. § 9-504. Perfection acquires significance upon the filing of a petition under Title 11. If a security interest is not properly perfected, it may be avoided by a trustee under 11 U.S.C. § 544(a).

There is some disagreement about whether a financing statement sufficiently indicates the collateral by incorporating an unattached description. The issue turns on the interpretation of the version of Article 9 of the Uniform Commercial Code adopted by the jurisdiction in question. Under U.C.C. § 9-504, a "financing statement sufficiently indicates the collateral that it covers if the financing statement provides:

> (1) a description of the collateral pursuant to Section 9-108; or (2) an indication that the financing statement covers all assets or all personal property.

U.C.C. § 9-504.

The Official Comment to U.C.C. § 9-504 explains that:

> A financing statement sufficiently indicates collateral claimed to be covered by the financing statement if it satisfies the purpose of conditioning perfection on the filing of a financing statement, i.e., if it provides notice that a person may have a security interest in the collateral claimed.

U.C.C. § 9-504 cmt. 2.

Generally, a description of collateral consisting of real or personal property "is sufficient, whether or not it is specific, if it reasonably identifies what is described." U.C.C. § 9-108(a). Article 9 provides six methods of description that reasonably identify collateral: (1) specific listing; (2) category; (3) type of collateral defined in the U.C.C.; (4) quantity; (5) mathematical computation or allocation; or (6) "any other method, if the identity of the collateral is objectively determinable." U.C.C. § 9-108(b).

In First Midwest Bank v. Reinbold (In re I80 Equipment, LLC), 938 F.3d 866 (7th Cir. 2019) the court held that a financing statement need not contain within its four corners a description of

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the collateral but can instead accomplish perfection of a security interest by incorporating a description contained in an unattached security agreement. The court emphasized that the Illinois version of the U.C.C. previously required a financing statement to "contain" a description of the collateral but had been revised to require the statement to "indicate" the collateral. As described in the comments to the Illinois statute, that revision adopted the system of "notice filing" under which the financing statement is filed to provide notice of the potential existence of a security interest, requiring further inquiry to disclose the full state of affairs. The court interpreted the Illinois version of the U.C.C. to permit a party to indicate collateral in a financing statement by referencing a description of the collateral in the parties' security agreement. In support of this construction, the court highlighted the distinct purposes served by security agreements – which create and define security interests – and financing statements – which are streamlined and filed to provide notice of potential security interests. Under this view, a third party obtains notice of a security interest through a financing statement and can then obtain an adequate description of that security interest by requesting a copy of the security agreement.

In a recent decision from the First Circuit, the court reached the opposite conclusion about the meaning the version of the U.C.C. in effect in Puerto Rico in 2008. *See* Altair Global Credit Opportunities Fund (A), LLC v. Fin. Oversight & Mgmt. Bd. for P.R. (In re Fin. Oversight & Mgmt. Bd. For P.R.), 914 F.3d 694 (1st Cir. 2019). There, the court held that: (a) certain financing statements filed in 2008 were insufficient because the statements lacked a sufficient description of the collateral; (b) those defects were remedied by financing statement amendments filed in 2015; and (c) the perfected security interests at issue were not avoidable under section 544(a).

In 2008, the version of Article 9 of the U.C.C. in effect in Puerto Rico required a financing statement to "'contain[] a statement indicating the types, or describing the items, of collateral.'" Id. at 705 (quoting P.R. Laws Ann. Tit. 19, § 2152(1) (2008)). The financing statements filed in 2008 described the collateral as the property described in the attached security agreement. The security agreement was, in fact, attached to the financing statements but it did not describe the property except by reference to an unattached resolution. Neither the 2008 financing statements nor the attached security agreement described the collateral by type or identified where to find the resolution. And, the resolution was not located at the U.C.C. filing office. An interested party would have had to search for the resolution at its own expense, without any guidance, and with no guarantees of timely or accurate answers from the debtor. If the resolution were located, an interested party might reasonably have concerns about the resolution's accuracy and completeness. Although the financing statements provided notice of an interest in some unidentified collateral, the court viewed the burden of identifying the specific collateral too onerous for third parties in light of the U.C.C.'s purposes of providing effective notice and facilitating the expansion of commercial practices. For these reasons, the statements were held insufficient to provide notice of the collateral to creditors and ineffective for purposes of perfection. This defect was later remedied by amended financing statements that described the collateral by reference to an attached security agreement that actually described the property without reference to any unattached documents.

These divergent decisions are predicated on the interpretation of different versions of the U.C.C. perfection statute. However, the results have less to do with the language of the statute than with

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the courts' views of the notice purposes served financing statements, and whether those purposes are well- or ill-served by statements that require interested parties to do some homework.

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First Circuit reverses, upholding the validity of bondholders' security interests in $2.9 billion of collateral.

Puerto Rico Retirement System Bondholders Win Their Security Interest Back

Reversing the district court in part, the First Circuit did not decide whether the Puerto Rico Oversight, Management, and Economic Stability Act, or PROMESA (48 U.S.C. §§ 2161 *et. seq.*), could be used to avoid security interests granted before the enactment of PROMESA.

Perhaps motivated by the venerable legal principle known as rachmones, the First Circuit reversed District Judge Laura Taylor Swain, who had ruled in August that bondholders did not have a perfected a security interest in collateral securing $2.9 billion in bonds issued by the island commonwealth's employee retirement system, commonly known as ERS. (Rachmones is a Yiddish term meaning pity or sympathy. It is sometimes spelled rachmunis or rachmanis.)

Significantly, however, the First Circuit did uphold Judge Swain's ruling under the Uniform Commercial Code that a UCC-1 financing statement cannot describe collateral by reference to a document not found in the filing office.

The Avoidance Litigation

After the Supreme Court ruled that Puerto Rico was ineligible for chapter 9 municipal bankruptcy, Congress quickly adopted PROMESA. Months later, the Financial Oversight and Management Board of Puerto Rico 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.

ERS, Puerto Rico's retirement system, was authorized by statute to issue secured debt. The retirement system issued bonds in 2008 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. Unlike the original UCC-1 in 2008, the 2015 UCC-3s contained complete descriptions of the collateral. However, the continuation statements identified the debtor as ERS but did not use a new name, commonly abbreviated as RSE. Allegedly, RSE was the new name officially given to ERS in the English translation of an amendment to the statute governing the retirement system. The amendment was enacted after the bonds were issued but before the UCC-3s were filed.

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Acting on behalf of the retirement system in Puerto Rico's debt-adjustment proceedings, the Oversight 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 August, Judge Swain granted the Board's motion for summary judgment and declared the security interest to be unperfected and therefore unenforceable.

Judge Swain said that a financing statement need only "reasonably" identify the collateral under UCC § 9-110. The collateral description by reference, she said, may only refer to a document attached to the UCC filing or to another document on file in the UCC clerk's office. She therefore held that the original UCC-1s in 2008 failed to perfect the security interest.

The question remained: Was the security interest perfected by the filing of the UCC-3s in 2015, which did include a description of the collateral?

For Judge Swain, the UCC-3s raised a different question: Was the debtor properly identified because the UCC referred to ERS, not RES?

UCC § 9-503(a)(1) requires that 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." A trade name is insufficient under UCC § 9-503(c).

Judge Swain ruled that the UCC-3s failed to perfect the security interest because she concluded that ERS was a trade name, which "Article 9 expressly provides is insufficient." She therefore held that the security interest was also unperfected by the filing of the UCC-3s.

To avoid the loss of secured status, the bondholders contended that the Board could not use Section 544(a) to invalidate a security interest granted before the enactment of PROMESA. However, Judge Swain held that Section 544(a) could be employed retroactively to avoid an unperfected security interest granted before the adoption of PROMESA.

The bondholders appealed.

The First Circuit's Reversal

The First Circuit reversed in part in an opinion on January 30 by Circuit Judge Sandra L. Lynch, who wrote two notable bankruptcy opinions in 2018 regarding the repeat-filing stay modification and the good faith defense to a discharge violation.

Agreeing with Judge Swain, Judge Lynch ruled that the bondholders were not perfected in 2008 because the collateral description was inadequate. Parting company with Judge Swain, Judge Lynch held that the bondholders did become perfected by the UCC-3s in 2015.

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With regard to the 2008 financing statements, Judge Lynch said they were "insufficient to perfect the security interest" because: (1) The collateral was "not described, even by type(s)," (2) the 2008 financing statements "do not tell interested parties where to find the referenced documents," and (3) the bond resolution laying out the collateral was "not at the UCC filing office."

Judge Lynch said bondholders were not secured at the outset because the original filings did not give "fair notice to other creditors and the public of a security interest."

On the other hand, Judge Lynch concluded that the bonds became secured on the filing of the UCC-3s in 2015. The opinion will have little precedential value beyond Puerto Rico, because she said the result turned on "a unique confluence of circumstances involving two languages and a translation."

Puerto Rico has two official statutory languages, Spanish and English. The 2013 Spanish language statute allegedly changing the retirement system's official name from ERS to RSE was not officially translated into English until a year later.

Judge Lynch explained that the English language version uses the two terms "seemingly interchangeably." Indeed, RSE is used only three times in the statute, while ERS appears more than 35 times.

Despite the prevalence in the usage of ERS, the Oversight Board contended that the one subsection in the statute using RES was the only provision that governed the retirement system's official name. On that basis, Judge Swain believed that ERS was not the proper name for UCC filings.

Interpreting the language of UCC § 9-503(a)(1), Judge Lynch said that the court was not obliged to follow only one clause in a statute to pinpoint the debtor's name in the "public organic record." Rather, she said, the "UCC provision directs focus to the entire 'public organic record.'"

In addition to the prevalence of the use of ERS in the English version of the statute, Judge Lynch pointed out that ERS was the name "consistently used by the [retirement system] itself, including in court filings, before and after the translation of the amended Act in 2014."

Having concluded that the bondholders were secured after all, Judge Lynch did not reach the question of whether the Bankruptcy Code's avoiding powers can be employed to set aside a transaction that occurred before the adoption of PROMESA.

The appeals court remanded the case to Judge Swain for further consideration in light of the opinion.

The opinion is *Altair Global Credit Opportunities Fund (A) LLC v. Financial Oversight and Management Board for Puerto Rico (In re Financial Oversight and Management Board for Puerto Rico)*, 18-1836 (1st Cir. Jan. 30, 2019).

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Seventh Circuit holds that a financing statement is sufficient if it describes collateral by reference to an unattached security agreement.

Seventh Circuit Splits with the First Circuit on Sufficiency of Financing Statements

The Seventh Circuit held that a financing statement under the Uniform Commercial Code sufficiently describes collateral by referring to an *unattached* security agreement. In other words, no description of the collateral need be contained within the four corners of the financing statement.

Prof. Bruce Markell told ABI that the opinion "neuters the collateral description requirement in Article 9 financing." Markell is now the Professor of Bankruptcy Law and Practice at the Northwestern Univ. Pritzker School of Law. Before returning to teaching, Prof. Markell was a bankruptcy judge in Nevada and a member of the Ninth Circuit Bankruptcy Appellate Panel.

The Security Interest in All Assets

The lender had taken a security interest in all of the debtor's assets. There was no dispute about the adequacy of the security agreement, which granted a security interest in 26 categories of collateral.

The timely filed financing statement described the collateral, in substance, as "all collateral described in the security agreement," which was not attached to the financing statement. Two years later, the chapter 7 trustee contended that the security interest was unenforceable because the financing statement lacked a sufficient description of the collateral.

The bankruptcy judge agreed with the trustee and ruled that the security interest was voidable because the financing statement itself contained no description of the collateral. The Seventh Circuit accepted a direct appeal.

Reversal Based on 'Plain Language'

Circuit Judge Michael B. Brennan reversed the bankruptcy court based on the "plain and ordinary meaning" of Illinois's version of the UCC.

In his September 11 opinion, Judge Brennan laid out the UCC's requirements regarding the sufficiency of a financing statement. In pertinent part, Section 9-502 requires the financing statement to "indicate the collateral covered by the financing statement."

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Next, Section 9-504 lists six ways in which a financing statement can "sufficiently indicate[]" the collateral. The sixth, catchall provision allows "any other method, if the identity of the collateral is objectively determinable."

Judge Brennan said that the current version of the Illinois UCC no longer requires "the financing statement [to] 'contain' a description of the collateral; after revision [in 2001] the statement must only 'indicate' the collateral."

According to Judge Brennan, the "plain reading of the text" leads to the conclusion that a financing statement may "indicate" the collateral by "pointing or directing attention to a description of that collateral in the parties' security agreement."

To buttress his conclusion that incorporation by reference is sufficient, Judge Brennan cited Seventh Circuit authority for the proposition that Article 9 of the UCC is neither a "minefield" for lenders nor a "windfall" for trustees. He also cited decisions by three bankruptcy judges in Illinois that he interpreted as allowing incorporation by reference.

To Judge Brennan's way of thinking, a financing statement is sufficient if it "puts third parties on notice that a creditor may have an existing security interest."

In short, Judge Brennan held that the "plain and ordinary meaning" of the revised Illinois UCC "allows a financing statement to indicate collateral by reference to the description in the underlying security agreement."

Observations

Judge Brennan did not cite or discuss contrary decisions from other states, notably the First Circuit's decision in *Altair Global Credit Opportunities Fund (A) LLC v. Financial Oversight and Management Board for Puerto Rico (In re Financial Oversight and Management Board for Puerto Rico)*, 914 F.3d 694, 711-712 (1st Cir. Jan. 30, 2019). There, the First Circuit said that a financing statement is insufficient if it describes collateral by reference to a document not found in the filing office. To read ABI's report on the *Puerto Rico* decision, click here.

"The [Seventh Circuit's] failure to cite, let alone discuss or distinguish, recent similar cases such as the First Circuit's recent *Puerto Rico* case underscores the frailty of its analysis," Prof. Markell said.

Although the Seventh Circuit is typically not prone to relying on authorities from elsewhere, law under the UCC should be an exception because Section 1-103(a)(3) says it "must be liberally construed and applied . . . to make uniform the law among the various jurisdictions."

Prof. Markell observed, "Under the [Seventh Circuit's] reasoning, wouldn't the mere fact of filing a financing statement 'indicate' that there is collateral described somewhere? Otherwise, why file the financing statement in the first place?"

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If there is a motion for rehearing, and if possible in Illinois, it might be wise if the circuit were to certify the question for consideration by the Illinois Supreme Court. Otherwise, lenders may begin referring to collateral by reference and thus expose themselves to the danger that an Illinois state court will later rule the description to be inadequate.

The opinion is *First Midwest Bank v. Reinbold (In re 180 Equipment LLC)*, 18-3291 (7th Cir. Sept. 11, 2019).

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The Automatic Stay

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Disagreeing with the Tenth and D.C. Circuits and siding with four other circuits, the Seventh Circuit rules that passively holding estate property violates the automatic stay.

Seventh Circuit Solidifies a Circuit Split on the Automatic Stay

Solidifying a split of circuits, the Seventh Circuit ruled that the City of Chicago must comply with the automatic stay by returning impounded cars immediately after being notified of a chapter 13 filing.

The decision lays the foundation for the Supreme Court to grant *certiorari* and decide whether violation of the automatic stay requires an affirmative action or whether inaction amounts to control over estate property and thus violates the stay.

The Second, Seventh, Eighth, Ninth and Eleventh Circuits hold that a secured creditor or owner must turn over repossessed property immediately or face a contempt citation. The Tenth and the District of Columbia Circuits have ruled 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), which prohibits "any act . . . to exercise control over property of the estate."

The same issue was argued on May 23 in the Third Circuit, where the lower courts were siding with the minority. *See Denby-Peterson v. NU2U Auto World*, 18-3562 (3d Cir.). For ABI's report on *Denby*, click here.

The Impounded Cars in Chicago

Four cases went to the circuit together. The facts were functionally identical.

The chapter 13 debtors owed between $4,000 and $20,000 on unpaid parking fines. Before bankruptcy, the city had impounded their cars. Absent bankruptcy, the city will not release impounded cars unless the fines are paid. If the cars are not redeemed by their owners, most of them are scrapped.

In 2016, Chicago passed an ordinance giving the city a possessory lien on impounded cars.

After filing their chapter 13 petitions, the debtors demanded the return of their autos. The city refused to release the cars unless the fines and other charges were paid in full.

The debtors mounted contempt proceedings in which four different bankruptcy judges held that the city was violating the automatic stay by refusing to return the autos. After being held in contempt, the city returned the cars but appealed.

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In all four cases, the owners confirmed chapter 13 plans treating the city as holding unsecured claims. The city did not object to confirmation or appeal.

In the four cases, the city never sought adequate protection for its alleged security interests under Section 363(e).

Thompson Controls

Circuit Judge Joel M. Flaum was not writing on a clean slate in his June 19 opinion, given the circuit's controlling precedent in *Thompson v. General Motors Acceptance Corp.*, 566 F.3d 699 (7th Cir. 2009). *Thompson*, he said, presented "a very similar factual situation."

Although *Thompson* came down only 10 years ago, Judge Flaum nonetheless wrote a comprehensive, 27-page opinion, perhaps sensing that the case will go to the Supreme Court on *certiorari*.

In *Thompson*, Judge Flaum said, "we held that a creditor must comply with the automatic stay and return a debtor's vehicle upon her filing of a bankruptcy petition. We decline the City's request to overrule *Thompson*." He also agreed with the bankruptcy courts "that none of the exceptions to the stay apply."

Quoting extensively from *Thompson*, Judge Flaum said that the Seventh Circuit had already "rejected" the city's contention that "passively holding the asset did not satisfy the Code's definition of exercising control." He noted that Congress amended Section 362 in 1984 by adding subsection (a)(3) and making the automatic stay "more inclusive by including conduct of 'creditors who seized an asset pre-petition,'" citing *U.S. v. Whiting Pools Inc.*, 264 U.S. 198, 203-204) (1983).

Again citing *Whiting Pools*, Judge Flaum said that Section 362(a)(3) "becomes effective immediately upon the filing of the petition and is not dependent on the debtor first bringing a turnover action." He added, the "creditor . . . has the burden of requesting protection of its interest in the asset under Section 363(e)."

Judge Flaum found support for his conclusion in Section 542(a). Again quoting *Thompson*, he said the section "'indicates that turnover of a seized asset is compulsory.'" *Thompson*, *supra*, at 704.

"Applying *Thompson*," Judge Flaum held "that the City violated the automatic stay . . . by retaining possession . . . after [the debtors] declared bankruptcy." The city, he said, "was not passively abiding by the bankruptcy rules but actively resisting Section 542(a) to exercise control over the debtors' vehicles."

Telling Chicago how to proceed in the future, Judge Flaum said the city must turn over the car and may seek adequate protection on an expedited basis. The burden of seeking adequate

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protection, he said, "is not a reason to permit the City to ignore the automatic stay and hold captive property of the estate, in contravention of the Bankruptcy Code."

In sum, Judge Flaum declined the city's invitation to overrule *Thompson*. He said, "Our reasoning in *Thompson* continues to reflect the majority position and we believe it is the appropriate reading of the bankruptcy statutes."

Exceptions to the Automatic Stay

Judge Flaum devoted the last third of his opinion to explaining why Chicago was not eligible for any of the exceptions to the automatic stay.

Section 362(b)(3), allowing acts to perfect or continue perfection of liens, does "not permit creditors to retain possession of debtors' property," Judge Flaum said. Rather, it allows creditors to file notices to continue or perfect a lien when bankruptcy has intervened. The city, he said, could perfect its possessory lien by a filing with the Secretary of State.

Judge Flaum cited Illinois decisions holding that giving up possession involuntarily does not destroy a possessory lien. The notion that turning over cars would abrogate the possessory lien was one of Chicago's primary arguments on appeal.

Judge Flaum held that Section 362(b)(4), excepting police or regulatory powers from the automatic stay, did not apply. On balance, he said, the municipal machinery to impound cars "is an exercise of revenue collection more so than police power."

Is *Certiorari* Next?

In the term that ends this month, the Supreme Court denied a petition for *certiorari* raising the same question. *See Davis v. Tyson Prepared Foods Inc.*, 18-941 (Sup. Ct.) (cert. denied May 20, 2019).

Davis, from the Tenth Circuit, was a challenge to the Tenth Circuit's holding in *WD Equipment v. Cowen (In re Cowen)*, 849 F.3d 943 (10th Cir. Feb. 27, 2017). In *Cowen*, the Tenth Circuit ruled 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." To read ABI's discussion of the denial of *certiorari*, click here.

In this writer's opinion, the Chicago parking ticket cases are a better vehicle for *certiorari* because they raise the issue more cleanly. *Davis* was a step or two removed from the question of whether overt action is required to violate the automatic stay.

Given the recent change in administration in Chicago, it is not certain that the city will pursue *certiorari*.

Eric Brunstad told ABI, "The issue is certainly not going away. I predict that eventually the Supreme Court will grant *certiorari* in a case involving the issue and resolve the conflict among

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the courts of appeals." Brunstad represented the debtor who unsuccessfully sought Supreme Court review in *Davis*.

The opinion is *In re Fulton*, 18-2527, 2019 BL 225881 (7th Cir. June 10, 2019).

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Third Circuit also holds that turnover in Section 542(a) is not automatic. The debtor must mount an adversary proceeding to obtain a turnover of property.

Circuit Split Narrows on the Automatic Stay and Turnover of Repossessed Cars

Taking sides with the minority in a circuit split, the Third Circuit held that the automatic stay in Section 362(a) does not require a secured creditor to turn over repossessed property immediately or face a contempt citation.

The Philadelphia-based appeals court went on to hold that a creditor is not required to turn over property under Section 542(a) unless the debtor has mounted an adversary proceeding and filed a complaint demanding turnover.

The appeals court found the answers in the language and purpose of the statute.

The identical issue is now before the Supreme Court on a pending petition for *certiorari* to the Seventh Circuit in *City of Chicago v. Fulton*, 19-357 (Sup. Ct.). The petition was filed in September. The response is due November 18. We may know before the year's end whether the justices will take the case and resolve the split. As it now stands, five circuits hold that a creditor violates the automatic stay by not turning over property on request after notice of filing. Three circuits believe that inaction does not violate the stay.

The Facts

The facts in the Third Circuit case were typical. The debtor had purchased a car but defaulted on payments to the lender. Before bankruptcy, the lender repossessed the car.

After filing, the debtor demanded that the lender turn over the car. When the lender did not comply, the debtor filed a turnover motion in bankruptcy court and sought the imposition of sanctions under Section 362(k) for willful violation of the automatic stay.

Bankruptcy Judge Andrew B. Altenburg, Jr., of Camden, N.J., directed the lender to turn over the auto, assuming the debtor could show proof of insurance. Predicting how the Third Circuit would rule, he followed the minority and denied the motion for sanctions, holding that the lender had not violated the automatic stay.

Also predicting how the Third Circuit would come down, District Judge Noel L. Hillman, also of Camden, upheld Judge Altenburg in an opinion in November 2018. To read ABI's report, click here.

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Stay Violation Requires an Affirmative Act

In his October 28 opinion, Circuit Judge Fuentes Julio M. Fuentes was answering a case of first impression in the circuit. He said that the Second, Seventh, Eighth, Ninth and Eleventh Circuits would find a stay violation in the circumstances, while the Tenth and District of Columbia Circuits would not.

The case turned on Section 362(a), which "operates as a stay . . . of . . . (3) any act . . . to exercise control over property of the estate." Applied to the case at hand, Judge Fuentes found no ambiguity in the statute.

For Judge Fuentes, the critical words were "control" and "exercise." From dictionary definitions, he deduced that Section 362(a)(3) "prohibits creditors from taking any affirmative act to exercise control over property of the estate." In other words, he said, "the text of Section 362(a)(3) requires a post-petition affirmative act to exercise control over property of the estate."

In the case on appeal, Judge Fuentes said that retaining possession of the car was not a post-petition affirmative act.

Beyond the language of the statute, Judge Fuentes said that his conclusion was in accord with "the legislative purpose and underlying policy goals of the automatic stay." The "primary purpose" of the stay, he said, is "to maintain the *status quo*."

By retaining possession of the car, Judge Fuentes said that the lender was maintaining the *status quo*. Holding otherwise, he said, "would directly contravene the *status quo* aims of the automatic stay." Congress, in his view, "did not intend passive retention to qualify" as an act to exercise control of estate property.

Judge Fuentes rejected the debtor's argument based on the 1984 amendments, which added the "exercise control" language. The amendment carried no weight, he said, because there was no legislative history explaining the intent of Congress.

Section 542(a) Doesn't Help

The debtor argued that Section 362(a)(3) operates hand in glove with Section 542(a), which says that someone in possession or control of estate property "shall deliver" the property to the trustee. To the debtor's way of thinking, the word "shall" means the person in control of property must turn it over automatically, without court compulsion.

To the contrary, Judge Fuentes said that turnover under Section 542(a) "is not self-effectuating; in other words, a creditor's obligation to turn over estate property to the debtor is not automatic."

"Rather," Judge Fuentes said, "the turnover provision requires the debtor to bring an adversary proceeding in Bankruptcy Court in order to give the Court the opportunity to determine whether the property is subject to turnover under Section 542(a)."

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As it was with the automatic stay, Judge Fuentes said that "the plain language" of Section 542(a) "also shows that the provision is not self-effectuating." That is to say, the "shall" language, he said, "is mandatory in the context of an adversary proceeding presided over by the Bankruptcy Court."

Because the lender elected not to participate in the appeal, the Third Circuit tapped Craig Goldblatt of Wilmer Cutler Pickering Hale & Dorr LLP in Washington, D.C., to submit a brief and argue on behalf of the lender. Coincidentally or not, Mr. Goldblatt is counsel for the petitioner for *certiorari* in *Fulton*. Mr. Goldblatt has argued three cases in the Supreme Court.

Observations

This writer interprets the opinion to mean that a debtor must initiate an adversary proceeding, pay the filing fee, file a complaint, and submit a motion for summary judgment or a motion for a temporary or preliminary injunction before securing possession of a car or other estate property.

In addition to delay, mounting an adversary proceeding will add measurably to the debtor's costs and attorneys' fees. On the other hand, the increased cost and delay may end the practice of filing a chapter 13 petition in the Third Circuit only to regain possession of a car.

The Third Circuit's discussion of Section 542(a) is a curious interpretation of "shall." In substance, the court says that turnover is mandatory only after the bankruptcy court has directed the creditor to turn over property. In that sense, the use of "shall" seems superfluous because court orders are always mandatory.

To read ABI's discussion of the Seventh Circuit's *Fulton* decision, which is the subject of a petition for *certiorari*, click here.

The opinion is *In Denby-Peterson*, 18-3562 (3d Cir. Oct. 28, 2019).