



AMERICAN
BANKRUPTCY
INSTITUTE

2018 Midwest Regional Bankruptcy Seminar

Great Debates

Timothy J. Hurley, Moderator

Taft Stettinius & Hollister LLP; Cincinnati

We've Had Our Differences, but Your Bankruptcy Filing Makes Me Whole

Resolved: Provisions for make-whole premiums on debts automatically accelerated by a bankruptcy filing should be enforced.

For: William J. Rochelle, III

American Bankruptcy Institute; New York

Against: Hon. Robert E. Gerber (ret.)

Joseph Hage Aaronson LLC; New York

There's Gold in Them Thar Shares

Resolved: Golden share provisions restricting the debtor's authority to file bankruptcy should be enforced.

For: Kim Martin Lewis

Dinsmore & Shohl LLP; Cincinnati

Against: Ellen Arvin Kennedy

Dinsmore & Shohl LLP; Lexington, Ky.

Damned If I Do (Fraud), Damned If I Don't (Malpractice): Bankruptcy Planning, Exempt Assets and Stuff Like That

Resolved: The debtor should convert nonexempt assets into exempt or restricted assets whenever possible before filing bankruptcy.

For: Robert A. Goering

Goering & Goering, LLC; Cincinnati

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Articles of Interest

Devin Burke Hahn, *Recovery of Make-Whole Premiums in Bankruptcy Cases: a Circuit Spilt and an Uncertain Shift*, 27 NO. 2 J. BANKR. L. & PRAC. NL ART. 4 (2018).

Oscar N. Pinkas & Lauren Macksoud, *Second Circuit Sets Interest Rate Standard and Denies Make-Whole in Momentive Cramdown Plan*, 37-JAN AM. BANKR. INST. J. 44 (2018).

W. Austin Jowers et al., *Ultra Petroleum: A Departure from Third Circuit's Treatment of "Statutorily Impaired" Claims*, 37-JAN AM. BANKR. INST. J. 60 (2018).

Momentive: Key Second Circuit Decision Tackles Make-Whole Premiums and Cramdown Interest, JD SUPRA, Oct. 31, 2017, <https://www.jdsupra.com/legalnews/momentive-key-second-circuit-decision-86558/>.

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Hollace T. Cohen, *Is the Absolute Priority Rule Alive and Well? Jevic Threatens the Rule and Other Core Bankruptcy Principles*, 26 NO. 1 J. BANKR. L. & PRAC. NL ART. 3 (2017).

Sabina Jacobs, *Possible Makeover for Make-Wholes after EFH Decision*, 36-JAN AM. BANKR. INST. J. 10 (2017).

William J. Rochelle, III, *Third Circuit Splits with New York by Allowing Makewhole Premiums in Chapter 11*, ROCHELLE'S DAILY WIRE, Nov. 18, 2016, <https://www.abi.org/newsroom/daily-wire/third-circuit-splits-with-new-york-by-allowing-make-whole-premiums-in-chapter-11>

Geraldine Ponto & Ferve E. Ozturk, *Getting the Whole Make-Whole: Momentive and Energy Future Holdings Consider Equity*, 33-NOV AM. BANKR. INST. J. 38 (2014).

Scott K. Charles & Emil A. Kleinhaus, *Prepayment Clauses in Bankruptcy*, 15 AM. BANKR. INST. L. REV. 537 (2007).

Cases of Interest

In re MPM Silicones, L.L.C., 874 F.3d 787 (2d Cir. 2017) – In bankruptcy court, Judge Drain confirmed debtor's proposed Chapter 11 plan. The noteholders appealed on theory that the plan violated the “absolute priority” rule, that Chapter 11 “cramdown” interest rate was inadequate, and that the lower court had erroneously denied their request for make-whole premium. The district court affirmed and noteholders appealed. The Second Circuit held that, among other things, senior lien noteholders were not entitled to make-whole premium on notes which had been accelerated automatically upon debtors' Chapter 11 filing.

In re Energy Future Holdings Corp., 842 F.3d 247 (3rd Cir. 2016) – Reversing the bankruptcy and district courts' decisions, the Third Circuit held that first and second lien noteholders were entitled to make-whole premiums when the debtor opted to redeem outstanding notes in post-petition refinancing. The court also found that automatic acceleration of the notes triggered by bankruptcy filing did not negate the premium.

In re Ultra Petroleum Corp., 575 B.R. 361 (Bankr. S.D. Tex. Sep. 21, 2017) – Noteholders claimed make-whole premium and interest at contractual rate in Chapter 11 surplus case. Debtors objected. Judge Isgur denied debtors' objection, holding that the debtors failed to rebut the prima facie validity of the noteholder's claim; that noteholders must be paid all that they are entitled under state law, including make-whole premiums, to be considered unimpaired; and that the noteholders were entitled to interest at the default contract rate until they were unimpaired. The Debtors' appeal was certified and is now pending before the Fifth Circuit Court of Appeals.

In re AMR Corporation, 730 F.3d 88 (2nd Cir. 2013) – Debtors moved to obtain post-petition financing to pay indentures and lender objected to require payment to include the make-whole premium. The bankruptcy court denied the debtors' motion. On appeal, the Second Circuit held that: debtors were not required to use proceeds of post-petition financing to pay obligations like make-whole premiums that had been accelerated by bankruptcy filing; New York law supported the enforcement of an automatic acceleration provision in an indenture agreement with a make-whole payment; and debtors' payoff of other indentures did not trigger obligation for make whole premium to lender.

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In re Premier Entm't Biloxi LLC, 445 B.R. 582 (Bankr. S.D. Miss. 2010) – In a solvent debtor case, the indenture prohibited early payment. And undoubtedly because prepayment was prohibited, there was no contractual right to a prepayment premium. Nevertheless, the court found damages entitlements that would indeed draw post-petition interest. The court also considered a variety of issues with respect to noteholders' entitlement to a prepayment premium in a case where concluding among other things, that the no-call provisions of a trust indenture were unenforceable in bankruptcy; that the provisions of the indenture providing for automatic acceleration of the notes on default arising from the debtors' bankruptcy rendered the notes mature at the time of their repayment; the fact that the noteholders had no contractual right to a prepayment premium as an addition to the claims they held as oversecured creditors, did not foreclose them from asserting an unsecured damages claim for the damages they suffered due to the debtors' early payment of notes in an environment characterized by falling interest rates; and that because the debtors were solvent, their noteholders were entitled to post-petition interest on their unsecured damages claim.

In re Chemtura Corp., 439 B.R. 561 (Bankr. S.D.N.Y. 2010) (Gerber, J.) -- In another solvent debtor case, in the context of the approval of a settlement of a claims for make-whole provisions in two series of notes, the court discussed at length the law (and divergence of authority) with respect to their allowability, and easily found the settlement reasonable. Also the court observed, among other things, that "I don't think anybody could seriously argue that a no-call provision could ever be specifically enforceable in bankruptcy."

There's Gold in Them Thar Shares

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For: Kim Martin Lewis

Dinsmore & Shohl LLP; Cincinnati

Against: Ellen Arvin Kennedy

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Articles of Interest

Can Golden Shares Block a Bankruptcy Filing?, LEXOLOGY, May 24, 2018, <https://www.lexology.com/library/detail.aspx?g=1ab3c518-779d-453d-9574-7287ff46e6ed>.

Bankruptcy Remoteness Going to a Court of Appeals—Fifth Circuit Issues Speedy, Focused Affirmance of the Dismissal Petition, JD SUPRA, May 24, 2018, <https://www.jdsupra.com/legalnews/bankruptcy-remoteness-going-to-a-court-44151/>.

Lawrence Mittman & Geoffrey Raicht, *The Fifth Circuit, on May 22, 2018, Renders Important Real Estate Lending Decision Regarding Golden Shares*, HAYNESBOONE, May 25, 2018, <http://www.haynesboone.com/alerts/the-fifth-circuit-renders-important-real-estate-lending-decision>.

Cecily A. Dumas, David S. Forsh, *Considerations in Evaluating LLC Operating Agreement Constraints on Voluntary Filings*, 36-DEC AM. BANKR. INST. J. 26, Dec. 2017.

Eric L. Johnson, Mark G. Stingley, *Intervention Energy Holdings: Good Public Policy, or Unnecessary Intrusion into State Law?*, 35-NOV AM. BANKR. INST. J. 20, Nov. 2016.

Fifth Circuit Issues a Narrow Opinion Requiring Corporate Authority to File a Petition, ROCHELLE'S DAILY WIRE, May, 25, 2018, <https://www.abi.org/newsroom/daily-wire/fifth-circuit-issues-a-narrow-opinion-requiring-corporate-authority-to-file-a>

Cases of Interest

In Re: Franchise Services of North America Inc. v. U.S. Trustee; Macquarie Capital (USA), Inc., No. 18-60093, 2018 WL 2325909 (5th Cir. May 22, 2018). Shareholder made \$3M investment in exchange for 100% of debtor's preferred stock. Simultaneously, debtor reincorporated in Delaware with an amended certificate of incorporation that required the consent of the majority of each class of the debtor's

shareholders prior to filing a voluntary bankruptcy petition. When debtor later filed for bankruptcy, the preferred stock shareholder filed a motion to dismiss debtor's bankruptcy petition on grounds that the petition for bankruptcy was not authorized. The Court affirmed the dismissal of debtor's petition, holding that neither U.S. nor Delaware law prevented a shareholder from exercising a right to vote against a bankruptcy petition when that shareholder was also an unsecured creditor.

In re Bay Club Partners-472, LLC, 2014 WL 1796688 (Bankr. D. Or. May 6, 2014) – When the creditor financed the purchase of an apartment complex, the debtor agreed to add a bankruptcy waiver provision in favor of the creditor to the debtor's operating agreement. Upon the filing of a bankruptcy petition without the creditor's approval, the creditor filed a motion to dismiss for cause pursuant to § 1112(b). In denying the motion, the court found that “[t]he bankruptcy waiver in ... the Operating Agreement is no less the maneuver of an ‘astute creditor’ to preclude [the debtor] from availing itself of the protections of the Bankruptcy Code prepetition, and it is unenforceable as such, as a matter of public policy.”

In re Lake Mich. Beach Pottawattamie Resort LLC, 547 B.R. 899 (Bankr. N. D. Ill. 2016) – After defaulting on obligations to the creditor, the debtor agreed to add provisions in the debtor's operating agreement that made the creditor a “special member” of the indebted LLC and allowed the creditor block the debtor's petition for bankruptcy were void as against public policy when the operating agreement also provided that the creditor, in exercising its veto rights, had “no duty or obligation to give any consideration to any interest of or factors affecting the Company or the Members.”

In re Intervention Energy Holdings, LLC, 553 B.R. 258 (Bankr. D. Del. 2016) – In consideration for a creditor's forbearance from pursuing remedy for a debt in default, a debtor agreed to name the creditor as a member of the LLC and amended the LLC's operating agreement to require unanimous member consent before filing a petition for bankruptcy. Judge Carey held that the parties' agreement effectively served as an advanced waiver of bankruptcy protections in violation of federal public policy and, therefore, was unenforceable.

In re Lexington Hosp. Grp., LLC, 577 B.R. 676 (Bankr. E.D. Ky. 2017) – Judge Schaaf held that provisions in an amended operating agreement enabling a creditor to block a petition for bankruptcy were void as contrary to public policy because a loan was conditioned on the debtor's agreement to the changes to the operating agreement and the purpose of the changes to the operating agreement was to prevent the debtor from filing bankruptcy without the creditor's permission.

In re Squire Court Partners Ltd. P'ship, 574 B.R. 701 (E.D. Ark. 2017), *appeal dismissed sub nom. Squire Court Partners Ltd. P'ship*, No. 17-2700, 2018 WL 654419 (8th Cir. Jan. 5, 2018) - Partnership established under Arkansas law was created to acquire and operate an apartment complex. Limited partner contributed \$1.3 million in exchange for a 99.98% interest in the debtor. Another entity became a limited partner and was given a .01% interest in the debtor. The general partner was given a .01% interest in the debtor. General partner had exclusive authority to control the debtor's assets and

affairs, but the partnership agreement required unanimous consent of all partners before any bankruptcy filing. After a default on a promissory note to Wells Fargo on the apartment complex, General partner filed a bankruptcy petition. Limited partner filed a motion to dismiss the bankruptcy case arguing that the debtor lacked corporate authority to file the petition. In holding that unanimous consent clause was not void as violating federal public policy, the court distinguished *Lake Michigan Beach*, *Intervention Energy*, and *Bay Club Partners*. The court found that in those three cases, the blocking provisions violated federal public policy because as a condition for supplying credit to a debtor, the creditor was attempting to limit the debtor's rights to file bankruptcy. The court held that “[t]he limited partners [of Squire Court], however, are owners, and not creditors of Squire Court.

**Damned If I Do (Fraud), Damned If I Don't (Malpractice):
Bankruptcy Planning, Exempt Assets and Stuff Like That**

Resolved: The Debtor Should Convert Non-exempt Assets Into Exempt or Restricted Assets Whenever Possible Before Filing Bankruptcy.

For: Robert A. Goering

Goering & Goering, LLC; Cincinnati

Against: Casey M. Cantrell Swartz

Taft Stettinius & Hollister LLP; Cincinnati

Articles of Interest

Jonathan R. Goldsmith, *Pigs Smell, Hogs Stink*, in AMERICAN BANKRUPTCY INSTITUTE, THE ETHICS TRIFECTA: HOW TO AVOID SANCTIONABLE BEHAVIOR, CROSSING THE LINE IN PRE-PETITION PLANNING, AND DANGEROUS CONFLICTS OF INTEREST, 071416 ABI-CLE 343 (Jul. 14, 2016).

Alvin C. Harrell, *Case Note: Fraudulent Transfers and Attorney Obligations in Bankruptcy*, 66 CONSUMER FIN. L. Q. REP. 56 (2012).

David Farmer, *Is Conversion of Nonexempt Property to Exempt Property on Eve of Bankruptcy Fraudulent Per Se?*, 12-JUL HAW. B.J. 30 (2008).

Timothy D. Moratzka, *Fresh Start, Head Start or Running Start: Bankruptcy Exemption Planning*, 22-APR AM. BANKR. INST. J. 10 (2003).

Nathan F. Coco & David C. Christian II, *Squirreling It Away: The Business Lawyer's Role in Pre-bankruptcy Planning*, 12 A.B.A. BUS. L. SEC. (2003), <https://www.americanbar.org/content/dam/aba/publications/blt/2003/01/squirreling-it-away-200301.authcheckdam.pdf>.

Georgianne L. Huckfeldt, *Conversion of Nonexempt Assets to Exempt Assets Prior to Bankruptcy—A Question of Fraud?*, 56 MO. L. REV. 857 (1991).

Lloyd D. Cowell, Jr., *The Debtor and Conversion of Nonexempt Assets to Exempt Assets on the Eve of Bankruptcy: Astute Bankruptcy Estate Planning or Fraud*, 18 CAP. U. L. REV. 567 (1989).

Cases of Interest

Taylor v. Freeland & Kronz, 503 U.S. 638 (1992) – The Court held that a Chapter 7 trustee could not contest a claimed exemption after a 30-day objection period passed even though the debtor's exemption claim had no basis. The Court noted, however, that debtors and debtors' attorneys could face penalties for improper conduct in bankruptcy proceedings, including denial of discharge, sanctions, and criminal penalties.

In re Bronk, 775 F.3d 871 (7th Cir. 2015) – After pre-bankruptcy planning with counsel, debtor took out a mortgage against his previously unencumbered home to establish college savings accounts for grandchildren and converted a \$42,000 certificate of deposit into an annuity. When debtor filed for bankruptcy, the trustee objected to the college saving account and annuity transactions. The court denied the claimed exemption for the debtor's college savings accounts, but found that an annuity was exempt as a retirement benefit.

In re Grand Jury Proceedings, 609 F.3d 909 (8th Cir. 2010) – In a grand jury investigation of bankruptcy fraud, debtors' attorneys were compelled to provide documents and testimony to the government under the crime-fraud exception to attorney-client privilege. The debtors' transfer of virtually all non-exempt property to close relatives in a manner that indicated concealment was a sufficient indication of fraudulent intent for the district court to find probable cause of crime or fraud.

In re Beverly, 374 B.R. 221 (9th Cir. 2007) – Circumstantial evidence surrounding a debtor's transfer of \$1 million of nonexempt property to former spouse overwhelming supported finding of intent to hinder, delay, or defraud creditors. Additionally, the court found that debtor's conversion of nearly all nonexempt assets evidenced that debtor's exemption planning was intended to defraud creditors.

In re Johnson, 880 F.2d 78 (8th Cir. 1989) – Debtor converted approximately \$400,000 of nonexempt property into exempt property, including his home, individual retirement accounts, and musical instruments, in anticipation of bankruptcy. A creditor moved to deny discharge on basis that the conversion established debtor fraud. The court held that conversion of property from nonexempt to exempt alone was not sufficient to establish fraud without additional indicia of fraud.

Norwest Bank Nebraska, N.A. v. Tveten, 848 F.2d 871 (8th Cir. 1988) – When a debtor converted \$700,000 of nonexempt property to exempt property immediately before petitioning for bankruptcy, the court found that circumstantial evidence indicated the debtor's pre-bankruptcy transfers were intended to defraud creditors. Although the court noted that "absent extrinsic evidence of fraud, mere conversion of non-exempt property to exempt property is not fraudulent as to creditors even if the motivation behind the conversion is to place those assets beyond the reach of creditors," the court found that circumstantial evidence regarding the debtor's knowledge of pending lawsuits and deteriorating investments could serve as the basis for a finding of intent to defraud, delay, or hinder creditors.

In re Adlman, 541 F.2d 999 (2d Cir. 1976) – Debtor wife was denied discharge in bankruptcy on ground that wife, within 12 months preceding filing of her petition in bankruptcy, transferred property with intent to hinder, delay or defraud her creditors. Second Circuit held that even though wife sold family home to relatives and husband and wife, continuing to live in house, leased house from the relatives, and even though wife used proceeds to pay premiums of life policies and to repay loans outstanding on such policies, where payments were made by wife to secure protection for herself and her children and there existed no evidence of extrinsic fraud committed by the wife in making the payments, trial judge erred in finding as a matter of law that wife had actual intent to defraud her creditors in making the payments.

In re Crater, 286 B.R. 756 (Bankr. D. Ariz. 2002) – Debtor sold \$40,000 of Krispy Kreme stock and paid outstanding second mortgage with proceeds immediately prior to filing Chapter 7 bankruptcy. A creditor moved to deny the debtors' discharge on grounds that debtor's pre-exemption planning showed deception and concealment. The court observed that denial of discharge is appropriate only when there is a preponderance of the evidence of debtor's actual intent to defraud, delay, or hinder creditors. "Badges of fraud" can indicate concealment, deception or fraudulent intent by themselves, while other "badges of fraud" are innocent by themselves or only suggest a possible motivation to hinder, delay, or defraud creditors. In this case, the debtor's action of selling his only significant unencumbered nonexempt asset to pay down a second mortgage shortly after being served with a lawsuit fell entirely within the "badges of fraud" that are innocent by themselves. The court denied the creditor's motion and found the debtors' actions proper.

In re Breuer, 68 B.R. 48 (Bankr. N.D. Iowa 1985) - Trustee sought to avoid fraudulent transfer, alleging debtors' transfer of proceeds from sales of real estate into exempt life policies made approximately three weeks prior to filing of petition constituted avoidable transfer. The court held that: (1) notwithstanding allegation that debtors were insolvent on date of transfer or became insolvent as result of transfer, transfer would not be avoided as one for which debtor received less than reasonably equivalent value and was insolvent on date transfer was made or became insolvent as result of transfer, where there was no proof debtors received less than reasonably equivalent value for property; (2) bankruptcy court would not find from fact of conversion alone that conversion of nonexempt assets into exempt assets constituted fraud on creditors justifying avoidance of transfer; and (3) debtors' conversion of real property interests to exempt life policies would not be avoided as one made to defraud.

In re Levine, 40 B.R. 76 (Bankr. S.D. Fla. 1984) - Chapter 7 trustee sought to impose lien on debtor's homestead property because debtor paid off a loan secured by the property with nonexempt assets on eve of bankruptcy, contending that transfer was actionable fraud on creditors. Court held that debtor's prebankruptcy transfer of nonexempt property to exempt homestead property was not ipso facto fraud and did not establish an intent to hinder or delay creditors, and thus equitable lien on homestead property was not justified.

Matter of Blue, 5 B.R. 723 (Bankr. S.D. Ohio 1980) – At the time of the filing of the bankruptcy petition, the debtor had a life insurance policy with the debtor's sister as beneficiary. After bankruptcy was filed, the debtor changed to beneficiary to his minor son, which would have made the policy exempt under Ohio law. The court held that nonexempt property cannot be changed to exempt property after commencement of a case.

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EXEMPTION PLANNING OR FRAUD?

1. It's FRAUD if you don't disclose *US v. Allen*, 73 F.2 105 4th Cir. 1993, attorney sanctioned for advising low value 102 BR 247.
2. No fraud if you change venue to use State or Federal exemptions.
3. Hooray for the Debtor.
 - a. *H.R. Rep. No. 95-595, 95th Cong, 1st Sess. 361 (1977), reprinted in App. Pt. 4(d)(i) infra (the conversion of non-exempt property into exempt property is not per se fraudulent).*
 - b. But do it before filing

See 11 USC 522 (B)(2)(b) exempt only property held by debtor immediately preceding filing.

The law concerning conversion to exempt property was not without opposition.

Proposed Bankruptcy Act Revision; Hearings on H.R. 31 and H.R. 32 before the Subcommittee on Civil and Constitutional Rights of the Committee on Judiciary, 94th Cong., 2d Sess. 1355 (1976) (Statement of Hon. Arnold K. Phelps).

The creditors lost.
4. Two contrasting cases decided by the 8th Circuit CA the same day.
 - A. *Hanson vs. First National Bank*, 848 F.2 866 1989. 35m converted by farmers to exempt property held proper.
 - B. *Northwest Bank v. Tveten*, 848 F.2 871. \$ 700,000 converted by Physicians to exempt annuities held improper.

ISSUES

Fraudulent Intent

Factual finding controlled

5. 3 Bad Things can happen when Fraud is found
 - A. Property recovered by trustee
 - B. Discharge denied
 - C. Criminal prosecution
6. Pay down mortgage to increase exemption
 - A. This was found improper in *In Re: Meyer*, 206BR 410 ED Va 1997.
 - B. See also *In Re: Reed*, 700 F.2, 986 (5th Circuit 1983). Elaborate scheme to sell property for less than fair market to pay down mortgage. Exemption allowed by discharge denied.

HISTORY

1800 Allowed only clothing and bedding of the debtor and spouse and children

1841 Added household & kitchen furniture and necessities not to exceed \$300

1867 Increased amount to \$500 and exemption allowed by State

1898 Act allowed only State Exemptions and specific Federal exemptions

1938 Chandler Act- Didn't change exemptions

The 1970 Commission on the Bankruptcy Laws of the United States found that reliance on State law exemptions was intolerable for what is supposed to be a National System. And that deference to State Law exemptions was "destructive to the goals or rehabilitation of individual debtors." Congress didn't buy it.

The 1997 National Bankruptcy Commission report also recommended that State opt out provisions be eliminated. Congress didn't buy it.

Issue of when a cause of action is property of the estate:

Tyler vs PH Capital Management- 763 F3 455 (6th circuit 2013)

When it's the claim minimally actionable whether or not it is fully mature.

Chapter 13

Are after acquired Inheritance Property of the Chapter 13 estate available to the Trustee for payment of pre petition debt.

In Re Robinson 271 BR437 The purpose of exemption law is generally expressed in terms such as “to prevent private destitution and hardship, to support and stabilize the home and family unit, and to prevent impecunious debtors from burdening the public purse by resorting to charity and welfare programs.”

11USC 1306(a) broadens 11USC541 to include all property acquired post-petition.

Is that acquisition subject to 541 (a)(5) that is the 180 day period for inclusion of inheritances

Carroll vs Logan 4th CCA 735F3 147 Yes

BAP 10th CCA 356 BR788

No In Re Key 465BR 709 BCSD GA 2012

11USC similarly expands 541 for individual Chapter 11 debtors

Funds to pay back loans on Pension Plans do not count as disposable income in

Chapter 13 11USC1322 F

Borrow \$25,000 from person to pay down Student Loan wait 91 days and file

Chapter 13. Include payments on Pension loans in Budget.

Spendthrift Trust 11 USC 541(c) (2)

A spendthrift trust is one which, by the terms of the trust or by statute, restrains the voluntary or involuntary transfer of a beneficial interest. In *Re Coumbe* 304BR378 (9th CA BP 2003)

(Be careful in RI & NH) some states do not recognize spendthrift trusts.

Of Self settled trusts not available for exemption see in *Re Spenlinhauer* 101F3 106 (1st CCA) 10 year received 541(e) (1) (d) self-settled annuity trusts not exempt. In *Re Darby* 212 BR 382

Pension Funds excluded as Estate Property *Patterson vs Schumate* 504 US 763

ERISA qualified plans exempt however plan must cover more than just owner & spouse to qualify. Wife's interest in ex husband's ERISA qualified plan under a QDRO exempt.

IRA's exempt *Rousy vs Jacoway* 544 US 320

Stock Bonus Pension or Profit Sharing Plan

Limited to amount necessary to support debtor and dependents 11 USC 522 (E)

What is a dependent?

In *Re Rigdon* 133 BR 460 Dependent means an individual usually a relative, who relies on the financial support of another, usually a relative.

How to declare exemption?

Schwab vs Reilly 560 US770 suggests that the declaration of exemption be stated as 100% of Fair market Value rather than "unknown" or "all" to protect the asset from post-petition income in value on assets that may have a higher future value. Not foolproof.

NOTE:

Keep an eye out for April 1, 2019 when Ohio Exemptions are recalculated (rounded to the nearest \$25).

Lackawana Parts Mfg vs Wiseman 133F2 482 6th CCA 1943

It is settled law that Fraud is not to be presumed. Something more is required than mere weight or preponderance of the evidence.

1571 Statute of Elizabeth

Tyne's case 3Co Rep 806

76 Eng Rep 809 (Star Chamber 1601

Facts to be Presented for Vote

D borrowed 100M for Business Venture Loan secured by Mort on Residence

D sued by Burger King

In February business partner paid off Debtor 100M for the business venture.

D paid off home mortgage 100M

In March D filed 7

The Homestead was exempt

Could the Trustee recover the 100M?

Debtor while insolvent got 53M from sale of inherited property

Consulted an attorney

Used 53M to buy exempt Insurance Policy

3 weeks later filed 7

Is 53M protected from 548 claim by Trustee?

Wife non working housewife guaranteed & co-signed for H on business loans.

House in wifes name sold to aunt for 125M continued to live there with family. She got 60M in cash

Wife used money to pay off loans on Insurance Policies on H life. H in bad health.

Insurance was exempt.

No evidence she knew & H insolvent (creditor forgot to ask).

5 1/2 months later Joint B with husband

Was the payoff of loan Fraudulent 548

Answer In Re Levine 40 BR76 (BC SD FL 1980)
Transfer OK

The transfer of non-exempt property to exempt property does not constitute an attempt to hinder dialog or defraud creditors.

What if 100M were from embezzled funds

(Different results)

Yes

In Re Brewer 68BR48 WD Iowa 1985

No

In Re Adlman 541 F.2d 999 2nd Cir 1976 (NY)

CONCLUSION

In *In re: Ford*, 773 F.2 52 C4 Circuit CA 1985 sums it up. Extrinsic evidence showing a fraudulent purpose is necessary to deny an exemption.

7. Rule 1009 allows amendment to schedules any time prior to the closing of the case.
 - A. This includes claims of exemption but 30 days' notice to the creditors and the trustee is required for time to object.

Feature

BY JOHN D. DEMMY

Controlling a Borrower's Decision to Seek Bankruptcy Relief

Editor's Note: Mr. Demmy was a guest on ABI's "Eye on Bankruptcy" program in June 2018, where he discussed the cases presented in this article. Watch the episode at eyonbankruptcy.com.



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Lenders seek to minimize risk, and a bankruptcy filing that a lender does not suggest or support presents risk. Thus, lenders consider loan structures involving "bankruptcy-remote" or "single-purpose" borrower entities, or other devices, in order to limit or eliminate that risk. Some of those "other devices" involve so-called "blocking provisions" or "golden shares,"¹ which (as described in an ABI Secured Credit Committee newsletter article²) have been met with disfavor by courts.

Whether an entity has authority to file for bankruptcy is governed by state law, and unauthorized filings must be dismissed.³ Thus, lenders as a condition to financing sometimes might require adoption by a borrower of provisions in its organizational and internal governance documents bearing on the mechanisms by which a company may file a bankruptcy case and who must authorize the bankruptcy filing.

Independent Directors, Managers or Members as a "Workable Option"

A commonly used device requires the unanimous consent to a bankruptcy filing of all the borrower's managers, members or directors and the installation of one or more independent managers, members or directors whose duties are limited, usually solely to the decision of whether the borrower should seek bankruptcy relief. This will ordinarily involve a process by the independent person to evaluate whether the best interests of the company and its creditors (and not just the lender) would be served by a bankruptcy filing.

Assuming an appropriate discharge of the independents' duties, the "independent professional" construct likely reduces the risk of obvious bad-faith or futile filings sought to simply delay or assert improper leverage against a lender with no reasonable expectation of benefit to other creditors. However, such likely actions do not block all bankruptcy filings, as independents are expected to, and it is anticipated that they will, exercise their duties (whether fiduciary or not) in such a manner that they will consent to a bankruptcy filing if such is in the best interests of the company and its creditors.⁴

Case Law Has Not Been Kind to Blocking Provisions or Golden Shares

A "blocking provision" or "golden share" construct is more aggressive than the independent professional approach, as it lodges the bankruptcy authorization decision with the lender rather than an independent third party. To date, such provisions have not been well received by the courts, including *Lake Michigan Beach* (blocking provision not requiring the lender/special member of the LLC borrower to consider the interests of the company in exercising its authority contrary to Michigan law), *Intervention Energy Holdings* (golden share that gave the forbearing creditor, "which owes no duty to anyone but itself," the ability to "viscerate the right of [the LLC] to seek federal bankruptcy relief" was unenforceable as being contrary to federal policy favoring access to bankruptcy relief); and *In re Lexington Hospitality Group LLC*⁵ (LLC's agreement to add an affiliate of the lender as a 30 percent member (which later became 50 percent), and giving such member a veto on a bankruptcy filing, was contrary to federal public policy).⁶

¹ In the bankruptcy context, (1) a "blocking provision" can be obtained by, for example, obtaining an agreement to appoint a director to the company's board and requiring unanimous board approval for a bankruptcy filing (see, e.g., *In re Lake Michigan Beach Pottawattamie Resort LLC*, 547 B.R. 899, 911 (Bankr. N.D. Ill. 2016)); and (2) a "golden share" ordinarily is a *de minimus* amount of equity issued by the borrower to the lender coupled with the requirement of unanimous equity consent to bankruptcy (see, e.g., *In re Intervention Energy Holdings LLC*, 553 B.R. 258, 261-62 (Bankr. D. Del. 2016)).

² See John D. Demmy, "Lender-Inspired Operating Agreement Limitations on a Limited Liability Company's Authority to Seek Bankruptcy Relief: 'Perfect' Is the 'Enemy' of the Achievable 'Good,'" *ABI Secured Credit Committee Newsletter* (Feb. 3, 2018), available at abi.org/membership/committees/secured-credit (last visited June 27, 2018).

³ *Price v. Gurney*, 324 U.S. 100, 106-07 (1945). For a Delaware corporation or limited liability company (LLC), the Delaware General Corporation Law (DGCL) and the Delaware Limited Liability Company Act, respectively, identify the persons or entities that have the authority to manage the affairs of the company (including whether to commence a bankruptcy case), and such default provisions can be altered by the company's certificate of incorporation or LLC agreement. See 8 Del. C. § 141(a) and 6 Del. C. § 18-402.

⁴ The lender nevertheless could seek dismissal because the case was filed "in bad faith" based on all the facts and circumstances, but such is very likely a lengthier, costlier and more uncertain process than showing at the very outset of the case that the filing was without proper "corporate" authority under state law. See, e.g., *In re JER/Jameson Mezz Borrower III LLC*, 461 B.R. 293 (Bankr. D. Del. 2011) (dismissing single-asset LLC's chapter 11 case because bankruptcy had been filed on eve of foreclosure and primarily as "litigation tactic").

⁵ *In re Lexington Hosp. Grp. LLC*, 577 B.R. 676 (Bankr. E.D. Ky. 2017).

⁶ These decisions represent almost a "heads you win, tails I lose" proposition for lenders: *Lake Michigan Beach*, *Intervention Energy Holdings* and *Lexington Hospitality Group* involved "foolproof" bankruptcy-blocking provisions and "veto" power; if such are void as contrary to federal public policy (even if valid under state law), then the unintended consequence of such a contractual provision upon invalidation by a court is that the decision to file a bankruptcy case in effect will be left with the people — the principals of the company — that the lender was trying to prevent from having such control.

What If an Equity Owner Holds the Veto or Blocking Power?

In *re Squire Court Partners Ltd. P'ship*⁷ dealt with a similar but different construct: unanimous equity consent was required for the company to file for bankruptcy, but none were creditors. A general partner (NHDC Texas) owned 0.01 percent of the company, and two limited partners owned 99.98 percent and 0.01 percent, respectively. The partnership defaulted on its mortgage obligations, the lender accelerated, and the guarantor of such obligations (NHDC's affiliate) refused to pay.

After failing to obtain consent from the limited partners, NHDC Texas caused the partnership to file for bankruptcy. It argued that the unanimous-consent provision was contrary to federal policy in part because a fiduciary must decide whether to seek bankruptcy relief, and the limited partners (which did not owe any fiduciary duties to the partnership and did not consider the interests of the partnership) had exercised an improper and self-interested veto.

In affirming the bankruptcy court's holding that the bankruptcy case was unauthorized and must be dismissed, the district court distinguished the *Lake Michigan Beach* and *Intervention Energy Holdings* decisions. Although not fiduciaries, the limited partners held "bona fide" equity positions in the company. Thus, those courts' policy concerns were not implicated.

The Fifth Circuit Enters the Fray

In *re Franchise Services of North America Inc.*,⁸ the veto was held by a party that (according to the debtor) was both a creditor and equityholder, and as such invoked the policy concerns expressed in *Lake Michigan Beach* and *Intervention Energy Holdings* (again, according to the debtor). In May 2013, the debtor engaged an investment bank in connection with its acquisition of another company. The debtor agreed to pay the investment bank \$3 million in fees but did not pay. A subsidiary of the investment bank bought the company and was then merged into the debtor. Another investment bank subsidiary invested \$15 million in the debtor to help finance the acquisition and received convertible preferred stock representing a 49.76 percent equity interest in the debtor if converted (the largest equity interest in the debtor). The investment bank subsidiary's investment was conditioned on the debtor's adoption of a certificate of incorporation preventing the debtor from filing for bankruptcy unless a majority of each class of the company's equity authorized the filing.

The debtor filed for chapter 11 relief without soliciting the vote of the investment bank subsidiary. In response to the subsidiary's motion to dismiss the bankruptcy, the debtor argued that the shareholder-consent provision was contrary to federal policy and violated Delaware law. After an evidentiary hearing, the bankruptcy court granted the motion, ruling that requiring the investment bank subsidiary's consent was not contrary to federal policy — even if, as the debtor argued, the investment bank and investment bank subsidiary

were treated as a single entity. The bankruptcy court declined to rule on whether the shareholder-consent provision was contrary to Delaware law, opting instead to leave the issue for the Delaware courts to decide in the first instance.⁹ On the debtor's motion, the bankruptcy court certified a direct appeal to the Fifth Circuit on three questions:

1. Is a provision, typically called a "blocking provision" or a "golden share," that gives a party (whether a creditor or an equityholder) the ability to prevent a corporation from filing bankruptcy valid and enforceable, or is the provision contrary to federal public policy?;
2. If a party is both a creditor and an equityholder of the debtor and holds a blocking provision or a golden share, is the blocking provision or golden share valid and enforceable, or is the provision contrary to federal public policy?; and
3. Under Delaware law, may a certificate of incorporation contain a blocking provision/golden share? If the answer to that question is "yes," does Delaware law impose on the holder of the provision a fiduciary duty to exercise such provision in the best interests of the corporation?

The Fifth Circuit determined that it could not answer these questions as stated because it would result in an advisory opinion. The court stated that the right held by the investment bank subsidiary did not fit neatly into either the "blocking provision" or "golden share" construct. In any event, ruling generally on the validity of "blocking provisions" or "golden shares" rather than on the facts — an equity interest obtained for \$15 million coupled with the bankruptcy consent right — would not be appropriate. Thus, the court declined to answer the overly broad Question 1; it also seemed to decline to opine on whether a "blocking provision" or a "golden share" is valid under Delaware law.¹⁰

In answering Question 2 in the negative, the court stated that "there [was] no compelling federal law rationale for depriving a bona fide equityholder of its voting rights just because it is also a creditor of the corporation."¹¹ Thus, the Fifth Circuit held, and limited its holding, as follows:

This is not an advisory opinion, and our holding is limited to the facts actually presented in this case.

We hold simply that federal bankruptcy law does not prevent a bona fide equityholder from exercising its voting rights to prevent the corporation from filing a voluntary bankruptcy petition just because it also holds a debt owed by the corporation and owes no fiduciary duty to the corporation or its fellow shareholders.¹²

The Fifth Circuit then went on to seemingly answer certified Question 3, stating that it was turning to "the main

⁹ The Delaware bankruptcy court in *Intervention Energy* also declined to rule on whether the "golden share" provision in that case violated Delaware law.

¹⁰ The Fifth Circuit stated that it "declined to resolve whether the shareholder-consent provision violate[d] Delaware law," in part because on appeal, the debtor expressly waived such argument by stating that the "abstract question as to whether Delaware would ever allow a blocking provision need not be debated." *Slip Op.* at p. 210.

¹¹ *Slip Op.* at p. 209.

¹² *Id.* at p. 209. In the context of this holding, the Fifth Circuit discussed and rejected the debtor's argument that even if federal policy did not prevent a creditor/equityholder from holding a veto over the company's bankruptcy filing, it would if that party did not owe any fiduciary duty to the company (*i.e.*, to consider the interests of the company and its other creditors in exercising the veto), stating that the debtor had offered "no good legal or logical rationale for such a holding." *Id.*

⁷ *In re Squire Court Partners Ltd. P'ship*, 574 B.R. 701 (E.D. Ark. 2017).

⁸ *In re Franchise Servs. of N. Am. Inc.*, 891 F.3d 198 (5th Cir. 2018), as revised (June 14, 2018) (hereafter, the "Slip Op.").

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event,” and posited the following: “[D]oes Delaware law allow [the investment bank subsidiary] to exercise the blocking right?”¹³ However, such seems at odds both with the phrasing of Question 3 and with the court’s conclusion that the debtor had waived its argument on “whether the shareholder-consent provision violates Delaware law.”¹⁴ In answering, the court referenced the DGCL provisions that allow a company’s charter to make provisions respecting the company’s management authority other than as set forth in the DGCL. In the absence of any on-point Delaware case, the court declined “to decide in the first instance” whether the DGCL would tolerate a shareholder veto provision. Finally, it is assumed that it would.¹⁵ In effect, the Fifth Circuit, like the bankruptcy court, declined to rule substantively on the first part of Question 3.

Next, the court considered whether the investment bank subsidiary as a shareholder nevertheless owed fiduciary duties to the debtor, a determination that could arguably impact the analysis (but at the end of the day, for the Fifth Circuit, apparently would not have). The Fifth Circuit’s survey of Delaware case law led it to conclude that a shareholder has fiduciary duties only when the shareholder holds a majority of the equity and if the minority shareholder “exercises control over the business affairs of the corporation” through control of the company’s board.¹⁶

Ultimately, the Fifth Circuit rejected the debtor’s argument that the investment bank/investment bank subsidiary exercised control over the debtor based on its near-50 percent ownership,¹⁷ its appointment of two of the company’s five directors and its veto right.¹⁸ The fact that the debtor had filed a voluntary petition (without soliciting the investment bank subsidiary’s vote) itself tended to show that the investment bank subsidiary did not have the required control.¹⁹ The court

further considered that whether the filing was authorized and whether control for fiduciary duty purposes existed are separate issues, and that the remedy for an alleged breach of a controlling shareholder’s fiduciary duty is not to ignore the requirements of a company’s charter in commencing bankruptcy, but rather to sue the shareholder for the breach.²⁰

What’s Next?

In the ABI newsletter article, it is speculated that lenders that chose not to go with the “independent professional” approach could try to avoid courts striking down contractually bargained-for bankruptcy filing veto provisions à la *Lake Michigan Beach* and *Intervention Energy Holdings* if they made a real equity investment in the company in return for such a right, rather than tying it to the lender’s status as creditor. The result in *Franchise Services* (and in *Squire Court Partners*) tends to confirm that view. However, what is the utility of this kind of bankruptcy-blocking mechanism if the lender simply wants to lend money and not invest in equity? What if the lender makes an equity investment of only a percentage point or two of the face amount of the loan in return for a “golden share”?²¹ Would that still be a “bona fide” equity interest that when coupled with a bankruptcy veto would not violate federal policy? Assuming that the Delaware legislature or courts do not issue a blanket prohibition over the inclusion or validity of blocking or golden share provisions in LLC agreements or corporate charters (and the prediction here is that they will not), and so long as there are smart and inventive lender and debtor lawyers, litigation over these concepts will continue, limited only by the creativity of counsel in formulating bankruptcy-remote lending scenarios and arguments in response thereto. *abi*

13 *Id.* at p. 209.

14 *Id.* at p. 210.

15 *Id.* at p. 211.

16 *Id.*

17 *Id.* at p. 212 (discussing, and citing cases with respect to, whether substantial minority ownership is “control”).

18 *Id.*

19 *Id.*

20 *Id.* at p. 214. The Fifth Circuit stated further that because it had concluded that the investment bank subsidiary was not a controlling shareholder, it did not need to decide whether it had breached any fiduciary duty. *Id.*

21 At least twice in its opinion, the Fifth Circuit in *Franchise Services* suggested that the outcome could be different if the equity investment was simply a “ruse” to protect the lender’s claim. *See, e.g., Slip Op.* at p. 209.

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